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Heads Up

Accounting implications of taxation ruling on franking of dividends paid by a company with accumulated losses

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- The Commissioner of Taxation has recently issued *TR 2012/05 - Income tax: section 254T of the Corporations Act 2001 and the assessment and franking of dividends paid from 28 June 2010* ('TR 2012/05' or 'the Ruling').

- The Ruling proposes two methods by which a company with accumulated losses can pay a final or an interim dividend out of current period profits and still have that dividend treated as one paid out of profits (instead of share capital) and hence allowed to be franked.

  - **First Method:**
    A legally effective directors' resolution declaring (or determining) to pay dividends out of current period profits which have been offset against accumulated losses in the current financial statements. This resolution should be passed at the same meeting where the directors approve the current financial statements.

  - **Second Method:**
    In the company's financial statements the particular period's profits are carried to a separate profit reserve based on a directors' resolution.

- According to this Ruling, in order for a company to be able to carry forward its current period profits such that they are available for payment of franked dividends in future periods for income tax purpose, the company must follow the Second Method as described above, i.e. carry the current period's profit in a separate profit reserve and not offset against accumulated losses.

- This 'Heads Up' does not address what is considered a dividend for the purpose of the Corporations Act 2001. Companies may wish to seek their own legal advice in relation to the payment of dividends under the Corporations Act 2001.

- We have identified certain interpretational issues relevant to the accounting implications of this Ruling as discussed later in this 'Heads Up'. We will provide an update as and when these get clarified.

Related Links
TR 2012/05
Counsel's advice to the ATO

Background

Companies, prior to the amendment of the Corporations Act 2001, were restricted to paying dividends out of profits. Section 254T of the Corporations Act 2001 was amended on 28 June 2010 to give companies more flexibility by replacing the 'profits test' with a new 'three tiered test' (also referred to as 'solvency test' or 'balance sheet test') that allows a company to pay dividends if all the following three conditions are satisfied:

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

Whilst there was a consequential amendment to introduce subsection 44(1A) to the Income Tax Assessment Act 1936 ('ITAA 1936'), which provides that a dividend paid out of an amount other than profits is taken to be a dividend paid out of profits for taxation purposes; section 202-45(e) of the Income Tax Assessment Act 1997 ('ITAA 1997') states that "a distribution that is sourced, directly or indirectly, from a company's share capital account…" is unfrankable. This has raised considerable controversy in relation to how the new dividend rule under Corporations Act 2001 affects frankability of dividends paid by companies with accumulated losses, i.e. whether dividends paid in such circumstances are to be treated as sourced indirectly from the company's share capital and hence not frankable.

Section 44 of the ITAA 1936 and section 202-45(e) of the ITAA 1997 are applied at the level of the individual company paying the dividend and therefore the comments below relate to the financial statements of an individual company.

TR 2012/05

The Commissioner's views for income tax purposes

The Commissioner considers in paragraph 36 of TR 2012/5 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'."*; while in paragraph 45 of TR 2012/05 the Commissioner remarks that *"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."*

The Ruling provides certain methods (described in paragraph 47 and 48 of TR 2012/05) whereby the dividends paid out of profits by companies with accumulated losses can be treated as not being sourced indirectly from the company's share capital for income tax purposes and hence be frankable.

The Ruling also provides examples on frankability of dividends paid out of unrealised capital profits of a permanent nature. This aspect of the Ruling is beyond the scope of this 'Heads Up'.

Although the Ruling comments on what is considered a dividend for the purpose of the Corporations Act 2001, the Commissioner comments (in paragraph 6 of TR 2012/05) that *"No ruling is made in respect of these matters*". Companies should seek their own legal advice to ascertain whether dividends are paid in accordance with the Corporations Act 2001. This 'Heads Up' does not comment further on the application of the Corporations Act 2001 in relation to the payment of dividends.

Methods described by the Commissioner by which dividends from current profits will be frankable for a company with accumulated losses

We have summarised in the following page how TR 2012/5 may be practically applied to current profits such that they can be used to pay frankable dividends in accordance with the Ruling despite the existence of accumulated losses. The examples in the summary are based on those used in the Ruling.

	First Method	Second Method
Description	A legally effective directors' resolution declaring (or determining) to pay dividend out of profits that have been offset against accumulated losses in the current period's financial statements.	Creation of a separate profit reserve in the statement of financial position and statement of changes in equity.
Timing of the resolution	Such a resolution should be passed at the same meeting as that where the directors approve the current period's financial statements.	The Ruling does not specifically comment on the timing of the resolution to create a separate reserve.
Ability to carry forward profit	The use of this method should be considered where a company intends to pay a dividend out of profits arising in the period for which accounts were most recently prepared. In the absence of applying the Second Method, this method alone cannot enable a company to carry forward the current period's profit to later years for payment of frankable dividends. As soon as the financial statements are approved by the directors, the current period profit is considered to have been adjusted against the accumulated losses.	**Companies which do not intend to pay the current period's profits as dividends and wish to retain their ability to use this profit for future dividend distribution that is frankable in later years, need to use the Second Method.** Example 2 of the Ruling suggests that use of separate profit reserves as a means of isolating profits of a particular period can provide companies with the ability to retain the identity of such amounts and carry them forward indefinitely for the purpose of paying franked dividends out of them.
Impact on financial statements	No separate impact on the financial statements	The statement of financial position and statement of changes in equity need to include profit reserves, separate to the retained earnings total. If this is not done then the company would lose the ability to use the current period's profit to pay frankable dividend in future years.
Example	A company has accumulated losses of $1,000,000 at 30 June 2011. It makes profits of $200,000 during the year ended 30 June 2012. The directors of the company declare dividends of $50,000 out of the 2011-12 profits and this resolution is passed in the same meeting held on 15 August 2012 when the company's financial statements for the year ended 30 June 2012 are approved. This dividend will be allowed to be franked under TR 2012/05. However without the application of Second Method, the balance of $150,000 of the profits will not be available for distribution of frankable dividends in future years. The balance of $150,000 profits will now become part of accumulated losses as at 30 June 2012, thus making it a total of $850,000.	A company has accumulated losses of $1,000,000 at 30 June 2011. It makes profits of $200,000 during the year ended 30 June 2012. The directors of the company declare dividend of $50,000 out of the 2011-12 profits and this resolution is passed in the same meeting held on 15 August 2012 when the company's financial statements for the year ended 30 June 2012 are approved. This dividend will be allowed to be franked under TR 2012/05 through the application of the First Method. The balance $150,000 is not adjusted against the accumulated losses but set aside in a separate reserve "2012 Profit Reserve" on the statement of financial position and statement of changes in equity, allowing it to be available for distribution of frankable dividends in future years under TR 2012/05.

Interpretational issues

We have identified certain issues in relation to accounting consequences arising from the practical application of TR 2012/05 for which we are seeking clarification from the Australian Tax Office. Whilst there may be other interpretational issues arising from the application of the Ruling, both accounting and otherwise, we have raised our concerns specifically for the following issues that affect the preparation of financial statements:

- It is unclear from the Ruling whether it is necessary to disclose a separate profits reserve for each accounting period in which a profit arises (eg 2012 profit reserve, 2013 profit reserve and so on) or whether a single reserve (eg. profits reserve) will be sufficient to demonstrate that profits have not been appropriated against accumulated losses.

- The Ruling refers to 'profits of a particular year' but does not contemplate whether it is possible to isolate interim profits within a reserve and to maintain such a reserve where there is a loss for the 'particular' year.

- The Ruling does not make it clear as to how the Commissioner intends to deal with dividends paid during the period commencing 28 June 2010 until the issue of TR 2012/5 that are not in accordance with this Ruling or whether separate profit reserves can be created for years where financial statements have already been issued.

- The Ruling comments briefly on the application of the relevant principles to proprietary companies that are not required to maintain audited accounts kept in accordance with Australian Accounting Standards. It states that in order to ensure, for taxation purposes, profits are available for distribution and validly paid as dividends in accordance with the principles set out in the Ruling, such companies should maintain 'similar' records and evidence concerning the availability and appropriation of profits. The Ruling provides no guidance as to what evidentiary requirements are needed to satisfy the 'similar threshold'.