SPEAKMAN LAW

May 2022

Issue 41

What's inside

Cost of living increases, rising interest rates, waning share market performance, a slow down in the surge of house prices, ram raids and a European war currently dominate the news, all of which provides good reason not to watch the news. There are other things to keep abreast of, however, notably a possible forthcoming welfare tax, and also a 'mini' form of capital gains tax on share sales (discussed below), continued challenges against trustees, and a rally for fairness in commercial bargaining. I discuss these subjects below and trust you enjoy the discussion.

Challenges Against Trustees

Challenges against decisions of trustees arise in a wide number of areas. I discuss here two alternative bases for challenging a trustee's decision, namely argument that the decision is ill considered and not in the best interest of the trust and secondly, based on a trustee's conflict of interest.

There are many instances of cases that have progressed through New Zealand courts on both scores. I have selected two cases as illustrative of the issues.

At issue in the 2019 case McLaughlin v McLaughlin was a family dispute concerning a block of farmland in Stoke, Nelson. Mr and Mrs McLaughlin senior had purchased the block in the 1960s with the intention ultimately of subdividing it into individual lots in order to maximise returns to the beneficiaries.

The land had been settled on a trust in which one of the sons, John, found himself as trustee and his 3 brothers were not. John, in agreement with an independent trustee, pursued a subdivision of the land, as his father had intended; two of the brothers opposed it and the third took a passive role, generally in support of the opposition lodged by his two brothers.

The Court had to decide whether John's pursuit of the subdivision was proper in light of the opposition mounted by his brothers.

Essentially the Court found that the commercial activities of the trust were legitimate, and it would be wrong for the Court to usurp the role of the trustees. Furthermore, the proposed subdivision was in accordance with the terms of the trust and the settlor's

Want to know more about the new Trusts Act?
We can help

wishes. This begs the question what more could the trustees have done to stave off a challenge by the beneficiaries. The reality is that there was nothing more that they could have done, other than seek Court approval at the outset.

The second case that I have selected for discussion is the Supreme Court 2016 decision in Fenwick v Naera, being a case based on the no conflict rule.

All Supreme Court decisions are of interest and this one all the more because of the conflict of interest issues at the heart of the decision. The case involved a number of Māori trusts that were parties to a joint venture agreement. The Court of Appeal had set aside Tikitere Trust's participation in the joint venture arrangement on grounds that two of the five trustees should not have participated in discussions and voting on the joint venture arrangements because of interests in, and links with, the other trust parties to the joint venture. On appeal, the Supreme Court addressed the self-dealing rule relating to trusts.

First, the Supreme Court decided that the self-dealing rule is not limited to purchases, and in any event has been applied to leases of trust property to trustees. At its most basic level, the self-dealing rule is based on the no-conflict rule: having an interest or duty on both sides of a transaction. The Court determined that where a trustee is interested in both sides of a transaction, that transaction is voidable (at the discretion of the Court even where the transaction was fair and honest, and the trustee has given full value for the property).

The Court also addressed whether the self-dealing rule applies when the trustee has not placed him or herself in a position of conflict of interest and duty but has been placed in the position expressly or by necessary implication by the settlor or the terms of the trust. The Court did not accept argument that this limited the self-dealing rule in any way and upheld the Court of Appeal's decision.

What these cases signal is that in circumstances where a course of action proposed by trustees may be unacceptable to one or more groups of beneficiaries, and especially where a trustee is conflicted (by being on both sides of the transaction), trustees are well advised to make application to the Court to countenance their proposed actions. Failure to do so may embroil the trustee in a protracted and costly dispute.

Break Fees & Exclusivity Arrangements

The commitment of resource by purchasers of large businesses often prompts early stage negotiation of an exclusivity arrangement and/or a break fee payable to the purchaser.

Perhaps the most common instance of a break fee is in the case of a business purchase, which inevitably being a major transaction, requires shareholder approval which may or may not be forthcoming.

Alternatively, a buyer may seek a break fee in the event the vendor fails to fulfil a material condition precedent or suffers a material adverse change.

What is an appropriate size of break fee? There is no hard and fast rule here. In the U.S. there is evidence of a maximum of 3-4% of the value of the transaction. Above that level, there is risk that a break fee may deter competing bidders thereby denying a vendor company the opportunity to receive the best available price or potentially swaying shareholders in favour of accepting an offer where rejecting it would cause them indirectly to incur the break fee. Where a break fee is sufficiently large to produce these effects, the directors run the risk of being in breach of their directors duties. In a takeover context, directors would also need to be mindful of the rules against defensive tactics in the Takeovers Code (rule 38), for the possibility of deterring a bidder who knows, that if it is successful, it will suffer the economic cost of the break fee.

Conversely, the commitment of resource by a vendor to assist a purchaser in its due diligence investigations might warrant a target company seeking a break fee from the purchaser. A break fee in these circumstances might be desired to protect the target company against the purchaser's failure to obtain financing or a regulatory approval (Commerce Commission clearance or authorisation or Overseas Investment Office approval) or failure to satisfy conditions by a sunset date.

Exclusivity arrangements are far more common and by and large take one of two forms:

a) "no shop" clauses preventing a target company from soliciting offers from third parties, or

b) "no talk" clauses preventing a target company from negotiating at all with third parties.

The commercial reality is that a prospective acquirer is exposed to expenditure of large sums in carrying out due diligence and to opportunistic behaviour by the directors of the target company to proffer the potential interest in support of an improved offer from a third party. An exclusivity arrangement guards a potential acquirer against that course.

For the target company of course it denies them the opportunity to explore the market. This again raises the spectre of directors duties and begs the question whether the directors are permitted to grant a right of exclusivity, particularly if the period is to span many months. That argument was made in a case involving Greymouth Petroleum in its pursuit of part of Fletcher Challenge's business. Argument to this effect has prompted limitation on an exclusivity arrangement by way of what is called a 'fiduciary out' clause. Such a clause permits a target company to overcome an exclusivity arrangement where compliance with it would put the directors in breach of their directors duties.

Good Faith in Commercial Bargaining

Is there such a thing? No; there is no general obligation on contracting parties to act in good faith, either in negotiating or in the performance of a contract. This reflects the need to preserve the freedom of the parties in their negotiations and the desire to avoid uncertainty. A duty that would allow parties to refuse to honour a contract on the grounds of unfairness or breach of good faith would introduce great uncertainty i.e. it would be unpredictable whether the clause had been breached.

What does an obligation of good faith impose? For example, a clause might state:

> "The parties will co-operate with each other in good faith to facilitate the performance of the Agreement."

Such a clause should, at the very least, prevent a party from taking action that frustrates the purpose of an agreement and prohibit a party from knowingly misinforming the other party.

An express term of good faith was included in a joint venture agreement between Symphony Group and Pacific Heritage that fell into dispute. The particular clause read:

> "the success of the joint venture is in part dependent on the parties working together in good faith….and each does agree that it will at all times act in good faith."

The joint venture comprised a 50/50 property development. Upon relations breaking down between the participants and resulting legal action, the Court determined that the failure to act, with the intention to frustrate a contract, did not constitute acting in good faith.

A related area of law is economic duress in commercial bargaining. Here again there is a strong principle of freedom for parties to negotiate a contract as they please. The recent UK decision in Pakistan International Airlines v Times Travel illustrates the point.

The airline had entered into a contract with Times Travel, a travel agent entitling Times Travel to commissions on tickets sold. The airline defaulted on the obligation to pay commissions, and took advantage of its superior bargaining position to force Times Travel to accept onerous terms. Times Travel had no option but to agree but nonetheless brought legal proceedings against the airline on the basis of economic duress – and lost.

Dividend Integrity Proposals

In March, the Government released a discussion document comprising proposals that notionally seek to buttress the top 39% marginal tax rate, but which in truth represent a further creep towards capital gains tax on share sales. The proposals, if adopted, will tax gains on sales of shares in the circumstances discussed below.

These proposals reflect Inland Revenue's concern that companies (and for that matter, trusts) are being used by high wealth individuals to avoid tax at the top 39% marginal tax rate. In addition to the dividend integrity proposals discussed here, this has precipitated the high net wealth research project (which I touch on in my November newsletter).

The broad effect of the proposals is that any sale of shares in a company by the controlling shareholder (holding 95% or more) will be treated as giving rise to a dividend to the shareholder to the extent that the company (and its subsidiaries) has retained earnings.

In the absence of a capital gains tax system (or a tax avoidance purpose), a shareholder would expect not to be taxed on the proceeds of sale of his or her shares. That expectation may be lessened in the case of an internal reorganisation (particularly if it produces a tax advantage by capitalising earnings that would otherwise give rise to a dividend; specific dividend stripping provisions already tax such arrangements in any event). The expectation of a tax free receipt would, however, remain where shares are sold by a controlling shareholder (or group of them) to a third party in a genuine sale transaction. These proposals, if adopted, will shatter that expectation where and to the extent that the company that is being sold has retained earnings.

Some commentators suggest none of this matters because the company would invariably declare a pre-completion dividend in any event. That dividend would effectively strip the company of its retained earnings and so there would be no problem. The company would naturally want to declare the pre-completion dividend in order to make use of its imputation credits. The theory here is that where a company has retained earnings, it must have paid tax on them and so will have imputation credits to attach to the pre-completion dividend. Moreover, those imputation credits would be lost upon the share sale because the continuity of shareholder test for carrying forward imputation credits would be breached, therefore encouraging declaration of the dividend.

This suggestion holds true in many cases, but not all. It presupposes that a company's retained earnings are backed by imputation credits. Consider a company that has shares in a foreign company. Dividends on those shares are exempt under the foreign company dividend exemption. Consider too a company that invests in a PIE. Amounts received from the PIE are excluded income. In neither case will the Company's retained earnings be backed by imputation credits. Similarly, a NZ company with investments in foreign investment funds and which chooses the FDR method of tax on its attributed foreign income will have no imputed retained earnings on any actual dividends received that exceed the FDR notional income calculation.

In each case, the proposals will accelerate a tax liability in opposition to current tax settings and with no ability to resolve the issue by way of an imputed pre-completion dividend.

Consider also, a sell down by a founding shareholder under an employee share scheme arrangement. The proposals have potential to tax the founder on the sale proceeds, which invariably will be priced into the sale price, making the employee's participation in the scheme more difficult.

It is my view that these proposals go too far and should be limited to tax avoidance arrangements.

Personal Services Income Attribution Rules

Hand in hand with the dividend integrity matters is a proposal to widen the scope of the personal services income attribution rules.

The attribution rule prevents an individual avoiding the top personal tax rate by diverting income to an associated company or trust. It is common for example, for an individual to incorporate a company and provide services through the company. The company is then taxed on its earnings at 28% and invariably pays a salary to the individual who provides the actual services. That salary may be at below market rates. To the extent it is, a tax advantage is obtained via deferral of the tax rate of tax on the amount 'retained' in the company representing the difference between the actual salary and the market value of that salary.

This practice gained notoriety as a result of the 2011 decision in Penny and Hooper v Commissioner of Inland Revenue that went all the way to the Supreme Court. That case involved two orthopaedic surgeons who had operated their respective surgery practices personally. Each of them chose to substitute a company through which to operate their practices. The quantum of salaries they extracted from their respective operating companies bore only a proportion of their pre-reorganisation earnings (in each case well below 50%) and were established to be below market value. To the extent of the below market level of salaries, a tax advantage was obtained and they were each found to have had a tax avoidance purpose.

This precedent perhaps arms Inland Revenue with all the ammunition it needs to combat these sorts of arrangements. Evidently, Inland Revenue thinks otherwise.

The existing personal services income attribution rule is subject to three principal criteria. These are:

a) at least 80% of the associated company (or trust's) income from personal services during the income year is derived from the supply of services to a single third party customer (the "80% single source rule");
b) at least 80% of the associated company (or trust's) income from personal services during the income year is derived from services that are performed by the individual (the 80% single supplier rule");
c) substantial business assets (property with a cost of more than $75,000 or 25% of the company – or trust's – total income from services for the income year) are not a necessary part of the business structure that is used to derive the business income.

Note that the attribution rule only applies where a minimum threshold of $70,000 annual earnings is reached.

It is proposed that the 80% single source rule be removed altogether. Inland Revenue is also considering lowering the threshold for the single supplier rule to 50% and increasing the threshold for the substantial business asset trust, to either $150,000 or

$200,000 (or 25% of the company – or trust's annual income).

No lift in the minimum $70,000 income threshold is proposed.

In order to visualise the effect of these proposals, take for example a single man/woman law or accounting practice, with perhaps one employed solicitor or accountant (in addition to the proprietor) and one support person. Inevitably, the source of the firm's income will be derived from an array of clients, at least 50 and perhaps well over 100, and with the largest single client representing perhaps 25% or thereabouts of the firm's revenue. The proprietor might bring in say, 60% – 70% of the fees through his or her efforts and the employed solicitor or accountant might bring in the other 30% - 40%. The firm will invariably rent premises and, incur rental, power, staff, professional indemnity insurance and other normal business operating costs. Its assets will be minimal, limited to the necessary office furniture and computers, along with cash on hand and debtors of course.

The firm will most certainly want the protection of limited liability (as far as it is available) and so the business will be operated through either a company or a limited partnership. Let's assume a company is chosen as the operating structure.

Presently, the personal services income attribution rule will not apply to the firm because neither the 80% single source rule nor the 80% single supplier rule is breached. Under the proposals, both these rules will be breached. The substantial business assets test will not remove the firm from the personal services income attribution rule because the assets of the business are minimal, notwithstanding sizable infrastructure costs (rent, staff costs etc) that may be 40% - 50% of the firm's income (and perhaps more).

Consequently, the personal services income attribution rule will apply to assign all the business income to the proprietor. To me this is a bridge too far, an overreach and well beyond Parliament's intention in legislating the personal services income attribution rule.

Our Website….

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

Come visit…

Please feel free to pop in for a visit at Level 15, 36 Kitchener Street, Auckland.

Contact details

Peter Speakman

Principal

T: +64 9 973 0577

M: 021 854 642

www.speakmanlaw.co.nz