CORPORATIONS AMENDMENT (CORPORATE REPORTING REFORM) ACT 2010

PAYMENT AND FRANKING OF DIVIDENDS

JOINT OPINION

The Corporations Act 2001 was amended by the Corporations Amendment (Corporate Reporting Reform) Act 2010 ("the 2010 Act") to substitute a new s 254T, in the following terms –

254T 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.

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 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).

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Until that amendment, s 254T had provided

254T Dividends to be paid out of profits

A dividend may only be paid out of profits of the company.

The substitution of the new s 254T was not accompanied by any abolition or easing of the limitations on the manner in which a company may reduce, return or itself deal in shares in, its capital; indeed, a further qualification was added to s 258F, dealing with cancellation of lost capital.

The amendment has given rise to some material uncertainty as to the manner in which some payments which might be made by companies to their members, ostensibly on the authority of the new s 254T, should be treated for the purposes of the Income Tax Assessment Acts. In our view, the proper treatment for assessment purposes will depend on the language of the Assessment Acts and the particular facts of the payments in question in any given instance, and not on any general principles as to the interpretation of s 254T, but we are nevertheless asked for our opinion as to the following questions of company law as well as those going to the application of the Assessment Acts.

Summary of advice.

The questions as stated in our brief are:

1. Can a company pay a dividend out of current year profits under section 254T of the Corporations Act if it has prior year losses, and/or it has net assets of a value less than share capital, without either (a)

also undertaking a reduction of capital pursuant to Chapter 2J of the Corporations Act, or (b) first reducing its share capital pursuant to s 258F of the Corporations Act?

2. Assuming the answer to question 1 is "yes", is a dividend paid in the circumstances posited in question 1 unfrankable for the purposes of s.202-45 in Division 202 of the Income Tax Assessment Act 1997, and in particular s.202-45(e)?

3. Can a company pay a dividend under section 254T of the Corporations Act out of any account, including for example asset revaluation reserves, "unbooked profit" accounts, expense accounts, reserve accounts with negative balances, or asset accounts, if the company has net assets of a value less than share capital, without either (a) also undertaking a reduction of capital pursuant to Chapter 2J of the Corporations Act, or (b) first reducing its share capital pursuant to s 258F of the Corporations Act?

4. Assuming the answer to question 3 is "yes", is a dividend paid in the circumstances posited in question 3 unfrankable for the purposes of s.202-45 in Division 202 of the Income Tax Assessment Act 1997, and in particular s.202-45(e)?

For the reasons which follow, we answer these questions:

1. Sometimes, but not always;
2. Not necessarily;
3. From asset revaluation reserves, sometimes, but not from the other nominated accounts;
4. Not necessarily.

These answers might be thought not to be especially helpful, but that is a consequence of the high level of abstraction in the questions. We endeavour in the discussion which follows to elucidate the issues and address some circumstances in which the answers have some practical relevance for assessment purposes. Before doing so, however, it is useful to put s 254T – as originally enacted and as now substituted – in some historical context.

Judicial limitations on dividends

The Corporations Act, and the law which surrounds and construes it, has its origins in the Joint Stock Companies Act of 1844 (7&8 Vic c 110) and the Companies Clauses Consolidation Act of 1845 (8&9 Vic c 16). Section 121 of the latter Act, which was to apply to all companies incorporated under later Acts, provided that "The company shall not make any dividend whereby their capital stock will be in any degree reduced" unless by way of return of capital stock, made with the assent of mortgagees and creditors and by a special resolution. When limited liability was introduced (by the Limited Liability Act 1855, 18&19 Vic c 133), the importance of maintenance of the capital proffered to the public as its fund of recourse was at the forefront: the Member for Oxford, Mr Cardwell, said of it in debate[1] that "There was no point on which commercial men more agreed than in the necessity of keeping up the capital of a Company when once subscribed, for, if they dispersed the capital as soon as raised, they would run the risk of creating fictitious credit." Later, in opposing the third reading of the Bill, he identified the risk "that Companies might be established to any amount, who would call up all their capital, and, having thus fulfilled the requirements of the Act, then redistribute the capital among the shareholders in the shape of dividends or otherwise; and then you would have a body endowed with corporate powers with no assets and no legal liabilities, which could enter the market and get any credit it could by any

1 Hansard, 3rd series, vol 139, col 345; http://hansard.millbanksystems.com/commons/1855/jun/29/partnership-amendment-bill

means obtain." In response to these complaints, the House of Lords amended the Bill to include in s 9 a provision imposing on any directors who should "declare and pay any dividend" when the company was insolvent, or would thereby become insolvent, liability for all the debts of the company.

The prohibition on distributions from capital did not survive the consolidating Joint Stock Companies Act of 1856 (19&20 Vic c 47), which instead inserted in the model Articles of Association a clause (Art 64) that "No dividend shall be payable except out of the profits from the Business of the Company." This provision, reiterated in Article 73 in Table A to the consolidating Act of 1862 (25&26 Vic c 89), limited dividends not simply to "profits" – as the repealed s 254T provided – but to "profits arising from the business of the company," a limitation which was to prove significant in relation to capital profits. The Acts also required that the Memorandum of Association, on registration of which the company was incorporated, should specify "the objects for which the proposed company is to be established." This requirement was taken by the Courts to continue by implication the limitation formerly stated in s 121 of the 1855 Act.

Judicial consideration of the Acts was materially affected by the novelty of the concept of a separate legal personality established by registration. Much of the discussion in the decades following the enactment of the legislation borrowed from other areas of law in a manner now seen to be mistaken. Companies were described as "statutory partnerships" and the established law governing partnerships was applied to companies as if they were simply a special case, while directors were characterised as "trustees" for the company and sometimes for its members. In *Flitcroft's case* (1882) 21 Ch D 519, for example, both Brett and Cotton LJJ based their reasons on the proposition that "directors are in the position of trustees, and are liable for … what they in breach of trust pay to others." In *Sons of Gwalia Ltd v Margaretic*

(2007) 231 CLR 160, Gummow J explained how the so-called "rule" in *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 was an example of "the gradual development of legal thought respecting the nature of corporate personality" which was able to be traced to "inapt analogy drawn from established areas of the law": [63], [89]. This conceptual elision must be borne in mind in reading the judgments, especially those regarding the concept of "capital."

Two presently relevant strands of reasoning wind through the cases: that capital cannot be applied in payment of dividends, and that capital which has been "sunk or lost" is no longer capable of any application and so cannot be said to be applied to paying dividends. Neither of these lines of authority rests directly on the prohibition in the standard Article, which was not statutory in force (adoption of the articles in Table A being optional). That Article 73 did not direct the evolution of the law concerning company distributions is largely attributable to the *laissez-faire* attitude of the courts, reflecting the prevailing community approach. In *Stevens v South Devonshire Railway Co* (1851) 9 Hare 313, 327 Turner VC rejected an argument as directed to a question "of internal management, with which the Court *cannot* interfere" (emphasis added), and this remained the approach until the early part of the next century: Lindley LJ in *Lee v Neuchatel Asphalte Co* (1889) 21 Ch D 1, 22 described the ascertainment of available profits as "a business matter left to business men," and Lord Macnaghten in *Dovey v Cory* [1901] AC 477, 488 declared it "undesirable" for a court to "formulate precise rules for the guidance or embarrassment of business men in the conduct of business affairs."

A company cannot distribute its capital in dividends

While the prohibition in s 121 of the 1845 Act was not replicated in the 1862 Act, that appears to have been so because it was regarded as unnecessary. A company was incorporated under that Act with a stated capital (s 8), which could be enlarged but not reduced (s 12) and defined the liability of the shareholders, viz, to the amount unpaid on their shares (s 38). Its objects were stated in its Memorandum on incorporation and were not capable of extension (s 12). Not until the Companies Act 1867 (30&31 Vic c 131) was a company permitted to reduce its capital, and then only under strict conditions. So in *Re Exchange Banking Co (Flitcroft's case)* (1882) 21 Ch D 519 the Court of Appeal held directors liable to make good dividends paid on the strength of fraudulent balance sheets, as being paid out of capital. The Master of the Rolls said (at 533) that

> "A limited company by its memorandum of association declares that its capital is to be applied for the purposes of the business. It cannot reduce its capital except in the manner and with the safeguards provided by statute, and looking at the Act 40 & 41 Vict. c. 26, it clearly is against the intention of the Legislature that any portion of capital should be returned to the shareholders without the statutory conditions being complied with. A limited company cannot in any way make a return of capital, the sanction of a general meeting can give no validity to such a proceeding, and even the sanction of every shareholder cannot bring within the powers of the company an act which is not within its powers. If, therefore, the shareholders had all been present at the meetings, and had all known the facts, and had all concurred in declaring the dividends, the payment of the dividends would not be effectually sanctioned. One reason is this – there is a statement that the capital shall be applied for the purposes of the business, and on the faith of that statement, which is sometimes said to be an implied contract with the creditors, people dealing with the company give it credit. The creditor has no debt but that impalpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, I may say, gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, and he had therefore a right to say that the corporation shall keep its capital and not return it to the shareholders, though it may be a right which he cannot enforce otherwise than by a winding-up order"

Cotton LJ at 535 concurred for similar reasons: "The assets of a company are to be dealt with only for the purposes of its business. The application of the capital in paying dividends was therefore a misapplication …" In *Guinness v Land Corporation of Ireland* (1882) 22 Ch D 349 a proposal that capital raised by the issue of one class of shares should be applied to paying a preference dividend on another class was rejected, although expressly provided for in the company's Memorandum, "not on the ground that it is a reduction of capital, but that it is a withdrawal of capital from the objects for which the company was incorporated." In *Lee v Neuchatel Asphalte Company* (1889) 41 Ch D 1 the Court reiterated the point, Cotton LJ saying at 17 that "it is established, and well established, that you must not apply the assets of the company in returning to the shareholders what they have paid up on their shares," and Lindley LJ saying at 23 that

> "The Act does not say that dividends are not to be paid out of capital, but there are general principles of law according to which the capital of a company can only be applied for the purposes mentioned in the memorandum of association. That is a fundamental principle of law, and if any of those purposes are expressly or impliedly forbidden by the statutes, the capital cannot be applied for those purposes even thought there may be a clause in the memorandum that it shall."

These views were endorsed in the House of Lords. In *Trevor v Whitworth* (1887) 12 App Cas 409, 437 Lord Macnaghten held a that a power could not be conferred on a company by its Memorandum to purchase its own shares, because "there are two conditions of the memorandum – the condition defining the objects of the company, and the condition defining its capital – one or both of which would be affected by such a power," and a power to purchase its own shares would be "repugnant and contradictory to itself" and "reduce one of the statutory conditions of the memorandum to an empty form." Lord Herschell at 415 rejected the power on the basis that while the capital might be lost on the pursuit of authorised operations, of which "all persons trusting the company are aware and take the risk," they "have a right to rely, and were intended by the Legislature to have a right to rely, on the capital remaining undiminished by any expenditure outside these limits, or by the return of any part of it to the shareholders." In *Dovey v Cory* [1901] AC 477, while declining to lay down "precise rules" for application of the general principle, their Lordships took it as a premise that, in the words of the Lord Chancellor, "companies cannot at their will and without the precautions enforced by the statute reduce their capital."

The courts in Australia have taken the same approach. In *Phillips v Melbourne and Castlemaine Soap & Candle Co* (1890) 16 VLR 111 Hood J described a payment of dividends from capital as "illegal, even apart from … this company's articles," and in *Davis Investments Pty Ltd v C of SD* (1958) 100 CLR 392, 413 Kitto J, citing *Trevor v Whitworth*, described it as a "fundamental principle of company law that the whole of the subscribed capital of a company with limited liability, unless diminished by expenditure upon the company's objects, (or, of course, by means sanctioned by statute) shall remain available for the discharge of its liabilities," an observation endorsed by the Full Court in *Australian Oil Exploration Ltd v Lachberg* (1958) 101 CLR 119, 132. In the former case Kitto J regarded a transfer "passing to the shareholder [any] assets of the vendor company representing any portion of its paid-up capital [as] necessarily invalid," and in the latter the Court held a transfer by a company of its only valuable asset, in consideration of the issue by another company of shares to the members of the transferor, to be *ultra vires* as an unauthorised distribution of its subscribed capital among its shareholders.

It was on this basis that the High Court in *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567, 576 recognised a "rule" that "a reduction of capital can only be effected in accordance with the statutory procedure and that there can be no return of capital except in accordance with that procedure."

The same observations, and the similar conclusion of the New Zealand Court of Appeal in *Jenkins v Harbour View Courts Ltd* [1966] NZLR 1, were adopted by Harman J in *British & Commonwealth Holdings Plc v Barclays Bank Plc* [1996] 1 BCLC 1, 7-10, upheld by the Court of Appeal [1996] 1 All ER 381.

The judicial language in some of these decisions invokes the doctrine that acts which are *ultra vires* the company are in consequence illegal and taint all that is part of or flows from the acts. This doctrine, which had unfortunate consequences (in that the courts would not assist what might be called innocent victims of an *ultra vires* act), has been partly excluded from Australian company law by s 124 of the Corporations Act:

> (1) A company has the legal capacity and powers of an individual both in and outside this jurisdiction. A company also has all the powers of a body corporate, including the power to:
>
> (a) issue and cancel shares in the company;
>
> (b) issue debentures (despite any rule of law or equity to the contrary, this power includes a power to issue debentures that are irredeemable, redeemable only if a contingency, however remote, occurs, or redeemable only at the end of a period, however long);
>
> (c) grant options over unissued shares in the company;
>
> (d) distribute any of the company's property among the members, in kind or otherwise;
>
> (e) give security by charging uncalled capital;
>
> (f) grant a floating charge over the company's property;
>
> (g) arrange for the company to be registered or recognised as a body corporate in any place outside this jurisdiction;
>
> (h) do anything that it is authorised to do by any other law (including a law of a foreign country).
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> A company limited by guarantee does not have the power to issue shares.

However, the grant of "the legal capacity and powers of an individual" does not overcome the implied statutory prohibition on returning capital to members otherwise than in accordance with the machinery provided by the statute itself (in the Corporations Act, in Chapter 2J). A distribution of assets to members is not within "the legal capacity and powers of an individual," for as Perram J observed in *St George Bank Ltd v FC of T* (2009) 176 FCR 424, 444 [86], an individual has no shareholders. The transfer of assets – as a matter affecting title to the assets – may be within the power of an individual, and so within the power of a company, but the character in which the transfer is made, and the consequences of the transfer as between the company and the transferee, are matters of company law, not matters affected by s 124.

In our view, the principle laid down in the Court of Appeal early in the history of companies incorporated by registration remains a fundamental principle of company law regulated by the Corporations Act. A company cannot distribute its subscribed capital among its members by way of dividend, nor in any manner not sanctioned by the Act. A purported declaration or payment of a dividend, by way of appropriation of a fund which is subscribed capital (however the transaction may be described), is invalid, and is not truly a dividend, but simply a misapplication of assets.

For the reasons we give below, the limitation in that principle is not removed by the substitution of the present s 254T for its predecessor.

Dividends payable only out of profits

The language of the former s 254T – providing that "a dividend may only be paid out of profits of the company" – has its direct origin in s 376 of the uniform Australian companies legislation of 1960-62, although earlier Victorian and Tasmanian legislation contained similar provisions (first in the Victorian Companies Act 1896, s 48). Indirectly, it has its origin in Article

73 in Table A to the Companies Act 1862, although Article 73 was expressed in the more limited terms of "profits *of the business* of the company."

The articles in Table A were included in the constitution of a company – as its "regulations" – only insofar as they were not displaced by the adoption of other articles on registration (s 14) or varied by subsequent special resolution (s 50). They derived their authority from the implicit contract among the company and its members, not from the statute itself, and so bound the members inter se but did not determine corporate capacity.

No overriding principle that dividends could only be paid from profits was recognised by the courts. In *Lee v Neuchatel Asphalte Co*, Lindley LJ said (22 Ch D at 21) "there is nothing at all in the Acts about how dividends are to be paid, nor how profits are to be reckoned; all that is left, and very judiciously and properly left, to the commercial world." In *Verner v General & Commercial Investment Trust* [1894] 2 Ch 239, 266, in a judgment endorsed by Lord Davey in *Dovey v Cory* [1901] AC 477, 493, his Lordship said that "the law is much more accurately expressed by saying that dividends cannot be paid out of capital than by saying they can only be paid out of profits." In *Ammonia Soda Co v Chamberlain* [1918] 1 Ch 266, 292 Warrington LJ rejected as having "no foundation in law," and in particular no foundation in the statutes, the proposition that no dividend could be paid from current profits if there were losses previously incurred and not made good by appropriation or application of current profits.

Limitations imposed by the articles, or by the acts of one of the company's organs (the Board or the general meeting), were recognised. A windfall profit on realisation of an investment could not be distributed until the "profits of the business" for the whole year had been ascertained, *Foster v New Trinidad Lake Asphalt Co* [1901] 1 Ch 208, but where the only limitation was that dividends should not exceed the amount recommended by the directors, a gain on the entire sale of an overseas business was held available for dividend, *Lubbock v British Bank of South America* [1896] 2 Ch 198. However, if the directors of a company appropriated profits to a reserve, they ceased to be "profits available for dividend," *Fisher v Black & White Publishing Co* [1901] 1 Ch 174. These were questions arising on the proper construction of the company's constituent documents, not questions of basic principle.

The effect of the enactment of s 376 of the 1961 legislation was to give statutory force to a more limited version of the constraint in the 1862 model Article: the limitation was to "profits," not to "profits of the business." The better view was that "profits" in this context meant profits as disclosed by accounts prepared in accordance with the requirements of the Act, *Marra Developments Pty Ltd v B W Rofe Pty Ltd* [1977] 2 NSWLR 616, 622. The prohibition in s 376 was re-enacted in s 565 of the uniform Companies Code and in s 201 (in 1989) and then s 254T (in 2001) of the Corporations Act.

The 2010 Act expressly repealed the limitation in the earlier legislation. That repeal does not, however, revive any earlier law: first, there was no earlier statutory authority to pay dividends, out of profits or otherwise, that issue being left to the constitution of the company and to its management; and second, ss 7 and 8 of the Acts Interpretation Act would in any event preclude revival of any earlier statute or doctrine. The language of the amending Act is unambiguous but if it were necessary to have recourse to extrinsic materials, the policy of the legislature was clearly to dispense with the rule in the former s 254T because of the difficulties in quantifying and identifying "profits" for the purpose of its application.

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: just as the proposition that rain will not fall unless there are clouds overhead is not the same as the proposition that rain will fall if there are clouds overhead.

Dividends and maintenance of capital

Much of the law concerning maintenance of capital, which underlay the reasoning of the courts in the early cases, has now been abrogated by statute. The requirement to state the capital of the company on incorporation, and to divide it into shares of a nominated par value to be paid up by the subscriber, has been repealed, s 117 and s 254C of the Corporations Act and s 1427 of the Company Law Review Act 1998. The prohibition on a company acquiring its own shares, and that on assisting in the acquisition of shares in the company, have been reduced to requirements that the assent of creditors and members be obtained in a prescribed manner: ss 257A, 259A and 260A. The procedure for reduction of capital has been reduced from one involving application to the Court and exercise of judicial discretion to one involving an ordinary resolution of members, s 256B, and a transaction contravening these provisions is not invalidated by the illegality involved in the contravention, s 256D, s 259F, s 260D.

But although the constraints have been loosened, they have not been wholly released. A reduction of capital, whether directly or (by buy-back or financial assistance) indirectly, must still be undertaken in the manner prescribed in the Act, with the safeguards there afforded to members and creditors – even if those safeguards are now looser, more *laissez-faire*, than was formerly the case. Contravention of the provisions is an offence on the part of those individuals involved.

Moreover, the legislature in substituting the new s 254T did not abolish, but rather retained and (albeit in a minor way) amended, the provisions of the Act dealing with reductions of capital and other transactions which would have the effect of diminishing the capital resources of the company. While a nominated authorised capital, and par values of shares, are no longer required, the precautions directed to maintaining the subscribed capital save so far as shareholders and creditors authorise are expressly retained. To construe s 254T as authorising any payment to shareholders which did not breach the requirements in paras (a)-(c) of s 254T(1) would be to make these precautions otiose, a result which the courts are reluctant to endorse: *Project Blue Sky Inc. v Australian Broadcasting Authority* (1998) 194 CLR 355 at 382 [71].

A reduction of capital must still comply with the statutory procedure and protections. This is a matter of substance rather than simply of form. As Bryson J said in *Redweaver Investments Pty Ltd v Lawrence Field Pty Ltd* (1991) 5 ACSR 438, 444, after citing the observations of Kitto J in *Davis Investments Pty Ltd v C of SD* (1958) 100 CLR 392 noted above, "the principle and the illegality [involved in distributing dividends from capital] are not limited to payments which on their face and according to the characterisation given to them by the parties to them are returns of capital, but the facts are examined in order to ascertain what in fact took place according to the substance of the matter." If the substance of the transaction is a return of capital otherwise than in a manner authorised by the Act, the application to the transaction of the label "dividend" will not cure the unlawfulness of its effect.

Lost capital need not be replaced

The proposition for which *Lee v Neuchatel Asphalte Co* (1889) 41 Ch D 1 is most frequently cited is that found in these passages from the judgment of Lindley LJ (at 22-3):

> "… the Companies Acts to do not require the capital [of a company] to be made up if lost. They contain no provision of the kind. … The capital may be lost and yet the company may be a very thriving concern. … If they [the company] think their prospects of success are considerable, so long as they pay their creditors, there is no reason why they should not go on and divide profits, so far as I can see, though every shilling of the capital may be lost. I cannot find anything in [the Acts] that precludes payment of dividends so long as the assets are of less value than the original capital."

It has been pointed out that the matter for decision concerned the acquisition of a wasting asset (an asphalt pit) and that his Lordship's comments were directed to capital "expended in acquiring [such a property, which] may be regarded as sunk and gone," and suggested that the observations go wider than was necessary to decide the case; and also that the "capital" of which his Lordship speaks is rather the "capital asset," the mine, than what is the issued capital of the company for the purpose of the distinction between capital and distributable profits. Nonetheless the proposition that lost capital need not be made good before current profits are distributed is now embedded in company law, and was so under the now repealed s 254T and its predecessors. So much was confirmed by the High Court in *Glenville Pastoral Co Pty Ltd v FC of T* (1963) 109 CLR 199 at 207 ("Profits may of course be distributed by a company while a going concern even though a loss of paid up capital previously incurred has not been made good") and by Mahoney JA in considering the specific prohibition in s 376 in *Marra Developments Pty Ltd v B W Rofe Pty Ltd* [1977] 2 NSWLR 616, 630.

Both decisions adopted the earlier reasoning of the Court of Appeal in *Verner v General & Commercial Investment Trust* [1894] 2 Ch 239 and

Ammonia Soda Co v Chamberlain [1918] 1 Ch 266. In the former case Lindley LJ began the joint judgment with the observation that

> "The broad question raised by this appeal is whether a limited company which has lost part of its capital can lawfully declare or pay a dividend without first making good the capital which has been lost. I have no doubt that it can – that is to say, there is no law which prevents it in all cases and in all circumstances."

In *Ammonia Soda Co v Chamberlain* the appellant submitted that "no dividends can properly be paid out of profits so long as there are losses previously incurred and not made good." This contention was rejected by the court, Warrington LJ saying at 292 that "In my opinion this alleged restriction has no foundation in law. It is not contended that there is anything in the statute imposing it and its suggested existence as a doctrine of the Court has been negatived by the Court of Appeal …" Scrutton LJ said of the argument that the consequence of the earlier losses was that it was

> "… capital that was lost, and when you have lost a thing you cannot use it for anything else, because you have lost it. You cannot pay dividends out of a thing which you have lost, because it is not there to pay dividends out of."

The same reasoning had been adopted by the Court in *Re National Bank of Wales* [1899] 2 Ch 629, 669: "paid up capital which is lost can no more be applied in paying dividends than in paying debts. Its loss renders any subsequent application of it impossible." While the reference to paying debts involves a misconception (it is assets, not reserves or the share capital account, which are used to pay debtors), the proposition that to the extent that the share capital account has been reduced by losses it is not available for appropriation to pay dividends is clearly correct.

Framed in terms of corporate accounting, what these decisions establish is that there is no obligation imposed on a company to appropriate current profits to make good a loss of prior periods which has had the consequence that the balance of capital and reserves has been reduced to an amount less than the capital subscribed: that is, in the words of the High Court, there is no obligation to apply the profits to "make good" the prior losses.

Where at the outset of a period in which a loss is sustained the company has credit balances both to the subscribed capital account and to a profits or reserve account the position is less clear. The Court of Appeal in *Re Hoare & Co, Limited and Reduced* [1904] 2 Ch 298 held it unnecessary to apply a loss wholly to reserves appropriated from prior profits. In that case the loss was an unrealised depreciation in value of the principal assets of the company (tied houses) and the court regarded the loss as one of capital, perhaps because of an elision of concept in the idea of the tied houses as capital assets into which the subscribed capital had been invested. The majority held that there could be no complaint about a rateable allocation of the loss on revaluation to capital and reserves. Vaughan Williams LJ was inclined to go further:

> "I do not use the words 'reserve fund' because it is not true, in fact, to say that there was any reserve fund at all. If there had been any reserve fund in this case, and if the reserve fund was a fund which appropriated this sum, which might be paid in dividends, but which the company did not think it prudent to distribute in dividends at the moment, intending to retain the sum in hand ready to distribute in dividends if they thought fit, unless the company by a proper resolution determined to do otherwise with it, I should have said that under such circumstances that could not be done. I should have said if you had a loss – as you have in this case by the reduction in market value of the tied houses – the whole of that loss was a loss which, for the purpose of this statute as to reduction of capital, ought to be entirely written off capital properly so called. We really have not that to decide in this case, because the facts do not raise such a case. But I do want to say before leaving that point that, as I understand it, however much capital you have lost at any given date, if your profit and loss account shows a profit balance, then to the extent of that profit balance you are entitled to distribute that money as dividend, notwithstanding the fact that you have lost capital which you have

> not replaced. Under these circumstances, so far as this undistributed money is to be considered, I think that even if it had arisen after the loss of capital, and you could have appropriated it to the payment of dividends when it would be right to do so, the whole of that loss would then properly be written off capital."

Current accounting standards may be said to require a different outcome. A century ago the prevailing view was that the profit and loss account was not a continuous one (cf *Stapley v Read Bros Ltd* [1924] 2 Ch 1), but current standards so treat it; and carrying the balance of profit for a year to the continuous account may be said to be an appropriation of the current profit to make good past losses. As always, the outcome in a particular case will depend on the particular facts of that case.

The particular cases for advice

We are asked a number of specific questions, but in each case on an "in principle" basis, that is, without reference to any particular factual context. The answer to the questions asked will depend in any case on what has actually happened; the statute, and the law as developed by the courts and affected by statutory amendment, will apply to the particular case according to its facts. The questions we are asked are therefore not amenable to definitive or "in principle" answers, and like Lord Macnaghten ([1901] AC at 488) we are not in a position to "formulate precise rules for the guidance or embarrassment of business men," or of taxation officers.

> *Can a company pay a dividend out of current year profits under section 254T of the Corporations Act if it has prior year losses, and/or it has net assets of a value less than share capital, without also either undertaking a reduction of capital pursuant to Chapter 2J of the Corporations Act, or first reducing its share capital pursuant to s 258F of the Corporations Act?*

For the reasons given above, we do not think there is any principle of law developed by the courts, or any statutory provision, which precludes the appropriation of profits of a current year to the payment of a dividend in a case where the company has suffered losses in a previous year, even if the losses of the previous periods have had the consequence that the net assets of the company, after payment of the proposed dividend, will be less than the amount of capital subscribed. There may, however, be circumstances in which such a dividend is not authorised: for example, where the company had no reserve of previously appropriated profit at the commencement of the current year, and the dividend exceeds the amount of profit of the current period (so that it would diminish the net assets of the company to a balance less than the remaining subscribed capital account at the commencement of the year).

If the company has appropriated the profits of the current year to make good past losses, that appropriation is binding: the profits cannot be "withdrawn" from the replenished profit and loss account, except to the extent that there is at year end a surplus (ie, where the profits exceed the past losses).

But for the reasons given, we do not think that a company can appropriate to the payment of a dividend any part of the balance of the subscribed capital account which remains after setting against it the balance of losses of earlier periods. The fact that such a proposed "dividend" would not offend the present s 254T – in that the company would be left both solvent and with a surplus of net assets, and creditors and members would not be prejudiced – is not a basis for justifying appropriation of subscribed capital to declaration and payment of a dividend.

Can a company pay a dividend under section 254T of the Corporations Act out of asset accounts recording, for example, internally generated goodwill, brands and mastheads, etc?

This question (and the suggestion on which it is presumably based) reveals a fundamental misconception of the process of declaring and paying a dividend.

Payment of a dividend is not simply a matter of transferring assets to members (for example, by bank transfer or delivery of a cheque) and posting the debit, which offsets the credit posted to the asset account, to any account which takes the accountant's fancy. A dividend is an appropriation of profits: it is not a charge on assets, but "the right of a shareholder to receive his aliquot proportion of the profits of the enterprise," *Re Chelsea Waterworks Co and Metropolitan Water Board* (1903) 73 LJKB 535, "it means, I apprehend, share of profits," *Henry v Great Northern Ry Co* (1857) 27 LJ Ch 1, 18. In *Verner v General & Commercial Investment Trust* [1894] 2 Ch 239, 266, Lindley LJ said that "a dividend presupposes a profit in some shape," and cannot be appropriated out of gross revenue or from a liability account (although the money for payment may be borrowed). In *Bond v Barrow Haematite Steel Co* [1902] 1 Ch 353, 363 Farwell J drew a distinction between interest (compensation for delay in payment) and dividends, a share of profits of trading, a concept which his Lordship went on to describe as the excess of receipts from a business over the outlay for the business, with due adjustment for levels of stock on hand.

Accounts recording internally generated goodwill, brands and mastheads are not profit accounts: they belong on the "other" side of the balance sheet, that is, they are asset accounts, not equity accounts. Assets can be acquired or disposed of (generating respectively debit and credit entries to the account recording them), but they cannot be appropriated as the source of payment of a dividend – while assets can be (in a different sense of the word) appropriated, meaning resorted to, in order to satisfy an entitlement to a dividend, in the same way as a bank account (a different asset) can be resorted to as the means by which a dividend is paid, they cannot be appropriated in the sense of allocated as the fund from which a dividend is declared.

Fundamentally, the question misconceives the operation of the double entry bookkeeping system. Payment of a dividend involves the disposal of an asset of the company, usually part of the balance of a bank current account; the asset account is necessarily in debit (recording something owned by or owed to the company) and the payment is recorded as a credit to the asset account. The other half of the "double entry" – necessary to keep the accounts in balance – is a debit to another account. Where the disposal is for consideration, the debit is to an asset account (eg, a bank account), but where the disposal is by way of payment of a dividend, the debit is to an equity account: a fund of profits, possibly a reserve fund, or a provision for payment itself created by posting a debit to a profits account. A dividend can neither be appropriated from, nor debited to, an asset account (such as "internally generated goodwill, brands and mastheads").

It may be that the proponents of the proposition embedded in the question have in mind that the asset concerned (the internally generated goodwill, brands or mastheads) might be revalued, the increase in recorded value credited to a revaluation reserve, and the revaluation reserve treated as a fund of profits which can be appropriated for the purpose of declaring a dividend. Under the former s 254T and its predecessors, there was doubt as to whether a reserve arising from revaluation of an unrealised asset could be appropriated for declaration of a dividend, the view of the Court of Sessions in *Westburn Sugar Refineries Ltd v IR Commrs* [1960] SLT 297 being that it could not, but that of Buckley J in *Dimbula Valley (Ceylon) Tea Co v Laurie* [1961] 1 All ER 769 being that it could. The view of Buckley J is now accepted as being correct, although the former s 254T and its predecessors were considered to limit the availability of such reserves to the case where there was a sufficient surplus on a balance of all accounts: *Lachberg* at 133. In *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567, 580 Mason J recorded without disapproval that it was accepted by the parties that the reasoning of Buckley J was correct, and in *FC of T v Sun Alliance Investments Pty Ltd (in liq)* (2005) 225 CLR 488 the High Court held that unrealised profits could be "derived" such that dividends paid were attributable to them.

The substituted s 254T puts the matter beyond doubt. Provided that the conditions in the new section are met, the fund recording unrealised profits can be appropriated to the payment of dividends – although it must be the case that the revalued assets truly have the allocated value, so that the solvency requirement of the new section is satisfied. The tax consequences of such an appropriation we return to below.

Can a company pay a dividend under section 254T of the Corporations Act out of expense accounts (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other Australian Accounting Standards

An expense account, like an asset account, is a debit account, not one recording a fund of profits available for appropriation. The observations of Lindley LJ noted above are apposite: "a dividend presupposes a profit," and can no more be appropriated from an expense than from gross revenue, both being components in the calculation of a profit which may be available for appropriation. The comments on the accounting for dividends, and the unavailability of debit accounts, made above are equally applicable to expense accounts.

Again, it may be that the proposition which sponsored the question is that profits recorded in accordance with Australian Accounting Standards are enlarged by the non-recognition of the expenses in contemplation. If that is so – and we would want to see a worked example based on actual facts before assenting to the proposition that it is so – the fund of profits available for appropriation would include, in the sense of being augmented by the exclusion of, the amount of the expenses.

However, if the "expenses" involve actual expenditure, as distinct from some book entry recording an allocation rather than a transaction, an issue would arise as to whether the assets of the company exceeded its liabilities by enough to support the proposed dividend.

It rather seems to us that this question rests on an incompletely formed theoretical construct divorced from any actual factual circumstance.

> *Can a company pay a dividend under section 254T of the Corporations Act out of negative reserve accounts (including accounts which are created and immediately debited into a negative), or other accounts with negative balances.*

Whether considered in legal or in accounting terms, this question makes no sense. A "reserve" account which is in debit is one which records a loss, not a distributable profit. There is nothing in, or recorded by, such an account which can be used (appropriated) to pay a dividend; the comments of Scrutton LJ in *Ammonia Soda Co v Chamberlain*, in relation to paying dividends out of lost capital, are apposite: "You cannot pay dividends out of a thing which you have lost, because it is not there to pay dividends out of." Similarly, the accounts postulated in this question are not "there to pay dividends out of."

In accounting terms, payment of a dividend involves a credit to the account recording the asset paid or transferred to the shareholder and a debit to the reserve account (absorbing, and recording appropriation of, the credit balance of the reserve). An account already in debit cannot be appropriated, by posting an offsetting debit, to declaration or payment of a dividend.

Nor is merely posting the debit (viz, that matching the credit on distribution of assets by way of dividend) to a previously empty or non-existent account appropriation of profits. The court would look to what the debit balance truly offset: that might according to the facts be a profit account, so that the entry is construed as truly an appropriation of those profits; or might be a capital account, in which event the "dividend" would be beyond capacity, as being purportedly made out of capital – see the observations of Bryson J in *Redweaver Investments Pty Ltd v Lawrence Field Pty Ltd* (1991) 5 ACSR 438 set out above.

Making journal entries which record no objective reality – such as creating two empty accounts and posting a debit to one and a matching credit to another, not to record any event or circumstance but simply to create opposing balances – is simply a pointless exercise in bookkeeping. It does not create any fund which is available for distribution as dividends.

> *Can a company pay a dividend under section 254T of the Corporations Act out of accounts for items of "other comprehensive income", within the meaning that term has in AASB 101 "Presentation of Financial Statements" that are not otherwise "profits"?*

The expression "other comprehensive income" is defined for its purposes in AASB 101 in these terms –

> *Other comprehensive income* comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other Australian Accounting Standards.

For the reasons given above, amounts debited to an expense account are not amounts which can be appropriated to the payment of a dividend.

The amount standing to the credit of an income account is not, per se, available for dividend. Income is a component in the calculation of profit, and it is only profit which can be divided and paid as dividends, as Lindley LJ pointed out in *Verner v General & Commercial Investment Trust* [1894] 2 Ch 239, 266. It was perhaps this concept which the court, comprised of Chancery lawyers, was grasping for in the expression of a requirement (articulated in the same judgment) that "circulating capital must be kept up" – that revenue receipts must be set against revenue expenses before any balance available for dividend can be struck.

In short, neither gross income nor gross expenses ("comprehensive" or not) can be appropriated to pay dividends. If there is a surplus of "other comprehensive income" over "other comprehensive expenses," and save so far as there is a concurrent loss recognised under the accounting standards, the surplus is – if the entries to the "other comprehensive income" accounts record something which has happened rather than mere notional allocations – a profit which should be available for dividend. But it is not necessarily so: it depends on the extent of any correlation between the accounting entries and objective reality.

Can a company pay a dividend under section 254T of the Corporations Act out of asset revaluation reserves?

The authorities in this regard are canvassed above, and in our view establish that an asset revaluation reserve is a fund of profits available for dividends. The former requirement that an available surplus be revealed on a balance of all accounts (*Australian Oil Exploration Ltd v Lachberg* (1958) 101 CLR 119, 133; *QBE Insurance Group Ltd v ASC* (1992) 38 FCR 270, 287) is now subsumed in, and to the extent that it required a surplus over subscribed capital displaced by, the requirement that the company's assets exceed its liabilities by at least the amount of the proposed dividend.

However, the requirement that there be a profit to be divided in dividends remains. There may be circumstances in which a revaluation of a single asset, without regard to the company's position in relation to its other assets and liabilities, will not disclose a distributable profit. Moreover, a distribution attributed the character of being "out of" an asset revaluation reserve must still satisfy the requirements of s 254T.

> *Can a company which has lost part of its subscribed capital pay a dividend out of asset revaluation reserves notwithstanding that its net assets are thereafter less than its subscribed capital?*

This question raises a particular instance of the issue examined in the preceding paragraph. The answer will depend on the specific circumstances in which the company suffered a loss of subscribed capital and on the origin of the asset revaluation reserve.

If the loss which reduced net assets to less than the capital subscribed was one incurred in a previous financial year as a result, for example, of adverse trading or of a loss on realisation of an investment or a "capital asset," and the surplus sought to be distributed is revealed on a revaluation of other investments or non-trading assets, the unrealised profit comprising the surplus may be distributed notwithstanding that after distribution the company's net assets are less than the subscribed capital.

Whether there is an unrealised "profit" available for distribution as a dividend may depend on the circumstances, and on the view which a court coming to consider s 254T in its present form takes of the scope of the decision in *Australian Oil Exploration Ltd v Lachberg* (1958) 101 CLR 119. The court there said

> It is necessary at this stage to refer briefly to one other argument which was advanced on behalf of A.O.E. This argument asserted that if a company engages in a transaction whereby it disposes, otherwise than in the course of its trading or business activities, of a single capital asset for a price in excess of the value at which that asset stands in its books, it may lawfully distribute the casual profit so made among its shareholders whatever the capital position of the company might otherwise be. This proposition was emphatically rejected by Wolff J. and we agree with him in thinking that this is not the law. It is enough on this point to say that a company has no capital profits available for dividend purposes unless upon a balance of account it appears that there has been an accretion to the paid-up capital (*Lubbock v. British Bank of South America*; *Verner v. General & Commercial Investment Trust*; *Foster v. New Trinidad Lake Asphalt Co. Ltd.* and *Cross v. Imperial Continental Gas Association*.)

The scope for varying views lies in the words "a company has no capital profits available for dividend purposes …". On one view, those words negate capacity to pay a dividend unless there is "an accretion to the paid-up capital." If that is the correct reading, it is reversed by the current s 254T(1)(a), which requires only an absence of a net asset deficit after payment of the dividend. The alternative view is that the words negate capacity to pay a dividend out of "capital profits" unless a profit is revealed on "a balance of account." If that is the correct view, and we think it is the view which a court is likely to prefer, an increase in the value of one asset is not available as a distributable profit if it is offset by a decrease in the value of another asset. So, for example, if one subsidiary of a company made a gift of all its assets to another subsidiary, so that the parent company's shares in the latter increased in value and those in the former decreased in value by the same amount, the increment in value in the recipient's shares would not comprise a distributable profit of the parent company.

If however an investment was wholly lost in one year of income, so that the company's net assets fell below its subscribed capital, which was written down accordingly, and in a later year an unrealised investment enjoyed a permanent increase in value, the latter increase would be a profit wholly available for dividend without breach of s 254T(1)(a).

We have confined our observations to increments in the value of investment or "capital" assets. As we understand the operation of accounting standards, all recognised changes in the value of trading assets (trading stock, or in the language of the earlier judgments, "circulating capital") must be brought to account in ascertaining the amount of operating profit, and there is no proper scope for setting aside as a distributable fund of profits an unrealised increment in the value of some trading stock while taking a concurrent fall in the value of other trading stock into the calculation of the trading profit or loss for the year, and treating a loss so calculated as a loss of, or a reduction in the balance of, the subscribed capital while distributing the separately recorded increment.

> *Can a company pay a dividend under section 254T of the Corporations Act out of so-called "unbooked profits"; that is, an expected current year profit that has not, as at the date of payment of the dividend, been recorded in the company's accounts?*

The declaration (or payment without formal declaration) of a dividend involves an appropriation of profits to be divided among the members; without that act, a payment to members is simply a misappropriation of the company's assets, for which the directors are accountable, *Re National Funds Assurance Co* (1878) 10 Ch D 118; *Duke Group Ltd v Pilmer* (1998) 27 ACSR 1, 295-304.

The profits appropriated must be recognised by adoption of accounts disclosing them as available (and they must be profits of the company paying the dividend). So much was decided, albeit in the context of the former s 376, in *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567, where Mason J said at 576

> Although s. 376 (1) does not explicitly identify the source of the profits to which it refers, it should also be understood as referring to the profits of the company which declares and pays the dividend. The sub-section is not a recent innovation. It has a history in Australian company law dating back to s. 48 of the Companies Act 1896 (Vict.), long before consolidated or group accounts became a gleam in the draftsman's eye. It has no statutory counterpart in the United Kingdom, though it is but a reflection of the principle enunciated in the English courts much earlier—see, e.g., *Burnes v. Pennell*; *In re National Funds Assurance Co.*. The principle, which was certainly designed to protect creditors and, I think, shareholders, more particularly where there is more than one class of shareholder in a company, inhibits the payment by way of dividends out of a company's capital. It is founded on the proposition recognized in *Trevor v. Whitworth* that a reduction of capital can only be effected in accordance with the statutory procedure and that there can be no return of capital except in accordance with that procedure – *In re Exchange Banking Co. (Flitcroft's Case)*. The rule is frequently expressed, as here, in the form of a prohibition against dividends being payable except out of profits.
>
> …
>
> Both the article and the section are to be understood as stipulating that the profits in an amount necessary to sustain the dividend are in existence in the company itself at the time of the declaration of the dividend. … The rule has been expressed in the United States in these terms: " ... corporations can only declare dividends from earnings, which must be present when the dividend is declared. They cannot be declared in anticipation of earnings." (*In re Given's Estate*). It has been stated in somewhat less inflexible terms in American Jurisprudence, vol. 19, 2d, s. 826:
>
>> The theory of a dividend is that it shall be payable only from ... earnings which are or will be ready for actual distribution at a definite date provided for in the resolution declaring the dividend. Generally, the earnings or profits from which dividends are properly payable must be present when the dividend is declared; it cannot ordinarily be declared in anticipation of earnings or on a mere hope or expectation of profits.

> It would be productive of confusion and uncertainty if companies were to declare dividends against the possibility that profits not in existence at the time of declaration would or might be earned or received by the time the dividend was paid. …

While these observations were made in the context of a now repealed section which enacted that "no dividends shall be payable to the shareholders of any company except out of profits," the requirement that there be profits – so that the dividend is not paid out of capital – remains in our view a fundamental part of company law, for the reasons we have given. Whether there are profits (and so whether the payment is not made out of capital) can only be ascertained by a taking of accounts, although it may be sufficient that the accounts were taken at an earlier date if the directors have satisfied themselves that the company's position has not deteriorated to such an extent that the previously ascertained fund of profits is no longer available for appropriation (*Lucas v Fitzgerald* (1903) 20 TLR 16; cf *Towers v African Tug Co* [1904] 1 Ch 558).

In our view, a dividend cannot be declared or paid from a profit that has not yet been derived, although as noted above, a profit may be derived without yet being realised.

Curious income tax results can follow when distribution of the amount of profits appropriated is effected by transfer of an asset in specie and the transfer is recorded, not at the market value of the asset, but at its book value (book value being equal to the amount of profits appropriated). In *Condell v FC of T* (2007) 66 ATR 100 the Full Court held the recipient to be assessable on the market value of the asset rather than the amount of profits formally appropriated, Gyles J on the basis that the amount was received as income according to ordinary concepts and the other members of the court on the basis that the only appropriation had been from a profit account. A more precise analysis in corporate law might have been that the company appropriated both the recorded profits and the unrecorded and unrealised revaluation profit to the distribution in specie, a course available to it on the view of Buckley J noted above and adopted in Australia.

Franking of dividends

We are next asked whether, if any of the distributions postulated in the questions set out above may be paid as dividends on the authority of s 254T, such distributions would be "unfrankable for the purposes of s.202-45 in Division 202 of the *Income Tax Assessment Act 1997*, and in particular s.202-45(e)."

Section 202-45 is in the following terms:

> **202-45 Unfrankable distributions**
>
> The following are ***unfrankable***:
>
> (b) a distribution to which paragraph 24J(2)(a) of the *Income Tax Assessment Act 1936* applies that is taken under section 24J of the *Income Tax Assessment Act 1936* to be *derived from sources in a prescribed Territory, as defined in subsection 24B(1) of the *Income Tax Assessment Act 1936* (distributions by certain *corporate tax entities from sources in Norfolk Island);
>
> (c) where the purchase price on the buy-back of a *share by a *company from one of its *members is taken to be a dividend under section 159GZZZP of that Act—so much of that purchase price as exceeds what would be the market value (as normally understood) of the share at the time of the buy-back if the buy-back did not take place and were never proposed to take place;
>
> (d) a distribution in respect of a *non-equity share;
>
> (e) a distribution that is sourced, directly or indirectly, from a company's *share capital account; …

Other paragraphs of the section deal with amounts specifically declared in particular sections to be unfrankable.

The term "distribution" is, in relation to companies, defined in s 960-120 to mean "a dividend, or something that is taken to be a dividend, under this Act." What is "taken to be a dividend," in addition to the extended definition set out below, includes for example the operation of s 47 of the

1936 Act, which deems certain liquidation distributions to be dividends paid to shareholders out of profits. The definition of "dividend" in s 6 of the 1936 Act is in these terms:

> ***dividend*** includes:
> (a) any distribution made by a company to any of its shareholders, whether in money or other property; and
> (b) any amount credited by a company to any of its shareholders as shareholders;
>
> but does not include:
> (d) moneys paid or credited by a company to a shareholder or any other property distributed by a company to shareholders (not being moneys or other property to which this paragraph, by reason of subsection (4), does not apply or moneys paid or credited, or property distributed for the redemption or cancellation of a redeemable preference share), where the amount of the moneys paid or credited, or the amount of the value of the property, is debited against an amount standing to the credit of the share capital account of the company; or
> (e) moneys paid or credited, or property distributed, by a company for the redemption or cancellation of a redeemable preference share if:
> (i) the company gives the holder of the share a notice when it redeems or cancels the share; and
> (ii) the notice specifies the amount paid-up on the share immediately before the cancellation or redemption; and
> (iii) the amount is debited to the company's share capital account;
>
> except to the extent that the amount of those moneys or the value of that property, as the case may be, is greater than the amount specified in the notice as the amount paid-up on the share; or
> (f) a reversionary bonus on a life assurance policy.

All of the amounts in respect of which questions are asked of us are either a "distribution made by a company to … its shareholders" or an "amount credited by a company to … its shareholders as shareholders," so that they are "dividends" as defined unless they are excluded as being "debited against an amount standing to the credit of the share capital account of the company" (neither the redemption of preference shares nor reversionary bonuses are presently in issue). The "share capital account" is defined in s 975-300:

975-300 Meaning of *share capital account*

(1) A company's ***share capital account*** is:

(a) an account that the company keeps of its share capital; or

(b) any other account (whether or not called a share capital account) that satisfies the following conditions:

(i) the account was created on or after 1 July 1998;

(ii) the first amount credited to the account was an amount of share capital.

(2) If a company has more than one account covered by subsection (1), the accounts are taken, for the purposes of this Act, to be a single account.

There is an exception in relation to "tainted" share capital accounts which is not presently relevant.

Thus the first question that arises, in relation to the postulated transactions, is whether the amounts in issue are "debited against an amount standing to the credit of the share capital account of the company," for if they are so debited they are not "distributions" which can be franked under s 200-20; and the second question is whether, if they are "distributions" as defined, they are "sourced, directly or indirectly, from [the] company's share capital account."

Debited to the share capital account

When the Act speaks of an amount being "debited against an amount standing to the credit of the share capital account of the company," it speaks not simply of the making of the entry in the company's accounting records, but of the entry as an act done with the authority of the company, given ordinarily by its board of directors: that is, a formal rather than a merely clerical act. The entry made to the "share buy-back reserve account" in *Consolidated Media Holdings Ltd v FC of T* (2011) 82 ACSR 637 was made with such authority and was (on the facts of that case) one debiting an amount to the share capital account of the company.

What is credited to the share capital account is the sums received on issue of shares. Amounts corresponding to the balance of that account, as reduced in accordance with Part 2J.1 of the Corporations Act and less any offsetting loss which has the result that part of the subscribed capital has been lost, can only be returned to members in the manner prescribed in Chapter 2J or Part 2H.2 of the Act; they cannot be distributed as dividends.

It is the substance of, and not the labels attached to, the transactions that determines whether the requirements of the Corporations Act are met, or the conditions of liability in the Income Tax Assessment Acts are satisfied: *Redweaver Investments Pty Ltd v Lawrence Field Pty Ltd* (1991) 5 ACSR 438, 444, *Consolidated Media Holdings Ltd v FC of T* (2011) 82 ACSR 637, 652. If a distribution made by a company is one of profits, it will not properly be debited to a share capital account and an entry purporting so to debit it will in our view not be efficacious to deny it the character of a dividend for assessment purposes, nor prevent it from being franked if the company takes the steps specified in s 202-20.

Correspondingly, debiting an amount to a notional account – such as was done in *Uther v FC of T* (1965) 112 CLR 630 – will not result in a distribution escaping taxation on the ground that it is not a dividend. In *Uther*, the majority found the taxpayer not to be assessable on the ground that the receipt (a sum substantially greater than the paid up value of the shares in question) was received on cancellation of a capital asset, shares in the company, and so was itself of a capital character. Kitto J dissented, holding that the amount distributed was only to the extent of the amount paid up on the shares a "return" of paid up capital so as to be excluded from the then definition of "dividend," and was as to the balance assessable as a dividend being paid out of profits. His Honour's dissenting judgment was later described by the whole court as "compelling," and adopted in both *FC of T v Slater Holdings Ltd* (1984) 156 CLR 447 and *FC of T v McNeil* (2007) 229 CLR 656.

The court is not bound by the labels attached by the parties to the transaction. A misappropriation of the company's assets (*Macfarlane v FC of T* (1986) 13 FCR 356) or a purported loan not intended to be repaid (*Keith A Summons Pty Ltd v FC of T* (1986) 80 ALR 95) will be assessed as a dividend for the purposes of the Act. The manner in which the ledgers are written up will not determine whether there is an assessable, or a frankable, distribution.

Sourced … from the company's share capital account

For similar reasons, 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. This was the approach taken by the court in *FC of T v Slater Holdings Ltd*, although the issue in that case was as to the words "paid out of profits" and there was no contest as to which reserves were appropriated to the payment.

Whether s 202-45(e) applies to exclude a distribution from the category of frankable distributions will depend on the facts of each particular case, and there is little value in an attempt to lay down general principles, since each generality is necessarily attended with so many qualifications directed to particular cases that ultimately it is of little if any guidance. In many cases, the payment by the company will not acquire the quality of a dividend at all: its true character will be seen to be a misappropriation of the company's assets, or a return of capital in breach of the requirements of the Corporations Act. In such cases, s 202-45 has no scope for operation. 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.

Purported franking of an unfrankable distribution

Section 202-5 of the 1997 Act provides that "an entity franks a distribution if … (b) the distribution is a frankable distribution." A payment or transfer which is not a "frankable distribution" cannot be franked with the consequences (including the availability of franking credits) provided for by the Act; a purported franking of such a payment or transfer is simply ineffective.

A payment or transfer may be unfrankable either because it is declared by the Act to be unfrankable (s 202-40 and s 202-45), or because it is not a "distribution" as defined in s 960-120. These provisions are discussed above.

Section 44(1A)

Concurrently with the substitution of s 254T, an amendment to s 44 of the Income Tax Assessment Act 1936 inserted a new subs (1A):

> (1A) For the purposes of this Act, a dividend paid out of an amount other than profits is taken to be a dividend paid out of profits.

The explanatory memorandum to the amending Bill explained the draftsman's reasoning in relation to the amendment:

> 3.15 For income tax purposes, a dividend is defined to mean, broadly, any distribution made by a company to its shareholders, other than an amount that is debited against the company's share capital

account (subsection 6(1) of the Income Tax Assessment Act 1936). Therefore, distributions made as a result of the amendments to section 254T of the Corporations Act will generally be dividends for income tax purposes.

3.16 Dividends paid to shareholders are included in assessable income provided that the dividends are paid by the company out of its profits (section 44 of the Income Tax Assessment Act 1936). As a result of these amendments, some corporate distributions that are dividends for Corporations Act purposes may not be paid by the company out of its profits.

3.17 Therefore, a consequential amendment to section 44 will deem these distributions to be paid by a company out of profits for the purposes of the income tax law. This will ensure that shareholders include these distributions in assessable income. [*Schedule 1, Part 4, item 56*]

3.18 Subject to the operation of the current imputation integrity rules, these distributions will be frankable under section 202-40 of the Income Tax Assessment Act 1997.

The assumption made in the second sentence of para 3.16 is, in our view and for the reasons we have given, mistaken. Subsection (1A) is otiose, despite the presumption against reading a statutory provision such that it has no work to do (*Project Blue Sky Inc. v Australian Broadcasting Authority* (1998) 194 CLR 355, noted above), because it was enacted on a false premise; the presumption that a provision is not otiose is rather one of construction of other provisions of the legislation than of the provision in question, and is not called into play where the provision is enacted to deal with a circumstance which does not exist, as for example occurred in *Permanent Trustee Australia Ltd v C of SR* (2004) 220 CLR 388, 431 [115].

A transfer of assets from a company to a person who is a member of the company may occur in a variety of circumstances. It may be for consideration, for example, upon sale. It may be a misappropriation of the assets transferred; in such circumstances the company has a right to recover the asset or its value, from the recipient or from the officer responsible for the transfer. Neither of these is properly called a distribution or a dividend. A purported distribution may be made in circumstances where the company is left with a deficit of assets; that too is not properly a distribution, as there is nothing to distribute, no equity in the company to appropriate to the members. Such amounts are not "dividends" as defined in s 6 of the 1936 Act, for they are not distributions or amounts credited "to shareholders." Section 44(1A) has no application to them.

Where the company has net equity, but no fund of profits – that is, its surplus of assets over liabilities does not exceed the amount of subscribed capital remaining after deducting past returns and losses of capital – a purported distribution is not a dividend but an informal and unauthorised return of capital. The Corporations Act preserves the validity of the transfer, but makes the action an offence on the part of the person responsible. Making false or misleading entries in the accounting records, such as debiting a "dividends overpaid" or "provision" account, does not convert the act into a dividend. In such circumstances, the amount is properly debited to share capital account, and the fact that the directors have failed to record the transaction in the accounting records, or have misrecorded it, does not make it any the less a distribution debited to share capital account, as is pointed out in *Consolidated Media Holdings Ltd v FC of T* (2011) 82 ACSR 637, 652 [71-2]. Such a distribution is not a "dividend" for the purposes of the Income Tax Assessment Acts, for it is excluded from the defined term by paragraph (d) of the definition, and in consequence s 44(1A) has no application to it. It is likely that in most factual circumstances such payments would comprise "capital proceeds" for the purposes of a CGT event – whether it be event A1 (s 104-10), event C2 (s 104-25), event G1 (s 104-135) or, if none of those, event H2 (s 104-155).

Where after the transfer of assets to members by way of distribution the antecedent balance of share capital account remains intact, the distribution is necessarily out of profits: it is out of a surplus, which is "profits" for the purposes of s 44, *FC of T v Slater Holdings Pty Ltd* (1984) 156 CLR 447, 460-1. To such an amount s 44(1A) has no application: it is not paid out of an "amount other than profits."

In short, despite the draftsman's misapprehension (one apparently repeated in the November 2011 Discussion Paper "Proposed amendments to the Corporations Act," at p 10), s 254T does not "otherwise authorise" a reduction in capital; "otherwise authorised" in s 256B refers to what is authorised by the balance of Chapter 2J. There is no "dividend" to which s 44(1A) has application.

The particular cases for advice

It will be apparent from the foregoing that we do not consider that the transactions hypothesised in the questions asked of us, with the exception of some distributions from asset revaluation reserves, rise to the level of attracting the operation of s 202-45(e).

Payment of money, or transfers of assets, of the company purporting to be dividends and justified by debits posted to asset accounts, expense accounts or "negative reserve" accounts are not dividends and cannot be frankable distributions. So far as the entries are conflated with the share capital account (and we do not think that is a proper construction), the accounts are to be read together – as was done in *Consolidated Media Holdings Ltd v FC of T* (2011) 82 ACSR 637, 652 – and the transaction properly regarded as a return of capital, debited to an account which is part of the share capital account.

Justification of a transfer of assets (including money) to a shareholder by entering a debit to an "other comprehensive income" account, or to an "unbooked profit" account is, we think, unlikely to occur in practice: an attempt to do so reveals the implausibility of the concept. On examination, it is likely that any such entry will be revealed to be either a misapplication of assets (with whatever consequences may flow under provisions such as Division 7A) or a disguised appropriation of profits. In the latter case, it will give rise to a liability to tax and may afford an opportunity to frank the distribution, but that is not as we understand it the mischief to which the present enquiries are directed: that is, if there are truly profits, and truly a distribution, the Act will operate according to its intended tenor.

Wentworth Chambers
29 November 2011

A H Slater

J O Hmelnitsky