Exactly two years after the introduction of changes to the Corporations Act relating to dividends, the Australian Taxation Office (ATO) has released Taxation Ruling TR 2012/5 which sets out what these changes mean to the ability of companies to frank their dividends.

While the ATO view has “mellowed” during the course of the protracted consultation process, there remain circumstances in which companies may purport to pay a Corporations Act dividend which the ATO does not accept can be franked.

Meanwhile, still underway is an equally protracted review process being conducted by Treasury in relation to the actual dividend provisions in the Corporations Act. So there remain further chapters to be written in this saga. In the meantime, most companies will now be able to proceed to pay and frank dividends with a greater level of confidence than has been the case for the last two years.

The Ruling is stated to apply from 28 June 2010. However, it remains to be seen whether the ATO will take a pragmatic approach to those companies that paid and franked dividends since that time contrary to the views now set out in the Ruling.

Can you frank that dividend?

TR2012/5 is a patchwork of examples and technical explanation. However, the key principles can be distilled as follows:

1. 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 Law (which means the company must be solvent and have positive net assets), and
   iv. it does not breach Part 2J.1 of the Corporations Law (which, based on the ATO’s legal advice, is not breached as long as the dividend is paid out of profits).

2. “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 be available for distribution by way of a dividend.

3. “Profits” exclude amounts disclosed as “Other Comprehensive Income” under Australian Accounting Standards (reflecting movements in various equity reserve accounts).
4. The above rules apply even if a company’s net assets are less than its share capital or the company has prior year losses. In particular, a franked dividend can be paid out of current year profits notwithstanding a prior year accumulated loss position (but see the conditions noted below).

5. “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”.

The ATO contends that its legal advice indicates that a distribution will fall under Part 2J.1 of the Corporations Act unless it is paid out of profits (broadly based on the considerations set out above). However, the Ruling states that, should this legal advice be incorrect, and a dividend is able to be paid otherwise than out of profits without being subject to Part 2J.1, then it will be treated as a frankable dividend for tax purposes provided it is not debited against a share capital account and then only to the extent that the company has net assets in excess of share capital.

**Current year profits**

A franked dividend may be paid from a current year profit notwithstanding a prior year accumulated loss (or loss of share capital) provided the company makes a decision to not offset the current year profit against the prior year loss.

This decision can be evidenced by one or more of the following:

a) the dividend is paid during the course of the relevant year (i.e. interim dividend) but only if the relevant current year profit is recognised in accounts, such as half year accounts

b) the dividend is declared prior to year end and reflected as a liability in the year end accounts

c) 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, or

d) the accounts of the company disclose the current year profit 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.

The Ruling makes it clear that these principles also apply to private companies.

**Capital return**

The ruling also provides comment on when a distribution will be treated as a return of capital for tax purposes, rather than a dividend. This will apply where the distribution is debited to a share capital account.

The Ruling notes that what constitutes a debit to a share capital account is currently subject to dispute in the Consolidated Media case (for which the ATO has sought special leave to appeal to the High Court).

However, the Ruling suggests that, depending on the facts and circumstances, if a distribution is debited to a new account (producing a negative balance) this could be treated as a return of capital or as an unfranked dividend, notwithstanding the outcome in the Consolidated Media case. This will no doubt be an area subject to further debate. But, in the meantime, companies should proceed with considerable caution.

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