SPEAKMAN LAW

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Four quotes I enjoyed reading recently:

- Success consists of going from failure to failure without loss of enthusiasm.
- If you're going through hell, keep going.
- History will be kind to me for I intend to write it.

And my favourite…

- We make a living by what we get, but we make a life by what we give.

A prize to the first who can tell me who's quotes they are. Hope you enjoy them and what follows, articles on corporate structures.

Tainted Capital Gains…

There is an expectation that proceeds from the sale of capital assets are tax free. There is also an expectation that where a company derives a capital gain, it is able to distribute the gain tax free to its shareholders.

These expectations are not always met. This has caught out many people and resulted in multiple professional indemnity claims against advisers who have not known any different.

Capital gains realised by a company cannot be distributed tax free to shareholders except on liquidation of the company. This surprises many. It certainly is restrictive and gives encouragement to use of limited partnerships and look through companies (LTCs) which do not suffer from this restriction.

Moreover, a capital gain realised by a company on transacting with an associated person is subject to a further rule that in many cases denies the ability to distribute the gains tax free at any time, even on liquidation. In such cases, these gains are forever "tainted". Distribution of them, whenever that may be, will trigger a tax liability. The distribution is treated as a taxable dividend like any other.

There is merit in this rule. It ensures that group companies are not able to shift capital assets from one to the other so as to create a capital reserve fund that supplants a distribution that would otherwise constitute a taxable distribution of retained earnings.

To illustrate the merit in this rule, take for example a company (Company A) which owns a forklift on capital account. It sells the forklift to an associated company (Company B), for an amount that generates a capital gain for Company A. Assume that Company A has a history of making profits and has a retained earnings balance with insufficient imputation credits to shelter them. By having generated the capital gain, Company A now has cash available to it that it would otherwise not have that it can distribute tax free to its shareholders (on liquidation).

There is nothing untoward or unsurprising in this, however, assume Company A and Company B (being related) manipulate the value of the forklift to an amount above market. The result then is that, on liquidation, a distribution of Company A's reserves will trigger less tax than otherwise would be so because Company A will be able to distribute a greater part of the cash available to it by way of a distribution of capital gain and a correspondingly lower part by way of a distribution of retained earnings. Similarly, Company B's cash resources will have been reduced, thereby correspondingly reducing the quantum of any distribution of retained earnings that it may otherwise make, ie an overall tax saving.

Prior to 2011 this rule applied extensively to transfers of capital assets from one company to another where there was as little as 20% commonality of shareholding between the companies. In 2011, threshold changes to circumstances where there was 50% commonality. The scope of this rule has been reviewed and has recently been narrowed.

It now applies only where commonality meets a threshold of 85%. Where that threshold is exceeded there will often be steps that may be taken to ensure no inadvertent tax problem arises. I would be happy to advise you on those steps.

Debt Remission…

Long heralded relief from the age old problem of debt remission is now law. This is a huge boost to resolving a longstanding problem. Nevertheless, relief is not available in all cases so be careful. Instead relief is limited to arrangements within an economic group.

For companies that are members of the same wholly owned group, relief from debt remission income is uniform and unrestricted as between New Zealand parties. Often, however, we are dealing with other than a wholly owned group. In these circumstances a proportionate debt rule applies. This rule seeks to ensure that relief from debt remission income is only available where there is no economic change for the debtor company and its shareholders. For example, where the debtor company has two shareholders, each with a 50% shareholding and each having advanced the same amount to the company, it would be common for both shareholders to write off the debts owed to them to the same extent. Where that occurs there is no change in the overall economic position either for the debtor company or the shareholders. All that happens is the debtor company's balance sheet is improved while the value of the shareholders investment in the company remains unchanged. In these circumstances writing off the debt triggers no tax liability.

On the other hand if the debt is held by only one of the two shareholders, writing off the debt does alter the economic position. That is because the debt write off is suffered by one only of the shareholders. This results in an improved economic position for the other shareholder. In these circumstances writing off the debt will trigger a tax liability for the debtor company. Where the company is a look through company (LTC) the tax liability instead falls on the benefitting shareholder.

As always, care is required in tax planning. While it is true that relief from debt remission now exists, there are specific rules that limit the scope of the relief. In many cases with appropriate planning it ought to be possible to structure arrangements so as to fit within the scope of the rules.

Is it better to issue Shares or Convertible Notes…

Companies are generally able to issue shares at any time. All that is required is a board resolution and accompanying certificate from the directors that the issue price is fair, both to the company and to the existing shareholders. There will only be a restriction on a company's ability to issue shares where the company has chosen to do so in its constitution or a shareholders agreement places such a restriction.

The starting position is that all shares confer on the holder the same rights to vote and to receive dividends. This is very often changed, either by

constructing preference shares (ie shares that confer a preferential entitlement to dividends and/or a return of capital) or establishing shares that have no rights to vote but a full entitlement to dividends, or vice versa. In a private company setting these different classes of shares are common, with the individual holding shares conferring the right to vote and with his or her family trust holding the dividend bearing shares. In this way the wealth from the shares accrues within the trust whilst the individual remains able to control the company, unfettered by his or her co-trustees.

An alternative to issuing shares is to issue convertible notes. Simply put, these are loan instruments that confer on the lender the right to either be repaid in cash or in shares.

In some cases repayment in shares is mandatory; such instruments are called mandatory convertible notes (**MCNs**), in contrast to optional convertible notes (**OCNs**). Convertible notes are popular for contributors of capital because, unlike shares, they allow the holder to take security for their investment, usually in the form of a general security agreement. It is usual also for the conversion price, that is the amount at which shares will be issued, to be at a discount to market.

Aside from the functionality for a lender to take security on subscribing for a convertible note, the decision whether or not to subscribe for shares or for convertible notes is usually driven by tax considerations.

Convertible notes are a hybrid of debt and equity. To the extent they are debt instruments, they come within the financial arrangement rules (**FA Rules**) in the Income Tax Act; to the extent they are equity instruments they fall outside those rules. Tax treatment seeks to isolate the debt and equity components. An issuing company will obtain a tax deduction for interest insofar as the debt component pertains.

OCNs gained tax notoriety by dint of the court decision in Alesco NZ Limited v Commissioner of Inland Revenue in 2011. Alesco, an Australian company, had sought to fund its NZ subsidiary to make an acquisition (for over $70m). It chose to fund the subsidiary by way of an issue of OCNs. That funding allowed Alesco in NZ to obtain an interest deduction while Australian tax treatment did not recognise interest income, hence a mis-match between the New Zealand and Australian tax systems facilitated a tax advantage.

Inland Revenue successfully challenged the arrangement as one involving tax avoidance, to the surprise of many who pointed to strict compliance with express rules in the Tax Act.

Notwithstanding the Alesco decision, which is limited to its own facts (notably the cross border aspect), convertible notes remain a valid and convenient method for raising capital. Commercially the security aspects and ability thereby to obtain a preferential right of repayment, coupled with tax efficiency make them more effective to an issue of shares in many cases. They are also used for employee share schemes but I will save that for another article.

Minority Shareholders – Means of Protection…

Company law contains important and significant protections for minority shareholders. But in a practical sense these protections are limited. The make up of a standard New Zealand company is that in the case of the vast majority of them control lies in the hands of one or a small number of large shareholders. The minority shareholders are commonly at their behest and can do little other than where their interests are oppressed or minority buy out rights are triggered (it is a very narrow set of events that trigger them).

Minority shareholders are therefore best advised, wherever possible, to seek protection under a shareholders agreement (**SHA**). The remainder of this article discusses what sort of protections might be possible under a SHA. If you would like to know more about protections against unfair prejudice and oppressive conduct or the circumstances triggering minority buy out rights just let me know.

Director representation. Knowledge of the company's activities and operational and strategic shifts is key. This is best served by director representation. A usual provision in a SHA is to entrench a shareholder's entitlement to appoint a director for the shareholders who have a minimum threshold of shareholding, often 20% (this right would need to be negotiated on entry). Where your shareholding sits below that level, seeking director representation again would need to be negotiated but would most likely be opposed. Where no seat at the board table is forthcoming it might nevertheless be

possible to achieve a similar result by way of provisions requiring the company to share important information on a periodic (often quarterly) basis and/or for the majority shareholders to consult with the minority shareholders over any strategic matters.

Key Transaction Approvals. With a small shareholding, the ability to block key transactions proposed by the majority is often nought. The majority would want it that way for the very reason that the ability to control a company's activities goes to the heart of the size of their investment. A compromise may be to require the company to submit to each shareholder, proposals for transactions that would commit the company to a selected threshold of expenditure. Where a minority shareholder opposes the proposal but does not have sufficient shareholding size to block it, a compromise may be the right to require a third party assessment with approval dependent on the merits of the transaction being independently assessed. At the very least a provision to the effect that all transactions be undertaken in good faith is advised.

Drag Along/Tag Along Rights. Perhaps the most significant and relevant forms of protection for minority shareholders lie in the exit provisions. Minority shareholders in private companies usually have nowhere to go. Should they wish to exit the company, they may (and often are required to) to offer their shares to the other shareholders. If they do not wish to acquire the offered shares, however, the minority shareholder more often than not remains stuck, for want of liquidity in the shares.

A common means to improve all shareholders' rights in these respects is "drag along" and "tag along" provisions in the SHA. Drag along provisions entitle the majority shareholder to require minority shareholders to sell their shares along with and on the same terms as the majority holder. This serves to ensure that the majority holder is not locked in where a buyer is only interested in acquiring 100% of the shares. The drag along aspects facilitate the majority holder to negotiate a sell for 100%.

Tag along rights on the other hand protect the minority shareholder. They allow the minority shareholder to join in and ride on the coat tails of the major holder.

Absent tag along rights, a minority holder could find itself left behind following a sale by the major holder, with a new majority shareholder about whom the minority holder may know nothing. The risk for the minority is a change in direction for the company, which the minority does not agree with but which it can do nothing about.

In either case, whether it be the drag along or tag along rights at play, there is potential for the minority to be prejudiced, unless the share sales are clearly at market. In the case of a third party buyer, it is trite that the transaction will be at market. Not so where the buyer is a party related to the majority holder. In that case, reference to market value is required. There is much confusion about what this means, often the expression fair market value is used. I will discuss that in my next newsletter.

Our Website…

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

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