SPEAKMAN LAW

Observations from my desk are that the last few months have delivered increasing focus on the housing crisis and introduction of tax changes in response to it, alarm has deepened at the likelihood of additional taxes being introduced (for my money, something in this sphere is inevitable), business lending has greatly tightened and the suppression of skilled immigrants continues to imperil a variety of sectors (notably, construction, education, horticulture and hospitality). In the context of my practice, there is growing distrust of the benefits of trusts and heightened objection to the tightening of tax rules around property investment.

Of particular note is the rapidity of which the rules are changing across so many sectors and for so many people. Nonetheless, I have confined this newsletter to a handful of topics, as appear below. I hope you enjoy them.

Carrying Forward of Tax Losses

Companies wishing to carry forward tax losses for use against profit arising in a later year will greatly welcome new rules that apply from the present income year that are far easier to work with than those that have long been applicable.

Up until this income year, companies wishing to carry forward tax losses have had to maintain uninterrupted continuity of shareholding of not less than 49% throughout the period commencing with the year the loss was incurred until the loss was utlilised. Application of that test has proved particularly cumbersome for start-up companies because they invariably breach the shareholding continuity requirements test by raising ordinary capital to facilitate their growth. It has also proved unnecessarily limiting for internal reorganisations, for example implementing estate planning.

There is now a new "business continuity test" by which a company may carry forward tax losses provided there is no major change in the business activities of the company.

This business continuity test effectively negates worry about changes in shareholding provided the losses have been generated no earlier than the 2013/14 income year.

The key plank in the new test is the requirement that the company's assets from which it derives its income remains the same or similar.

At a practical level, the new test affords far greater, and welcome, flexibility. Reorganisations of business operations within a group, introducing new shareholders (e.g. family members or pursuant to an employee share scheme), interposing trust ownership of shareholdings are all frequent and innocent commercial happenings that previously have been hamstrung and henceforth will not be.

Similarly, capital raisings for start-ups have invariably entailed working around the detailed measurement of company ownership rules in the Tax Act, often by issuing loan capital, convertible notes or redeemable preference shares. Inevitably these have demanded compromises. That commercial setting has now changed, considerably for the better.

The ingredients of the new test, notably what is a 'major change' and what is meant by 'business activities' in that context will take time to bed down in specific situations. Nonetheless, the thread of something far more workable than previously, is now there and is welcomed.

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What's inside

Trusts – Importance of Residence of Settlor

Consider this scenario. You, as a New Zealand resident have established a trust, over time the assets of the trust have built up and amongst those assets, there is a share portfolio comprising both local and international shareholdings. You have been offered an employment role overseas which you pursue. No one advises you against continuing with your trust so you simply leave it in place.

You will have unknowingly, have created a potential problem for yourself. The problem is that you will have fallen into the interplay that bedevils the taxation of trusts in New Zealand. At its worst (and the worst is inevitable unless you take corrective steps), the result will be a 45% tax on distributions from the trust's accumulated income and capital gains.

This is not a new consequence (it has been so for 30 plus years) but nonetheless, in my experience, it continues to catch people unawares and perhaps is gaining greater prevalence as trust assets grow, particularly with prospering equity markets in the last decade or so.

What can you do about it?

There are two lifelines available to you. The first is to ensure that the trustees distribute all foreign sourced income to the beneficiaries in the year the trustees derive that income. Although that will mean the beneficiaries are taxable on that income, the applicable tax rate will be their marginal tax rate, and not the penal 45% tax rate worryingly referred to above. The second thing that can be done (particularly appropriate where it has become too late to distribute the income to the beneficiaries as beneficiary income), is to make an election under section HC33 of the Tax Act by which you elect responsibility for the tax liabilities to the trust. Such an election can be made at any time within 4 years of the trust deriving the overseas sourced income.

Tax consequences for trusts that entail any degree of foreign investment or establishment can be tricky. Advice in this area is strongly recommended to avoid unwanted surprises.

Memorandum of Wishes – Should You Have One?

Focus on trusts with the passing of the Trusts Act has, in turn, brought focus to the question whether one should have a memorandum of wishes (MOW) in accompaniment with his or her trust and the extent to which it binds the trust.

It is perfectly natural for a person, at the time of establishing a trust, to indicate to the trustees, what he or she would like the trustees to do. Often it will be helpful for the trustees to receive an indication of wishes from the founder of the trust. Nonetheless, giving a MOW, and moreover reliance by trustees on a MOW, demands caution and adoption of best practice, as noted below.

A MOW, at least of the type contemplated in this article, sits outside the trust deed and legally speaking is not part of the trust arrangement at all. Trustees are, again legally speaking, required only to have regard to and observe the terms of the trust as set out in the trust deed (and by one school of thought, need not pay regard to a MOW at all). There is therefore a dilemma as regards a MOW – how might it be given in such a way that the trustees will have due regard to it and yet not undermine the trust and the trustees duties by doing so?

Best practice is to write into the trust deed a provision for a settlor (or such other person who may have contributed substantive assets on the trust) to provide a MOW, directing the trustees to take note of it.

This gives the Court an express reference in the trust deed recognising the need for the trustees to refer to a MOW. In this way, the trustees cannot be criticised for having regard to a MOW and not solely regarding the trust deed in the exercise of their powers. Without such a provision, there is argument that adherence by the trustees to a MOW is improper because it would effectively empower the giver of the MOW with the rights to amend the trust deed from time to time, via replacement and successive MOWs.

Accordingly, I recommend existing trust deeds be amended on this score, and for new trusts to contain such a provision. Such a clause may read:

"The Settlor may from time to time provide one or more Memoranda of Wishes to the Trustees and intend that the Trustees take into account the wishes expressed therein in exercising their powers under this deed, without being legally bound by those wishes."

Who can provide a MOW? Usually it is the settlor who provides a MOW. That won't be appropriate though where the settlor is a nominee, perhaps the solicitor who drafted the trust deed.

In fact anyone can provide a MOW, but for the trustees to choose to have regard to it, the person who has contributed the assets to the trust would ordinarily be the provider of the MOW. That begs the question what is to happen once that person is deceased, bearing in mind that a trust may continue for 125 years (extended from 80 years by the new Trusts Act) and 'outlive' the founder of the trust.

Might the founder's children be entitled to give a MOW? It is really up to the trustees at that point. While a MOW given by the founder's children is certainly feasible, the trustees will need to balance its directions against the intentions of the trust, as far as they can discern them to be. As always, trustees used to step back, look at the big picture and make all decisions in good faith for the benefit of the trust.

Rental Properties – Removal of Interest Deductions

Housing affordability is a major concern, as all readers know well. The issue exacerbates many unwanted behaviours, hinders hope for many parts of society and invariably promotes division between the haves and have-nots.

A fix is needed, few people debate that. I will leave it to the economists and those working in the housing and building industries to agree on what that fix should be, they being the experts in that area and expert in that area is something I am not.

On the other hand, comment on removal of interest deductions connected with residential investment properties is certainly something I am qualified to discuss. I could also discuss the extensions of the 'brightline test' to 10 years but I reserve the discussion here to the subject of interest deductions.

Readers will know that what is proposed (and presently being consulted on) is that from 1 October interest deductibility is to be denied on all residential investment properties acquired on or after 27 March 2021. For properties acquired before that date, interest is to be reduced over the next 4 income years. The main home is exempt, as is farmland along with retirement villages, and hotel and motel accommodation.

When these announcements were made, concern was perhaps most strongly felt by residential property developers. That concern is, in good part, alleviated by a carve out for 'new builds'. Interest deductions incurred in connection with a 'new build' will remain available, consistent with the Government's efforts to enhance housing supply as one part of the puzzle in redressing housing affordability.

What is a 'new build'? We need to see some draft legalisation to be able to answer that. Will, for example, conversion of an office block into residential apartments qualify? What about add-ons, such as an additional unit to an existing block of units? No answers to these questions are presently available.

Another important question is whether interest costs, for which no deduction has been allowed, will be recognised as a deductible expense against tax payable on the capital gain arising in the year of sale. Again, presently there is no answer to that question.

For many reasons the draft legislation is keenly awaited. The sooner this is issued the better, given the uncertainty facing so many who are affected in the interim. This is one instance where, in my view, it would have been advisable for the Government to have released draft legislation to accompany its announcement, thereby answering many of the present unanswered questions, and then to have consulted on the draft legislation.

Where a Company Suffers a Loss, is a Shareholder Entitled to Compensation?

An indirect consequence of a loss suffered by a company is a reduction in the value of the shareholders' shares. Can a shareholder seek recovery for that reduction in value? This is referred to as the reflective loss principle i.e. a loss suffered at the company level reflects upon the shareholders, causing them loss also.

In New Zealand, our company law acts as a major obstacle for a shareholder seeking recovery for a reduction in the value of his, her or its shares arising from a loss suffered by the company. The obstacle is section 169(2) of the Companies Act which bars a shareholder from pursuing a claim for a loss of this type against a director for breach of duty owed to the shareholder. The underlying idea is to deny double claims, one by the company and another by the shareholder for the same loss.

Nonetheless, shareholders (and creditors) are not always barred from seeking recovery on account of a loss suffered at the level of the company, as two cases show. The first is a 1996 New Zealand case

(Christensen v Scott). Mr and Mrs Christensen were equal shareholders and directors in a company. The company collapsed following negligence on the part of the company's professional advisors (it's lawyers and accountants). The Christensen's founded their initial claim on a duty of care owed to them as shareholders. This claim failed to overcome the obstacle referred to above and lost. But that was not the end of the story. The Christensen's subsequently sued the advisors in their capacity as clients for breach of duty owed to them as clients, and not as shareholders. That claim was successful. Hence, a shareholder might not always be denied recovery for a reflective loss of the type discussed here.

A recent UK Supreme Court decision is an example of a creditor obtaining recovery, overcoming the reflective loss principle. That case involved a claim by a creditor against two companies in circumstances where the creditor had been deliberately thwarted by the person in control of these companies. The creditor had succeeded in obtaining a judgment from the court in the creditor's favour for breach of contract by the two companies. In response, Mr Sevilleja (who controlled the companies) stripped the companies of their assets, diverting them to himself, and then proceeded to liquidate the companies. The creditor brought a claim against Mr Sevilleja in tort (a different legal basis from either contract law or company law) and succeeded. A claim in company law would have failed on account of the reflective loss principle, but the unconscionable behaviour permitted a claim in tort.

A common situation where a shareholder seeks to bring a claim for his, her or its loss is pursuant to warranties given in a share sale agreement. Purchasing shareholders need to be careful to ensure that the breadth of warranties is adequate for two reasons. First, absent a warranty to fall back on, a shareholder will often be denied the right to claim for a loss in the value of the shareholder's shares where the company suffers loss, as a result of the reflective loss obstacle discussed here. Secondly, any inadequacy in the scope of a warranty is often compounded by what is called a No Reliance clause, by which a purchaser is denied a claim against a vendor other than in respect of a matter that is expressly warranted by the vendor.

Insider Trading

Insider trading regulation most often comes to the limelight in the case of publicly listed companies, as is currently the case facing Eric Watson in relation to various of his US shareholdings.

New Zealand company law also extends insider trading laws to private companies, no matter how small or how large. Their application in relation to a private company with only 2 shareholders was at issue in a 2015 Court of Appeal case discussed below. That case illustrates that insider trading laws carry considerable weight.

The introduction given in the judgment neatly paints the picture and reads "A company director buys the shares of a minority shareholder. The director does so without telling the minority shareholder that the company is in the process of negotiating a highly lucrative deal that, were it to go ahead, would significantly affect the value of the shares. Shortly after the shares are transferred, the lucrative deal does indeed go ahead. The minority shareholder (who had also been an employee of the company) finds out about it and sues the director."

To paint the picture further, the minority shareholder sold his shares to the majority holder and director for $1m; unbeknown to him their true value was nearly $3m. The director simply chose to withhold that little detail (from the minority shareholder). What are a director's obligations here? Is the director required to disclose information to minority shareholders so as to put them on a level playing field? Are majority shareholders (as applied to directors) required to do that?

The law is very clear in these respects. It is directors who are subject to insider trading laws; they do not apply to majority shareholders (though shareholder agreements and specific rules for listed companies may apply to them). They do not impose on directors an obligation to disclose information; instead they require a director to abstain from dealing with shares unless at fair value.

In the scenario discussed above the insider trading provisions (section 149 of the Companies Act) effectively denied the director from taking advantage of the lucrative deal that he was in the midst of negotiating, known only to him. His only options were either to not buy the shares off the minority shareholder or do so, only after telling him everything that the director knew. Interestingly, on the facts the Court established that the director owed a fiduciary duty to the minority shareholder to disclose the lucrative deal to him in any event. This was due to the minority shareholder's employment relationship with the company and the extent of the director's control of the company.

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