SPEAKMAN LAW

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"Queen of light took her bow, and then she turned to go,

The Prince of Peace embraced the gloom, and walked the night alone. Oh, dance in the dark of night, sing to the morning light. The dark lord rides in force tonight, and time will tell us all."

Led Zeppelin lyrics, a special prize to the first of you who can pick the song. With Hillary and Donald head to head it seems apt to say "the pain of war cannot exceed the woe of aftermath" (more from Robert Plant). November 8 we will know where we stand.

Meanwhile on the home front there has been a constant shudder of activity. Selected items appear here. I trust they are helpful and interesting, as always if you require further information, I am here to help…

Takeovers Code – Small Companies Minimum Asset Threshold…

Those familiar with the Takeovers Code will immediately sympathise with the inordinate compliance costs (north of $100,000; for large and complex takeovers, costs can be many multiples of that). For small companies, costs at this level are unduly burdensome.

Those familiar with the Takeovers Code will know that it is not just companies listed on the NZX that are in this boat; any company with more than 50 shareholders and 50 share parcels is subject to the Code regardless of whether its shares are listed on a stock exchange and regardless of size.

At the heart of the Takeovers Code is the fundamental rule in Rule 6 of the Code which denies a shareholder the ability to obtain greater than a 20% stake in a Code company without making a full or partial offer (for the shares not already held by the offeror). The fundamental rule applies universally unless the arrangement falls within one of the exceptions. Those exceptions prescribe that the offeror need not make a full or partial offer where shareholder approval at general meeting is obtained nor where the offeror already has a 50% holding and the increase in shareholding is of no more than 5% in a 12 month period (known as "creeping"). There is also an exception in the case of a shareholder who already has a 90% holding, for whom there are no restrictions on increasing their stake.

Proposals are afoot to assist small companies in these respects. These proposals are by way of an intended amendment to the Takeovers Act which, if passed, will introduce a minimum threshold in order for the Code to apply.

It is proposed that the Code will only apply to companies that have a minimum asset base of $20m and which would otherwise be a Code

What's inside

- Takeovers Code; small companies minimum asset threshold
- Shareholder Approvals – when are they required?
- Limited Partnerships – safe harbour against no management rule
- Corporate Tax Legislative Developments
- Tax indemnities in Share Sale Agreements
- Hybrid Mismatch Arrangements

Briefly - sport

- ABs now with 18 straight wins, tests against Ireland, Italy, Ireland (again) and France to come then 3 tests against the Lions next year
- Black Caps chasing 270 to win first ever home series in India, skittled for 70, meanwhile England lose to Bangladesh for first time in a test
- US win Ryder Cup, Mickelson shoots 63 to tie with Sergio Garcia in lowest ever halved match
- Nico Rosberg leads Lewis Hamilton in Formula 1 standings

Briefly – Law/Special Interest

- Sky/Vodafone merger: Commerce Commission issues a never before published letter of unresolved issues citing concerns around vertical/conglomerate effects
- Deutsche Bank seeks to bolster its balance sheet by selling $400m stake in Las Vegas gambling group
- Pooling order granted making Steel & Tube Holdings Limited liable for debts of its failed subsidiary
- David Cunliffe to resign from politics
- Every day more money is printed for Monopoly than the US Treasury

company (ie 50 or more shareholders or companies in respect of which its shares are listed on the NZX).

This is a welcome addition to the exemptions from the Code, albeit it will likely be of only minimal practical application given NZ has only 1000-1500 Code companies.

Shareholder Approvals – When are they required…

An often asked question and often blurred issue is when does a company need to obtain shareholder approval and where is the dividing line for matters within the purview of the directors?

The starting point is the management rule in section 128 of the Companies Act which broadly confers on the directors the jurisdiction to manage unless the constitution, or a shareholders' agreement, says otherwise. Section 128 broadly puts management powers in the hands of directors. Shareholders may not, even at general meeting, override directors' decisions, nor dictate that directors act in a particular way.

There are exceptions to this, however. First, section 109 of the Companies Act permits management review by shareholders at general meeting (section 121 offers similar rights). At a meeting of shareholders called pursuant to section 109 (or section 121), shareholders will have an opportunity to question, discuss and be heard on matters of management. Indeed a shareholder may even require that a certain resolution be put to the meeting. That resolution will not be binding on the directors (unless the constitution otherwise provides) but, nevertheless, only a brave board of directors would proceed against the wishes of the shareholders, as ultimately the shareholders' recourse is to remove the directors.

A second and paramount exception is that contained in section 129 for major transactions. A transaction that involves gross assets that are the greater part of those of the company, ie over 50% is a major transaction. A company may not enter into a major transaction without shareholder approval. In addition some other matters are reserved to the shareholders. These are resolutions to:

1. appoint or remove a director or auditor;
2. adopt or amend a constitution;
3. approve an amalgamation;
4. put the company into liquidation.

Notably, unlike the position under the earlier Companies Act, unless otherwise provided for in the company's constitution, the board may by itself (ie without recourse to the shareholders) issue shares, approve transfers of shares and reduce capital.

For privately held companies it is usual to be more prescriptive on the directors' powers. There is often a desire for greater control at the shareholder level. This is usually achieved by way of appropriate provisions in a shareholders' agreement. Examples of matters that are often reserved to shareholders in this way are:

a. material changes in the size, nature and scope of the company's business or cessation of any part of it;

b. material changes in the company's structure, whether by alteration to shares or a change to the company's constitution;

c. the sale or disposal of property with a value in excess of, say, 20% of the company's net shareholders' funds;

d. an acquisition at that same threshold;

e. loans, other than in the ordinary course of business;

f. incurring liabilities, including by taking on staff, in excess of, say, 10% of the company's shareholders funds.

Hand in hand with this issue is what authority does an individual director (being one of a number of directors) have. The usual starting point to answer that question is the express power to delegate management powers, contained in section 130 of the Companies Act. By that section a company may, through its board, delegate management powers to individual board members or senior executives as best suit it. More often, however, no express delegation has been made and instead "custom" operates. Where this is the case, laws of agency and ostensible and implied authority apply. Those issues have been well traversed in law and are well beyond the scope of this article.

Limited Partnerships – Safe Harbour against No Management Rule…

I have established many limited partnerships. I have found them to be popular given their flow through tax treatment and relaxed rules prescribing eligibility of partners (unlike a look through company for example, a company may be a limited partner in a limited partnership and there is no restriction on the number of partners).

A problematic issue is retention for a limited partner of control over the partnership's activities. Here, the no participation in management rule applies namely, by section 20 of the Limited Partnerships Act, a limited partner is not permitted to take part in the management of the limited partnership. A breach of this rule carries the penalty of loss of limited liability for the partner concerned.

There are some "safe harbours" in which a limited partner may participate without losing liability. An example is the ability to take part in decisions to vary or replace the partnership agreement.

Notwithstanding these safe harbour zones the usual means by which a limited partner is given management powers is indirectly via the general partner. It is the general partner that has the powers of management of a limited partnership. Usually this is a company. That is so as to obtain limited liability for the general partner.

This begs the question who controls the general partner company. In this respect, it is common for each of the limited partners to hold the shares in the general partner company and, by way of a shareholders' agreement, to prescribe how the general partner goes about managing the limited partnership. In this way, although no limited partner participates directly in management of the partnership, the limited partner is nevertheless, indirectly, able to have input into the management of it.

Potentially a limited partnership may be a director of the general partner company. In that capacity it is not difficult to envisage the limited partner negotiating contracts on behalf of the limited partnership, for example banking arrangements. At issue then is whether this oversteps what a limited partner may do and cause the limited partner to fall foul of the no management rule.

There is no law on this. The answer probably lies in the partner's own assessment of risk. As mentioned, the consequence of breaching the no management rule is loss of limited liability for the partner concerned. That is a major deterrent and that risk will, for most, ensure they stay well clear of wherever the boundary may lie. If the separate legal entity status of the general partner company is respected there should be no issue here; in that instance it is the general partner (acting through its directors) that manages the limited partnerships. However, more and more our courts are, seemingly, moving towards what might be called a "substance" approach. A continuing trend in that direction may well mean that these sorts of arrangements breach the no participation in management rule.

Corporate Tax Legislative Developments…

I discuss here relaxation of the related party capital gains rules, removal (mostly) of share class restrictions for look through companies (LTCs) and the rules related to corporate beneficiaries of trusts with a shareholding in a LTC.

Ever since I have been in practice, I have lived with the problematic related party capital gain rule. By that rule, with some exceptions, a gain realised on the sale of a capital asset to a related company becomes "stigmatised"; such gain does not trigger an immediate tax liability but cannot be distributed tax free to shareholders, even on liquidation. The rationale for this rule is broadly to prevent an asset being transferred around a group of companies in order to create capital reserves that may be distributed tax free.

This year's big tax bill will, if passed, relax this rule. The new rule will see the problem reduced to situations where the transferor and transferee are companies that are commonly owned as to 85%. The new rule will also permit, without creating a tax consequence, an asset to be transferred to a commonly owned company where the asset is then on-sold to a non-related party prior to liquidation of the original asset owning company. Relaxation of this rule is welcomed. In tandem with that is a wish for the new rule to be given retrospective effect (so as to effectively shelter capital gains that have already been created by commonly owned companies). We shall wait to see whether submissions to that end are accepted.

A little known rule is that LTCs may not have more than one class of shares, ie all shares in a LTC must carry precisely the same rights. This restriction is to be largely removed. Under the Bill it will be possible to have different classes of shares provided all shareholders have the same rights, proportionally, to dividends and other distributions. Similarly, all shareholders must have the same rights, proportionally, to vote on distributions and variations to capital of the LTC.

Again, these changes are welcomed.

The Bill also proposes tightening of the rules relating to corporate beneficiaries of trusts that hold shares in a LTC. Existing rules prohibit a company from being a shareholder in a LTC, but do not prohibit a trust from being a shareholder regardless of any corporate beneficiaries. Only where a distribution is made by the trust to the corporate beneficiary is it considered. In that case the natural persons with voting or other interests in the company are brought into the reckoning for determining whether the LTC continues to meet the 5 or fewer shareholder eligibility requirement.

The rules are to be tightened here to effectively prohibit a trust that holds shares in a LTC from making a distribution of income to a corporate beneficiary. This is regardless of the source of the income that is distributed by the LTC (ie even if sourced other than from the LTC) and regardless of the number of natural person shareholders in the company.

This amendment seems sensible given the policy against corporate (and potential widespread) shareholding in a LTC.

Tax Indemnities in Share Sale Agreements…

Warranties and indemnities in an agreement for sale and purchase of shares or of a business generally reflect a "your watch/our watch" philosophy, ie vendors are prepared to accept liability for anything that has happened under its period of ownership; purchasers wish to limit their risk to events under the purchaser's period of ownership and control.

In relation to tax matters they are extremely difficult to negotiate. Take for example, a gain realised on sale of a property that is sold subsequent to the purchase of shares in the company. Sale of shares in the company itself will not trigger a tax liability in relation to the property; it is only the subsequent decision by the purchaser to cause the company to sell the property that triggers a tax liability. The obvious question is whether the vendor should be liable for tax that arises from a decision made by the purchaser after completion. If so, for what period following completion ought the vendor remain on the hook?

Similarly, a tax liability for a target company might arise due to the purchaser having a different view of the tax treatment adopted by the company under the vendor's ownership. A purchaser might in those circumstances file an amended return for a pre-completion period and/or make a voluntary disclosure. Should a vendor bear liability in those circumstances? Take further the example of a vendor of a company with tax losses. A sale of a property by the company while still under the vendor's ownership would invariably not trigger a tax impost due to the ability to utilise the losses. Sale of the shares, however, would (assuming a transfer of more than 49% of the shares) cause the tax losses to be forfeited; where sale of the property post completion is a taxable event, no longer will there be tax shelter and instead there will be a tax impost. Should the vendor wear that impost? Where that tax impost generates a tax credit, should the vendor effectively be allocated that credit against its indemnity liability? If so, how and to what extent? Likewise a common scenario is a company's imputation credit account having a debit balance at year end, post completion, essentially as a result of pre-completion dividends having been too large or provisional tax paid pre-completion having been underestimated. This won't be known until year end. What protections should a purchaser seek in these respects?

Despite the obvious complexity in these examples it is usually possible to negotiate a set of tax warranties and indemnities that strike a balance between protecting the purchaser's position and not unfairly burdening the vendor.

Often that balance is achieved through inserting limitations on warranties, both as to amount and the period of time within which a purchaser may bring a claim. For tax matters, the period that is usually agreed upon between the parties to a sale and purchase agreement is usually the same period as that within which Inland Revenue may increase the assessment in a tax return (this period is known as the statutory time period and is generally 4 years from the end of the year in which the taxpayer files its tax

return). As to amount, a purchaser will usually expect indemnity on a dollar for dollar basis. Some of the circumstances discussed above, however, may afford a vendor opportunity to negotiate a lower amount.

An essential component of a tax indemnity clause is what actions are to be taken following an event that gives rise to or may give rise to a claim under a tax indemnity. The parties will first need to establish which of them is to control matters with Inland Revenue. Where the vendor admits liability (and pays out under the indemnity), the right to control the fight with Inland Revenue usually passes to the vendor. Where the vendor does not admit liability, the reverse applies. In that case, at issue becomes what steps must the purchaser take to defend the position against Inland Revenue and in what proportion should the cost of the dispute with Inland Revenue be shared between vendor and purchaser. Usual practice here is to seek an opinion from an independent expert tax adviser as to the merits of disputing the matter with Inland Revenue and to go from there.

The long and short of it is that much care is required in negotiating tax clauses in sale and purchase agreements. I have considerable experience in it and am happy to assist.

Hybrid Mismatch Arrangements…

Inland Revenue recently issued a discussion document addressing hybrid mismatch arrangements. These are cross border arrangements that take advantage of different jurisdictions treating the same financial instrument differently. An example is a convertible note instrument that is treated in NZ as having, in part, a debt component and which is treated overseas as an equity instrument. The tax results that can be expected under such an arrangement are a tax deduction in NZ with no corresponding recognition of income in the overseas jurisdiction of the counterparty to the arrangement.

These arrangements are recognised worldwide as problematic for tax authorities across the globe. They have for some years been analysed by the OECD and have attracted considerable written material.

The general approach in Inland Revenue's discussion document is to seek to avoid a mismatch in tax results. That is intended to be achieved by disallowing a party a deduction in NZ where the counterparty is not correspondingly taxed on the income in its own jurisdiction and to bring to tax in NZ an amount for which a foreign counterparty obtains a deduction at home. Specific rules to effect that result have not yet been crafted. When they do appear, expect them to be complicated.

Commentary in the discussion document will be of concern to foreign trusts. New Zealand's tax rules exempt foreign source income of the trust where there is no New Zealand settlor. As evident from the focus on trusts following the Panama Papers escapade, investors in some foreign jurisdictions have been attracted by New Zealand's tax rules in these respects and have obtained advantageous tax results in the form of no tax in their home country nor in New Zealand. This is attributable to the tax rules in the investor's home jurisdiction that treat the New Zealand trust as an entity in its own right and therefore do not tax income derived by the trust. In the result, taxation will only arise in the country in which the investor puts its assets to use; commonly a tax haven is the chosen country in which case the income is not taxed anywhere.

If the recommendations in the discussion document are adopted, New Zealand's tax rules will respond to this result in one of two ways (see paragraphs 7.28 and 7.29). The first possibility is that the New Zealand foreign trust will be taxed in New Zealand on its foreign sourced income where that income has not already been taxed, to the extent that the income is allocated as beneficiary income to a non-resident beneficiary.

There is a caveat, namely that the beneficiary must on its own or in tandem with others have some degree of control over the trust, eg the power to appoint trustees. The second possibility is simply to tax the New Zealand foreign trust on its foreign sourced income to the extent that that income is not taxed in any other country.

This possibility is expressed in the discussion document as a logical response where the investor/settlor (nor any other person) is not taxed. Curiously, however, the possibility of taxing a New Zealand foreign trust on its foreign source income was considered and rejected by Mr Shewan in his recent report into foreign trusts commissioned by the Government in response to the reputational issues for New Zealand following the Panama Papers. Clearly then there are arguments against adopting one or more of the recommendations in the discussion

document. I shall report on developments as they occur.

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