

# BALDWIN'S BULLETIN

*The newsletter of commercial law firm Baldwins*

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*Baldwins is a member of the international Network of Leading Law Firms*

**Partners & Editors:** Joe Lederman, Accredited Specialist (LIV) in Tax Law & Business Law

Sam Recht, Accredited Mediator & Commercial Litigation Partner

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## A TAX SYSTEM ON ITS DEATHBED

We begin this Baldwins Bulletin by asking whether the Australian income tax system is dead, or is it capable of resurrection? There are so many signs now that the system is unworkable and irredeemable.

A recent article by Alan Kohler, in the Australian Financial Review (21/8/02), quoted Sydney tax barrister Michael Inglis, who identified the introduction of the self-assessment system as the big mistake that began the terminal decline of the tax system.

Our own view is that when self-assessment came in, the tax assessment business was privatised even though the accounting profession (and the clients of accountants) may not have realised that they had to pay a price.

Meanwhile, the Tax Office, who were relieved of their tax assessment tasks, adopted the privileged position of "armchair critic" of taxpayers and tax agents. The removal of tax officials from dealing at the coalface of practical taxation assessment problems removed them from taxation reality, and hence taxpayers have suffered a plethora of indigestible, unworkable, incomprehensible and impractical tax legislation ever since self-assessment began. The Tax Act is now 8,500 pages long and lengthening every month, to which one can add the reams of paper constituting the "explanatory memoranda" and "tax rulings" that are meant to aid in the interpretation of the law but are often ambiguous, unhelpful and skewed to maximising tax revenue.

The Institute of Chartered Accountants has recently written to the ATO threatening steps that could result in the system grinding to a halt.

The tax legislators actually encourage a form of lawlessness by legislation that includes absolute discretions making the incidence of taxation a function of the whim or arbitrariness of a tax officer. One example is the legislation governing restrictions on thin capitalisation.

Under the old 'thin cap rules', taxpayers knew that there was a prescribed debt to equity ratio (e.g. 3:1). Yet under the new rules, no ratio is specified. Instead, one is required to rely on a totally subjective analysis by the Tax Office of what it considers to be notionally sufficient capital equity (terms such as "safe harbour capital amount" and "Arm's length capital amount"). The legislation then goes on to describe the minimum capital requirement as an amount which the Tax Office will impute as a notional amount of capital that would reasonably be expected to exist for an entity based on factual assumptions and taking into account relevant factors (ss. 820-405 and 820-410 of ITAA 1997).

Not only is such gobbledegook as clear as muck, but the ATO pours more mud into muddy waters by issuing a 128 paragraph draft tax ruling TR 2002/D4 (36 pages) that purports to set out a 6-step methodology which is meaningless in the context of the real world of business finance.

The signs of imminent self-destruction of the tax system are there. The writing is now on the wall.

## RESTRAINTS OF TRADE

It is not unusual for many types of contracts to impose restraints on the activities of one of the parties. For example, such restraints often appear in employment agreements (on the employee), sale of business agreements (on the vendor) and partnership agreements (on each partner).

Such restrictive clauses are inserted to protect the goodwill of the business by preventing competition that would cause detriment to the business.

Although section 51(2) of the *Trade Practices Act 1974* ("TPA") recognises the legitimacy of some restraints by exempting them from the sanctions of the TPA, the High Court in the recent case of *Peters (WA) Limited v Petersville Limited* [2001] HCA 45, held that common law requirements could still strike down part or all of the restraint of trade clause.

It is important that restraint clauses be drafted in a way that allows for "reading down" or severance of any part of the clause that might be considered unreasonable. Therefore, such clauses usually contain cascading or several overlapping restrictions.

It is desirable to consider other alternative, or supplementary, restrictions. For example, the law can protect trade secrets and confidential information to a greater extent than an unreasonable restraint that unreasonably prevents a person from carrying on his or her profession. Other alternatives might include a put option or a purchase price refund that can be triggered in some circumstances prescribed by our agreement as a protective mechanism.

The tax character of the receipt of the payment for the restraint covenant will vary according to the tax status of the taxpayer and the receipt being either on revenue or capital account, depending on factual circumstances. Likewise, the payment may sometimes qualify for a tax deduction. However, in the recent *Jupiters Limited case*, the Federal Court held that a special rental payment to secure exclusivity arrangements was on capital account and non-

deductible because the circumstances of that case indicated the payment should be treated as a capital payment. If such payments are not tax deductible on revenue account, we can advise on whether it would be possible to add the cost of such payments to one's cost-base for the purposes of calculating and reducing a future CGT liability.

## INTERNATIONAL NEWS

### USA

Baldwins advises USA corporations on entry requirements (inc food composition and labelling laws) for the Australian market. Our firm has extensive links to US suppliers as well as network contacts for entry into US markets for Australian businesses.

### UK

Joe Lederman recently met in London with various UK-based lawyers, accountants, and migration consultants. He also attended the annual meeting in London of the international Network of Leading Law Firms and was the only Australian elected to the Advisory Board. The Chairman of the NLLF is Earl Cohen of Mansfield, Tanick & Cohen a highly-regarded firm in Minnesota.

### Singapore

Joe Lederman met with various major venture capital fund managers in Singapore including representatives of funds related to the Singaporean government's enterprise initiatives. Baldwins advises professionally in the venture capital area and can match suitable innovative technology projects for introduction to prospective financiers in the appropriate situation.

### Israel

On 4 August 2002, the Israeli Parliament passed a most wide ranging package of tax reforms. Effective 1 January 2003, the impact will be significant for expatriate Australians living in Israel as the new laws will tax Israeli residents on worldwide income irrespective of remittance to Israel. Non-residents (for Israeli tax purposes) will be taxed on income generated in Israel. In association with our Israel and other overseas consulting networks, Baldwins can assist with advice to those who need to prepare for these changes.

## LAND TAX ATTACKS

The State Revenue Office is hungry for more land tax revenue and is issuing amended assessments to many property owners.

**Aggregation of Trust Assessments:** *The State Revenue Office is reviewing land tax assessments for trustees and, in some cases involving trusts having a common trustee, has aggregated the land values for a number of different trusts as a single landholding – resulting in a massive increase in the land tax liability.*

The State Revenue Office is claiming to base its revised assessments and determinations on *Famajohn Nominees* (1999 decision of Justice Balmford), where the taxpayer was unsuccessful in overturning an adverse assessment.

**Baldwins is advising on steps to be taken both in relation to existing assessments and future reduction strategies.**

**Valuation issue:** Another separate land tax dispute issue for the future will relate to the valuation of properties. According to valuation experts, the average assessment value of a property in the Melbourne CBD in 2002 increased by over 30%. Since land tax assessments are based on municipal council valuations, clients need to realise that they can be locked in, for land tax purposes, to the council value unless an objection is *made in time* to the valuation shown in the council's rate assessment. **Currently, land tax assessments are based on the year 2000 value but future land tax assessments will be based on the values shown in the latest municipal rate assessments.**

## CONTRACTS AND BUSINESS STRATEGY

**Consider the following question: What is that toughest legal contract you have ever committed yourself to?**

Surprisingly, you might not have realised it but the answer is possibly any one of the following: (a) the standard terms and conditions of the software licence for your computer operating system; (b) the standard terms and conditions of your bank credit card; or (c) the standard terms

and conditions of your telephone service provider.

Now, if you look at the fine print, you will see a number of common elements: retention of control by the supplier, releases and indemnities by which the supplier is absolved from various responsibilities, and a denial of the existence of any representations other than statutory liabilities.

Did you agree to such onerous terms and conditions because you felt you had no choice?

### WHY HAVE A CONTRACT?

**First**, any business is in a position to have its own contracts if there is a demand for its goods or services.

**Secondly**, contracts protect both parties if they clarify the rights and obligations of each party during the contract term and upon termination.

Some people have the mistaken belief that they need to make additional promises in the contract to demonstrate the benefits of the contract. This is unnecessary and can create undesirable legal risks.

In drawing a supplier's standard customer contracts, our drafted documents incorporate special features such as:

- (1) the layout can exhibit the essential commercial terms on the face of the document;
- (2) easy-to-read non-lawyer's language whenever possible;

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- (3) allowing for alternative pricing models with different structures for pricing;
- (4) flexibility in terms and conditions including provision for overriding "Special Conditions" allowing for special negotiated terms; also consider possible future variations by the supplier with a range of alternative options to the customer;
- (5) insertion of mandatory warranties but adopting a tight application and usage;
- (6) limiting liability exposure of the client supplier as to total amount, as to claim amounts, as to time for claims, and/or limits on the method of claim;
- (7) clearly define the scope of the supplier's obligations.

## OFFERING EMPLOYEES EQUITY

Successful businesses exhibit teamwork and a high level of motivation in the team. Factors such as the decreasing business role of the family unit, the shrinking number and functionality of extended families, the lack of imperatives to run a "family business", and the later marriage/remarriage phenomena, mean that entrepreneurial innovators must be attracted to the idea of creating a "business family" as an alternative to a "family business" model.

Offering shares in the business to one's employees not only facilitates the sharing of profits and capital growth but creates the greater sense of proprietorship, responsibility and motivation that engenders more teamwork vital for the future growth of the business.

**Baldwins has been involved in planning and documenting many employee participation arrangements. Many factors and legal issues are considered so that the documentation can achieve the desired objectives, which vary from business to business.**

There is no reason why either private companies or public companies cannot offer more attractive employee equity arrangements. However, some of the schemes offered in the past were based on concepts that might no

longer work, for example the issue of share options in an ESOP, which relied solely on the potential capital growth of a business. Without sufficient capital growth, the options become worthless pieces of paper, and the employees holding them become dispirited rather than motivated.

Accounting standards will require Australian companies to expense share options from 2005 and tax laws will need to change correspondingly. Presently, the expensing of options would result in the loss of franking credits and taint capital accounts by characterising the reinvested share capital (or a share buy-back) in a manner similar to bonus shares out of a capital reserve or unfranked dividends, and thereby potentially liable to "untainting tax".

There exist better alternatives, worthy of consideration by businesses, whether public or private companies or trusts.

## FAMILY ASSET REORGANISATIONS

**If families, or individuals within a family, want to part ways in their business or investment dealings, either by a dissolution of the group or a mix of payments or distributions, it is extremely important to consider the possible tax consequences for the clients. For example, some types of changes to a family trust could unnecessarily trigger a resettlement or other similar Capital Gains Tax (CGT) event in some circumstances.**

In reorganising a family group structure, the potential tax and stamp duty liabilities require that great care be taken. For example, a pre-CGT asset (i.e. an asset that was acquired prior to 19 September 1985 and would therefore remain exempted from capital gains tax on its disposal) might become a post-CGT asset so that a tax liability may consequently arise. Worse still, some "CGT events" in relation to a post-CGT asset in the course of a reorganisation of assets might actually trigger an immediate CGT liability. Likewise, unwanted income tax or stamp duty liabilities might be triggered by a

capital distribution or deemed dividend payment by liquidation or vesting.

Luckily, from 1 July 2002, there is no longer any stamp duty in Victoria on transfers of most unlisted shares and units (other than “property rich” entities). Furthermore, from 1 July 2002, there are additional avenues for possible CGT rollover relief for jointly-owned entities that divest themselves of certain equities (e.g. shares in companies, or units in fixed trusts).

**Discretionary Trusts:** Whilst discretionary trusts are not eligible for the new so-called “demerger” relief (to come into effect from 1 July 2002), it is still possible for a discretionary trust to obtain some of the other CGT concessions such as (i) the CGT 50% discount and (ii) the CGT “small business” concessions including full or partial CGT exemptions (but only if certain preceding events have occurred in relation to the income and capital of the discretionary trust so that the “controller” test is met, and also that the “small business” associated entity AUD\$5m threshold test can be met). The discretionary trust also has other structural advantages in succession planning.

Although the tax issues are very complex, there are different ways to achieve the family’s objectives whilst at the same time reducing the scope for substantial liabilities that could be an unwanted consequence of the reorganisation.

## THE UNSIGNED WILL ON COMPUTER

A recent case, *in the Will of Mark Edwin Trethewey* [2002] VSC 83, highlights the major impact of section 9 of the Wills Act 1997.

The case concerned an application by the de facto wife of the deceased to admit to probate an unsigned Will left on the deceased’s computer. Evidence was given by the deceased’s sister that in discussions months prior to his death, the deceased had expressed his wish for his de facto wife to be the legal guardian of his two children from a prior marriage and he mentioned one-third of his estate was to be distributed to his de facto wife

and one-third to each of his two children. This was supported by evidence given by the deceased’s friend that he had also expressed the same wishes in the two to three years prior to death.

The Will was discovered on the deceased’s computer and was consistent with the same intentions as those expressed to the deceased’s sister and friend. Section 9(1) states that for an informal document to be admitted to probate, there must be a document detailing the testamentary intentions of the deceased and intended to be the Will of the deceased. As the computer file contained data capable of being reproduced, the Will was found to be a “document” within the definition under section 38 of the *Interpretation of Legislation Act* 1984.

Justice Beach was of the view that as the deceased had typed his name at the bottom of the document, it was sufficient to constitute a signature. As such, the computer file was admitted to probate as a Will. In addition, Justice Beach found that the word “executor” did not have to appear in the Will. It was sufficient that the document clearly directed a person to perform the duties of an executor and the applicant was held to become the executor.

## INHERITANCE CHOICES

### Where does control lie?

One of the most important issues in estate planning for Willmakers and trust controllers - and also in advising the potential beneficiaries of an estate or a trust - is to determine what is in the estate or trust and which entity owns or controls the various assets.

There can be a range of means for asserting control over different types of assets that were controlled by the deceased.

### Which jurisdiction?

Other legal issues may arise if the deceased had died with substantial assets either owned or controlled by the deceased but where no Will exists (an “intestacy”). One such issue is the

choice of jurisdiction in which to have the estate administered. For example, the deceased may have been living outside Australia at the time of death but have substantial Australian assets. Conversely, a deceased Australian may have assets in a number of different interstate or overseas jurisdictions.

It is important to note that in some non-Australian jurisdictions, there are substantial inheritance taxes that can be imposed if the person was domiciled there. Australia has a capital gains tax ("CGT") which can result in a substantial tax burden on Australian assets and also can be imposed where asset dispositions are made in favour of non-residents. Even though the Australian CGT is not a recognised Inheritance Tax (so that relief is regrettably unavailable under various Inheritance Tax reciprocal treaties that exist internationally), its effect is often the same as an inheritance tax. When introducing the CGT regime, the then-Treasurer Paul Keating said that death would not be regarded as a "disposal" for CGT purposes, except in two very exceptional circumstances. Unfortunately, Mr Keating omitted the full picture because he forgot to add that death **will always be** treated as an "acquisition" by the person inheriting the asset!! This means that there are always capital gains tax implications for the beneficiary of an estate.

Apart from the various tax consequences of inheritance, another important issue in choosing the jurisdiction to administer the estate is the potential for claimants to the estate. Claims against an estate may be limited by the law of each jurisdiction to different classes of persons.

## UK SUPERANNUATION

Baldwins, in conjunction with UK-based advisers, can assist with professional advice on appropriate planning for UK and Australian taxation laws for any member of a UK retirement fund or UK private pension arrangement. For prospective migrants to Australia or expatriates returning to Australia, various tax issues will need to be addressed.

## NEW BALDWINS EMPLOYEE



*Pictured: Ms Jacqueline Wood*

Jacqueline previously worked in the taxation advisory area of Deloitte's Brisbane office for 3 years. We welcome her to Baldwins.

## PLANNING FOR SUPER PAYOUTS ON DEATH

Careful planning is required for one's superannuation fund entitlements payable on death. Who will the benefits be paid to? What are the tax implications? How best can one effect one's preferences? Baldwins can provide a range of estate planning solutions.

Although superannuation legislation now prescribes a "Binding Death Nomination", many trust deeds do not offer this option (some of the larger funds claim the administrative costs are too burdensome). Yet, in any case the law says the document is valid only for 3 years, so that its purpose can be defeated by forgetfulness after 3 years.

There are alternative ways to achieve one's objectives, taking account of different components of the death benefit and alternatives for the form the benefit may take, with different tax and cash flow implications. Family relationships also have a bearing on the disposition of the death benefits.

Baldwins can provide more specific professional advice as well as in the wider context of estate and succession planning covering also family companies and trusts.

## IN-HOUSE ASSET REVIEWS FOR SUPER FUNDS

The use of an interposed unit trust allowed many a self-managed superannuation fund to invest in a geared real estate investment whilst circumventing the prohibition on superannuation fund borrowings. However, from after 11 August 1999, the new “Part 8 Associate rules” and the amended “In-house asset rules” took effect. These rules prevented a self-managed superannuation fund from holding more than 5% of fund assets (measured by market values) in associated entity assets with few exceptions.

Any breach of these rules would result in the fund becoming non-complying and liable to hefty tax liabilities at the top marginal income tax rate applied to the value of the fund assets (excluding the value of the Undeducted Contributions component). In other words, almost half of the assets of the non-complying fund might become liable to confiscation by the Tax Office!

However, the new rules permitted a number of “transitional arrangements” so that some superannuation funds could maintain the status quo for some such investments.

Nevertheless, for some superannuation funds, the unit trust investment structure may have outlived its usefulness or created its own problems. For example, the ATO does not like arrangements in which fund members live on the property - having regard to the existence of the “sole purpose” test. Moreover, the “main residence” tax exemptions for CGT and land tax are not available for such circumstances. Very substantial capital growth has also created additional income tax problems for some.

Baldwins can provide professional advice and appropriate solutions to these problems covering the many different factual circumstances that may apply.

## “CONTROLLER” SUPERANNUATION CASES

On 3 December 2001, Justice Merkel of the Federal Court handed down judgment against the taxpayer in the case of *Harris v FC of T* (2002 ATC 4017). The taxpayer was denied a tax deduction for contributions to a non-complying superannuation fund made under Sec. 82AAE where the taxpayer claimed to be both the “eligible employee” and “controller”.

In *Elias v FC of T* (3 July 2002) (2002 ATC 4579), a taxpayer failed in the Federal Court to win a deferment from additional tax and penalties in relation to an adverse tax assessment involving a similarly disallowed “controller superannuation arrangement”. This was despite the fact that the client had relied on a favourable private tax ruling. The ATO was not bound by its own tax ruling given to the taxpayer’s lawyer in relation to another of the lawyer’s clients. The Court also held that the taxpayer had not given sufficient information to the Tax Office on his financial position and had not shown sufficient cause to justify the ATO granting a tax deferment.

## BUSINESS EQUITY AND SUCCESSION AGREEMENTS

To avoid disputes over business operations or succession arrangements for a business, it is a good idea to document an agreement between the parties (eg. for co-shareholders in a company or co-unit holders in a unit trust or co-investors or partners in a joint venture or partnership).

The existence of such an agreement can prevent disputes and immediate repayment obligations in the event of the unexpected death of one of the principals. Such an agreement can deal with the methodology of the business valuation and manner of payment by instalment or otherwise.  
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Appropriate life and disablement and trauma insurances can facilitate funding arrangements for certain events that will trigger there being an outgoing party, such as a principal's death or traumatic physical event causing an inability to continue in the business. Some events may trigger other mechanisms and formulae for a buy-out. The capital gains tax and income tax implications require the sort of innovative approaches that Baldwins can tailor to the circumstances.

## **EMPLOYER RESPONSIBLE FOR PROMISES OF “HEADHUNTER”**

In the recent decision of *O'Neill v Medical Benefits Fund of Australia* (2002) FCAFC 188 (17 June 2002), the Full Court of the Federal Court held that an employer can be liable for representations made by a headhunter who is engaged by the employer for the recruitment process.

The decision is significant in that employers can be liable for large awards of damages, even if the employee is dismissed in accordance with their employment contract. Also, under the *Trade Practices Act 1974* an employer can be liable for the representations of a headhunter to a potential employee.

The facts of the case where that Mr O'Neill had been employed for almost 10 years in a managerial position with National Mutual Health Insurance. An executive search company, on behalf of MBF, approached Mr O'Neill. The headhunter told Mr O'Neill that the job MBF was offering would be “as secure as his current secure positions with National Mutual”. In addition, an employee of MBF, in the HR department, stated that the position MBF was offering was for the “long haul”. However, after approximately 2 years he was retrenched by MBF, receiving payment in lieu

of notice in accordance with his employment contract.

The Full Court found that Mr O'Neill relied on these representations in accepting employment with MBF and that they constituted “misleading and deceptive conduct” under the *Trade Practices Act 1974*. It held that MBF was liable for representations by its own employee and those of the external headhunter. The loss suffered by Mr O'Neill could be quantified by ascertaining the difference between the salary he would have earned with National Mutual, and the salary with MBF and in the employment he entered after being retrenched. The period of the loss would be the period Mr O'Neill would have been expected to stay in the employment of National Mutual.



## **WILL YOUR FOODS BE LEGAL IN 2003?**

Changes to the Food Standards Code means changes to the way all foods and beverages are marketed in Australia and New Zealand. The “old” Code disappears in December 2002, and the new Code has a wide-ranging impact on every product and every food label... including those sold by every food company. Baldwins has developed comprehensive databases for check listing purposes for ingredients and revised food compositional and labelling standards.

Baldwins Food Law Department can help you avoid problems that can be caused by an enforcement agency or a trouble-stirring competitor. Contact Mr Joe Lederman or Mr Ron Cossen of Baldwins on (03) 9606 0022.