

Tax and Superannuation Update – Summer 2002 Edition

Alienation of PSI – Fact or Fiction

Back in 1981, the then Treasurer, John Howard, introduced Part IVA of the Tax Act to stop tax cheats. Part IVA is against arrangements ('schemes') that minimise tax. This is because they are "works of fiction". Such schemes are punishable by the taxman.

Twenty years later we now have Treasurer Peter Costello championing 'A New Tax System' ('ANTS'). Costello claims that ANTS is so good that it renders Part IVA obsolete.

At the core of ANTS is the Alienation of Personal Services Income ('Alienation') provision. Alienation argues that there are really only two kinds of taxpayers - employers and employees. Everyone has to be slotted into one category or another. This makes it much easier to collect tax.

The Tests

If you are an employee, you are not entitled to 'business' deductions and concessions. Further your employer withholds money from you to cover your estimated tax liability. What if you are self employed and your income is mainly a reward for "personal efforts and skills"?

Bad luck you are presumed to be an employee - unless you can pass these tests:

Results test (you have to pass all 3)

- the income is paid to achieve a specific result (not just provide hours of labour)
- if tools or equipment are necessary to do the work, you have to provide them yourself; and
- you must be liable to rectify the defects in your work.

Have you passed? If not, then you may still be an Employer under the '80% rule'. If 80% or more of your income is from one client, you fail - you're an employee. If you pass, you still have to pass one of the following:

1. 'unrelated clients' test - You must "have personal services income from two or more clients who are not associated with each other or with you (or the individual, if you are a personal services entity)". The clients must come from direct advertising or word of mouth, not an agency.
2. 'employment' test - You must "have employees or engage sub-contractors who perform at least 20% (by market value) of the principal work" or "apprentices for at least half the income year". You can count related persons who perform principal work but you can't count companies, partnerships or trusts associated with you. If you operate through a personal services entity, you can't count yourself as an employee for this test.
3. 'business premises' test – The business premises must be:
 - owned or leased by you;
 - used more than 50% of the time by the individual doing the work;
 - used exclusively by you;
 - physically separate from the private residence of the individual or their associates; and
 - physically separate from the business address of your clients or their associates.

Confused? Costello isn't. Besides, if you aren't sure, you can still have all the fun of applying for a determination from the ATO. (*Or risk the penalties for making a mistake. – Ed.*)

ANTS has caused considerable consternation in the business sector. There is still great uncertainty over what effect Alienation will have. Industry groups such as Financial Advisers have lobbied to be able to decide for themselves how to proceed until such time as all the facts are on the table and the law can be applied fairly and equitably.

For others? Well - time will tell, but you may want to think about booking an appointment to see your Adviser and Accountant to discuss restructuring your affairs. However, beware, The taxman is sure to closely watch what you do to make sure you don't fall in breach of good old Part IVA.

Pre-emptive rights – A low hand in a high stakes game

Late 2001, an Adviser presented me with a difficult situation. Apparently, years ago, the Adviser asked her clients if a Business Succession Plan was documented and put in place for the business. The clients dutifully answered "Yes" - they had such a plan. They said that they had "pre-emptive rights" in their Memorandum & Articles for the company. Pre-emptive rights generally give the remaining owners the right to purchase the outgoing owner's equity on terms no worse than those offered by an outside (unrelated) purchaser. Soon after the Adviser had made her inquiry, one of her clients suffered an accident. The client was unable ever to work again. The remaining owners checked their "pre-emptive rights". They had the standard clause in their company documents. Sadly "pre-emptive rights" only operate upon death. They are useless for sickness. Years passed. Chaos ensued. Recently, the sick individual died. The "pre-emptive rights" now operate in the absence of any agreement between the business owners. The client's spouse attempted to sell the shares to the remaining owners. The Accountant did an excellent and unbiased valuation of the business.

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The client's spouse didn't care. She "knew" the business was worth more. More likely, she knew that she needed more to uphold the lifestyle of her and her children. Besides, even at "proper" value the remaining business owners had no spare cash and an already-unhappy bank manager. Apparently, the bank manager was concerned that the business would have to buy out the dead man's estate. Given that he owned 70% of the shares in the business, the bank manager felt that the business could fail. After all, the business had to fund the buyout some way, and the profitability had declined since the majority shareholder found himself unable to work. The business was not doing all that well.

Seeking legal advice, the deceased's spouse discovered that the shares could be offered to the public. The shares were broadly advertised. Eventually, an offer was made for the shares by a member of the public who did not want to pay top dollar, but offered cash.

Naturally, when you get a hot purchaser on the line you want to close the deal. With "pre-emptive rights" you can't quite do that. You have to take whatever offer is on the table and offer the exact same deal to the remaining partners. Under these "pre-emptive rights" the remaining owners had 28 days to accept the offer. After 28 days if you hear nothing then you can accept the offer made by the member of the public.

Well - 28 days came and went. I don't know the real reason why, but the remaining owners apparently didn't even respond. The dead man's spouse went back to the willing purchaser. Sadly the willing purchaser was not quite as willing any more. Financial considerations meant that a 3 month settlement was needed. This was a new deal. The new offer had to go back to the remaining owners. Any variation has to be offered to the remaining owners on the same terms. The same 28 day provision applied. The business was always volatile, and the business had to be revalued every time an offer was made. Each valuation was less than the last.



**Ensure you get the best advice
when drawing up your Succession
Plan**

The matter is not yet resolved. The remaining owners claim that cash is hard to find. The public buyer has gone cold, and the bank is unwilling to advance more borrowings on a business that is under threat.

Be warned! There is no substitute for your Accountant, Adviser and Tax Lawyer working together with you as the business owner to ensure that your business will not die with you.

For your peace of mind, ask yourself the following:

- What happens if one of the partners becomes of unsound mind, divorces, becomes a bankrupt, suffers stress, dies, or gets cancer? What do the spouses of the insured business owners think will happen?
- Have you had a letter of advice concerning the taxation consequences of the plan?
- Do you have to rely on the pre-emptive rights in the company documents, or is there a way to introduce more certainty into the process, along with some insurance proceeds to enable a fuss-free buyout?

- Has the issue of Keyperson insurance been considered, and have the taxation consequences of the company receiving proceeds for capital or revenue purpose been documented?

These questions are only part of the process of putting in place the building blocks of sound business succession planning. Certainty, the ready availability of funding, and the painless progression of the company are the fundamentals of sound business succession planning that should be available to every business owner in the country.

John left his Super to his Mistress. His wife was upset...

Is the Superannuation Complaints Tribunal bound by a valid Binding Super Nomination? How effective was John's binding nomination in his Super Fund? The Federal Court looked at this question in the recent case *Collins v AMP*. The Court held that the complainant could not appeal to the Superannuation Complaints Tribunal (SCT). The SCT had no power to overturn a binding death nomination. A disgruntled wife doesn't even have standing to appeal under section 14 and 15 of the Superannuation (Resolution of Complaints) Act 1993.

However you can appeal to the SCT on the Trustee's discretion on the validity of the nomination and the trustees' discretion on the type of benefit that is paid. Therefore the disgruntled wife can argue that the binding nomination was not valid. Did John fill out the binding nomination form correctly? Was John dotty and not of sound mind? Was there a correct witness

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(no beneficiaries)? Did the nomination comply with the law (i.e. older than 3 years)?

The disgruntled wife can only overturn a binding nomination on these grounds.

What if John had a Self Managed Super Fund?

SMSFs are a power to themselves. Generally the SCT has no power to hear SMSF issues. In particular the SCT has no jurisdiction to hear these matters for SMSFs. A binding nomination forces your Trustee to follow your wishes. Again your disgruntled wife can get around this by challenging the validity of the binding nomination. With the SCT out of the picture, this means a trip direct to the Supreme Court. (*Lots of money for lawyers - Ed.*)

DIE BEFORE THE LAW TAKES EFFECT

- Married (boy and girl) - your spouse can challenge your Will. You can leave your spouse \$1,000 in your Will. Your spouse can still challenge your Will. You can even leave your spouse 99% of what you own and still your spouse can challenge your Will.
- Ex-spouse - your ex-wife or ex-husband can still challenge your Will if you are paying maintenance or have still time left to complete a property settlement.
- Heterosexual defacto - if you are "maintaining" your defacto partner then they can challenge your Will. (What constitutes "maintaining" changes with each Court case. If you keep a mistress, (*or toy-boy - Ed.*) then that is probably enough. If you live with someone then that is probably also enough to prove "maintaining").
- Homosexual defacto. If your homosexual partner dies then currently under WA law you have no rights to challenge the Will.

DIE AFTER THE LAW TAKES EFFECT

Both homosexual and heterosexual defactos will be in exactly the same position "as if you were married". This means an automatic right to challenge your Will. There is no way out.

BREAK-UP WITH YOUR PARTNER – NOW

If you are married then your spouse gets maintenance and a property settlement when you separate. Everyone else (all defactos - homosexual and heterosexual) generally get nothing. You walk away with no property and no maintenance.

Afraid to get married for fear of being taken to the cleaners?

Do you live in a defacto or homosexual relationship? Currently, Western Australian law treats legally married couples differently to such defacto couples. With reforms to State laws in the offing, this situation may not last for much longer. Legal rights for defactos in the case of break-up or death are about to change.

Don't panic. Before the law comes into effect, you can still:

- redo your Estate Planning documents
- move assets into new structures
- complete a pre-nup (Binding Financial Agreement)
- bail out of the relationship (*Easier said than done - Ed.*)
- do nothing and cry about it later

So how does my legal position change?

It all depends on whether you're dead or dumped.



Wanted: Meal ticket. Must be Fin/Sec, DTE, G/L and have GSoH. Marriage not essential

Estate, your sewing machine, even part of your Super is put in a big bucket. The Family Court then decides on who gets what. Your ex-partner may get your Merc even though they can't even drive it! Welcome to the world of married couples.

How do I protect my financial interests?

It is important that you talk to your Adviser and Accountant. They can work with you and arrange for a Tax Lawyer to review your Estate Planning documents, prepare a pre-nuptial agreement and move the assets into more effective business structures.

If you break up after the law takes effect, your only recourse is to the gladiatorial Family Lawyer. At this point, you probably won't even care about saving tax or planning for the future. Your priority will be to "make that ##### pay for all those wasted years". If you don't address these issues with your Accountant and Adviser now, you may fall to the Family Lawyer's axe later.

BREAK UP WITH YOUR PARTNER – AFTER THE LAW TAKES EFFECT

Everyone (married, not married, same sex, whatever) is treated like a married couple breaking up. You get your chance to seek maintenance and a property settlement via the Family Court.

Is anything safe?

Everything in your family trust and company, your Mercedes, the money from your mum's