

## New Dividend Payment Rules 2010

From 28 June 2010, the law relating to the payment of dividends by companies has changed, including the replacement of the traditional "profits test" for determining whether a company can pay a dividend. As a result, companies now need to ensure that:

- their constitutions are consistent with the new law;
- they are aware of the new tests that apply in determining whether a company is permitted to pay a dividend (and what the limits are on the amount of the dividend);
- procedures, minutes and supporting documentation in relation to directors' determination of whether or not to pay a dividend are updated; and
- they are aware of the taxation consequences that are likely to apply.

### What are the new requirements to be met before a company can pay a dividend?

Previously, a company could only pay dividends out of the company's profits.<sup>1</sup> The *Corporations Amendment (Corporate Reporting Reform) Act 2010* has replaced this requirement on and from 28 June 2010, so that a company may only pay a dividend if **each** of the following three tests is satisfied.

Test	Explanation
Balance sheet test	The company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend.
Fair to shareholders	The payment of the dividend is fair and reasonable to the company's shareholders as a whole.
No material prejudice to creditors	The payment of the dividend does not materially prejudice the company's ability to pay its creditors.

### Practical considerations for companies in assessing the three tests

#### Balance sheet test

Under this test, the assets of the company that is paying the dividend must exceed its liabilities, and the excess must be sufficient for the payment of the dividend. Some issues that companies will need to consider in applying this test are as follows.

- The balance sheet test is to be applied immediately before the time that the dividend is **declared**. This raises two timing issues. Firstly, this timing requirement has the effect that **directors must now declare dividends**, rather than determine to pay a dividend at a future date.<sup>2</sup> A dividend is treated as a debt owing by the company at the time that a dividend is declared<sup>3</sup>, whereas merely fixing the time for payment of a dividend (that is, where the directors determine to pay a dividend at a future date) does not create a debt until the time fixed for payment arises, and the decision to pay the dividend can be revoked at any time before then. Accordingly directors need to assess the company's ability to pay

the dividend both at the time of declaration and at the (future) date when the dividend will be paid. Directors may consider reducing the period between the date of declaration of the dividend and the date when it is paid where there is a risk of material changes to the company's financial position and outlook between the two dates.

Secondly, **the balance sheet test must be met immediately before the dividend is declared**. A dividend will usually be declared some time after the date as at which the company's most recent audited or audit-reviewed financial reports were prepared. It appears that directors cannot solely rely on the company's most recent set of audited or audit-reviewed financial reports to assess whether the company meets the balance sheet test. Directors will need to consider the weight to place on unaudited management accounts, particularly where the headroom between assets and liabilities is tight, such as might be the case where the company's asset values are marked to market and the market is volatile.

- Assets and liabilities are to be calculated 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**. As a result, directors will need to consider, for example, the potential for non-cash adjustments to fair values of assets to affect the company's asset level at the time the dividend is to be declared.
- Small proprietary companies that do not prepare and/or have audited financial statements (and some large proprietary companies that prepare special purpose financial statements that do not apply all accounting standards) need to take particular care to ensure that, when assessing the balance sheet test, they have taken into account all accounting standards relating to impairment write-downs; possible unrecognised liabilities such as derivatives, deferred tax liabilities, restoration provisions, share-based payment liabilities, deferred revenue and annual leave and long service leave provisions that may not be recorded; proper recognition of revenue and liabilities and proper classification of debt and equity – as the application of such standards may result in a different balance sheet than the internal management accounts.
- This balance sheet test is to be applied on an individual company (rather than whole of group) basis. That is, a company in a corporate group which fails the balance sheet test may not pay a dividend even if the group as a whole would meet the balance sheet test.

#### Fair to Shareholders

The dividend must be fair and reasonable to the company's shareholders as a whole. No guidance has been given as to what circumstances may lead to a payment of a dividend not being fair or reasonable. This test will not be difficult to meet where the company has only one class of shares and all have the same dividend rights. For example, for a public company, all shares of the same class must have the same dividend

rights (unless the constitution provides otherwise).<sup>4</sup> However a company may have different classes of shares with different dividend entitlements. Will a dividend payment to one class of shareholders effectively strip the company of surplus assets that may otherwise have been payable to another class in priority on a winding up? If so, the payment of the dividend to the first class may not (depending on other circumstances surrounding the dividend) be fair and reasonable to the company's shareholders as a whole.

### **No material prejudice to creditors**

Payment of the dividend must not materially prejudice the company's ability to pay its creditors.

A note to the new section 254T states that the payment of a dividend that results in the company being insolvent is an *example* of a dividend materially prejudicing the company's ability to pay its creditors. It would seem to follow that the payment of a dividend could be said to materially prejudice a company's ability to pay creditors without the company necessarily being insolvent as a result.

Whilst no other guidance has been provided on this test, presumably any prejudice must be real and substantial, rather than theoretical and minor: by its nature, the payment of a dividend reduces company assets and accordingly would prima facie in most circumstances reduce the company's capacity to pay creditors. In the only reported case to discuss the meaning of "material prejudice" (*CSR Limited*<sup>5</sup>) – albeit in the context of the (same) test which applies to the capital reduction provisions of the Corporations Act,<sup>6</sup> the Federal Court said,

*"[w]hether prejudice is 'material' will be a question of judgment to be determined in light of all relevant circumstances...One is, we think, on safe ground, however, in treating "material prejudice" to a company's ability to pay its creditors as relating to the creation of a material as opposed to theoretical increase, in the likelihood that the reduction in capital will result in a reduced ability to pay creditors".*<sup>7</sup>

If, on a reasonably predictable or plausible (as opposed to merely theoretical) scenario, the company will not be able to pay all of its creditors, then the company's ability to pay its creditors is likely to be materially prejudiced by the payment of the dividend.

## **What should companies be doing now?**

### **1. Make sure your constitution is up to date (and don't forget your subsidiaries!)**

Some company constitutions provide that dividends may only be paid out of profits. Companies whose constitutions contain such provisions should consider having them amended at upcoming shareholder meetings so that they align with the new law. If your constitution includes the old profit test and you do not amend it, then you will need to meet the profits test in addition to the three new tests outlined above.

In our view, on balance, constitutions should also provide for the declaration of dividends. The application of the balance sheet test literally depends on a dividend being declared, and without a power to declare dividends, there may be doubt about the source of the directors' authority to make the declaration.

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### **2. Update your procedures for evaluating whether to pay a dividend**

Procedures should reflect a process that enables directors to properly assess the company's compliance with the three new tests as part of the directors' overall dividend assessment. This should include receiving all documents and other information as directors may require to properly assess the financial position of the company. This is particularly important when assessing whether to declare an interim dividend or any other dividend at a time when directors may not have access to up-to-date audited financial reports.

### **3. Consider the ASX Listing Rules regarding options and convertible shares**

One apparent effect of the new section 254T is that, with the abolition of the profits test, capital can be returned to shareholders without complying with the shareholder approval requirement in section 256B of the Corporations Act if the three section 254T tests are met.<sup>8</sup> However, for companies that are listed on the ASX and are intending to effect reductions of capital through dividends (rather than just utilising dividends for the distribution of profits), the application of the ASX Listing Rules relating to adjustments to the terms of options and convertible securities will need to be considered.

### **4. Be aware of the tax consequences**

Consequential amendments to the *Income Tax Assessment Act 1936* (Cth) mean that a dividend not paid out of profits (that is, a dividend that is, in whole or in part, a payment of capital), will be treated for tax purposes as if it were paid out of profits and so will be assessable in the hands of shareholders. The Explanatory Memorandum to the *Corporations Amendment (Corporate Reporting Reform) Bill 2010* notes that, subject to integrity rules, dividends paid out of capital should be capable of being franked. When paying dividends in excess of profits, companies will need to consider whether the ATO is likely to disallow shareholders the benefit of such franking credits under the integrity rules. The ATO has not as yet published any guidance in this respect.

Companies may also wish to consider the tax consequences of alternative methods of distributing capital, such as by way of capital reductions or share buybacks (although these methods of reducing share capital do require varying levels of prior shareholder approval).

1 Previous section 254T of the *Corporations Act 2001* (Cth) (the **Corporations Act**). The *Corporations Amendment (Corporate Reporting Reform) Act 2010* (Cth) replaces section 254T of the Corporations Act.

2 It is unclear whether this drafting in the legislation is simply a mistake or is intentional. In any event, unless and until section 254T is amended to remove the reference to the "declaration" of dividends, directors should declare (rather than determine to pay) dividends.

3 Section 254V(2) and section 588G(1A) (item 1) of the Corporations Act.

4 Section 254W of the Corporations Act.

5 *CSR Limited, in the matter of CSR Ltd* [2010] FCAFC 34.

6 Section 256B of the Corporations Act.

7 At [44] – [46] per Keane CJ and Jacobson J.

8 Shareholder approval will be required under section 256B for capital reductions where shares are to be cancelled. Also, section 256B does not have a balance sheet test, however generally speaking it would be unusual to find circumstances where a company that cannot pass the balance sheet test could reduce its share capital without materially prejudicing its ability to pay creditors.

**Amendments to your company  
constitutions \$198<sup>inc GST</sup>**

**Ph 1300 880 963  
for further assistance**