[Insert DD Month YYYY]

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[Insert Client Name]

[Insert Client Position]

[Insert Company Name]

[Insert Company Address]

[Suburb State Post Code]

Dear [Insert Client Name]

**Re: Assessability and franking of dividends paid under the *Corporations Act***

Under the *Corporations Act* *2001* (***Corporations Act***), a company must satisfy a solvency test rather than a profits test in order to pay a dividend. The Commissioner of Taxation has issued Taxation Ruling TR 2012/5 to clarify when a dividend paid in compliance with the definition of dividend under the *Corporations Act* would be assessable for tax purposes and the circumstances in which any such dividend would be frankable or unfrankable.

**Executive Summary**

We provide an explanation of the following:

* the requirements of section 254T of the *Corporations Act*, which essentially set out the criteria as to when a dividend can be paid in accordance with the *Corporations Act*
* Taxation Ruling TR 2012/5, which outlines the Australian Taxation Office’s (**ATO**) view on what will constitute a dividend for tax purposes and whether or not it can be franked.

**Amendments to section 254T of the *Corporations Act***

Section 254T of the *Corporations Act* historically provided that a dividend may only be paid out of profits of a company (the profits test). It was generally accepted that ‘profits’ in this context meant retained or ascertained accounting profits of a permanent character.

However, from 28 June 2010, the test as to when a dividend was paid became a three pronged ‘balance sheet test’ stating that a company must not pay a dividend unless:

1. the company’s assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend
2. the payment of the dividend is fair and reasonable to members as a whole
3. the payment of the dividend does not materially prejudice the company’s ability to pay its creditors.

For these purposes assets and liabilities are calculated in accordance with prevailing accounting standards.

**Amendment to section 44 of the *Income Tax Assessment Act* 1936**

In response to the changes to the *Corporations Act*, section 44(1A) was inserted into the *Income Tax Assessment Act 1936* (***ITAA 1936***).

Section 44(1A) ensures that a dividend paid out of an amount other than profits (e.g. unrealised capital profit reserves) is taken to be a dividend paid out of profits and would ordinarily be assessable income in the hands of a resident shareholder.[[1]](#footnote-2)

This rule operates as a catch-all provision and ensures that company distributions that are paid in reliance on the ‘net assets’ test in section 245T of the *Corporations Act* (and not out of profits) continue to be assessable in the hands of shareholders under section 44 of the *ITAA 1936*.[[2]](#footnote-3)

Following these amendments, the ATO issued a Discussion Paper that raised some concerns over the ability of a company to frank a dividend that is not paid out of profits – e.g. where a company pays a dividend and does not have a positive retained profits balance at the end of the year. In these circumstances, there was a concern whether the dividend could be said to be sourced directly or indirectly out of share capital and as a result be regarded as an unfrankable distribution.[[3]](#footnote-4)

It was clear from the Discussion Paper that if such a dividend was indirectly sourced out of share capital this would lead to an undesirable outcome in that a shareholder would be taxed on what is essentially a return of share capital without any franking credit relief.

**Taxation Ruling TR 2012/5**

In this ruling, the Commissioner sought to clarify the taxation of dividends paid in compliance with section 254T of the *Corporations Act* and to clarify how such distributions would be treated for tax purposes given the definition of “dividend” under section 6(1) of the *ITAA 1936* and whether such amounts were frankable under Part 3-6 of the *Income Tax Assessment Act* *1997* (***ITAA 1997***).

The key points made in the ruling are as follows.

1. *What constitutes a dividend for tax purposes?*

Paragraph 36 of the ruling provides that the better view is that dividends can only be paid from profits and not from amounts other than profits for the purposes of the *Corporations Act* and company accounting.

Accordingly, the Commissioner ‘s view is that the amendments to section 254T of the *Corporations Act* should be regarded as imposing three specified additional restrictions as to when a dividend can be paid.

In reaching this conclusion the Commissioner also noted in paragraph 36 of the ruling that “…inherently a dividend can only be paid out of profits, having regard to the ordinary and legal meaning of the word.”

Alternatively, the Commissioner noted in paragraph 37 of the ruling that if a contrary view was taken that a dividend can be paid out of an amount other than profits, the distribution would satisfy the definition of dividend under section 6(1) of the *ITAA 1936* and would be frankable provided the company’s net assets exceeded its share capital by at least the amount of the dividend.

1. *Dividend paid out of current trading profits - frankable*

A company that pays a dividend to its shareholders in accordance with its constitution and the *Corporations Act*, that is paid out of current trading profits recognised in its accounts and which are available for distribution, is not prevented from franking the dividend merely because the company has unrecouped prior year accounting losses, or has lost part of its share capital.

However, the ruling indicates that great care must be taken when accounting for any current year profits in a company’s books, as any appropriation of those current year profits (to recoup prior year accounting losses) prior to the distribution would mean that any dividend paid that is attributable to those profits would arguably be unfrankable on the basis that there are no current year profits.

1. *Dividend paid out of an unrealised capital profit – sometimes frankable*

A company that pays a dividend to its shareholders in accordance with its constitution and 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 from franking the dividend provided the company’s net assets exceed its share capital by at least the amount of the dividend.

However, where a company has a deficiency in net assets below its share capital, whether a dividend can be paid out of an unrealised capital profit of a permanent character and whether it would be a frankable distribution depends on the specific circumstances concerning the deficiency including the loss of subscribed capital, the nature of the unrealised profits and whether the company’s accounts reveal other profits and losses.

1. *Distribution that is an unauthorised reduction and return of share capital - unfrankable*

The ruling emphasises that a distribution (even if it is labeled as a dividend) paid by a company to its shareholders, that does not comply with the net assets tests under the *Corporations Act* is in all likelihood an unauthorised reduction in and return of share capital. Such a distribution would prima facie be treated as capital proceeds for a CGT event, such as CGT event G1 which applies where a capital payment is received in respect of a share owned in a company. However, the ATO does concede that such a distribution could still in some circumstances be an assessable unfrankable dividend.

In summary, it appears that whilst the ATO accepts that a payment to shareholders from an amount other than profits is acceptable under the *Corporations Act* and will often be a dividend for tax purposes, their interpretation and application of the franking provisions make it particularly unattractive to do so in certain circumstances.

**Introduction of temporary loss carry back rules**

In the 2020-21 Federal Budget, the government announced the introduction of a temporary loss carry back. The loss carry back rules have now been enacted and allow companies with an aggregated turnover of less than $5 billion to carry back a tax loss for the 2020, 2021, 2022 or 2023 income years and apply it against tax paid in a previous year (as far back as the 2019 income year).

The amount of the loss carry back for the 2020, 2021, 2022 or 2023 income year is limited to the lower of the amount of tax paid in earlier income years, being the 2019, 2020, 2021 or 2022 income years (as relevant) and the amount of the franking account balance at the end of the current income year.

It is therefore important when determining whether or not to pay franked dividends to shareholders to be mindful that the amount of any potential loss carry back will be impacted by the franking account balance.

**Proposed changes**

In February 2023, the government introduced legislation into Parliament to amend the tax laws in relation to:

* preventing companies from attaching franking credits to distributions to shareholders made outside or additional to the company’s normal dividend cycle, to the extent the distributions are funded directly or indirectly by capital raising activities that result in the issue of new equity interests and
* changing the franking rules for listed companies in relation to on-market share buybacks and selective share capital reductions.

If you have further queries on any details contained within this letter or on any other matter, please do not hesitate to contact me on [insert telephone number].

Yours faithfully

[Insert Name and Title]

1. Section 44(1A) of *ITAA 1936* states: ‘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.’ [↑](#footnote-ref-2)
2. Refer to Taxation Ruling TR 2012/5. [↑](#footnote-ref-3)
3. Refer to paragraph 202-45(e) of the *ITAA 1997*. [↑](#footnote-ref-4)