

Tax Brief

20 January 2012

Distribution clarity? Round 3

On 21 December 2011 the ATO released TR 2011/D8 dealing with the relationship of the new corporate law rule for dividends and the tax legislation, along with counsel's legal opinion it has obtained as part of the process. Unfortunately the draft ruling creates as many uncertainties as it solves. This tax brief discusses the draft ruling and the associated legal opinion.

We have discussed the development of these issues in two recent tax briefs, see http://www.gf.com.au/TB_ATOContinuesTheDistributionConfusion.pdf and http://www.gf.com.au/20111207TaxBrief_Distribution.pdf, so we keep the discussion here brief.

Counsel's opinion

Many issues are canvassed in the opinion but the four most interesting points are as follows:

- It is not possible to pay a dividend debited to share capital notwithstanding the expression of a different view in the Treasury Consultation Paper on further changes to section 254T.
- Dividend in a corporate law context inherently involves a distribution of profits and section 254T has not done away with this meaning.
- Section 254T acts as a prohibition not permission. Something which is a dividend as involving a distribution out of profits is prohibited if it fails the different tests in section 254T. Something which is not a distribution out of profits is not a dividend even if it satisfies section 254T.
- Section 44(1A) which deems anything which is a dividend for tax purposes to be out of profits is "otiose".

These views make life difficult for the ATO. The first bullet point makes sense to us but brings the ATO into potential conflict with Treasury which is handled by providing an alternative view in the draft ruling. This is probably the first time that Treasury has been the source of an alternative view for ruling purposes! The other bullet points, with respect, hardly seem to give effect to the intent of the 2010 amendments to corporate and tax law.

Draft ruling

The draft confirms the points previously announced about dividends out of current year profits and revaluation reserves – they will generally be assessable as dividends and frankable. The qualifications hinted at previously may be a concern, however.

In relation to dividends out of current year profits it is made clear that accounts in accordance with the accounting standards have to be prepared in relation to the dividend and if the current year profits are set off against negative retained earnings in those accounts, then it is not possible to pay a dividend out of the profits. A footnote indicates that it may be necessary under accounting standards to set current year profits against previous negative retained earnings (prior year losses) in which case a dividend out of current year profits when there are negative retained earnings will not be possible!

In relation to dividends out of revaluation reserves, prior case law on the out of profits test is relied on for the view that such dividends will not be possible where after the dividend net assets do not equal or exceed share capital (a condition which is not required in the case of a dividend out of current year profits).

One difference under the draft ruling compared to previous material is that the ATO is not as keen to default to the outcome of an unfrankable dividend which is generally adverse to taxpayers. Rather an intermediate default position often occurs of a CGT event. What immediately springs to mind is CGT event G1 relating to a distribution which is not a dividend and first writes down the cost base of the shares, especially as the draft ruling refers to such cases as a return of share capital. But the ruling perversely does not state this proposition, leaving open the possibility of CGT event H2 (which the ATO relied on in the alternative in McNeil's case). If CGT event H2 applies then the outcome is generally as undesirable for taxpayers as an unfranked dividend, at least for resident shareholders.

One suspects the drafter of the ruling was the subject of fatigue as the end approached. While early in the explanation section the draft manages to juggle several possibilities depending on precisely what corporate law requires, towards the end we get this broad and rather confusing statement:

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

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distribution is a dividend it would be taxed as an assessable, unfrankable dividend sourced indirectly from a company's share capital account.

This seems to answer in the negative one constantly asked question whether a company may pay a dividend out of negative retained earnings (assuming that section 254T is not offended) but in a jumble of concepts and situations. It would be helpful if the specific situation were dealt with separately and clearly and if Example 5 which comes close to dealing with this case were to have the distribution debited to negative retained earnings rather than a dividend reserve.

Whatever the outcome of this on-going saga – which we will convey in due course – it stands as a sad metaphor for the current state of Australian taxation: poor policy implementation compounded by administrative confusion. Welcome to the New Year.

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