Franking pitfalls

28 June 2016

In brief

The next couple of months will see many companies finalise 30 June accounts and present directors with proposals for shareholder distributions. Companies with franking credit balances may consider providing shareholders with the benefit of those credits by paying a franked dividend.

Our imputation system was developed and costed on the basis there would be a certain level of franking credit wastage and it contains a long list of legislative 'pitfalls' which are designed to ensure this outcome. Companies and their directors need to navigate carefully.

In detail

'Profits'

The *Corporations Act 2001* was amended in 2010 to revise the tests for payment of a dividend. Section 254T provides that a dividend may not be paid unless:

- the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend
- payment of the dividend is fair and reasonable to the company's shareholders as a whole, and
- payment of the dividend does not materially prejudice the company's ability to pay its creditors.

However, section 254T does not authorise the payment of a dividend; it simply sets out circumstances in which a dividend cannot be paid. A distribution that satisfies these tests might still need to satisfy other requirements if it represents a reduction of share capital.

The income tax law requirements for the payment of a franked dividend are even more restrictive. A dividend may not be franked if it is sourced 'directly or indirectly' from share capital.

The upshot of these requirements is that companies should look to source franked dividends from distributable profits.

Taxation Ruling TR 2012/5

The Australian Taxation Office (ATO) released TR 2012/5 to provide companies with guidance on the identification of profits from which a company can pay a franked dividend. The key principles of this ruling can be summarised as follows:

a) A dividend can be franked if:
   i. It is paid out of profits
   ii. It is paid in accordance with the company's Constitution
   iii. It does not breach section 254T of the Corporations Act, and
   iv. It does not constitute a 'capital reduction' under Part 2J.1 of the Corporations Act.

b) Profits must be recognised, in accordance with Australian Accounting Standards, in the stand-alone accounts of the company which is paying the dividend (i.e. rather than in the consolidated accounts of a group of companies) and must be available for distribution.

c) Profits exclude amounts disclosed as 'Other Comprehensive Income' under Australian Accounting Standards (typically unrealised 'fair value' adjustments).

d) Dividends can be paid out of 'current year profits' even if a company has prior year losses, provided the profits have not been offset against those prior year losses. Current year profits will be available for distribution where:
   i. The dividend is paid during the course of the relevant year (i.e. an interim dividend), but only if the relevant current year profit is recognised in 'year-to-date' accounts.
   ii. The dividend is declared prior to year-end and reflected as a liability in the year end accounts.
   iii. The Directors resolve to declare (or determine) the payment of a dividend out of current year profits at the same time as their resolution to approve the accounts for that year.
   iv. The accounts of the company disclose the current year profits in a separate equity account (and do not offset that account against the prior year accumulated loss). In this case, any balance in that separate profit account also remains available for the payment of future franked dividends.

e) Profits can include an unrealised capital profit of a permanent nature where the company has a surplus of net assets over share capital. Where a company has net assets less than share capital, the ability to pay a dividend out of unrealised capital profits will depend on a consideration of 'relevant facts and circumstances'.

Benchmarking rules

The imputation system contains 'benchmarking rules' to ensure some level of uniformity of franking for all shareholders of a company.

The rules require that all frankable distributions made by a company during a franking period must be franked to the same percentage. For public companies, dividends paid within each 6 month period must be franked to the same extent. For private companies, this period is 12 months corresponding to the company's tax year. Significant differences in franking percentages between periods also need to be disclosed to the ATO.

Listed public companies with only a single class of shares are exempt from the benchmarking rules.

Franking credit schemes

Section 177EA of the *Income Tax Assessment Act 1936* is a powerful weapon which can operate to deny the benefit of franking to shareholders or to require a company to take up a franking debit where the Commissioner determines that:

1. a franked distribution is paid under a scheme that involves the disposal of shares, and
2. the scheme has been carried out with a purpose (other than an incidental purpose) of enabling the relevant taxpayer(s) to obtain the franking benefit.

As an example of the potential operation of section 177EA, the ATO released Taxpayer Alert TA 2015/2: Distributions funded by raising capital to release franking credits to shareholders. The Alert notes the ATO's concern that section 177EA may be triggered where a company raises capital for the purpose of paying a franked dividend.

These concerns might also extend as far as dividend reinvestment plans that are fully underwritten.

Other pitfalls

Having considered the availability of profits, benchmarking rule and franking credit scheme rules, you are still far from 'home free' when it comes to franking a dividend that provides franking benefits for shareholders. Other potential pitfalls include:

(i) the distribution must not be made in respect of a 'non-equity share' (under the tax debt/equity characterisation rules)

(ii) the shareholder must hold the shares 'at risk' for the purposes of the '45 day rule' and 'related payment rule'

(iii) the dividend must not be part of an arrangement to stream franking credits to those shareholders who derive a greater benefit than other shareholders

(iv) the dividend must not be part of 'dividend stripping' operation

(v) the dividend cannot be paid by an 'exempting entity' (i.e. where non-resident shareholders hold at least 95 per cent of the interests in the company), and

(vi) the dividend cannot be paid by a 'former exempting entity' from credits that arose during a period when the entity was owned at least 95 per cent by non-resident shareholders.

The takeaway

The payment of franked dividends is a task which is fundamental for Australian companies and their directors. And yet, the taxation provisions seem designed to make this task as difficult as possible.

The myriad of potential pitfalls can be successfully navigated… but with care.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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