[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 sets 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.
* New legislative changes to:
	+ dividends funded by capital raisings, and
	+ off-share market buy-backs and selective share cancellations by listed public companies.

**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 the 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 notes 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 notes 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*, which is paid out of current trading profits recognised in its accounts and is 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*, which is paid out of an unrealised capital profit of a permanent character recognised in its accounts and is 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.

If 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 be a frankable distribution depends on the specific circumstances concerning the deficiency. These circumstances include:

* 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, which does not comply with the net assets tests under the *Corporations Act*, is in all likelihood an unauthorised reduction and return of share capital. Such a distribution would prima facie be treated as capital proceeds for a CGT event. For example, CGT event G1 may apply where a capital payment is received in respect of a share owned in a company. However, the ATO concedes that such a distribution could still, in some circumstances, be an assessable unfrankable dividend.

In summary, whilst it appears 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.

**Dividends funded by capital raising**

New Legislation prevents distributions made on or after 28 November 2023, from being frankable if funded (either wholly or in part) by capital raisings under section 202-45(ea) of the *ITAA 1997*.

The purpose of this new change is to discourage artificial or contrived arrangements where capital is raised to fund the early release of franking credits on dividends, with the overall outcome not resulting in any significant change to the financial position of the entity.

Broadly, a distribution (either wholly or in part) made by an entity will be unfrankable all of the following conditions are satisfied:[[4]](#footnote-5)

1. either of the following apply (“established practice condition”):
	1. the entity has a practice of making distributions of that kind on a regular basis and the relevant distribution is not made in accordance with that practice, or
	2. the entity does not have a practice of making distributions of that kind on a regular basis,
2. there is an issue of equity interests in the entity or another entity (whether before, at or after the time at which the relevant distribution was made),
3. it is reasonable to conclude having regard to all relevant circumstances that:
4. the principal effect of the issue of any of the equity interests was the direct or indirect funding of a substantial part of the relevant distribution or the relevant part, and
5. any entity that issued, or facilitated the issue of, any of the equity interests did so for a purpose (other than an incidental purpose) of funding a substantial part of the relevant distribution or the relevant part,
6. the issue of equity interests was not a direct response in order to meet a requirement, direction or recommendation from APRA or ASIC.

In considering whether the above conditions are satisfied, the Commissioner will take into account a range of different matters. These are outlined in sections 207-159(2)-(4) of the *ITAA 1997*.

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)
4. Refer to section 207-159 of the *ITAA 1997*. [↑](#footnote-ref-5)