

NEW DIVIDEND PAYMENT RULES

Until recently, if a company was to declare a dividend, it could only do so out of profits. Due to a recent amendment to the Corporations Act 2001, the traditional profits test has been replaced with new tests to determine if a company can declare and pay dividends.

The changes mean that, from 28 June 2010, companies may only pay dividends where each of the following tests is satisfied:

- (a) the company's assets must exceed its liabilities immediately before the dividend is declared and the excess must be sufficient for the payment of the dividend (balance sheet test); and
- (b) the payment of the dividend is fair and reasonable to the company's shareholders as a whole (fairness test); and
- (c) the payment of the dividend does not materially prejudice the company's ability to pay its creditors (material prejudice test).

The new rules are contained in section 254T of the Corporations Act 2001 and raise a number of issues which must be considered when dealing with the declaration of, and the timing of, the payment of a dividend. For example:

- According to section 254T, assets and liabilities are to be calculated in accordance with accounting standards in force at the relevant time (even if the standard does not otherwise apply to the financial year of the company). Each company must apply the balance sheet test and, even if a consolidated group meets the test, no dividend may be declared by a group-member company if it does not. Each company must also take into account all relevant accounting standards to ensure an accurate assessment of assets and liabilities, rather than simply relying on internal management accounts.
- The section mandates that directors must "declare" a dividend rather than determine that one will become payable at a future time. The "declaration" of a dividend creates a debt at the time of the declaration which may be enforced against the company. The practice of determining to pay a dividend in the future does not create a debt and may be withdrawn prior to payment. The practical effect of this is that the company must satisfy the test at the time of the declaration and, in all likelihood, at the time for payment (although the section does not state this). The company will need to ensure that it can demonstrate compliance with the test at both times and may need to reduce the time between the declaration and the payment date, where there is a risk of material changes in its financial prospects.
- Great care also needs to be exercised where a dividend is to be declared based on financial statements that may not be current. Where, for example, financials are current to 30 June but the dividend may not be declared until the end of Q1, the directors must ensure that management accounts are accurate up to the date of the declaration and comply with the balance sheet test at that date.
- In the application of the fairness test, the shareholders "as a whole" need to be considered. If, for example, a company has only 1 class of shares on issue it is unlikely to fail this test. However, if it has several different classes on issue, declaring a dividend

on one class and not another may result in unfairness, where the latter class effectively is deprived of a return of capital on a winding up.

- The material prejudice test needs to be applied in a realistic way rather than resorting to theoretical considerations. For example, payment of a dividend by itself reduces the resources of the company and may be argued to result in material prejudice. However, it must be shown that there is no material prejudice to creditors using realistic measures and reasonable considerations to satisfy the test. Each situation must be considered on its merits and from case to case. While it might seem self-evident, the section does state, by way of example, that payment of a dividend, which makes the company insolvent, will be materially prejudicial to the ability to pay creditors.

What to do?

- Review your company constitutions to ensure that they are not inconsistent with the new rules. Some company constitutions contain provisions that require a company to pay dividends only out of profits. Where the constitution contains such a provision, the company must comply with the profits test **and** the 3 new tests above.
- Review all procedures for declaring dividends to ensure they satisfy the new tests.
- Consider any taxation consequences which arise where a dividend is to be paid otherwise than out of profit. For example, where the 3 tests are satisfied, a company may pay dividends out of capital. Consider the availability of access to franking credits in such circumstances or other requirements of the Corporations Act 2001 regulating reductions in capital.

ACIS can assist in adopting a new constitution for your companies. If you have any queries or would like a quote for amendments to your company constitutions, please call toll-free on 1800-773-477.