

THE END OF REDEEMABLE PREFERENCE SHARES

By Tim Neilson

In the September/October 1998 issue of the Journal of Australian Taxation, Paul Abbey summarised certain changes to the Corporations Law provisions dealing with share capital and concurrent tax changes dealing primarily with distributions by a company. Mr Abbey addressed briefly the Corporations Law rules and tax consequences of redemption of redeemable preference shares and, amongst other things, expressed the view that a redemption of redeemable preference shares from profits would not give rise to "tainting" of the share capital account of the company redeeming those shares. The Australian Securities and Investment Commission has issued a Practice Note suggesting that a redemption from profits of redeemable preference shares would have the effect of "tainting" the share capital account. This article submits that Mr Abbey's view is correct. This article concludes that, whether or not Mr Abbey's views are correct, tax and corporate law changes, including those to which Mr Abbey referred in his article, have rendered redeemable preference shares largely redundant as a means of capital raising for most companies.

1. BACKGROUND

Traditionally, redeemable preference shares have been used mostly as a form of alternative to debt financing. A conventional redeemable preference share issue would involve the issue of shares which were redeemable for an amount equal to the capital and premium subscribed for them, with no further right to participate in profits on redemption or a winding up - that is, the rights to return of capital and premium corresponded closely with a right to repayment of principal of a loan. The redeemable preference shares would generally carry a fixed cumulative dividend, corresponding broadly to a right to receive interest on a loan (although of course a dividend could be payable only to the extent that the company had profits available). Technically, a redeemable preference share could, and sometimes did, carry other rights (eg, a full right of participation in surplus profits on a winding up), but this article will address only issues arising from the more usual form of issue carrying rights only to a return of monies subscribed and to a fixed rate of dividends.

Interest is generally assessable income of an Australian resident lender, and although a borrower may obtain a tax deduction for interest,

some borrowers may not be able to use deductions effectively (eg, borrowers who are tax-exempt or who are in tax losses). Dividends are not deductible to the paying company, and they are assessable income of an Australian resident recipient, but the recipient might not in fact end up paying tax on the dividends (eg, an Australian resident corporate shareholder may be entitled to the "intercorporate dividend rebate" under s 46 of the *Income Tax Assessment Act 1936* (Cth) ("ITAA36"), or franking credits may have the effect that a low tax rate shareholder, or a non-resident shareholder, ends up paying no tax on the dividends). Accordingly, there were circumstances where a financier would prefer to receive dividends (which were tax-free because, for example, the operation of the s 46 rebate) rather than interest, and the potential "borrower" would not mind paying dividends rather than interest (eg, if the "borrower" was in tax losses and could therefore not immediately use the tax deduction for the interest) - or at least the "borrower" could be induced to pay dividends rather than interest by being offered finance at a "rate" of cumulative dividend on redeemable preference shares lower than interest rates. (If the redeemable preference shares could be treated as equity rather than debt for accounting purposes there might be additional attractions for the

"borrower" in a preference share funding.) Well before the *Company Law Review Act 1998* (Cth) ("CLRA") was introduced, attempts had been made to curb that practice, by denying tax relief on dividends which were comparable to interest on a loan - see ss 46C and 46D of the ITAA36, and the definition of "frankable dividend" in s 160APA of the ITAA36. Therefore, even before the CLRA was enacted, redeemable preference shares were less prevalent than they had formerly been. Co-operative companies still sometimes use redeemable preference shares to accommodate the frequent changes in their membership which may, desirably, involve a shareholder departing without there being an immediately identifiable incoming shareholder.¹

2. POSITION PRIOR TO CLRA AND TAXATION LAWS AMENDMENT (COMPANY LAW REVIEW) ACT 1998 ("T(CLR)A")

Under former s 192(3)(b) of the *Corporations Law* ("CL"), redeemable preference shares could be redeemed only "out of" profits or the proceeds of a fresh issue of shares. That section applied only to a return of paid-up capital on redemption of redeemable preference shares. A premium on redemption could be paid either from profits or from the share premium account (former s 192(4) of the CL).

As a practical consequence, redeemable preference shares were usually issued at, for example, one cent par value and \$999.99 premium, so that s 192(3)(b) imposed only a minute hindrance to redemption.

It is understood that on a redemption of redeemable preference shares funded from the proceeds of a fresh issue of shares ("share funded redemption"), there was a crediting to the share capital account of the share capital received from the fresh issue, and a debiting of the share capital

account of the amount of paid-up capital returned on redemption ("returned capital").

On such a redemption funded from profits ("profit funded redemption"), the then law required those profits (that is, an amount equal to the returned capital) to be transferred to a "capital redemption reserve".² Given that the profits were, therefore, not paid to the shareholder, the expression "out of" profits in s 192(3)(b) seems to have been either merely a somewhat misleading label, or an elliptical reference to redemption "out of" funds the required replacement of which within the company's accounts would be sourced from its profits. The then law seems to have required two debits, each equal to the amount of returned capital, to the share capital account and to profits (retained earnings or whatever). The effect would have been that the net assets of the company were reduced by an amount equal to the returned capital; share capital was reduced to reflect the disappearance of the relevant shares, profits were reduced to reflect the transfer to the "capital redemption reserve", and the "capital redemption reserve" acted as a balancing item for that double debit and also as a repository of what used to be profits. The capital redemption reserve was required to be treated in a manner fairly similar to paid-up capital - see former s 192(5) of the CL.

From a taxation perspective, payment of the redemption premium out of the share premium account did not, *prima facie*, constitute a "dividend" - former para (d) of the definition of "dividend" in s 6(1) of the ITAA36. Certain anti-avoidance provisions could treat a distribution from the share premium account as a "dividend", but given the abolition of share premium accounts, discussed below, this article will not discuss those provisions.

Repayment of returned capital on redemption was also generally not treated as a dividend -

¹ However, those redeemable preference shares would usually not carry a fixed rate of dividend.

² CL, former s 192(5).

former para (e) of the definition of "dividend" in s 6(1) of the ITAA36. Again, anti-avoidance provisions would almost invariably have to have been considered in an attempt to confirm that position. It does not seem to matter whether the redemption was a share funded redemption or a profit funded redemption. The *Explanatory Memorandum* to the T(CLR)A seems to imply otherwise, in the case of a profit funded redemption, but no explanation is given. Perhaps it was assumed that on a profit funded redemption, profits were paid to the shareholder - if that had been done, it would not have complied with former s 192(5) of the CL.

3. EFFECT OF CLRA

The CLRA effectively abolished the concept of share premium account for CL incorporated companies, along with the concept of par value. A CL incorporated company's former share premium account is now a part of its share capital. One consequence of the CLRA is, therefore, that the source for the vast bulk of funds for redemption of redeemable preference shares has now ceased to be available for that purpose (subject to transitional provisions for redeemable preference shares on issue when the CLRA took effect - s 1447 of the CL).

Section 254K of the CLRA has the effect that a redemption of redeemable preference shares must still be either a share funded redemption or a profit funded redemption. Given the abolition of share premium accounts, redemptions will therefore have to be funded either from the proceeds of a fresh issue or from profits.

The CLRA was intended to simplify and streamline the procedure for companies to carry out a reduction of share capital, but there is still a general prohibition on carrying out a reduction of share capital except as "authorised" under the CL or in accordance with the procedure set out in s 256A onwards of the CL ("normal reduction procedure").

A note to s 256B implies that "s 254K(2) authorises" the reduction of capital involved in the redemption of redeemable preference shares, the implication being that a redemption of redeemable preference shares is not required to be carried out in accordance with the normal reduction procedure. There is no longer a s 254K(2), and that section only imposed the (now redundant) requirements concerning a "capital redemption reserve". Perhaps the note should refer simply to s 254K, or perhaps to s 254J(1) or (2) or both. However, those sections seem not to do all the necessary work, since s 258E purports to authorise "any reduction in share capital involved in" a share funded redemption. There is no corresponding provision specifically and expressly authorising any reduction of capital involved in a profit funded redemption. It would seem, though, that the CL is intended to operate on the basis that a profit funded redemption is not intended to involve a normal reduction procedure,³ that is that a profit funded redemption involves no unauthorised reduction of capital.

It is possible that these provisions were intended to operate on the basis that:

- (a) a share funded redemption would involve crediting the proceeds of the fresh issue to the share capital account, and debiting of the share capital account with the returned capital (that is, the whole amount paid on redemption, except anything actually paid as a dividend eg, arrears of cumulative dividend);
- (b) s 254K does not authorise the debiting of the share capital account on a share funded redemption but, possibly, it or s 254J authorises the actual cancellation of shares on either form of redemption if such an authorisation is necessary;⁴
- (c) a profit funded redemption would involve no debiting of the share capital account, but would rather simply involve a debiting of retained earnings (or other source of profits)

³ See eg, para 12.40 of the *Explanatory Memorandum* to the Bill which introduced the CLRA.

⁴ See CL, s 254J(2) and the last part of s 256B(1).

and payment of the profits to the shareholder - it may be noted that the CL no longer requires the profits to be credited to a "capital redemption reserve"; and

- (d) therefore s 258E was necessary for share funded redemptions but not for profit funded redemptions.

The Australian Securities and Investment Commission has issued *Practice Note* PN 68 which (at paras 96 to 103) addresses certain consequences of redemption of redeemable preference shares. At para 101, the *Practice Note* states that where all or part of the redemption "is met out of profits, s 254K(b) requires an additional entry in the nature of a transfer from retained profits in order to preserve the capital of the company", and goes on to state that, broadly, the relevant amount of profits must be transferred into the share capital account, and the same amount is to be debited from share capital and credited to cash (which is presumably then paid to the holder of the redeemable preference shares).

The *Practice Note* presumes that the amount paid to the shareholder must be debited against the share capital account. As has been noted above, that was probably the case under the former provisions of the CL since the relevant amount of profits was required on profit funded redemption, to be transferred to the "capital redemption reserve". Now that the requirements concerning "capital redemption reserves" no longer apply, there would seem no reason to assume that the profits can not be paid directly to the shareholders, nor does there appear to be anything in the CL which either prevents that, or requires that the amount paid on redemption be debited against the share capital account. On the contrary, as outlined above, the CL expressly authorises the relevant debit to the share capital account for a share funded redemption, but conspicuously fails to do so in respect of a profit funded redemption.

It is therefore submitted that Mr Abbey's view is correct, and the *Practice Note* is in error. The consequence of the *Practice Note* would seem to be that the share capital account of the company making the redemption would become "tainted". "Tainting" will not be discussed in detail in this article. Suffice it to say that "tainting" carries consequences in the nature of anti-avoidance penalties. It would seem unlikely that Parliament would expressly provide, in the CL, for a particular method of redeeming redeemable preference shares, and at about the same time prescribe anti-avoidance consequences for any company which made use of that method.

4. EFFECT OF T(CLR)A

The T(CLR)A amends the definition of "dividend" for tax purposes (contained in s 6(1) of the ITAA36), at least in respect of "dividends paid ...by a company with shares with no par value" (Item 8, Sch 3, T(CLR)A). Companies incorporated under the CL have "shares with no par value"⁵ including, it would seem, redeemable preference shares, even if the terms of issue of the redeemable preference shares entitle the holder to a specified amount on redemption. This article refers (except where expressly stated) to the definition of "dividend" applicable to "shares with no par value". Tax lawyers should, though, be aware that they may need to examine the old definition if they are, for example, advising on distributions by a company incorporated in an overseas jurisdiction where par value rules are still in force.

The definition of "dividend" no longer refers to share premium account.

The definition of "dividend" as now in force can cover any amount paid by a company on redemption or cancellation of a redeemable preference share, subject to an exclusion for amounts debited to the company's share capital account. The exclusion applies to such an amount only to the extent that it does not exceed the amount paid-up on the share immediately before

⁵ See CL, s 254C.

the cancellation or redemption (as specified in a notice given by the company to the shareholder when it redeems or cancels the share). The exclusion is set out in para (e) of the definition of "dividend" in s 6(1) of the ITAA36. As Paul Abbey has pointed out in his article, because the exclusion is in para (e) rather than para (d), s 6(4) of the ITAA36 cannot treat such a payment on redemption of a redeemable preference share as being a "dividend".

5. COMBINED EFFECT OF CLRA AND T(CLR)A

A profit funded redemption by a CL incorporated company now seems to run the risk that either:

- (a) the proceeds of redemption are a "dividend" for tax purposes, because the proceeds of redemption are not "debited" to the share capital account (or any purported debit is not validly made); or
- (b) the redemption involves (or should involve) a debit to the share capital account which is not specifically "authorised" by any provision of the CL, and accordingly can be made only if the normal reduction procedure is followed. The redemption also results in the relevant share capital account becoming "tainted".⁶ The company carrying out the redemption would be able to elect (under ss 160ARDR to 160ARDT of the ITAA36) to "untaint" the account, at cost of a potentially substantial franking debt. If the order of accounting entries set out in the *Practice Note* is followed, and such an election is not made before redemption of the redeemable preference shares, the redemption payment will constitute a "dividend" even though it is paid out of the share capital account.⁷

For all the reasons noted above, it is considered that the first alternative is the correct one. It is quite possible that it was intended that the proceeds of a profit funded redemption would be treated as a "dividend" for tax purposes. The effect of issuing redeemable preference shares and then executing a profit funded redemption seems to be to increase share capital and then reduce profits. If those steps could be carried out without the proceeds being treated as a "dividend", companies could effectively turn their profits into share capital by the issue and redemption of redeemable preference shares, enabling them then to distribute those monies to ordinary shareholders without those distributions being "dividends" for tax purposes (subject, of course, to extensive anti-avoidance provisions which deem non-dividends to be dividends - eg, ss 45A to 45D and 160AQCNP of the ITAA36).

There may be some shareholders who would not mind receiving proceeds of a profit funded redemption as "dividends" - eg, possibly, Australian resident companies which are "public companies" for tax purposes or (at least in the case of substantially or fully franked dividends) low tax rate taxpayers such as superannuation funds. However, the moment a taxpayer actually wants to receive a dividend, the taxpayer will need to consider extensive anti-avoidance provisions which are the converse of those referred to above, that is, anti-avoidance provisions which would treat a "dividend" as a non-dividend (or at least deny the recipient any type of tax relief which reduces or eliminates the tax on that dividend) - eg, ss 160AQCBA and 177EA of the ITAA36.

Quite apart from the matters discussed above, shares redeemable by a profit funded redemption might now be less attractive to investors, since the holder of such shares will not necessarily be able to predict that when the time for redemption

⁶ See *Practice Note* PN 68, para 102, which states, "ASIC has been made aware that the treatment required by the Law on the redemption of preference shares out of profits (as outlined in [PN 68.101]) may have taxation consequences which might not exist if the Law did not require a redemption 'out of profits of the proceeds of a new issue of shares made for the purpose of the redemption'. Some may seek to argue that the outcome detailed in [PN 68.101] is an unintended consequence, however, ASIC believes it is in accordance with the requirements of the Law."

⁷ See the definitions of "dividend" and "share capital account" in ITAA36, s 6(1).

arrives, the company will have sufficient profits to fund the entire amount payable on redemption. One of the great advantages of the old share premium account system was that, where redeemable preference shares were (as usual) issued at a very small par value and a very large premium, the premium could be returned from the share premium account, and the company needed only a small amount of "profits" in order to do a profit funded redemption, and even if it did not have those profits, a redemption could possibly be arranged by means of a very small share subscription to fund a share funded redemption.

A share funded redemption does not seem to have the tax problems referred to above, but a share funded redemption will, nowadays, need to be funded by as much capital being subscribed into the company as is going out, which somewhat limits the usefulness of redemption as a means of repaying capital to shareholders. Again, the old share premium account system alleviated that. Co-operative companies with continuously fluctuating memberships apparently still often do share funded redemptions, but even they will now not be able to keep a "buffer" by way of a share premium account.

There is nothing to prevent redeemable preference shares being the subject of reduction of capital in accordance with the normal reduction procedure, nor being the subject of a share buy-back.⁸ The CLRA was intended to "make it easier for companies to return capital to

shareholders",⁹ by altering the requirements for a share buy-back or reduction of capital. Those alterations, to the extent that they are successful in their aim, reduce the comparative advantage of issuing a share as a "redeemable preference share" compared with issuing other forms of share capital. Cancellation by reduction of capital or share buy-back would not involve the tax complexities outlined above (although, naturally, consideration would have to be given to various general anti-avoidance provisions such as s 45B, and in the case of a share buy-back attention would have to be paid to the specific provisions of Div 16K of Pt III of the ITAA36). It may be, therefore, that a share buy-back or a reduction of capital proves a more convenient method of cancelling redeemable preference shares than an actual redemption. If it is envisaged that a share will be cancelled or redeemed in one of those ways, one might question the usefulness of purporting to issue it as a "redeemable preference share" in the first place. It is understood, also, that the accounting standards now tend to require some redeemable preference shares to be treated as "debt" rather than equity for accounting purposes¹⁰ which would remove any balance sheet attractions of funding by such redeemable preference shares rather than by debt.

Accordingly, the CLRA and the T(CLR)A may well play their part in causing redeemable preference shares to become an extremely rare form of share capital.

⁸ See CL, s 254J(2).

⁹ See the Second Reading Speech introducing the Bill which became the CLRA.

¹⁰ AASB 1034, para 8.2.

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