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November 2009 Newsletter

This newsletter deals with the practical application of the expansion of the “small business CGT concessions” and the continuing problems with “incorporated partnerships”.

TAXATION

PRACTICAL APPLICATION OF THE EXPANSION OF THE “SMALL BUSINESS CGT CONCESSIONS”

1. Background

In our November 2008 newsletter, I dealt with the proposed amendments to the “small business CGT concessions” then found in *Tax Laws Amendment (2008 Measures Number 7) Bill 2008*. As noted in that newsletter, the “small business CGT concessions,” if they apply, have the effect of decreasing the otherwise assessable capital gain to nil in the year of income of the CGT event.

The purpose of this article is to discuss the practical applications of these amendments, which are now found in subsections 152-10(1A) and (1B) of the *Income Tax Assessment Act 1997* (“*Tax Act 1997*”).

2. Practical application of subsections 152-10(1A) and (1B)

For any of the “small business CGT concessions” to apply, the “basic conditions” of Section 152-10 of the *Tax Act 1997* must be satisfied. In considering whether the “basic conditions” are satisfied, one of the enquiries is whether, just before the CGT event, the sum of the following amounts does not exceed \$6m:

- the “net value of the CGT assets” of the taxpayer;
- the “net value of the CGT assets” of entities “connected with” the taxpayer;
- the “net value of the CGT assets” of any “affiliates” of the taxpayer or entities “connected with” the taxpayer’s “affiliates”.

Though the main residence and amounts in superannuation are normally excluded from the

calculation, in practice I have seen many cases where the “net asset value” exceeds \$6m. At first glance, the taxpayer is unable to claim any of the “small business CGT concessions”.

One of the alternative tests to the “maximum net asset value test” is the “small business entity” test. One of the problems with that test is that the taxpayer who is selling the asset must carry on business in the current year. Where the asset sold is, say, the property used by other entity to carry on a business, the taxpayer selling the asset is not a “small business entity” so this test is not satisfied.

The tests found in subsections 152-10(1A) and (1B) are alternative tests to both the “maximum net asset value test” and the “small business entity” test. In particular, provided:

- the entity that is an “affiliate” or is “connected with” the taxpayer carries on business; and
- such an entity is a “small business entity”,

the test found in subsection 152-10(1A) can be satisfied.

The operation of subsection 152-10(1A) is best illustrated by way of the following example. Assume:

- husband and wife own the property upon which “X Co” carries on a business, with husband and wife being the directors and shareholders of “X Co”;
- husband and wife sell the property upon which “X Co” carries on the business,

then husband and wife can, potentially, claim the “small business CGT concessions” provided “X Co” is a “small business entity”. This is notwithstanding the fact that:

- the “net asset value” of husband and wife and “X Co” exceeds \$6m; and
- husband and wife do not carry on business in the year of income of sale of the property.

3. Other issues

Taking the above example of the husband and wife owning the property and “X Co” carrying on the business, the potential applications of subsection 152-10(1A) are as to:

- husband and wife selling the property to an arms length purchaser; or
- husband and wife transferring the property to the trustee of a superannuation fund in which husband and wife are the members.

In relation to the second scenario, the following additional factors would need to be taken into account:

- the ability of the trustee of the fund to purchase the property in terms of the investment standards found in *Superannuation Industry (Supervision) Act*;
- the ability of the trustee of the fund to purchase the property in view of cash reserves and concessional and non-concessional contributions that can be made to the trustee of the fund;
- the GST consequences; and
- the stamp duty consequences.

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COMPANY LAW

“Incorporated partnerships” – continuing problems

The Courts and participants continue to grapple with issues thrown up by what commercially are regarded as business partnerships but legally are relationships between two or a few shareholders in a single company, which owns an asset or business. Whilst this structure has many benefits including in dealings with third parties, partnership law does not normally cover the

relationship between shareholders and the Corporations Act only covers it in a patchy manner.

The most relevant provision in the Australian Corporations Act is s.320 which grants the Court a discretion to make a number of alternative orders where the Court finds that conduct has occurred which is unfairly prejudicial to a shareholder. In those circumstances, the Court may make orders including an order for purchase or sale of shares, for the winding up of the company, for sale of assets or that a shareholder have a right to pursue a claim on behalf of the company (e.g. that a director had breached his duties).

This section was recently considered by the High Court, along with other issues, in the case of *Campbell v Backoffice Investments Pty Limited*.

Mr Campbell had established a business and eventually incorporated a company to carry on the business. In January 2005 Mr Weeks, through his company Backoffice Investments (“Backoffice”), entered into a share purchase agreement to purchase one of the two issued shares in the company from Mr Campbell for \$850,000. The relationship between Mr Campbell and Mr Weeks broke down very quickly and by April 2005 a provisional liquidator was appointed to the company. On 31 May 2005 the provisional liquidator sold the company’s assets to another company controlled by Mr Campbell for \$196,815. That money was used to pay the company’s creditors and the provisional liquidator’s fees and expenses. The company, and Backoffice, were left with nothing.

Backoffice claimed that through the provision of Mr Weeks as joint managing director, it was entitled to share jointly in the management of the company and that there was an expectation that this would continue. It said that Mr Campbell’s conduct was unfairly prejudicial or oppressive in that he refused to pay Backoffice’s proper invoice unless Mr Weeks agreed to unreasonable demands, including a reduction in fees and a re-allocation of his duties as director, that Mr Campbell changed the password to deny access by Mr Weeks to the accounting system, and Mr Campbell refused to attend a board meeting with Mr Weeks to try and avoid participation by Mr

Weeks (and therefore Backoffice) in the management of the company.

Whilst the trial judge ordered Campbell under s.320 to buy back the share purchased by Backoffice for a sum of \$853,000, the NSW Court of Appeal (which the High Court agreed with on this issue) instead found that as a matter of discretion the Court should have considered that the unfairly prejudicial conduct was no longer continuing now that the company was now in liquidation, so that there is no point in making orders under s. 320. One of the appeal judges also found that the conduct was more personal than corporate so that even if the company was not in liquidation, in his view the conduct was not bad enough to make orders under s.320.

The High Court also dismissed a misrepresentation claim by Backoffice saying that the relevant representations appeared to have been statements of opinion that in any event were not relied on. The Court sent back to the Court of Appeal the question of whether or not there was a breach of any warranties in the share sale agreement. One of the earlier appeal judges said that in any case the damages for breach of the applicable warranty were in any case only nominal.

In short, a disaster for the new investor Backoffice.

In hindsight, Backoffice would have been well advised to conduct more extensive due diligence before purchase, and to ensure that the sale and shareholders agreements more specifically covered key matters.

To fill gaps in the legal coverage, shareholders are also well advised to have a shareholders agreement that sets out in detail the intended participations in management, dividends, other payments (e.g. consultancy fees), default rights, terms for entry or exit and for winding up, terms for sale of the business in the event of a dispute, obligations in relation to contributions of capital, loans and personal guarantees, performance obligations in relation to services, and restrictions on competition with the business, amongst other matters.

Whilst there was a shareholders agreement between Backoffice and Campbell, the Court held that it did not, for example, state or imply an obligation on the parties to ensure that they did not give grounds for a complaint of unfairly prejudicial conduct.

One of the key issues a shareholders agreement should deal with, particularly in a 50/50 arrangement, is how to resolve any deadlock. The alternatives include appointment of an independent director (if the parties can agree and the nominee would accept), referral of issues to an independent expert, agreement for sale of the business in the absence of the dispute being resolved after notice and mediation, and a “Russian roulette” clause under which in a dispute either party may serve a notice on the other specifying a price for 50% of the shares. The recipient of the notice can choose whether to buy or sell at that price, so that the party serving it needs to be careful of the price they choose. The risks attaching to this mechanism will often encourage the parties to reach a commercial resolution.

In all of these situations there is a risk that the business will deteriorate during the dispute, as the parties focus on each other rather than the business. However these alternatives, if included in a shareholders agreement, may at least save the parties from extensive litigation and provide a more certain outcome.

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