SPEAKMAN LAW

June 2016

Issue 18

Leaves are falling all around…

Ah that's the way it should be, like a leaf is to a tree, so fine. Well, if the sun shines so bright, our way is darkest night, the road we choose is always right. Lyrics from Zeppelin's Ramble On/Bron-Y-Aur; with winter upon us after such a long arid summer, they seem appropriate. All the same, nice to have a change of season!

Been an exceptionally busy first part of the year. Signs are that will continue. Shortly I will be joined by another solicitor, Lisa Brown, to join myself and Natalie Stewart on the legal side, and Wendy (PA).

In the meantime topics emerging from the last few months are discussed here. I trust you find them both of interest and of help.

Closely Held Companies…

In my last newsletter I commented on proposed changes to the rules for look through companies (**LTCs**). Those changes have now progressed to Bill stage. In the course of doing so there has been one material about take to the changes outlined in that newsletter. Initially, it had been intended to extend to six years (doubling the existing period) the period during which beneficiaries who receive distributions from a trust are counted as look through owners. The proposals in the Bill, however, leave this period unchanged at 3 years. It will remain the case that existing LTCs with trustee shareholders need to manage their distribution policies to ensure trust distributions do not result in the LTC having more than 5 owners and losing eligibility.

There is another significant change in the context of closely held companies. It is relaxation of the problem around related party capital gains. It has been a longstanding policy (and law) that capital gains realised by companies may not be distributed tax free except upon liquidation. The cost (and commercial consequences of liquidation) often prohibit liquidation as an option. T+hat has driven a preference for LTCs and limited partnerships which, being flow through entities, do not suffer from this problem.

What's inside

- Closely Held Companies
- Panama Papers
- Employee Share Schemes
- Shareholder Remedies
- Joint Ventures

Briefly - sport

- Danny Lee world golf ranking 38, No. 3 in Australasia, behind Jason Day and Adam Scott
- Multiple new All Blacks to play Wales, Elliot Dixon no surprise, Liam Squire a big surprise
- NZ cricket summer schedule announced, Pakistan tests before Xmas. Bangladesh on boxing day in Christchurch, ODIs v Australia and South Africa

Briefly – Law/Special Interest

- Govt review of Law Commission report "Review of Law of Trusts" ongoing, 2.5 years on
- Overseas Investment Office characterisation of overseas persons where custodians involved differs from practice; custodian treated as holder without look through
- MH370; More debris, no answers and search to end in early August
- Donald Trump: latest headline "Illegals treated better than US veterans"

This problem has been exacerbated by provisions that "taint" capital gains. Those provisions have long been troublesome and are easily overlooked. They are now to be relaxed. Under the relaxed rules it will no longer be problematic where an asset is sold to an associate that is not a company. Nor will it be a problem where an asset is sold to another company where common ownership between the two companies is below 85%. Likewise, it will no longer be problematic where common ownership between the two companies is equal to or greater than 85% provided the asset is sold to a third party prior to each company being liquidated. This essentially respects the original policy intent which was to deny group companies the ability to create capital gains upon transfer from one group company to another.

Panama Papers…

What is the fuss about? Has New Zealand's tax system been set up to facilitate tax fraud? Are wealthy New Zealanders using a loophole here to avoid NZ tax? Is there damage to New Zealand's reputation? Answers follow.

There is fuss because of links between Panama and many high profile and wealthy foreigners who evidently do have the design of escaping tax in their home country. No, New Zealand's tax system has not been set up to facilitate tax fraud. Nor are wealthy New Zealanders using a loophole here to avoid NZ Tax. However, most certainly there is damage to New Zealand's reputation. We enjoy a reputation as a jurisdiction with a comprehensive and balanced tax system. In this area at least this creates reputational issues. Consequently, expect there to be changes to our tax rules. My pick is those changes will be significant.

New Zealand's connection with the Panama papers comes about as a result of the way we tax trusts. The laws and manner in which we tax them have remained largely unchanged for near on 30 years. They were designed to ensure wealthy New Zealanders with investments in trusts were brought within the tax net, without overreaching. This design has at its heart a focus on the person establishing the trust (**Settlor**) and not the trustees.

This design has proved effective to ensure New Zealanders are fairly taxed on their trust investments. However, at the same time it has allowed foreigners to establish a trust here as an ownership vehicle for their overseas assets. Use of a New Zealand trust (a foreign trust) has facilitated these foreigners to escape tax in their home jurisdiction. Seemingly, this is what the Panama papers reveal, presumably along with other things.

Respective New Zealand governments over the period in which this trust regime has prevailed have not seen fit to make any substantive changes to the regime. Presumably that has been because no New Zealand tax has been avoided or stood to be avoided. Nevertheless, unquestionably foreigners have used New Zealand's trust laws as an intermediary to tax plan. That has damaged our reputation, likening us in these respects to a tax haven.

Undoubtedly this was the furthest thing from the minds of the designers of our trust taxation regime. They will have thought that the regime was both novel and comprehensive.

Mr Shewan (appointed by the Government to review) has a balancing act to achieve a result that remedies the reputational issues going forward on the one hand against ensuring our tax system does not "over reach" on the other. I foresee that is a difficult task.

Employee Share Schemes…

New rules taxing employee share schemes are proposed. Those rules are designed to overcome arrangements, particularly the use of share trusts, that allow gains on shares to be delivered to employees tax free. The rules recognise that these share gains represent part of an employee's remuneration. The intention is to tax them accordingly, like any other form of employee remuneration.

At the same time it is not clear under existing law whether the cost to employers of providing shares to employees is deductible. It is proposed to expressly provide employees with a deduction equal to the amount of income taxable to the employee.

Existing employee share arrangements commonly provide for shares to be set aside in a trust for later transfer to the employee if and when the employee satisfies conditions. Frequently, transfer of shares to the employee will occur automatically upon expiry of a restrictive period, continued employment for a designated period being the sole condition. In other cases conditions may include achievement of

milestones either by the employee or by the Company.

Existing taxation rules measure the taxable amount on the shares by reference to their value at the commencement of the trust period. Any incremental gain in the value of the shares while they are set aside for the employee (previous to transfer of the shares to the employee) is ignored for tax purposes. That is true regardless of any benefits that the employee might have on the shares in the meantime.

Proposed new rules will ignore the value of the shares at commencement of the trust period. Instead they will tax them according to their value on satisfaction of the conditions to transfer the shares to the employee.

The proposals distinguish conditions that are substantial from those that are not. The taxing point on the shares will be triggered by satisfaction of those conditions that are substantial regardless of any other conditions that remain outstanding. One condition that will be ignored is a sale restriction on the shares. Often employees are denied the right to freely sell the shares post receipt of them. Any such restriction will not defer the tax liability.

Options and convertible notes are also frequently used in the context of employee share schemes. The benefit under an employee share option is taxed on exercise resulting in any uplift during the exercise spread being taxed. That will not change. Convertible notes are taxed differently again and are more tax efficient than option schemes. The proposals signal that the tax rules regarding them will be reviewed.

I forecast that these proposals, if implemented, will greatly curtail trust schemes. Future employee share schemes, if these proposals are adopted, are likely to comprise option schemes that are relatively simple to implement and easy to understand, though not highly tax efficient. On the whole they will likely discourage share ownership as a means of benefitting employees, with simple bonus schemes being preferred in many cases.

Shareholder Remedies…

The rights of shareholders to direct management of a company is often tested and frequently shareholders are sorely disappointed. Their disappointment could in many respects be avoided by way of a shareholders agreement to which the company is a party. The comments below assume no shareholders agreement operates to add substance to rights and remedies available to shareholders at law. Where a shareholder agreement does seek to substantively add shareholder protections, care needs to be taken in any event to ensure shareholders do not cross the boundary of indoor management and become directors, thereby assuming directors duties.

The starting point in the context of shareholder remedies is the provision for management review offered by section 109 of the Companies Act. That section expressly permits shareholders to comment on the management of the company at a meeting of shareholders. There is, however, a limitation on the usefulness of this right. That is because any resolution passed by shareholders relating to the management of the company is not binding unless the company's constitution contains a provision to that effect. Nevertheless, where a Board chooses not to abide by such a resolution, the directors are then exposed to the risk of a further meeting of shareholders called for the purpose of removing them as directors. A resolution to that effect at a properly convened meeting would be binding.

Shareholder proposals are a similar form of remedy. Shareholders are permitted to submit proposals, of up to 1000 words, at forthcoming shareholder meetings. Again resolutions that spring from these will not be binding where they seek to interfere with the management of the company.

A more often used, and more effective tool, is the right to convene a meeting of shareholders under section 121 of the Act. Any shareholder with 5% or more of the voting power in a company may require the company to convene a meeting. Resolutions to be tabled at the meeting are to be presented and contained in the notice of meeting. Procedural requirements for the meeting are contained in the First Schedule to the Act and may be modified, and often are, by the constitution.

A shareholder's right to information is expressly provided for. By section 178, shareholders may make a request to the company for information held by the company. In response to the request, the company must either provide the information or agree to do so in a stipulated time or upon payment of reasonable charges. A company has only limited rights to refuse the information, broadly being where the information is to be used for an improper purpose.

Other shareholders remedies will be discussed in a later newsletter.

Joint Ventures…

In an earlier newsletter (see issue 12, May 2014) I discussed joint ventures generally, in particular focusing on the choice of structure and exit arrangements. Their prevalence is so frequent, I have chosen to make some additional comments.

Often the joint venture participants bring different ingredients to the arrangement, one providing finance, the other providing expertise. For the financial participant, the contribution and commitment of the other party will be pivotally important. Protections in this area are common. Obviously protection against death or disability (or other disabling type events) of the "expert" is desirable. Key man insurance coupled with appropriate buy out rights are utilised here. Beyond that, protection becomes a matter of what can be negotiated. Parties may agree upon strict contributions of time on the part of the expert and assumption of control or takeout rights where the expert fails to deliver. Or, such failure may trigger consultation rights, perhaps with their own triggers and consequences where the parties are unable to agree.

It is wise to expressly provide for consultation procedures in a joint venture agreement. That is because there will be many and varied circumstances in which the parties are unable to agree, at first, and agreement is critical to implementation of the project. Hence, an agreed process for consultation is strongly recommended.

Hand in hand with this issue is regulation of related party arrangements. They are common place in joint venture arrangements and carry potential for unfairness, or perceptions of it, due to the lack of independence. Some process for establishing fair value is needed. It will be up to the parties to assess how best to achieve that, some form of independent appraisal or right to it is usual. Alternatively a link to an agreed performance measure may be appropriate.

Nothing is straight forward in these respects with each arrangement having its own peculiarities and unique features.

Our Website…

Read our newsletters online at www.speakmanlaw.co.nz.

Come visit…

Please feel free to pop in for a visit at Suite B, Level 1, 7 Windsor Street, Parnell.

Contact details

Peter Speakman

Principal

T: +64 9 973 0577

M: 021 854 642

www.speakmanlaw.co.nz