TR 2012/5 - Income tax: section 254T of the Corporations Act 2001 and the assessment and franking of dividends paid from 28 June 2010

Taxation Ruling

Income tax: section 254T of the *Corporations Act 2001* and the assessment and franking of dividends paid from 28 June 2010

Contents Para

This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant 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.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

[**Note:** This is a consolidated version of this document. Refer to the Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]

What this Ruling is about

1. This 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. This includes the definition of a dividend for taxation purposes under subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936), the assessment of dividends under section 44 of the 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 for taxation purposes. This Ruling is not about non-share dividends or returns paid on non-equity shares.

Definitions

2. For the purposes of this 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 a financial year that meet those requirements. For the purposes of this Ruling, accounts do not include general ledger accounts or journal entries.

> **'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 include[2] 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 account of the company. 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.

> **'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 under paragraph 202-45(e) of the ITAA 1997.

> '**Net assets**' means the amount by which a company's assets exceed its liabilities, calculated in accordance with accounting standards in force at the relevant time (even if the standard does not otherwise apply to the financial year or company concerned).[3]

---

[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 (AASB), 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] See section 254T of the Corporations Act. See also the 'AASB Framework for the Preparation and Presentation of Financial Statements' at paragraphs 102 to 108.

'Profits' means profits recognised in a company's accounts which are available for distribution by way of dividend. Profits include: (i) revenue profits[4] from ordinary business and trading activities, dividends received from other companies, and realised capital profits recognised in the statement of financial performance in a company's accounts; and (ii) unrealised capital profits of a permanent character[5] recognised in a company's accounts. Note that in this Ruling, dividends sourced from revenue profits are contrasted to dividends sourced from unrealised capital profits of a permanent character and are treated differently in terms of a company's ability to frank a dividend, having regard to the company's net asset position compared to its share capital. Profits do not include amounts of income or loss included in the other comprehensive income statement[6] irrespective of the fact that those amounts contribute to the retained earnings/accumulated loss account in the statement of financial position in a company's accounts.[7]

'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,[8] or any other account (whether or not called a share capital account) that satisfies 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.[9]

---

[4] See *Marra Developments Ltd v. B W Rofe Pty Ltd* [1977] 2 NSWLR 616 at 630-631 per Mahony JA; and *QBE Insurance Group Ltd & Ors v ASC & Anor, NRMA Insurance Ltd v. ASC* (1992) 38 FCR 270 at 286-287 per Lockhart J.

[5] See *QBE Insurance Group Ltd & Ors v. ASC & Anor, NRMA Insurance Ltd v. ASC* (1992) 38 FCR 270 at 287 per Lockhart J, *Australasian Oil Exploration Ltd v. Lachberg & Ors* (1958) 101 CLR 119 at 133 per Dixon CJ, McTiernan & Taylor JJ; and *FCT v. Sun Alliance Investments Pty Ltd (in liq)* (2005) 225 CLR 488 at 510-511 per Gleeson CJ, Gummow, Kirby Callinan & Heydon JJ.

[6] Other comprehensive income includes amounts such as foreign exchange gains and losses on translation events; cash flow hedges; revaluation reserves; and actuarial gains and losses on defined benefit plans – see AASB 101 paragraphs 90-98. Other comprehensive income amounts are generally impermanent and may be subject to further fluctuation before becoming profits as a result of realisation. See also the decision of the High Court in *FCT v. Sun Alliance Investments Pty Ltd (in liq)* (2005) 225 CLR 488 at 511 paragraph [64].

[7] The definition of profits for the purposes of this Ruling is limited to the application of section 254T of the Corporations Act. The meaning of profit for the purposes of section 44 of the ITAA 1936, which is governed by a large body of judicial and legislative material, is not discussed in this Ruling.

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

[9] At the time of writing, a decision of the Federal Court concerning the construction of section 975-300 was the subject of an application for special leave to appeal to the High Court: *Consolidated Media Holdings Ltd v. FCT* [2012] FCAFC 36; 2012 ATC 20-308. This Ruling therefore does not address the proper construction of section 975-300 of the ITAA 1997.

Ruling

3. Paragraph 202-45(e) of the ITAA 1997 does not prevent a company from franking a dividend paid to its shareholders that is paid out of profits recognised in the company's accounts and available for distribution, and is paid in accordance with the company's constitution and without breaching section 254T or Part 2J.1 of the Corporations Act, merely because the company has unrecouped accounting losses accumulated in prior years or has lost part of its share capital.[10] That dividend will be assessable income of its resident shareholders under paragraph 44(1)(a) of the ITAA 1936.[11]

4. Paragraph 202-45(e) of the ITAA 1997 does not prevent a company from franking a dividend paid to its shareholders out of an unrealised capital profit of a permanent character recognised in its accounts and available for distribution, provided that the company's net assets exceed its share capital by at least the amount of the dividend,[12] and the dividend is paid in accordance with the company's constitution and without breaching section 254T or Part 2J.1 of the Corporations Act. That dividend will be assessable income of its resident shareholders under paragraph 44(1)(a) of the ITAA 1936.[13]

5. Paragraph 202-45(e) of the ITAA 1997 prevents the franking of a distribution paid by a company to its shareholders where that distribution is a reduction or return of share capital, including an unauthorised reduction or return of share capital that does not comply with section 254T or Part 2J.1 of the Corporations Act, even if it is labelled as a dividend. That distribution will be taxed as a capital gains tax (CGT) event under the CGT 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.

6. Whether profits are available for distribution as a dividend by a company or not, and have been distributed as a dividend in compliance with the law, or not, depends on the operation of the provisions of the Corporations Act, on the constitution of the distributing company, and on the acts or omissions of its directors and members, and not on the terms of the ITAA 1936 or the ITAA 1997. No ruling is made in respect of these matters. However, some practical observations appear in the Explanation at paragraphs 20 to 26 and 44 to 54 of this Ruling, and in the Examples at paragraphs 8 to 16 and Further Examples at paragraphs 73 to 86 of this Ruling.

---

[10] See *Ammonia Soda Co Ltd v. Chamberlain* [1918] 1 Ch D 266 at 283-285; *Re National Bank of Wales* [1899] 2 Ch 629 at 699-671; *Verner v. General and Commercial Investment Trust* [1894] 2 Ch 239 at 266-267.

[11] Subject to exceptions such as the shareholder being exempt.

[12] *Lubbock v British Bank of South America* [1892] 2 Ch 198 at 201; *Australasian Oil Exploration Ltd v Lachberg & Ors* (1958) 101 CLR 119 at 133; *QBE Insurance Group Ltd & Ors v. ASC & Anor, NRMA Insurance Ltd v. ASC* (1992) 38 FCR 270; (1992) 110 ALR 301; and *Dimbula Valley (Ceylon) Tea Co* v. *Laurie* (1961) Ch 353.

[13] Subject to exceptions such as the shareholder being exempt.

Date of effect

7. This Ruling applies from 28 June 2010. 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
27 June 2012

Appendix 1 – Explanation

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

Examples of dividends paid out of profits

8. The following examples (and those set out in the Further Examples at paragraphs 73 to 86 of this Ruling) are intended to illustrate the taxation principles set out in the Ruling section at paragraphs 3 to 6 of this Ruling and the issues discussed in the Explanation at paragraphs 8 to 72 of this Ruling. They do not appear in the Ruling section because they reflect the operation of the Corporations Act. For the purposes of the examples it is assumed that the requirements of the Corporations Act,[14] the Australian Accounting Standards and the company's constitution have been complied with. It is also assumed that the company is a going concern and the company's accounts have entries preceding those represented here.

[14] For example the entity is a reporting entity that is required to prepare financial reports in accordance with Part 2M of the Corporations Act and must comply with the requirements of the accounting standards. Further, the directors of the entity are required under section 295(4)(d) of the Corporations Act to make a declaration as to whether a company's financial statements comply with the accounting standards.

Example 1: interim dividend[15] *determined and final year dividend declared,*[16] *and both paid out of profits netted off against accumulated losses*

9. *The accounts of Youyang Ltd disclose an accumulated loss position of ($100) as at 30 June 2011. Youyang Ltd's half year reporting date is 31 December.*[17] *For the six months ending 31 December 2011, Youyang Ltd makes $25 of profits (current period profits). On 29 February 2012, Youyang Ltd prepares and lodges an interim financial report with the Australian Stock Exchange (ASX) pursuant to Appendix 4D of the ASX Listing rules 4.1 to 4.2C. That report is in the same form as the company's statutory half yearly accounts also lodged with the Australian Securities and Investments Commission (ASIC).*[18]

10. *On 29 February 2012, Youyang Ltd makes a market announcement that it will distribute a dividend from the $25 profit.*

11. *The interim financial report/half yearly statutory accounts of Youyang Ltd*[19] *show $65 of net accumulated losses [as it has offset the $100 accumulated loss with the $25 of profit for the six month period ending 31 December 2011 and it also has $10 of other comprehensive income (disclosed in 'Other Reserves' in the Balance Sheet), which for the purposes of this Ruling does not constitute 'profit']. Youyang Ltd's interim accounts are as follows:*

[15] Note that AASB 110 'Events after Reporting Period' at paragraph 12 requires that where an entity declares dividends to holders of equity instruments after the reporting date, the entity shall not recognise those dividends as a liability at the reporting date. Therefore, only dividends declared before the end of the reporting date can be recognised as a liability in the accounts. For the purposes of the Examples in paragraphs 8 to 16 of this Ruling, however, no liability is recognised in the accounts as the interim dividend is determined rather than declared. Further, the Commissioner will look to factors beyond whether the liability is recognised in the accounts when determining the source of the dividend for taxation purposes.

[16] The application of section 254V(2) of the Corporations Act, which provides that a debt is incurred at the time of declaration if so provided by the entity's constitution, should not impact the taxation consequences of this example.

[17] Section 302 of the Corporations Act.

[18] Division 302 of Part 2M.3 of the Corporations Act.

[19] Prepared in accordance with the requirements of Division 2 of Part 2M.3 of the Corporations Act.

	30 June 2011 – full year accounts	*31 December 2011 – interim/half year accounts*
Statement of comprehensive income		
Profit and loss		
Current year profit	*0*	*25*
Other comprehensive income		
Net change in other reserves	*0*	*10*
Total comprehensive income	*0*	*35*[20]
Statement of changes in equity		
Accumulated profit/(loss) reserve		
Opening	*(100)*	*(100)*
Current year profit	*0*	*25*
Subtotal	*(100)*	*(75)*
Other comprehensive income	*0*	*10*
Closing (all reserves)	*(100)*	*(65)*
Balance sheet		
Cash	*90*	*110*
PPE	*20*	*35*
Net assets	*110*	*145*
Share capital	*210*	*210*
Other reserves[21]	*0*	*10*
Accumulated profit/(loss) reserve	*(100)*	*(75)*
Equity	*110*	*145*
Notes to the financial statements		
Reconciliation of movement in retained profits/accumulated losses		
Opening Balance	*(100)*	*(100)*
Net Profit		*25*
Dividends Paid		*0*
Closing Balance	*(100)*	*(75)*
Dividends paid or provided for during the reporting period		
Interim dividend proposed for period ended 31/12/11 (the financial effect of this dividend will be recognised in subsequent financial reports)	*0*	*20*
	0	*0*

[20] Note that the amount in other comprehensive income is not included in the definition of 'profit' for the purposes of the income tax law.
[21] Constituting $10 of other comprehensive income as per the Statement of Comprehensive Income.

12. *A meeting of the directors of Youyang Ltd approves the accounts and passes a resolution determining to pay a dividend of $20 from the $25 of current year profits. On 1 April 2012, Youyang Ltd pays a dividend of $20 to its shareholders.*

13. *In the second half of the financial year, Youyang Ltd makes further profits of $25. Youyang Ltd's final year accounts[22] lodged with ASIC (and financial reports lodged with the ASX) show net accumulated losses of $60 [as it has offset the $100 accumulated loss with the $50 of profit for the year ending 30 June 2012, and it has paid an interim dividend of $20, and it also has $10 of other comprehensive income (disclosed in 'Other Reserves' in the Balance Sheet), which for the purposes of this Ruling does not constitute 'profit']. No provision is made in the accounts for the final dividend not yet declared.[23] On 15 September 2012, a meeting of the directors of Youyang Ltd approves the accounts and declares a final dividend of $20. Youyang Ltd's accounts are as follows:*

[22] Prepared in accordance with Division 1 of Part 2M.3 of the Corporations Act.
[23] Per paragraph 12 of AASB 110 'Events after Reporting Period'.

	30 June 2011 – full year accounts	***30 June 2012 – full year accounts***
Statement of comprehensive income		
Profit and loss		
Current year profit	*0*	*50*
Other comprehensive income		
Net change in other reserves	*0*	*10*
Total comprehensive income	*0*	*60*
Statement of changes in equity		
Accumulated profit/(loss)		
Opening	*(100)*	*(100)*
Current year profit	*0*	*50*
Dividends paid to owner	*0*	*(20)*
Subtotal	*(100)*	*(70)*
Other comprehensive income	*0*	*10*
Closing (all reserves)	*(100)*	*(60)*
Balance sheet		
Cash	*90*	*100*
PPE	*20*	*50*
Net assets	*110*	*150*
Share capital	*210*	*210*
Other reserves[24]	*0*	*10*
Accumulated profit/(loss) account	*(100)*	*(70)*
Equity	*110*	*150*
Notes to the financial statements		
Reconciliation of movement in retained profits/accumulated losses		
Opening Balance	*(100)*	*(100)*
Net Profit		*50*
Dividends Paid		*(20)*
Closing Balance	*(100)*	*(70)*
Dividends paid or provided for during the reporting period		
Interim dividend paid for the period ended 31/12/11	*0*	*20*
Final dividend proposed for the year ended 30/06/12 (the financial effect of this dividend will be recognised in subsequent financial reports)	*0*	*20*
	0	*40*

[24] Constituting $10 of other comprehensive income as per the Statement of Comprehensive Income.

14. *As the $20 interim dividend determined to be paid and the final declared dividend of $20 are sourced from available profits (as evidenced by the accounts and the contemporaneous legally effective directors' resolutions approving the accounts and the dividend payments), they will be frankable, and will be assessable income of Youyang Ltd's resident shareholders. The offsetting or netting of profits against accumulated losses in the interim and final accounts indicates an appropriation of those profits against losses. However, the conclusion that profits have been appropriated against losses arising from the accounts is displaced by the legally effective resolution of the directors to pay a dividend at the same directors' meeting in which the accounts were approved. The $10 of 2012 profit carried to the accumulated loss account and undistributed by way of dividend is appropriated against prior year losses and ceases to be available for appropriation for distribution as a dividend.*

Example 2: final dividend declared and paid out of profits carried to a profits reserve, and there are accumulated losses

15. *The accounts of Listerfield Pty Ltd as at 30 June 2011 disclose an accumulated loss position of ($70) as a result of prior year activities. However, during the second half of the year ended 30 June 2012, Listerfield Pty Ltd performs more successfully, making profits. After the end of the 2012 financial year, a meeting of the directors of Listerfield Pty Ltd approves audited accounts in which the 2012 profits are booked.*[25] *Notes to the accounts record that a meeting of the directors resolved that those profits were not offset against Listerfield Pty Ltd's accumulated losses but were appropriated to a '2012 Profit Reserve'. Those profits are not otherwise made unavailable for distribution as a dividend. Listerfield Pty Ltd's statement of financial position (that is, the balance sheet) for the year ended 30 June 2012 is as follows:*

Assets and Liabilities		*Equity*	
Cash	*80*	*Share capital*	*140*
Property, plant and equipment	*20*	*Accumulated losses*	*(70)*
		2012 Profit Reserve	*30*
Net assets	*100*	*Total equity*	*100*

[25] For example, the current year profits are recognised in the annual financial reports or interim financial reports. Note that the financial reports and notes for a financial year are required to give a true and fair view of the entity (section 297 of the Corporations Act) and directors are prohibited from giving false or misleading information under section 1308 of the Corporations Act.

16. *A meeting of the directors of Listerfield Pty Ltd declares*[26] *a final dividend of $25 to be paid to shareholders from the profits of the 2012 financial year identified in the accounts and carried to the 2012 Profit Reserve. As the dividend is sourced from available profits, the $25 dividend will be frankable and will be assessable income of its resident shareholders. The remaining $5 in the 2012 Profit Reserve will retain its character as profit and be available for distribution in future years, provided the amount is not netted or offset against accumulated losses, or otherwise appropriated so that it becomes unavailable for distribution as a dividend.*

Explanation

17. This Ruling explains the taxation and franking consequences of the changes to the circumstances in which a company is prohibited from paying a dividend in compliance with section 254T of the Corporations Act and the consequential insertion of subsection 44(1A) of the ITAA 1936, which apply to company dividends declared[27] on or after 28 June 2010.

18. The Commissioner's views on the interpretation and operation of the Corporations Act are based on legal advice obtained from Senior Counsel.[28]

19. The proper treatment of a dividend payment for taxation assessment and franking purposes in each case is a question of the application of the Taxation Acts[29] and the Corporations Act to the facts and circumstances of the particular payment.[30]

Background

20. In *Commissioner of Taxation (NSW) v. Stevenson* (1937) 59 CLR 80 at 97, Rich, Dixon and McTiernan JJ stated:

> In all income tax legislation a difficulty has been found in determining the occasion when and the extent to which shareholders shall be taxed in respect of the profits of a company … The difference between capital and income depends upon the relation of the recipient to the source of the receipt [but] … [i]n systems of taxation which are not content with taxing the profits at the source in the hands of the company that earns them, but tax the shareholder in respect of the income which he derives from the share, it has not

---

[26] Alternatively, determines to pay (see section 254V of the Corporations Act).
[27] The reference to 'declare' in section 254T of the Corporations Act is taken to include a determination to pay a dividend.
[28] See the legal opinion 'Payment and Franking of Dividends' by A H Slater QC & J O Hmelnitsky obtained by the Commissioner on these issues, available at http://law.ato.gov.au/pdf/pbr/slater_and_hmelnitsky-payment_and_franking_of_dividends.pdf.
[29] The ITAA 1936 and the ITAA 1997.
[30] Including the company's constitution; minutes of meetings of the directors and shareholders; financial records, reports and statements; the actions and omissions of the company's directors and officers; and any other relevant facts and circumstances.

> been found possible to discriminate among the various shareholders according to the relation in which the individual stood to the particular profit distributed … [A]ll dividends are in such systems made taxable in the hands of the shareholder for the time being … The criterion adopted is usually that of the company law, namely, that without a return of the share capital of the company there has been a declaration of dividend and a payment accordingly.

21. While the income tax law has been much altered over the years, this statement remains essentially true.[31] The adoption (for some purposes) of a criterion for the taxation of shareholders which is 'that of the company law' has the consequence that the effect of a transaction between company and shareholders as a matter of company law may be relevant to, or even determinative of, the liability to income tax of the shareholder in respect of the dividend. Alterations of the company law may therefore bear upon the liability of shareholders to income tax. However, it is important to understand that company law is only relevant to the extent that it is adopted by the income tax law as a criterion for taxation. It is essential both to begin and end with an analysis of the relevant taxing provisions.

22. The principal provision bearing on the taxation of shareholders in respect of dividends is section 44 of the ITAA 1936. The main operative provision is subsection (1). Subsection 44(1) includes in the assessable income of a shareholder in a company (whether the company is a resident or a non-resident) in the case of a resident shareholder, dividends that are paid to the shareholder by the company out of profits derived by it from any source, and in the case of a non-resident shareholder, out of profits derived from sources in Australia.[32] But the reference to 'profits' is not a reference to profits for company law purposes,[33] and subsection 44(1A)[34] extends the operation of the section to dividends that are not paid from profits.

---

[31] Indeed subsequent amendments have if anything strengthened the link by reducing or eliminating the relevance of the character of the receipt in the hands of the shareholder. See the discussion in *FCT v. Slater Holdings Ltd* (1984) 156 CLR 447; (1984) 15 ATR 1299; 84 ATC 4883, and paragraphs 55 to 58 of this Ruling.
[32] These provisions parallel the source provisions formerly in section 25 of ITAA 1936 and now in section 6-5 of the ITAA 1997.
[33] See paragraphs 56 to 58 and 62 of this Ruling.
[34] Discussed at paragraphs 38 to 43 of this Ruling.

23. Importantly, however, 'dividend' is a defined term: see subsection 6(1) of the ITAA 1936. The definition in subsection 6(1) extends the meaning of the term beyond its ordinary meaning to include any distribution by a company to its shareholders in money or property, but subject to an exclusion in all cases for an amount debited to amounts standing to the credit of the company's share capital account. 'Share capital account' is defined by section 975-300 of the ITAA 1997. The references in section 975-300 to 'share capital' are references to a company's share capital for company law purposes. This is the first point at which the income tax law adopts company law as one of its criteria for taxation. An application of the definition of dividend to a company distribution requires consideration of whether it has been debited to amounts standing to the credit of a company's share capital account, which in turn requires consideration of what the company has done with its share capital as a matter of accounting and for company law purposes. The effect, broadly speaking, is to exclude from taxation as a dividend for income tax purposes a return of capital for company law purposes that is debited to an amounts standing to the credit of a share capital account as defined by section 975-300. A return of capital which is not a dividend under the ITAA 1936 or the ITAA 1997 is also not a 'distribution' in relation to the company for the purposes of those Acts: see section 960-120 of the ITAA 1997. Because it is not a 'distribution' it is also not a frankable distribution for the purposes of section 202-40 of the ITAA 1997.

24. A distribution may be a return of share capital for company law purposes yet not be debited to amounts standing to the credit of a share capital account, or may be debited in part only to that account. Such distributions may be dividends as defined and may be included in the assessable income of a shareholder under section 44 of the ITAA 1936 if the other requirements of that section are met. They may also be 'distributions' for the purposes of section 960-120 and section 202-40 of the ITAA 1997. However, a dividend or distribution is not a frankable distribution if it is sourced, directly or indirectly, from a company's share capital account: paragraph 202-45(e) of the ITAA 1997. This, for the reason explained above, is the second point at which income tax law adopts company law as one of its criteria for taxation. Unlike the definition of dividend in subsection 6(1) of the ITAA 1936, paragraph 202-45(e) of the ITAA 1997 does not require the amount of a distribution to be debited against amounts standing to the credit of the company's share capital account. Rather, it requires the distribution to be 'sourced', directly or indirectly, from it.

25. This ruling, for the reasons to be explained, broadly advances two propositions. First, a dividend paid by a company, or a distribution distributed by a company, as defined for taxation purposes, will not be directly or indirectly sourced in a company's share capital account when it is a lawful division of profit for company law purposes, and hence not a return of capital for company law purposes (whether authorised or unauthorised), because the two categories are, as *Commissioner of Taxation (NSW) v. Stevenson* (1937) 59 CLR 80 at 97[35] suggests, mutually exclusive. Second, a return of capital for company law purposes will be sourced in a company's share capital account even if it is a dividend or distribution for tax purposes.

26. It is against this background that the recent changes to the Corporations Act are examined.

27. Ruling on the taxation and franking of dividends paid in compliance with the new section 254T of the Corporations Act requires reconciling concepts arising under the Taxation Acts, the Corporations Act, previously decided case law, and present accounting standards. Previous case law[36] was predominately decided in light of previous accounting standards[37] and provisions of the Corporations Act, which differ in significant respects from those presently in force. For instance, under previous accounting standards, unrealised profits were booked to the balance sheet without being taken through the profit and loss statement, and capital profits had to be taken through the profit and loss statement as extraordinary items.

28. Movements in asset values that are now recognised as other comprehensive income were not always previously recognised. Under present accounting standards, the distinction between capital profits and trading profits is no longer uniformly required. Certain realised capital profits (such as a gain on disposal of a capital asset) are recognised as profits in the statement of financial performance.

---

[35] The main authority is *RA Hill v Permanent Trustee Company of NSW Ltd* [1930] AC 720.

[36] Such as the decisions in *QBE Insurance Group Ltd & Ors v. ASC & Anor, NRMA Insurance Ltd v. ASC* (1992) 38 FCR 270; *Marra Developments Ltd v. B W Rofe Pty Ltd* [1977] 2 NSWLR 616; *Australasian Oil Exploration Ltd v. Lachberg & Ors* (1958) 101 CLR 119; *Glenville Pastoral Co Pty Ltd (in liq) v. FCT* (1963) 109 CLR 199; *FCT v. Sun Alliance Investments Pty Ltd (in liq)* (2005) 225 CLR 488; [2005] HCA 70; 60 ATR 560; 2005 ATC 4955.

[37] That is, prior to 1 January 2005 when Australia adopted the International Financial Reporting Standards (IFRS). The AASB mirrors the standards formulated by the International Accounting Standards Board (IASB) rather than wholly adopting them. The introduction of IFRS based standards was an impetus for the AASB (then known as the Australian Accounting Research Foundation) to seek amendment of section 254T of the Corporations Act. See also Legislation Review Board of the Australian Accounting Research Foundation's 2002 Position Paper 'Payment of Dividends under the *Corporations Act 2001*'.

29. The links between the doctrines of capital maintenance and profits in the Corporations Act were previously more explicit, as were the links between the Corporations Act and the Taxation Acts, in respect of concepts such as share capital and profits. The changes resulting from the introduction of the International Financial Reporting Standards (IFRS) in 2005 were recognised by ASIC and the AASB as affecting the payment of dividends by corporate entities.[38]

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

30. 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:

(a) the company's assets exceed its liabilities immediately before the dividend declaration and the excess is sufficient for the dividend payment;

(b) the dividend is fair and reasonable to members as a whole; and

(c) creditors are not materially prejudiced.

Assets and liabilities are calculated in accordance with accounting standards in force at the time.[39]

31. 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.[40]

32. 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,[41] a dividend paid out of an amount other than profits is taken to be a dividend paid out of profits'.

---

[38] Australian Accounting Standards Board, *IFRS and distributable dividends,* 31 October 2005; Australian Securities & Investments Commission, *ASIC clarifies impact of IFRS on dividends,* IR 05-57, 5 October 2005.

[39] 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).

[40] See: *Industrial Equity Ltd & Ors v. Blackburn & Ors* (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. ASC & Anor, NRMA Insurance Ltd v. ASC* (1992) 38 FCR 270 at 285.

[41] Subsection 6(1) of the ITAA 1936 defines 'this Act' to include the ITAA 1997 and parts of the *Taxation Administration Act 1953*.

Effect of the new section 254T of the Corporations Act

33. 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.

34. 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 the payment of a dividend in compliance with section 254T, and to the assessment and franking of dividends for taxation purposes.

35. 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.[42] 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.[43]

36. 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.

---

[42] See *Henry v. Great Northern Ry Co* (1857) 27 LJ Ch 1 at 18, *Re Chelsea Waterworks Co and Metropolitan Water Board* (1904) 73 LJKB 532. *Halsbury's Laws of England*, 1983, Volume 7(1) 4th edn, Butterworths, London 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.'

[43] Beach J cited *Henry v. Great Northern Ry Co* (1857) 27 LJ Ch 1.

37. If, contrary to the Commissioner's view, a dividend can be paid out of an 'amount other than profits' and the distribution satisfies the definition of dividend under subsection 6(1) of the ITAA 1997, 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) of the ITAA 1936

38. Subsection 44(1A) was inserted into the ITAA 1936 to ensure that any company distributions that were not paid out of profits within subsection 44(1) of the ITAA 1936 but were paid as dividends in reliance on the new section 254T of the Corporations Act would 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.

39. 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 *Corporations Amendment (Corporate Reporting Reform) Act 2010* (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.

40. 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.

41. A payment that is a dividend paid or credited in compliance with the 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 account of the company.[44] However, this is not the basis upon which the ability to frank dividends is determined under Part 3-6 of the ITAA 1997.[45] Section 202-45 of the ITAA 1997 identifies those distributions which are not frankable. 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.

42. 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.[46] 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.

43. 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'. However, the payment of 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) of the ITAA 1936 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. Whether a dividend is sourced directly or indirectly from a company's share capital account within paragraph 202-45(e) of the ITAA 1997 does not turn on whether the distribution is deemed to be paid out of profits.

Profits

44. 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 or declaring a dividend, or in the documentation that accompanies or supports the resolution, or in notes to the accounts.

---

[44] See the definition of 'dividend' in subsection 6(1) of the ITAA 1936.
[45] Subject to the operation of section 177EA of the ITAA 1936, the general anti-avoidance provision specifically dealing with the receipt of imputation benefits.
[46] See paragraph 3.18 of the Explanatory Memorandum to the CACRRA.

45. 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 a dividend.[47]

46. For the purposes of administering the taxation and franking of dividends under the ITAA 1936 and the ITAA 1997, profits are generally considered to be available for distribution as a dividend if they have not been appropriated or earmarked for other purposes. Prima facie, offsetting or netting profits against accumulated losses may amount to an appropriation of those profits for that purpose, rendering the profits unavailable for distribution as a dividend. There are various ways in which profits may be identified as not earmarked or appropriated for purposes other than payment of a dividend.

47. One way of ensuring that profits are available for dividend distribution for taxation purposes is, as a result of a directors resolution reflected in the accounts or approving the accounts, to carry the profits for a particular year to a separate profit reserve in the statement of financial position and the statement of changes in equity in a company's accounts, rather than to reduce the balance of accumulated losses carried forward by offsetting or netting the profits against the accumulated losses account in those statements.[48] (See Example 2 at paragraphs 15 and 16 of this Ruling).

48. Where the profits of a particular year are offset or netted against accumulated losses in the statement of financial position and the statement of changes in equity in the interim or final accounts, another way of ensuring that profits are nevertheless available for dividend distribution for taxation purposes is to pass a legally effective resolution determining or declaring to pay a dividend out of the profits of that year or half year at the same directors' meeting as that at which the accounts are approved by the directors.[49] Such a resolution will generally displace the conclusion that the netting or offsetting of profits against accumulated losses in the accounts is an appropriation of the profits against accumulated losses. (See Example 1 at paragraphs 9 to 14 of this Ruling).

---

[47] 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 by AH Slater QC & JO Hmelnitsky 'Payment and Franking of Dividends', obtained by the Commissioner on these issues, available at http://law.ato.gov.au/pdf/pbr/slater_and_hmelnitsky-payment_and_franking_of_dividends.pdf). See also *Ford's Principles of Corporations Law* online edition at para [18.190]

[48] See *FCT v. Miller Anderson Ltd* (1946) 73 CLR 341; [1946] HCA 2 per Dixon J.

[49] The approval of an entity's financial statements and accounts must comply with the financial reporting requirements outlined in Part 2M of the Corporations Act. The decision to pay a dividend must be legally effective and binding under the Corporations Act. The board minutes must be kept in accordance with statutory provisions under the Corporations Act including provisions that make it an offence for a person to make or authorise a false or misleading statement or document. Board minutes are evidence of the truth of what they represent (see *ASIC v. Hellicar & Ors* [2012] HCA 17 at paragraphs 63 and 65 per French CJ, Gummow, Hayne, Crennan, Kiefel & Bell JJ).

49. Netting or offsetting of profits against accumulated losses in the accounts may not be conclusive of an appropriation against losses, and that conclusion can be displaced as discussed at paragraph 48 of this Ruling. However, where profits are offset or netted against accumulated losses in the accounts and there is no other evidence that is inconsistent with the application of profits against losses in the accounts, it will generally be concluded that profits are no longer available for dividend distribution. Any dividends subsequently purportedly paid out of them would be taxed either as an unfrankable dividend, or a return of share capital subject to the capital gains tax provisions, depending on the particular facts and circumstances. For this reason, for taxation purposes, it is essential for a company to maintain proper evidence of legally effective directors' resolutions and accounts that establish that profits are available for distribution as a dividend, and are properly applied to dividend distributions at the relevant time.

50. To the extent that profits offset or netted against accumulated losses in the statement of financial position and the statement of changes in equity in a company's accounts are not appropriated for dividend distribution (by declaration of, or determination to pay, a dividend by a meeting of the directors) at the time the final year accounts are approved by the directors, it would generally be concluded that they have been appropriated to the reduction of prior year losses in the company's subsequent accounts, and are thereafter no longer available for distribution as a dividend in subsequent periods.[50]

51. Proprietary limited companies may not be required to maintain audited accounts kept in accordance with Australian Accounting Standards. However, for the purpose of section 254T of the Corporations Act, a company's assets and liabilities must be calculated in accordance with the accounting standards, even if they do not otherwise apply.[51] Although accounting standards and auditing requirements may not apply, for taxation purposes, proprietary companies should also ensure that profits are available for distribution and are validly paid as dividends in accordance with the principles set out in this Ruling. Proprietary companies should maintain similar records and evidence concerning the availability and appropriation of profits for payment of dividends as set out in the Ruling section in paragraphs 3 to 6 and the Examples at paragraphs 9 to 16 of this Ruling, to ensure that dividends paid to shareholders are frankable.

[50] See *Marra Developments Ltd v. BW Rofe Pty Ltd* [1977] 2 NSWLR 616 at 631 per Mahoney J.
[51] Although there may be reduced disclosure requirements under AASB 1053.

52. A company paying a dividend to shareholders must itself have sufficient ascertained profits available for appropriation for the distribution of the dividend.[52] Accounts will often be prepared on a consolidated basis for a corporate group that consists of a parent company listed on the Australian Stock Exchange and its subsidiary companies. Consolidated accounts[53] including the parent entity disclosures (which are often in a note to the financial report) will provide sufficient evidence of the existence of profits, and of the appropriation of profits for declaration, or in the case of determination, payment, of a dividend (in conjunction with minutes of the board of directors and other company records), provided that the parent company, as a stand alone legal entity itself has profits available for appropriation for the distribution at the time of declaration, or in the case of determination, payment, of a dividend. Profits are ascertained in accordance with the company's constitution and accounts and the Corporations Act.[54] Section 44 of the ITAA 1936 and paragraph 202-45(e) of the ITAA 1997 are applied on that basis at the level of the individual company paying the dividend.

53. Similarly, for tax consolidated groups under Part 3-90 of the ITAA 1997, the head company itself must have ascertained profits available for appropriation for the distribution of a dividend at the time of determination or declaration and payment. Pursuant to Subdivision 709-A of the ITAA 1997, in a tax consolidated group, the head company maintains a single franking account for the entire tax consolidated group and the accounts of any subsidiary members essentially become inoperative.[55] Where a subsidiary joins a consolidated group, any surplus franking credits of the subsidiary member are transferred to the head company's franking account.[56] However, the availability of profits in the head company for the purposes of section 44 of the ITAA 1936 remains to be ascertained in accordance with the company's constitution and accounts and the Corporations Act.[57]

---

[52] *Industrial Equity Ltd & Ors v. Blackburn & Ors* (1977) 137 CLR 567 at 578-579 per Mason J; *Re CMPS & F Pty Ltd* (1997) 24 ACSR 728 at 730.
[53] Pursuant to AASB 127. See also *FCT v. Sun Alliance Investments Pty Ltd (in liq)* (2005) 225 CLR 488 at 512 per Gleeson CJ, Gummow, Kirby, Callinan & Heydon JJ.
[54] *Industrial Equity Ltd & Ors v. Blackburn & Ors* (1977) 137 CLR 567 at 576-579 per Mason J.
[55] Section 709-65 of the ITAA 1997.
[56] Subsection 709-60(2) of the ITAA 1997.
[57] *Industrial Equity Ltd& Ors v. Blackburn & Ors* (1977) 137 CLR 567; [1977] HCA 59.

54. In relation to the profits from which a dividend can be paid, in *QBE Insurance Group Ltd & Ors v. ASC & Anor, NRMA Insurance Ltd v. ASC* (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 & Ors* (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).[58]

The definition of 'dividend' for tax purposes

55. 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.

[58] 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.

56. 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[59] derived by the company. Thus, for taxation purposes, a dividend paid out of profits is assessable income of a shareholder in a company.[60]

57. The taxation law definition of dividend in subsection 6(1) of the ITAA 1936 is broader than the general law and Corporations Act meanings, and may include distributions that are not paid out of profits.[61] For taxation purposes misappropriations of company money or property, unauthorised payments and unauthorised dispositions of property by a company may be dividends in some circumstances, 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.

58. 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 account of the company is not a dividend for taxation purposes within the meaning of 'dividend' in subsection 6(1) of the ITAA 1936.[62] It will usually be a return of share capital taxed under the capital gains tax provisions in Part 3-1 of the ITAA 1997.

59. Generally a share capital account that has been tainted under Division 197 of the ITAA 1997 will not be considered a share capital account for the purposes of the taxation law except in certain circumstances provided for in subsection 975-300(3) of the ITAA 1997.[63] Thus, a distribution debited to a tainted share capital account will be a dividend as the exception in paragraph 6(1)(d) of the ITAA 1936 will not apply to tainted accounts as they are not regarded as share capital accounts.

60. However, subsection 975-300(3) of the ITAA 1997 provides exceptions to the general proposition that a tainted share capital account is not treated as a share capital account for the purposes of the Act. Specifically, paragraph 975-300(3)(ba)of the ITAA 1997 lists paragraph 202-45(e) of the ITAA 1997 as one such provision.

---

[59] The concept of profits here is wider then the definition of profits in paragraph 2 above. See *FCT v. MacFarlane* (1986) 13 FCR 356; (1986) 17 ATR 808; 86 ATC 4477.

[60] Provided, in the case of a shareholder who is a non-resident, that it is paid from profits derived by the company from sources in Australia. See also paragraph 3.17 of the Explanatory Memorandum to the CACRRA.

[61] See *FCT v. MacFarlane* (1986) 13 FCR 356; (1986) 17 ATR 808; 86 ATC 4477.

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

[63] The dictionary in section 995-1 of the ITAA 1997 states that a share capital account has the meaning given by section 975-300 of the ITAA 1997.

61. Where a company has a tainted share capital account, a distribution debited to that account will be a dividend which is assessable under subsection 44(1) of the ITAA 1936, and the dividend will be unfrankable under paragraph 202-45(e) of the ITAA 1997 because it is sourced directly from a share capital account.[64]

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

62. In applying the definition of dividend in subection 6(1) of the ITAA 1936 to a shareholder, 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 shareholder.[65] (See also Taxation Determination 2009/5 at paragraph 15.)[66] Hence it is also necessary in determining whether an amount is debited against an amount standing to the credit of the share capital account of a company to do so from the company's perspective; indeed, it would be difficult to do otherwise.

63. 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 which applies to in-specie distributions 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'.[67]

64. 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.

---

[64] Note that once tainted, all distributions out of the share capital account will be taxed as unfranked dividends unless and until the account is untainted via the payment of untainting tax.

[65] See *FCT 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 judgment in *FCT v. Uther* (1965) 112 CLR 630. This dissenting judgment 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.

[66] In *MacFarlane v. FCT* (1986) 13 FCR 356 at 376 it was held that even where the primary taxing provisions for company distributions (sections 44 and 47 of the ITAA 1936) required that the dividends be paid out of profits, they did not rely on, or require, the existence of the conditions necessary to declare a lawful dividend under the then Companies legislation.

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

65. In circumstances where, for example, a debit is made to a new account producing a negative balance, whether regard may be had to the substance of the transaction from a company law perspective in determining the source of the debit is the subject of dispute. In *Consolidated Media Holdings Ltd v. FCT [2011] FCA 367; 2011 ATC 20-259*, 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 by Emmett J at first instance [2011] FCA 367 that the reserve account was part of the company's share capital account, which was debited in making the distribution.[68] The decision was reversed on appeal [2012] FCAFC 36[69] and is at the time of writing the subject of an application for special leave to the High Court. [The conclusion of Emmett J that the distribution was, as a matter of company law, a return of share capital is not, however, in contest. That conclusion the Commissioner considers relevant to the operation of paragraph 202-45(e) of the ITAA 1997].

66. The determination or declaration and payment of a dividend require 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 in compliance with section 254T of the Corporations Act from 'unbooked' profits, underived profits, asset accounts such as internally generated goodwill, negative reserve accounts, or an amount of other comprehensive income may 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 CGT provisions. However, 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

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

---

[68] *Consolidated Media Holdings Ltd v. FCT* [2011] FCA 367; 2011 ATC 20-259 at paragraphs 48, 49, 70 and 71 per Emmett J. Note that this decision arose under analogous provisions regarding share buy-backs in Division 16K of the ITAA 1936, not the subsection 6(1) definition of dividend in the ITAA 1936. In such circumstances, shareholder approval under section 256B of the *Corporations Act* might also be required and the Commissioner considers the dicta of Emmett J relevant, pending the final disposition of this matter.

[69] The decision of the Full Federal Court in *Consolidated Media Holdings Limited v. FCT* [2012] FCAFC 36; 2012 ATC 20-308 proceeded on a different basis to that of Emmett J.

68. 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.[70] That case law is applicable to the new section 254T of the Corporations Act and Division 202 of the ITAA 1997.

69. 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 profits of the relevant financial year 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 period 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.[71] Capital that has been lost or sunk is no longer capable of any application, including for the payment of dividends.[72]

70. 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 of a permanent character 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.[73]

---

[70] 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, *Industrial Equity Ltd & Ors v. Blackburn & Ors* (1977) 137 CLR 567; [1977] HCA 59, *FCT v. Slater Holdings Ltd* (1984) 156 CLR 447; (1984) 15 ATR 1299; 84 ATC 4883*, 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 the position is open to doubt: 'The decisions in cases in this area are old. In accounting circles it is now thought that sound accounting practice demands that past trading losses should be made good before a dividend is declared'.

[71] 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.

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

[73] For some further consideration of these issues see the legal opinion by AH Slater QC & JO Hmelnitsky obtained by the Commissioner in connection with this ruling, 'Payment and Franking of Dividends' available at http://law.ato.gov.au/pdf/pbr/slater_and_hmelnitsky-payment_and_franking_of_dividends.pdf.

71. Under section 258F of the Corporations Act, in certain circumstances a company may reduce its share capital by cancelling any paid-up share capital that is lost or is not represented by available assets; that power does not apply if the company also cancels shares, or if the cancellation of paid-up share capital is inconsistent with the requirements of any accounting standard.

72. This ruling does not address any specific integrity measures (for example section 177EA of the ITAA 1936, section 45B of the ITAA 1936 or other like provisions) in the income tax laws dealing with the payment of dividends.

Further Examples

Example 3: dividend paid out of current year profits identified but not yet booked in the accounts

73. *Assume the same facts for Listerfield Ltd as stated in Example 2 at paragraphs 15 and 16 of this Ruling, except that the profits for 2012 have not yet been booked in the final accounts. In May 2012, the directors of Listerfield Ltd identify that the company will have $30 of current year profits from ledgers and management accounts. The company determines to pays $30 to its shareholders in June 2012 as a purported dividend prior to the amount being recognised or booked in its final audited accounts. As the $30 purported distribution was paid out of expected profits as yet unbooked in audited accounts, 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.*

Example 4: Debit to reserve

74. *Upwey Ltd has the following balance sheet:*

Assets and Liabilities		*Equity*	
Cash	*100*	*Share capital*	*190*
Property, plant and equipment	*140*	*Accumulated losses*	*(40)*
Investment in subsidiary	*40*	*Permanent and unrealised capital profit reserve*	*130*
Net assets	*280*	*Total equity*	*280*

75. *Upwey Ltd is assumed to have a positive franking account balance due to its activities in prior years. Upwey Ltd determines to pay an $80 dividend. To pay the $80 dividend the company makes the following accounting entries:*

Dr Permanent and unrealised capital profit reserve		*$80*
Cr Cash	*$80*	

76. *In this example, the company has sourced the distribution from a species of profit account which is ascertained in its accounts, 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 (assuming it satisfies all the other criteria in section 202-45 of the ITAA 1997). However, if Upwey Ltd's net assets were less than its share capital, either before or after Upwey Ltd makes the distribution from the reserve (on the basis that it is an unrealised capital profit of a permanent character) it may not be frankable as a result of paragraph 202-45(e) of the ITAA 1997 depending on the particular facts and circumstances.*

77. *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 earnings[74] when the 'net asset' test in section 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) of the ITAA 1936 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 5: dividend paid partly out of profits and partly out of share capital

78. *Sherbrooke Ltd has the following balance sheet:*

Assets and Liabilities		*Equity*	
Cash	*100*	*Share capital*	*60*
		Retained earnings	*40*
Net assets	*100*	*Total equity*	*100*

[74] 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.

79. *Sherbrooke Ltd purports to determine to pay a dividend of $50 pursuant to section 254T of the Corporations Act. To pay the $50 distribution, Sherbrooke Ltd commits the following entries:*

DR retained earnings		*40*
DR share capital		*10*
CR Cash	*50*	

80. *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 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 6: dividend paid out of an amount other than retained earnings (such as a reserve account) and net assets are less than share capital

81. *Pilbara Ltd has the following balance sheet:*

Assets and Liabilities		*Equity*	
Cash	*100*	*Share capital*	*180*
Property, plant and equipment	*30*	*Accumulated losses*	*(50)*
Net assets	*130*	*Total equity*	*130*

82. *Pilbara Ltd purports to determine to pay a dividend of $100 pursuant to the new section 254T of the Corporations Act.*

83. *Pilbara Ltd does not credit accumulated losses but rather creates a dividend reserve to effect payment:*

Dr Dividend reserve		*100*
Cr Cash	*100*	

84. *The balance sheet of Pilbara Ltd post dividend distribution will be as follows:*

Assets and Liabilities		*Equity*	
Cash	*(0)*	*Share capital*	*180*
Property, plant and equipment	*30*	*Accumulated losses*	*(50)*
		Dividend reserve	*(100)*
Net assets	*30*	*Total equity*	*30*

85. *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) of the ITAA 1936 and unfrankable on the basis that it was sourced indirectly from the share capital account of Pilbara Ltd under paragraph 202-45(e) of the ITAA 1997.*[75]

86. *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.*

[75] In *Consolidated Media Holdings Limited v. FCT* [2011] FCA 367; 2011 ATC 20-259, 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. Note that this matter is currently the subject of an application for special leave to appeal to the High Court of Australia. The decision of the Full Federal Court in *Consolidated Media Holdings Limited v. FCT* [2012] FCAFC 36; 2012 ATC 20-308 proceeded on a different basis to that of Emmett J at first instance, and the Commissioner considers the dicta of Emmett J relevant, pending the final disposition of this matter.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.

87. 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.

88. 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.

89. If such a payment was a dividend, the Commissioner is of the view it would be subject to taxation as illustrated in some of the other examples above.

Appendix 3 – Detailed contents list

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

References

Previous draft:

TR 2011/D8

Related Rulings/Determinations:

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

Subject references:

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

Legislative references:

- ITAA 1936
- ITAA 1936 6(1)
- ITAA 1936 6(1)(d)
- ITAA 1936 6(4)
- ITAA 1936 25
- ITAA 1936 44
- ITAA 1936 44(1)
- ITAA 1936 44(1)(a)
- ITAA 1936 44(1A)
- ITAA 1936 44(1B)
- ITAA 1936 45B
- ITAA 1936 177EA
- ITAA 1997
- ITAA 1997 6-5
- ITAA 1997 Pt 3-1
- ITAA 1997 Div 197
- ITAA 1997 Pt 3-6
- ITAA 1997 Div 202
- ITAA 1997 202-25
- ITAA 1997 202-40
- ITAA 1997 202-45
- ITAA 1997 202-45(e)
- ITAA 1997 Pt 3-90
- ITAA 1997 Subdiv 709-A
- ITAA 1997 709-60(2)
- ITAA 1997 709-65
- ITAA 1997 960-120
- ITAA 1997 975-300
- ITAA 1997 975-300(3)
- ITAA 1997 975-300(3)(ba)
- ITAA 1997 995-1
- TAA 1953
- Corporations Act 9
- Corporations Act 254T
- Corporations Act 254T(2)
- Corporations Act 254V
- Corporations Act 254V(2)
- Corporations Act 256B
- Corporations Act 258F
- Corporations Act 285
- Corporations Act 286
- Corporations Act 292
- Corporations Act 295(4)(d)
- Corporations Act 297
- Corporations Act 302
- Corporations Act 334
- Corporations Act 1308
- Corporations Act Pt 2J.1
- Corporations Act Pt 2M
- Corporations Act Div 1 of Pt 2M.3
- Corporations Act Div 2 of Pt 2M.3
- Corporations Amendment (Corporate Reporting Reform) Act 2010

Case references:

- Ammonia Soda Company Ltd v. Chamberlain [1918] 1 Ch 266
- ASIC v. Hellicar & Ors [2012] HCA 17
- Australasian Oil Exploration Ltd v. Lachberg & ors (1958) 101 CLR 119
- Churchill International Inc v. BTR Nylex Ltd (1991) 4 ACSR 693
- Commissioner of Taxation (NSW) v. Stevenson (1937) 59 CLR 80
- Condell v. FCT [2007] FCAFC 44; (2007) 66 ATR 100; 2007 ATC 4404
- Consolidated Media Holdings Ltd v. FCT [2011] FCA 367; 2011 ATC 20-259

- Consolidated Media Holding Ltd v. FCT [2012] FCAFC 36; 2012 ATC 20-308
- Dimbula Valley (Ceylon) Tea Co v. Laurie (1961) Ch 353
- FCT v. McNeil (2007) 229 CLR 656, [2007] HCA 5; (2007) 64 ATR 431; 2007 ATC 4223
- FCT v. Miller Anderson Ltd (1946) 73 CLR 341; [1946] HCA 2
- FCT v. Slater Holdings Ltd (1984) 156 CLR 447; (1984) 15 ATR 1299; 84 ATC 4883
- FCT v. Sun Alliance Investments Pty Ltd (in liq) (2005) 225 CLR 488, [2005] HCA 70, 60 ATR 560; 2005 ATC 4955
- 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; [1977] HCA 59
- Lubbock v. British Bank of South America [1892] 2 Ch D 198
- MacFarlane v. FCT (1986) 13 FCR 356; (1986) 17 ATR 808; 86 ATC 4477
- Marra Developments Ltd v. BW Rofe Pty Ltd [1977] 2 NSWLR 616
- QBE Insurance Group Ltd v. ASC, NRMA Insurance Ltd v. ASC (1992) 38 FCR 270; (1992) 110 ALR 301
- RA Hill v. Permanent Trustee Company of NSW Ltd [1930] AC 720
- Re Chelsea Waterworks Co and Metropolitan Waterboard (1904) 73 LJKB 532
- Re National Bank of Wales [1899] 2 Ch 629
- Re Spanish Prospecting Co Ltd [1911] 1 Ch 92
- Verner v. General & Commercial Investment Trust [1894] 2 Ch 239

Other references:

- AH Slater QC & JO Hmelnitsky Joint Opinion 'Payment and Franking of Dividends' 29 November 2011
- Australian Accounting Standards Board Australian Accounting Standards
- Australian Accounting Standards Board IFRS and distributable dividends 31 October 1995
- Australian Securities and Investments Commission ASIC Clarifies impact of IFRS on dividends IR 05-57, 5 October 2005
- Explanatory Memorandum to the Corporations Amendment (Corporate Reporting Reform) Act 2010
- Ford's Principles of Corporations Law online edition
- Halsbury's Laws of England, 1983, vol. 7(1), 4th edn, Butterworths, London
- PSLA 2008/10

ATO references
NO: 1-3O2H8Q2
ISSN: 1039-0731
ATOlaw topic: Income Tax ~~ Entity specific matters ~~ franking of dividends – company matters