Capital and dividends – achieving a sustainable and efficient model

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Sustainable capital management is a key focus area for boards because companies must balance internal capital needs with returning profits to shareholders. A company's capital management strategy will change over time in response to the business lifecycle, economic environment and shareholder appetite, with dividends forming a critical component of this strategy.

In Australia, dividend payments have grown substantially in the past few years even though earnings growth has been modest.[1] This means finance teams are under significant pressure to ensure directors have confidence in any plans to pay dividends.

Paying a dividend is not easy. As a starting point, companies need to ensure that any dividend they pay is legal; that is, it complies with the *Corporations Act* 2001 (Cth) (the Corporations Act). While the *Corporations Act's* dividend requirements may seem straightforward, in practice they're not. Given the accounting is critical in assessing whether a dividend payment is legal, directors will look to accounting and finance teams to support them.

In this article, we consider two key questions for finance teams:

- When can an Australian company pay a dividend?, and
- What do multinational groups need to consider when paying a dividend?

When can an Australian company pay a dividend?

There are a few things to consider before announcing a dividend to the market, such as the rules about paying a dividend (i.e. whether your company has met the Net Assets Test and the Profits Test) and when to involve accounting teams.

What are the 'rules' in paying a dividend?

The key principles of Section 254T of the *Corporations Act* are that a Company is prohibited from paying a dividend unless:

1. it has positive net assets before and after the payment (the Net Assets Test)
2. the dividend is fair and reasonable to the company's shareholders as a whole, and
3. the dividend does not materially prejudice the company's ability to pay its creditors.

Since its introduction in 2010, various legal opinions have concluded that the Net Assets Test has not displaced, but has added to, the historic requirement in Australian case law for the dividend to be paid from profits of the company (commonly referred to as the Profits Test).

The insolvent trading provisions must also be considered by directors; that is, no director who has reasonable grounds for suspecting the company is insolvent or would become so should permit a dividend to be declared or paid. Finally, directors need to ensure that they comply with any relevant requirements set out in the company's constitution when paying a dividend.

[1] M Bergmann, 'The Rise in Dividend Payments', Reserve Bank of Australia, *Bulletin*, March Quarter 2016.

When do accounting and finance teams become involved?

Most companies have communicated a dividend policy to their investors that they strive to meet each year. Finance teams should plan for this in advance. In practice, we see company directors asking finance teams to confirm that both the Net Assets Test and the Profits Test are satisfied before declaring dividends and that any additional requirements imposed by a company are also met. When determining the net assets and profits of the company, the amounts must be calculated in accordance with accounting standards in force at the relevant time. This includes mark to market adjustments, provisioning, impairment write-downs and other non-cash transactions. Critically, any impairment due to a missed forecast or business downturn might deplete accounting profits, limiting what is available to pay as a dividend even though the business may have sufficient cash on hand.

How do these tests work in practice?

It is a misconception in Australia that dividends can be paid from a group's consolidated retained profits or that the consolidated net assets can be used to meet the *Corporations Act* 'rules'. This is not the case. Both the Net Assets Test and the Profits Test are applied at the legal entity level.

This means that when paying dividends up to a holding company and then to shareholders, these respective tests are applied to each legal entity that makes a return to its parent. For example, in a group of companies with extensive and complex holding chains, profit generated by a trading subsidiary at the bottom of the chain will need to pass through each intermediate holding company to reach the parent company. Accumulated losses at any of these intermediate holding companies may result in dividend traps; that is, the losses, depending on when they were incurred and accounted for, may absorb any dividends paid up, preventing those profits from passing to the parent to be distributed to shareholders.

In short, directors can't automatically assume that profits generated by subsidiaries are available for distribution as dividends by the parent, not least because the accounting requirements as they apply to an entity's separate financial statements differ significantly from the accounting requirements that apply to an entity's consolidated accounts.

What happens if these tests are not met?

If a dividend is not paid in accordance with the law, it could be treated as an unauthorised return of capital, with civil and criminal penalties being applied to directors of the company. Alternatively, the dividend could be deemed to be a loan to shareholders. It could also be determined that a contravention of the *Corporations Act* and/or common law has occurred.

Finally, there are important tax consequences that cannot be ignored. A distribution, even if labelled a 'dividend', will not be frankable if it does not meet the necessary accounting and legal requirements, including that it is paid in accordance with the particular company's constitution. There may also be changes in the treatment of the distribution in the hands of the recipient.

These are serious consequences and highlight the need for finance teams to make sure any dividends proposed can meet the accounting requirements outlined. Directors will look to the finance team to ensure the company has sufficient net assets and profits to meet their planned dividend payments. It is essential to understand how the law applies and to ensure the role of accounting in the broader dividend management policy is not overlooked.

What do multinational groups need to consider when paying a dividend?

Considerations for paying a dividend become more complex as soon as other jurisdictions come into play. Extracting profits from foreign subsidiaries can involve a multitude of regulatory and reporting complexities. The UK, South Africa and Singapore have a legal profits test similar to Australia. New Zealand and the USA have a purely solvency based regime. Other countries will have other differing requirements. For every jurisdiction an entity operates in, a unique set of legal requirements, including any local variants of Australia's Net Assets and Profits tests, will apply with respect to what constitutes capital and dividends, and how these can be transferred between entities or across borders.

For multinational organisations, exposure to foreign exchange also needs to be considered for both accounting and tax requirements as legal entity foreign exchange profits may be taxable and losses can erode profits available to pay a dividend. The central finance teams of multinational companies often grapple with the question of how to manage foreign exchange exposures on internal capital transactions, particularly where different functional currencies are involved. Loans between group companies eliminate entirely for consolidated reporting but the foreign exchange exposures at the individual legal entities do not. This overlaps with the more general consideration of efficient deployment of debt versus equity capital in the group.

Additionally, the risk of impairment of investments in subsidiaries is heightened when foreign currency exposures are involved. If an Australian parent is forced to impair an investment in its foreign subsidiary, any dividend income received may be offset against impairment charges. The net income of the parent that is available for distribution could then be diminished.

The Australian tax treatment of distributions paid by foreign companies will need to be carefully considered where the distribution otherwise doesn't satisfy a foreign equivalent to the Australian Net Assets and Profits tests. Finance teams should expect robust scrutiny of accounting positions adopted in these circumstances. Implementing strategies to maximise distributable profits in foreign subsidiaries may alleviate such complexities.

Early planning is key

Finance teams have a critical role in ensuring satisfaction of the Net Assets Test and the Profits Test at each relevant legal entity when paying a dividend. Directors will need comfort that the relevant tests and requirements can be met and will look to finance teams to provide this.

This means early planning for future dividends.

Planning to pay a dividend? Keep these tips in mind

- Expect to prepare supporting information for each entity through which any group dividend may flow.
- Keep an eye on the available impairment headroom of investments in individual subsidiaries within the consolidated group ahead of any planned distributions.
- Ensure sustainable dividend paths are modelled as part of any transaction diligence, whether it's an acquisition, divestment or reorganisation.

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