

TR 2011/D8 - Income tax: Section 254T of the Corporations Act and the assessment and franking of dividends paid from 28 June 2010

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Draft Taxation Ruling

Income tax: Section 254T of the Corporations Act and the assessment and franking of dividends paid from 28 June 2010

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1 This publication provides you with the following level of protection:

This publication is a draft for public comment. It represents the Commissioner’s preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

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What this Ruling is about

1. This draft Ruling is about the taxation of dividends paid in compliance with section 254T of the *Corporations Act 2001* (the *Corporations Act*) from 28 June 2010; including the assessment of dividends under section 44 of the *Income Tax Assessment Act 1936* (ITAA 1936), the franking of dividends under Part 3-6 of the *Income Tax Assessment Act 1997* (ITAA 1997), and the circumstances in which a dividend will be paid out of profits. This draft Ruling is not about non-share dividends or returns paid on non-equity shares.

Definitions

2. For the purposes of this draft Ruling the following key terms are used:

‘**Accounts**’ means the financial reports and statements of a company properly kept in accordance with the *Corporations Act* and prepared in accordance with Australian Accounting

Standards from the company's financial records,¹ and includes interim and half yearly financial reports and statements prepared during the financial year that meet those requirements.

'Company' means a company incorporated under the Corporations Act that is limited by shares.

'Dividend' means a dividend as defined in subsection 6(1) of the ITAA 1936, which includes any distribution made by a company to any of its shareholders, whether in money or other property, and any amount credited by a company to its shareholders as shareholders; but does not include² moneys paid or credited by a company to a shareholder or any other property distributed by a company to shareholders 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 of the company.³

'Frankable distribution' means a distribution under section 202-40 of the ITAA 1997 that is not an unfrankable distribution under section 202-45 of the ITAA 1997, among other things and in particular, a distribution that is not sourced, directly or indirectly, from a company's share capital account.

'Profits' means profits recognised in a company's accounts which are available for distribution by way of dividend.

'Share capital account' means share capital account as defined in section 975-300 of the ITAA 1997 which is an account the company keeps of its share capital,⁴ or any other account (whether or not called a share capital account) that satisfied the following conditions: (i) the account was created on or after 1 July 1998, and (ii) the first amount credited to the account was an amount of share capital. Two or more accounts together may constitute the share capital account.

¹ Financial records, reports and statements as required by sections 285, 286 and 292 of the Corporations Act. Australian Accounting Standards made by the Australian Accounting Standards Board, as defined in section 9, and in force under section 334, of the Corporations Act, and under which assets and liabilities are calculated pursuant to subsection 254T(2) of the Corporations Act.

² Subject to the exception to the exclusion in subsection 6(4) of the ITAA 1936.

³ The taxation law definition is wider than the usual or company law meaning of dividend, and can include illegal distributions and distributions of money or property that do not satisfy section 254T of the Corporations Act.

⁴ Subject to exceptions for tainted share capital accounts under Division 197 of the ITAA 1997.

Ruling

3. A company that pays a dividend to its shareholders, in accordance with its constitution and without breaching section 254T or Part 2J.1 of the Corporations Act, that is paid out of current trading profits recognised in its accounts and available for distribution, is not prevented by paragraph 202-45(e) of the ITAA 1997 from franking the dividend merely because the company has unrecouped prior year accounting losses or has lost part of its share capital. That dividend will be assessable income of its resident shareholders under paragraph 44(1)(a) of the ITAA 1936.⁵

4. A company that pays a dividend to its shareholders, in accordance with its constitution and without breaching section 254T or Part 2J.1 of the Corporations Act, that is paid out of an unrealised capital profit of a permanent character recognised in its accounts and available for distribution, is not prevented by paragraph 202-45(e) of the ITAA 1997 from franking the dividend provided the company's net assets exceed its share capital by at least the amount of the dividend. That dividend will be assessable income of its resident shareholders under paragraph 44(1)(a) of the ITAA 1936.⁶

5. A distribution (even if it is labelled as a dividend) paid by a company to its shareholders, that does not comply with section 254T or Part 2J.1 of the Corporations Act, is an unauthorised reduction and return of share capital that will be taxed as a CGT event under the capital gains tax provisions in Part 3-1 of the ITAA 1997, or will be taxed as an assessable unfranked dividend, depending on the particular facts and circumstances of the payment.

Example

6. The following example and those in the Appendix 2 Alternative Views are intended to illustrate the taxation principles set out and the issues discussed in the Explanation. For the purposes of the examples it is assumed that the requirements of the Corporations Act, the Australian Accounting Standards and the company's constitution have been complied with. It is also assumed that the company has a history of trading and making distributions, and the company's accounts have entries preceding those represented here.

⁵ Subject to exceptions such as the shareholder being exempt.

⁶ Subject to exceptions such as the shareholder being exempt.

Example 1: dividend paid out current year profits and there are accumulated losses

7. Company A is in an accumulated loss position as a result of prior year trading. However, in the current year, Company A performs more successfully, making trading profits. A meeting of the directors of the company approves financial statements in which the current year trading profits are booked.⁷ The current year trading profits are not offset against Company A's accumulated losses, and are not otherwise made unavailable for distribution. Company A's balance sheet is as follows:

<i>Assets and Liabilities</i>		<i>Equity</i>	
	Cash 80		Share capital 140
Property, plant and equipment	20		Accumulated losses (70)
	<hr/>		<u>Current year profit 30</u>
Net assets	100		Total equity 100

8. Company A determines to pay a \$30 dividend to shareholders from the current year profits identified in the accounts. As the dividend is sourced from current year profits the \$30 dividend will be frankable, and will be assessable income of its resident shareholders.

Date of effect

9. When the final Ruling is issued, it is proposed to apply from 28 June 2010 before its date of issue, and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

 21 December 2011

⁷ For example, the current year profits are recognised in the annual financial reports or interim financial reports.

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.*

10. This draft Ruling explains the taxation and franking consequences of the changes to the circumstances in which a company is prohibited from paying a dividend under section 254T of the Corporations Act and the consequential insertion of subsection 44(1A) of the ITAA 1936, which apply to company dividends declared⁸ on or after 28 June 2010.

11. The Commissioner's views on the interpretation and operation of the Corporations Act are based on legal advice from Counsel.⁹

12. The proper treatment of a dividend payment for taxation assessment and franking purposes in each case is a question of the application of the Corporations Act and the Taxation Acts¹⁰ to the facts and circumstances of the particular payment.

The amendments to section 254T of the Corporations Act and subsection 44(1A) of the ITAA 1936

13. The *Corporations Amendment (Corporate Reporting Reform) Act 2010* (the CACRRA) changed the prohibitions in section 254T of the Corporations Act governing the circumstances in which a company can pay a dividend from a 'profits test' to a three part 'balance sheet test', from 28 June 2010. The new section 254T of the Corporations Act provides that a company must not pay a dividend unless:

- (i) the company's assets exceed its liabilities immediately before the dividend declaration and the excess is sufficient for the dividend payment, and
- (ii) the dividend is fair and reasonable to members as a whole, and
- (iii) creditors are not materially prejudiced.

Assets and liabilities are calculated in accordance with accounting standards in force at the time.¹¹

⁸ The reference to 'declare' in section 254T of the Corporations Act is taken to include a determination to pay a dividend.

⁹ See the legal opinion obtained by the Commissioner on these issues.

¹⁰ The ITAA 1936 and the ITAA 1997.

¹¹ If a company is not required to prepare audited financial reports, balance sheet solvency can be determined by reference to the records required to be kept pursuant to section 286 of the Corporations Act (see paragraph 3.12 of the Explanatory Memorandum to the CACRRA).

14. The Corporations Act previously provided that ‘a dividend may only be paid out of profits of the company’ (‘the profits test’). The phrase ‘out of profits’ in the previous section 254T of the Corporations Act was generally accepted as a reference to retained or ascertained accounting profits of a permanent character.¹²

15. As a result of the substitution of the new section 254T of the Corporations Act, subsection 44(1A) was inserted into the ITAA 1936. Subsection 44(1A) of the ITAA 1936 provides that: ‘For the purposes of this Act,¹³ a dividend paid out of an amount other than profits is taken to be a dividend paid out of profits’.

Effect of the new section 254T of the Corporations Act

16. The better view appears to be that like the previous section 254T of the Corporations Act, the new section 254T does not authorise any act by a company; the section merely prohibits the payment of dividends in the specified circumstances. In particular, the new section 254T does not ‘otherwise authorise by law’ a reduction of share capital for the purposes of section 256B and Part 2J.1 of the Corporations Act. It appears that the procedures to approve a share capital reduction in Part 2J.1 of the Corporations Act would also have to be met for a company to pay a dividend not prohibited by section 254T of the Corporations Act that was sourced from share capital.

17. Although profits are no longer referred to in section 254T of the Corporations Act, the concept of profits as the source of a dividend payment continues to be relevant to section 254T, and to the assessment and franking of dividends for taxation purposes.

¹² See: *Industrial Equity Ltd & Ors v Blackburn* (1977) 137 CLR 567 at 578-579; *Marra Developments Ltd v BW Rofe Pty Ltd* [1977] 2 NSWLR 616 at 628-630; and *QBE Insurance Group Ltd & Ors v ASIC* (1992) 38 FCR 270 at 285.

¹³ Section 6(1) of the ITAA 1936 defines ‘this Act’ to include the ITAA 1997 and parts of the *Taxation Administration Act 1953*.

18. The ordinary meaning of 'dividend' is a share of profits allocated by a company to its shareholders. In *Henry v Great Northern Ry Co* (1857) 27 LJ Ch 1 it was stated that a dividend is an appropriation of a share of a company's profits, being the right of a shareholder to receive his aliquot proportion of the profits of the enterprise.¹⁴ According to Lindley LJ in *Verner v General & Commercial Investment Trust* [1894] 2 Ch 239 at 266: 'dividends presuppose profits of some sort'. In an Australian context it has been stated: 'A dividend is a share of profits, whether at a fixed rate or otherwise, allocated to the holders of shares in a company', per Beach J in *Churchill International Inc v BTR Nylex Ltd* (1991) 4 ACSR 693 at 696.¹⁵

19. The better view appears to be that for the purposes of the Corporations Act and company accounting, dividends can only be paid from profits and not from 'amounts other than profits'. The new section 254T of the Corporations Act imposes three specified additional prohibitions on the circumstances in which a dividend can be paid, as inherently a dividend can only be paid out of profits, having regard to the ordinary and legal meaning of the word dividend.

20. If, contrary to the Commissioner's view, a dividend can be paid out of an 'amount other than profits', it would be taxable as follows. A company that pays a dividend to its shareholders in accordance with its constitution and without breaching section 254T or Part 2J.1 of the Corporations Act that is paid out of an amount other than profits is not prevented by paragraph 202-45(e) of the ITAA 1997 from franking the dividend provided the company's net assets exceed its share capital by at least the amount of the dividend. That dividend will be assessable income of its resident shareholders under paragraph 44(1)(a) of the ITAA 1936 as a result of the deeming in subsection 44(1A) of the ITAA 1936.

Subsection 44(1A)

21. Subsection 44(1A) was inserted into the ITAA 1936 to ensure that any company distributions that were not paid out of profits but were paid as dividends in reliance on the new section 254T of the Corporations Act would continue to be included in shareholders' assessable income as dividends under section 44 of the ITAA 1936, by deeming such dividends to be paid 'out of profits' for taxation purposes. This is subject to the exclusion of amounts debited against an amount standing to the credit of the share capital account that are not dividends for taxation purposes under the definition of dividend in subsection 6(1) of the ITAA 1936.

¹⁴ See *Stroud's Judicial Dictionary*; *Henry v Great Northern Ry Co* (1857) 27 LJ Ch 1 at 18, *Re Chelsea Waterworks Co and Metropolitan Water Board* (1903) 73 LJKB 535. *Halsbury's Laws of England*, Volume 7(1) at paragraph 717, states: 'The ordinary meaning of 'dividend' is a share of profits, whether at a fixed rate or otherwise, allocated to the holders of shares in a company.'

¹⁵ Cited in *Butterworths Australian Legal Dictionary*. Beach J cited *Henry v Great Northern Ry Co*.

22. Subsection 44(1A) of the ITAA 1936 operates as a catch all provision, to ensure that any amounts that are paid by a company that are dividends for the purposes of the Corporations Act or taxation purposes are assessable income of shareholders. However, subsection 44(1A) of the ITAA 1936 does not have the effect that all dividends are frankable under the imputation provisions in the ITAA 1997. The Explanatory Memorandum to the CACRRA stated at paragraph 3.18 that:

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

23. The rules governing the imputation system, contained in Part 3-6 of the ITAA 1997, include a number of provisions that provide guidance about the intended scope and object of imputation. The guide to the imputation system in section 202-25 of the ITAA 1997 states: 'Generally, distributions that are made out of realised profits can be franked'. Those distributions that are not frankable are identified in section 202-45 of the ITAA 1997.

24. A payment that is a dividend paid or credited in compliance with new section 254T of the Corporations Act will be an assessable dividend for taxation law purposes as well, provided it is not debited against an amount standing to the credit of the share capital of the company. However, this is not the basis upon which the ability to frank dividends is determined under Part 3-6 of the ITAA 1997. Paragraph 202-45(e) of the ITAA 1997 provides that a distribution that is sourced, directly or indirectly, from a company's share capital account is unfrankable.¹⁶

25. Paragraph 202-45(e) of the ITAA 1997 is considered to be a structural integrity rule as that term was used in paragraph 3.18 of the Explanatory Memorandum to the CACRRA.¹⁷ Subsection 44(1A) of the ITAA 1936 does not have the effect that all dividends that are paid out of profits or amounts other than profits are frankable distributions for the purposes of Part 3-6 of the ITAA 1997. Such an interpretation would render the structural integrity rules in Part 3-6 of the ITAA 1997 redundant, and the Explanatory Memorandum to the CACRRA indicates that was not intended. The structural integrity rules were not repealed, and both the ITAA 1936 and the ITAA 1997 should be interpreted to retain practical scope for their application.

26. Paying a dividend out of profits is not a requirement for a distribution to be frankable under section 202-40 of the ITAA 1997. Although the deeming in subsection 44(1A) applies for the purposes of 'this Act' (which includes the ITAA 1997), that does not assist in the satisfaction of section 202-40 of the ITAA 1997. Where a dividend is sourced directly or indirectly from a company's share capital account within paragraph 202-45(e) of the ITAA 1997 it is not sufficient that it is deemed to be paid out of profits.

¹⁶ Subject to the operation of section 177EA of the ITAA 1936, the general anti-avoidance provision specifically dealing with the receipt of imputation benefits.

¹⁷ See paragraph 3.18 of the Explanatory Memorandum to the CACRRA.

Profits

27. Profits must be recognised in a company's accounts and be available for distribution by way of dividend. Profits can be recognised in the company's annual financial statements for the preceding year, or in properly prepared half yearly or interim financial statements for the current financial year. The source of the profits from which a dividend will be paid would usually be expected to be recorded in the directors' minutes of the resolution determining to pay a dividend, or in the documentation that accompanies or supports the resolution.

28. If profits are applied against prior year losses or losses of share capital or otherwise applied or appropriated they will cease to be available for distribution by way of dividend.¹⁸

29. In relation to the profits from which a dividend can be paid, in *QBE Insurance Group Ltd & Ors v ASIC & Anor, NRMA Insurance Ltd v ASIC* (1992) 38 FCR 270 at 286-287, Lockhart J stated:

Plainly profits of a company available for dividend may be trading profits derived during the relevant financial year. Also, it is well established that capital profits, in the sense of profits earned on the realisation of capital assets, may be available for dividend provided there has been an accretion to the paid up capital: see *Australasian Oil Exploration Ltd v Lachberg* (1958) 101 CLR 119 at 133 and the cases there cited and *Marra Developments* per Mahoney JA at 629. The position with respect to unrealised accretions to the value of assets has been considered, though to a limited extent, in certain of the authorities. It has been held that unrealised accretions to the value of a company's capital assets may be available for dividend where it is clear (and, by inference, only where it is clear) that the accretion in value is of a permanent character: see *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* (supra) at 371-372; *Marra Developments* at 629 ... However, the authorities attach the rider that capital profits of this kind cannot be utilised for payment of dividend unless its paid up capital is intact. There must upon a balance of account be an accretion to the paid-up capital: *Lachberg* (supra) (at 133) and *Marra* (at 630).¹⁹

¹⁸ Under current Australian Accounting Standards, carrying the balance of profit for a year to the continuous profit and loss account may represent an appropriation of the current profit to make good past losses (see the legal opinion obtained by the Commissioner on these issues, ATO 254T advice final 1211).

¹⁹ See also the decision in *FCT v Sun Alliance Investments Pty Ltd (in liq)* (2005) 225 CLR 488 at 511 paragraph [64] where the High Court stated: 'so would it be productive of confusion and uncertainty if companies were to declare dividends against profits that are subject to constant fluctuations', in the context of considering whether a distribution 'could be reasonably be taken to be attributable to profits derived', where the profits at issue were ascertained but unrealised accretions in value to an asset portfolio.

The definition of ‘dividend’ for tax purposes

30. Subsection 6(1) of the ITAA 1936 defines ‘dividend’ to include:

- (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 its shareholders as shareholders, subject to a number of exclusions. In particular, an amount of money paid or credited by a company to a shareholder or any other property distributed by a company to shareholders which is debited against an amount standing to the credit of the share capital account of the company is excluded from being a dividend by paragraph (d) of the definition of dividend contained in subsection 6(1) of the ITAA 1936.

31. This definition of dividend in subsection 6(1) provides the basis for the application of section 44 of the ITAA 1936; subsection 44(1) of which includes in a shareholder’s assessable income dividends paid to the shareholder by a company out of profits derived by the company. Thus, for taxation purposes, a dividend paid out of profits is assessable income of a shareholder in a company.²⁰

32. The taxation law definition of dividend in subsection 6(1) of the ITAA 1936 is broader than the general law and Corporation Act meanings, and may include distributions that are not paid out of profits. For taxation purposes misappropriations of company money or property, unauthorised payments and unauthorised dispositions of property by a company may be dividends, and they may be deemed to be paid out of profits by subsection 44(1A) of the ITAA 1936 depending on the particular facts of each case.

33. A distribution (even if it is labelled a dividend) paid by a company subject to the Corporations Act to its shareholders that is debited against an amount standing to the credit of the share capital of the company is not a dividend for taxation purposes within the meaning of ‘dividend’ in subsection 6(1) of the ITAA 1936.²¹ It will be a return of share capital taxed as a CGT event under the capital gains tax provisions in Part 3-1 of the ITAA 1997.

²⁰ See paragraph 3.17 of the Explanatory Memorandum to the CACRRA.

²¹ Subject to the exception in subsections 6(4) and 44(1B) of the ITAA 1936.

What is a debit against an amount standing to the credit of a company's share capital account?

34. In determining whether an amount is debited against an amount standing to the credit of the share capital account of a company, the source of the distribution from the company's perspective must be considered to determine the appropriate taxation treatment rather than the character of the receipt in the hands of the shareholder²² (see also TD 2009/5 at paragraph 15).²³

35. The changes to section 254T of the Corporations Act have not altered what is defined as a dividend for tax purposes or the process for determining what is a taxation law dividend. This position is summarised in paragraph 4 of Taxation Ruling TR 2003/8 as follows:

‘The amount of a dividend in respect of a distribution of property... to a shareholder in their capacity as a shareholder will be the money value of the property at the time it is distributed, reduced by the amount debited to a share capital account of the distributing company in respect of the distribution’.²⁴

36. Therefore, in applying the definition of dividend in subsection 6(1) of the ITAA 1936 it is generally the form of the distribution from the company's perspective that is examined. Thus, if a company makes a distribution to a shareholder it will prima facie fall within the definition of a dividend, unless it is subject to one of the exclusions in subsection 6(1) of the ITAA 1936.

37. However, in circumstances where, for example, a debit is made to a new account producing a negative balance, regard may be had to the substance of the transaction in determining the source of the debit. In *Consolidated Media Holdings Ltd v Commissioner of Taxation* [2011] FCA 367 the taxpayer debited a distribution to an account entitled ‘Share Buy-Back Reserve Account’ resulting in a debit balance in that account in circumstances where the account had never had a credit balance or credit entry. It was held that the reserve account was part of the company's share capital account, which was debited in making the distribution.²⁵

²² See *Federal Commissioner of Taxation v Slater Holdings Ltd* (1984) 156 CLR 447 at 457, 84 ATC 4883 at 4887 per Gibbs CJ (with whom Mason, Brennan, Deane and Dawson JJ agreed) endorsing the reasoning of Kitto, J in his dissenting judgement in *FCT v Uther* (1965) 112 CLR 630. This dissenting judgement was again discussed with approval by the High Court in *FCT v McNeil* (2007) 229 CLR 656 at 666. See *Condell v FCT* (2007) 66 ATR 100 at 102-103.

²³ In *MacFarlane v FCT* (1986) 13 FCR 356 at 376 it was held that the primary taxing provisions for company distributions (sections 44 and 47) require that the dividends be paid out of profits, but they do not rely on, or require, the existence of the conditions necessary to declare a lawful dividend under the Companies legislation.

²⁴ Subject to the operation of subsection 6(4) and section 45B of the ITAA 1936.

²⁵ *Consolidated Media Holdings Ltd v Commissioner of Taxation* [2011] FCA 367 at paragraphs 48, 49, 70 and 71 per Emmett J. In such circumstances, shareholder approval under section 256B of the Corporations Act might also be required. Note that this decision is currently subject to appeal to the Full Federal Court.

38. The determination and payment of a dividend requires an appropriation of profits recognised in a company's accounts that are divided among the shareholders. Depending on the particular facts and circumstances, a 'dividend' purportedly paid under section 254T of the Corporations Act from 'unbooked' profits, underived profits, asset accounts such as internally generated goodwill, negative reserve accounts, or a gross amount of other comprehensive income will be a misappropriation of a company's assets that will not be a dividend under subsection 6(1) or for the purposes of section 44 of the ITAA 1936, and will be taxed as a return of share capital under the capital gains tax provisions. Or if such a distribution is a dividend it would be taxed as an assessable, unfrankable dividend sourced indirectly from a company's share capital account.

Franking of dividends

39. Dividends paid in compliance with the new section 254T of the Corporations Act out of profits are frankable on the basis set out in paragraphs 3 to 5 of this draft Ruling, even if a company's net assets are of a value less than its share capital or the company has prior year losses.

40. The presence of accumulated losses and a deficiency of a company's net assets below its share capital do not change the character of an amount of profits ascertained in a company's accounts, or a dividend paid out of such an amount. Previous case law establishes that prior accumulated losses do not have to be recouped before a dividend can be paid out of current year profits.²⁶ That case law is applicable to the new section 254T of the Corporations Act and Division 202 of the ITAA 1997.

²⁶ See *Ammonia Soda Company Ltd v Chamberlain* [1918] 1 Ch 266, *Marra Developments v B W Rofe* [1977] 2 NSWLR 616 at 629, *Australasian Oil Exploration Ltd v Lachberg & Ors* (1958) 101 CLR 119; *Glenville Pastoral Co Pty Ltd (in liq) v FCT* (1963) 109 CLR 199, *IEL v Blackburn* (1977) 137 CLR 567, *FCT v Slater Holdings Ltd* (1984) 56 ALR 306, *Re Spanish Prospecting Co Ltd* [1911] 1 Ch 92 at 98, *MacFarlane v FCT* (1986) 17 ATR 808 at 815. Compare *Ford's Principles of Corporations Law* online edition at para [18.190] where it is stated there is doubt over that: the authorities are old, and modern accounting should require losses to be made good before dividends can be paid.

41. The accounts of the prior and current years evidence the fact that share capital has been lost in a previous year and is not available for any purpose, and that current year profits are an available source for a dividend payment without prior year losses being recouped, provided those profits are not applied against the losses or otherwise made unavailable for distribution. Current year profits do not have to be applied against the accumulated losses as a matter of law or accounting, and hence are capable of retaining their character as profits available for distribution.²⁷ Capital that has been lost or sunk is no longer capable of any application, including for the payment of dividends.²⁸

42. In circumstances where a company has a deficiency of net assets below its share capital, whether a dividend can be paid out of an unrealised capital profit, and whether it would be a frankable distribution are questions of fact and law, the answers to which depend on the specific circumstances of the loss of subscribed capital, the nature of the unrealised profit, whether the company's accounts reveal other profits and losses, and the interpretation of section 254T of the Corporations Act. These are questions of fact and interpretation of section 254T that cannot be dealt with in this public Ruling.²⁹

Appendix 2 – Alternative views

43. An alternative view of the new section 254T of the Corporations Act is that it otherwise authorises by law a company to reduce its share capital for the purposes of section 256B and Part 2J.1 of the Corporations Act. Under that view, a company could pay a dividend out of share capital in compliance with the new section 254T.

44. A company might also be able to achieve the same outcome by paying a dividend out of share capital pursuant to section 254T of the Corporations Act and also obtaining proper authorisation for some or all of the dividend payment as a reduction of the share capital of the company pursuant to Part 2J.1 of the Corporations Act.

45. If such a payment was a dividend, the Commissioner is of the view it would be subject to taxation as illustrated in the following examples.

²⁷ See TR 2003/8 and PSLA 2008/10. For taxation purposes 'profits' takes its ordinary meaning, which is wider than the Corporations Act conception, and includes any gain made by a company and disclosed by a comparison between the states of the business at two points in time.

²⁸ *Re National Bank of Wales* [1899] 2 Ch 629 at 669.

²⁹ For some further consideration of these issues see the legal opinion obtained by the Commissioner in connection with this ruling, ATO 254T advice final 1211.

Example 2: dividend paid out of current year profits identified but not yet booked in the accounts

46. Assume the same facts for Company A as stated in Example 1 of this draft Ruling. Company A makes \$30 of current year profits, however the company determines and pays \$30 to its shareholders as a purported dividend prior to the amount being recognised or booked in its accounts or financial reports. As the \$30 purported distribution was paid out of an identified but as yet unbooked current year profit, the payment will either not be a dividend for taxation purposes and/or the Corporations Act, or if it was a dividend for taxation purposes and/or the Corporations Act, it would not be a frankable distribution under paragraph 202-45(e) of the ITAA 1997. The same conclusions would apply in respect of amounts that are not able to be booked or recognised in a company's accounts under the Australian Accounting Standards.

Example 3: Debit to reserve

47. Company B has the following balance sheet:

<i>Assets and Liabilities</i>		<i>Equity</i>
Cash	100	Share capital 190
Property, plant and equipment	140	Accumulated losses (40)
<u>Investment in subsidiary</u>	<u>40</u>	<u>Asset revaluation reserve 130</u>
Net assets	280	Total equity 280

48. Company B is assumed to have a positive franking account balance due to its activities in prior years. Company B determines to pay an \$80 dividend. To pay the \$80 dividend the company makes the following accounting entries:

Dr Asset revaluation reserve \$80

Cr Cash \$80

49. In this example, the company has sourced the distribution from a species of profit account which is ascertained in its accounts, namely the asset revaluation reserve, although it does not have any current or retained earnings. The payment of the \$80 dividend does not result in net assets being less than share capital either before or after the dividend payment. On this basis, the dividend will be assessable under paragraph 44(1)(a) of the ITAA 1936, and will be a frankable distribution as it will not be sourced indirectly from the share capital account.

50. However, a company's accounts may contain no positive profit amounts and only be represented by positive amounts of share capital. In those circumstances where the distribution is debited to retained earnings³⁰ when the 'net asset' test in s 254T of the Corporations Act is satisfied, such a distribution would be sourced indirectly from share capital for the purposes of paragraph 202-45(e) of the ITAA 1997. Accordingly any such distribution either would not be considered to be a dividend, and would be taxable under the capital gains tax provisions; or if a dividend it would be assessable under paragraph 44(1)(a) as a result of the deeming in subsection 44(1A) of the ITAA 1936, and considered an unfrankable distribution sourced indirectly from a company's share capital account.

Example 4: dividend paid partly out of profits and partly out of share capital

51. Company C has the following balance sheet:

<i>Assets and Liabilities</i>		<i>Equity</i>	
Cash	100	Share capital	60
		<u>Retained earnings</u>	<u>40</u>
Net assets	100	Total equity	100

The company purports to determine to pay a dividend of \$50 pursuant to the new section 254T of the Corporations Act. To pay the \$50 distribution Company C commits the following entries:

DR retained earnings	40
DR share capital	10
CR Cash	50

³⁰ The Commissioner is given to understand that this would be to negative retained earnings in this context. The example proceeds on the assumption that section 254T of the Corporations Act does not prohibit such a distribution.

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52. For taxation law purposes, the \$40 portion of the distribution debited to the retained earnings balance would be a dividend pursuant to subsection 6(1) of the ITAA 1936. It would be able to be franked in accordance with the principles stated in this draft Ruling. However, the amount debited against the share capital account would not be a dividend for taxation purposes pursuant to the exception contained in paragraph (d) of subsection 6(1) of the ITAA 1936. As the \$10 would not fall within the definition of a dividend for taxation law purposes, it would not be assessable pursuant to subsection 44(1A) of the ITAA 1936. For tax law purposes, the \$10 distribution would be treated as a return of share capital that would give rise to a CGT event under the capital gains tax provisions in Part 3-1 of the ITAA 1997.

Example 5: dividend paid out of an amount other than retained earnings (such as a reserve account) and net assets are less than share capital

53. Company D has the following balance sheet:

<i>Assets and Liabilities</i>		<i>Equity</i>	
Cash	0	Share capital	180
<u>Property, plant and equipment</u>		<u>Accumulated losses (50)</u>	
	<u>130</u>		
	Net assets	130	Total equity
			130

54. The company purports to determine to pay a dividend of \$100 pursuant to the new section 254T of the Corporations Act.

55. Company D does not credit accumulated losses but rather creates a dividend reserve to effect payment:

Dr Dividend reserve	100
Cr Cash	100

56. The balance sheet of Company D post dividend distribution will be as follows:

<i>Assets and Liabilities</i>		<i>Equity</i>	
Cash	(100)	Share capital	180
Property, plant and equipment	130	Accumulated losses (50)	
		<u>Dividend reserve (100)</u>	
	<u>Net assets</u>		Total equity
	30		30

57. Assuming such accounting entries and such payments are possible under the Corporations Act, given that the dividend reserve is not a profit reserve and net assets do not exceed share capital, the payment would not be a dividend for taxation purposes and would be taxed as a return of capital under the capital gains tax provisions. Alternatively, if the payment was a dividend for taxation law purposes, it would be assessable under subsection 44(1A) and unfrankable on the basis that it was sourced indirectly from the share capital account of Company D under paragraph 202-45(e).³¹

58. In circumstances where a company has a deficiency of net assets below its share capital, whether a dividend can be paid out of an amount other than profits, and whether it would be a frankable distribution are questions of fact and law, the answers to which depend on the specific facts and circumstances of the loss of subscribed capital, the nature of the unrealised profit, whether the company's accounts reveal other profits and losses, and the interpretation of section 254T of the Corporations Act.

Appendix 3 – Your comments

59. You are invited to comment on this draft Ruling, including the proposed date of effect. Please forward your comments to the contact officer via email to 254T@ato.gov.au by the due date.

60. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: 24 February 2012
Contact officer: Jonathan Todd
Email address: 254T@ato.gov.au
jonathan.todd@ato.gov.au
Telephone: 02 937 48303
Facsimile: 02 937 48628

³¹ In *Consolidated Media Holdings Limited v Commissioner of Taxation* [2011] FCA 367, Emmett J held that irrespective of the fact the account was not called the share capital account, it was held to be an amount of share capital.

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Sydney NSW 2000

Appendix 4 – Detailed contents list

61. The following is a detailed contents list for this Ruling:

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2003/8; TR 2006/10;
TD 2009/5

Subject references:

- accounts
- accumulated losses
- Capital Gains Tax
- company
- corporations
- distribution
- dividend
- frankable distribution
- franking
- loss
- net assets
- prior year losses
- profits
- share capital
- share capital account
- unfrankable distribution

Legislative references:

- ITAA 1936
- ITAA 1936 6(1)
- ITAA 1936 6(1)(d)
- ITAA 1936 6(4)
- ITAA 1936 44
- ITAA 1936 44(1)(a)
- ITAA 1936 44(1A)
- ITAA 1936 44(1B)
- ITAA 1936 45B
- ITAA 1936 177EA
- ITAA 1997
- ITAA 1997 Part 3-1
- ITAA 1997 Division 197
- ITAA 1997 Part 3-6
- ITAA 1997 Division 202
- ITAA 1997 202-25
- ITAA 1997 202-40
- ITAA 1997 202-45
- ITAA 1997 202-45(e)
- ITAA 1997 975-300
- TAA 1953
- Corporations Act 9
- Corporations Act 334
- Corporations Act 254T
- Corporations Act 254T(2)
- Corporations Act 256B

- Corporations Act 285
- Corporations Act 286
- Corporations Act 292
- Corporations Act Part 2J.1
- Corporations Amendment (Corporate Reporting Reform) Act 2010

Case references:

- *Ammonia Soda Company Ltd v Chamberlain* [1918] 1 Ch 266
- *Australasian Oil Exploration Ltd v Lachberg & Ors* (1958) 101 CLR 119
- *Re Chelsea Waterworks Co and Metropolitan Waterboard* (1953) LJKB 535
- *Churchill International Inc v BTR Nylex Ltd* (1991) 4 ACSR 693
- *Condell v FCT* (2007) 66 ATR 100
- *Consolidated Media Holdings Ltd v FCT* [2011] FCA 367
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- *FCT v Slater Holdings Ltd* (1984) 156 CLR 447
- *FCT v Sun Alliance Investments Pty Ltd (in liq)* (2005) 225 CLR 488, [2005] HCA 70, 60 ATR 560
- *FCT v Uther* (1965) 112 CLR 630
- *Glenville Pastoral Co Pty Ltd (in liq) v FCT* (1963) 109 CLR 199
- *Henry v Great Northern Ry Co* (1857) 27 LJCh 1
- *Industrial Equity Ltd & Ors v Blackburn* (1977) 137 CLR 567
- *MacFarlane v FCT* (1986) 13 FCR 356
- *Marra Developments Ltd v BW Rofe Pty Ltd* [1977] 2 NSWLR 616
- *Re National Bank of Wales* [1899] 2 Ch 629
- *QBE Insurance Group Ltd & Ors v ASIC* (1992) 38 FCR 270

- *Re Spanish Prospecting Co Ltd* [1911] 1 Ch 92
- *Verner v General & Commercial Investment Trust* [1894] 2 Ch 239
- Explanatory Memorandum to the Corporations Amendment (Corporate Reporting Reform) Act 2010
- Ford's Principles of Corporations Law online edition

Other references:

- Australian Accounting Standards Board Australian Accounting Standards
 - Butterworth's Concise Australian Legal Dictionary
 - Halsbury's Laws of England
 - PSLA 2008/10
 - Stroud's Judicial Dictionary
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ATO references

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