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SHAREHOLDER AGREEMENTS – TAX AND STAMP DUTY

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1. I intend to cover four tax lines in my discussion of shareholders agreements.

2. The tax lines to be covered are Queensland stamp duty, income tax (including capital gains tax), and goods and services tax.

3. My thinking about shareholders agreements has been shaped by two influential articles in the Australian Business Law Review, in 1978 and 1994 respectively. Finn J (as he now is) wrote "Shareholder Agreements" (1978) 6 ABLR 97-104, and Goldwasser wrote "Shareholder Agreements – Potent Protection for Minorities in Closely Held Corporations" (1994) 22 ABLR 265-295.

4. I reference these articles because there is no particular tax or charge levied against shareholders agreements, as such. Rather, a lawyer approaching the topic must consider what the shareholder agreement purports to do, whether the draftsman has achieved that object, and thus what the legal (including revenue law) effect has been or will be.

1 Purposes of shareholder agreements

5. Finn puts it well in saying that a shareholder agreement is one device:[1]

> … *eliminating the causes of future dispute while at the same time providing such means for resolving the disputes which do occur, as will not jeopardise the business itself.*

6. Finn points out that a shareholder agreement may simply be an agreement among shareholders requiring that they vote their shares in a particular way on certain matters. He gives as examples:

   (a) Appointments to the board;

   (b) Dividend policy;

   (c) Sale of the company's undertaking.[2]

7. Both Finn and Goldwasser point out that such agreements may act for the protection of a minority by providing a basis for the minority to enforce participation in management, to be bought out, or to have the company wound up voluntarily.[3]

8. Other functions of a shareholder agreement can include:

   (a) Prohibiting a member from participating in other businesses which compete;[4]

   (b) Requiring a member to lease or sell property to the company to enable the company to begin business operations;[5]

   (c) Protecting confidential information;[6]

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1 Finn, above, page 97.5.

2 Finn, above, page 97.

3 Finn, above, page 98; Goldwasser, above, pages 291-292.

4 Finn, above, page 97.

5 Finn, above, page 97.

(d) Doing those things which, though legally permitted, cannot be achieved through the company's constitution.[7]

9. In practice, the company is made a party to the shareholder agreement. This means that the company itself has rights of enforcement, for example in relation to confidentiality and non-competition.

10. There are conceptual difficulties with a person contracting, as a fiduciary such as a director, to exercise his votes or powers in a particular way. Finn points out that the simplest way to overcome that is to require that the exercise of certain powers be reserved to company in general meeting, in accordance with the Constitution (which would need therefore to be amended from a standard document).[8]

11. Nice questions arise as to how far a shareholder agreement may intrude upon voting rights of shareholders. For the present, I will assume that the draftsman has found a way to dispel such doubts, in my discussion of the revenue consequences of such provisions.[9]

2 Impact of Restrictions on Voting Rights

12. Under this heading I wish to consider the relevance of voting agreements on provisions of revenue laws triggered by voting power and the like.

2.1 Queensland Duty

13. Queensland abolished duty on the transfer of the marketable security, as such, which used to be taken under Chapter 2 *Duties Act* 2001. New South Wales and South Australia retain such duty in off-market transactions.

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6 Goldwasser, above, page 269.

7 The constitution, though an agreement (amongst other things) between the shareholders, cannot regulate matters going beyond the position of a shareholder as a member of the company. Refer Goldwasser, above, page 269.

8 Finn, above, page 101.

9 Finn, above, pages 101-102; Goldwasser, above, pages 274-278.

14. But Queensland retains:

    (a) Landholder duty under Chapter 3 Part 1;

    (b) Corporate trustee duty under Chapter 3 Part 2; and

    (c) A statutory deeming that shares in a landholder are included whenever Chapters 2 & 3 refer either to property in Queensland or dutiable property. Likewise, a reference to property in Queensland or dutiable property in those chapters is taken to include shares in a corporate trustee or "relevant corporation for a corporate trustee". In fact, these provisions in section 498, which represent a major trap for even experienced practitioners, have a very complex operation which lies beyond the scope of today's paper. Suffice to say that any dealings with shares in a company must be seen through the prism of Chapters 2 & 3, reading those chapters both as they appear on their faces and with the additional operation given by section 498.

2.2 Landholder Duty

15. Today is not an occasion to explore the entry points for landholder duty. A basic assumption must be made of practitioners in Queensland that they are aware of the duty laws.

16. Suffice to say that Queensland no longer has a land-rich regime, but rather a landholder regime under which a corporation with land-holdings of $2m or more is deemed to be a "landholder": section 165. The purpose of this is to ensure that the duty base is not eroded by transacting through the medium of a corporation which owns land, as opposed to transacting directly with the land. Tracing provisions (using a misleadingly wide definition of "subsidiary" in section 166) gather up into the deemed entitlement of a corporation the land-holdings of an entity and its subsidiaries.

17. Although this is now an everyday assessing provision, the complications which arise mean that some specialist knowledge must now be employed in every dealing with a corporation.

18. For example, one can now acquire an interest in a landholder by "the abrogation or alteration of a right for a share": section 162(2)(c). This was to overcome the decision in *Commissioner of Stamp Duties v MIM Holdings Ltd* [2001] 1 QdR 294. Section 162(3) declares for the avoidance of that doubt, now, that "an acquisition of shares … is not necessary to acquire an interest in a landholder".

19. Nevertheless, I do not consider that every alteration of the right of a share will be caught by landholder duty. To begin, there are thresholds so that a person must make a "relevant acquisition": sections 157(1) and 158. The thresholds themselves are difficult to explain simply, but basically for a private landholder it is 50 per cent or more. Once that threshold is crossed, further acquisitions are also taxed.

20. Secondly, it must be an acquisition of an "interest" in a landholder. A person has an "interest" in the landholder if the person "has an entitlement as a shareholder … to a distribution of the landholder's property", which for a corporation is defined to be an entitlement "on its winding up": section 159(1).

21. That interest is then expressed as a percentage of the value of all the landholder's property that would be distributed if, immediately after the person acquired the interest, the corporation were to be wound up: section 160(a).

22. As has become customary in such provisions, section 161 requires an assumption that a person would maximise his entitlement by exercising all powers and discretions he might have to change the constitution of the company, vary share rights, and other like things: see in particular section 161(1)(b).

23. Thus, one must take care in considering shareholder agreements, so that the kinds of rights being affected do not lead to an unexpected increase in an "interest" of a shareholder, respecting an entitlement as shareholder to a distribution of property on winding up; or lead to some to potential chain of reasoning whereby a shareholder could change share rights or the constitution or otherwise increase entitlement to a distribution on a winding up.

24. For example, care would need to be taken to ensure that any enhanced or special voting rights of a shareholder could not be the springboard for the Commissioner to assert that a particular shareholder should have exercised special voting rights to the maximum extent possible so as to increase the distribution to that or another shareholder on a winding up of the company.

2.3 Corporate Trustee Duty

25. I did mean for this paper to restrict itself to dealing with shareholder agreements, as opposed to agreements affecting trusts. Naturally one can also have a unit holder agreement, or an agreement which purports in some way to regulate the conduct of the affairs of a trust by a trustee. The problems in doing that are relatively obvious, but I simply wish to allude to some particular problems under the various revenue laws.

26. In Queensland, we have corporate trustee duty which is duty on a "relevant acquisition": section 205.

27. This can occur in one of two ways. A relevant acquisition can occur if a person acquires a "share interest" in a "corporate trustee". Secondly it can occur if a person acquires a "share interest" in a "relevant corporation for a corporate trustee". In both cases, the acquisition must be part of an arrangement under which a person obtains in some way a "benefit relating to the property held by the corporate trustee on trust": section 207.

28. Here the term "share interest" is relatively confined. It is defined as a person's interest as shareholder in either a corporate trustee or a "relevant corporation for a corporate trustee": section 208.

29. The key is that a corporate trustee must be an unlisted corporation which is the trustee of the discretionary trust: section 209. Note that there is no definition of "discretionary trust" and the term may be wider than you suspect. However for practical purposes these provisions seem to attract the Commissioner's interest if it is a trust which is neither a unit trust nor a fixed trust.

30. There are complex rules for tracing here. Essentially, if there is trust property somewhere in a structure, and you are dealing with shares in a company, you will need to go through the exercise of tracing to see whether you have a dealing with shares either in a "corporate trustee" in terms of section 209, or shares in a "relevant corporation for a corporate trustee" in terms of section 211. The latter is an unlisted company that has an interest, either directly or through one or more other corporations, in a corporate trustee.

31. The keys here, in terms of shareholder agreements, are the terms "share interests" in section 208, and the concept of acquiring a share interest in a corporation in terms of section 212. Both are focused around a person's "interest as a shareholder". One can acquire a share interest in a corporation by becoming a shareholder or (if one is already a shareholder) by one's share interest increasing.

32. It seems to me that mere changes to voting rights are unlikely to lead to such an acquisition of a share interest. Of course, as with landholder duty, any bargain under which shares are to be acquired, for example, under an agreed mechanism for buy-out, could lead to imposition of stamp duty.

2.4 Other States

33. You should be aware that other States have duty imposed on landholder or land-rich entities, and some States also impose duty in relation to corporate trustees and those that hold shares in corporate trustees. New South Wales and South Australia retain duty on the off-market transfer of a marketable security, as such, despite all other States abolishing that duty. (South Australia has only just deferred the abolition – see Information Circular 44.)

34. Particularly perplexing are the significant differences between each of the State's provisions about landholder duty, so that an ordinary trading company which happens to have significant fixtures (taking it above the various thresholds for landholder duty) can unexpectedly find itself the subject of attention.

2.5 CGT Small Business Concession

35. I suppose that there might be a number of different ways in which agreements as to voting rights could impact on Federal income tax (including CGT).

36. One obvious way would be in relation to the small business concessions offered under Division 152 *Income Tax Assessment Act* 1997.

37. In turn, varying shareholder voting rights might have a variety of impacts even within Division 152.

38. Let us focus, for the sake of argument, on the impact of a shareholder agreement, varying voting rights in relation to particular issues (for example, how directors are to be elected and whether the company's undertaking is to be sold), on whether shares in that company, when sold, can satisfy the basic conditions for relief in section 152-10.

39. Leave aside the other basic conditions.[10]

[10] These can include a maximum net asset value test or a requirement that the taxpayer be a "small business entity" (as the chief ways of satisfying characteristics of the taxpayer).

40. If the CGT asset which has been disposed of is a share in a company, just before the CGT event either:[11]

    (a) The person disposing of the share must be a "CGT concession stakeholder" in the company; or

    (b) "CGT concessions stakeholders" in the company must together have a small business participation percentage in the taxpayer of at least 90 per cent.

41. Let us simply deal with the first of those two possibilities.

42. The taxpayer must show that he is a CGT concession stakeholder in the company in which he held the share.

43. One way of satisfying that would be for the taxpayer to show that he is a "significant individual" in the company: section 152-60.

44. To be a "significant individual" in a company, the individual must have a "small business participation percentage" in the company of at least 20%: section 152-55.

45. The small business participation percentage is worked out under section 152-65.

46. For ease of calculation, let us assume that we are not tracing down through indirect small business participation percentages, but simply have a flat structure of one company in which there are a number of shareholders.

47. The direct small business participation percentage in a company under section 152-70(1) is the smallest of several figures resulting from holding legal or equitable interests in shares in the company:

    (a) The percentage of **the voting power** in the company;

    (b) The percentage of any dividend that the company may pay;

    (c) The percentage of any distribution of capital that the company may make.

[11] Refer section 152-10(2).

48. It is thus conceivable that an agreement about exercise of voting power, to vary the usual rights of ordinary shares so that they must be exercised in a particular way on particular issues, could result in a taxpayer falling below the 20% required for that taxpayer to be a "significant individual".

49. This would result in the small business concession being placed in jeopardy for that shareholder.

50. For this reason, I think some care must be taken in the long term structuring of companies to ensure that, while protecting the rights of minorities, other parties' access to valuable small business concessions are not defeated.

3 Sale arrangements

51. One of the obvious ways of avoiding difficulty in shareholder arrangements is for the shareholder agreement to provide what is to occur on disagreement leading to a shareholder desiring to exit.

52. One of the most cut-throat of arrangements, designed to disengage one of two warring parties, is the so-called Savoy clause.

53. The clause in *ACP Publishing Pty Ltd v FC of T* (2005) 142 FCR 533 (Full Court) was as follows:

> *7.1 Either News or ACP (hereinafter called "the offeror party') may at any time after the date six months from the date of this Deed offer in writing to sell or procure the sale to the other party (hereinafter called "the offeree party') the offeror party's interest under this Deed for the sum of money specified by the offeror party in the said offer. If the offeree party shall not have accepted the offer by giving notice in writing within fourteen (14) days after the making of the offer the offeror party shall thereupon be deemed to have notified the offeree party that the offeror party will purchase from the offeree party all of the offeree party's interest under this Deed for the sum specified in the offeror party's original offer and the offeree party shall in that case be bound to sell to the offeror party. Completion of any sale or purchase pursuant to this Clause 7 shall take place within twenty-one (21) days after acceptance of the offer by the offeree party or the deemed notice by the offeror party as the case may be, and this Deed shall subject to Clause 7.3 cease to operate.*
>
> *7.2 In this Clause 7 any reference to the interest of any party under this Deed shall mean in the case of ACP the right to receive the share of the net profits of the Business as provided in Clause 3.1 and shall mean in the case of News the*

> *right title and interest of News in and to the Rights including (but without limiting the generality of the foregoing) in respect of the new title and of each of the separate titles "TV Week', "TV Times' and "TV Guide' and of the goodwill attached to any or all of those titles.*
>
> *7.3 If pursuant to an exercise of the Savoy Clause the purchaser is ACP and ACP shall continue publication of the magazine then for a period of one (1) year from completion (or such lesser period as publication continues) Downlands or News or a related corporation of News (as News may nominate prior to completion and from time to time) shall be engaged by ACP to print and bind the magazine for a price that is no more than that which would otherwise be generally available to ACP from other printers for the printing and binding of a similar magazine in similar quantities."*

54. That was a deed about sale of assets, but the like clause is seen in Magnus & Kidby *Property Joint Ventures: Structures and Precedents* (2ed), precedent clause P11-016, styled as a "Russian Roulette" clause, the other name it goes by.

55. The point of mentioning *ACP* is that all these kinds of sale clauses raise difficult questions about options and conditional agreements.

56. In *ACP*, which was an asset sale clause, the question was whether a clause signed pre-GST, resulted (on exercise post-GST of the right to require purchase) in a taxable or GST-free transaction. It would have been GST-free had provisions of the *A New Tax System (Goods and Services Tax) Transition Act* 1999 applied.

57. While Gyles J was in dissent, his excursus on the law of options is beyond reproach:

> *72 There is an unsettled issue as to whether an option is a conditional contract (Ballas v Theophilos (No 2) (1957) 98 CLR 193 per Williams J at 207; Braham v Walker (1961) 104 CLR 366 at 376 per Dixon CJ; Westminster Estates Pty Ltd v Calleja (1970) 91 WN (NSW) 222 at 227-228; Laybutt v Amoco Australia Pty Ltd (1974) 132 CLR 57 per Gibbs J at 71-76; Barba v Gas & Fuel Corporation (Vic) (1976) 136 CLR 120 at 137; United Scientific Holdings Ltd v Burnley Borough Council [1978] AC 904; Spiro v Glencrown Properties Ltd [1991] Ch 537; Fairey A/asia v Commissioner of Stamp Duties (SA) (1998) 72 SASR 1 at 5).*
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> *73 Hoffman J (as Lord Hoffman then was) said in Spiro at 544:*
>
> > *"An option is not strictly speaking either an offer or a conditional contract. It does not have all the incidents of the standard form of either of these concepts. To that extent it is a relationship sui generis. But there are ways in which it resembles each of them. Each analogy is in the proper context a valid way of characterising the situation created by an option. The question in this case is not whether one analogy is true and the other false, but which is appropriate to be used in the construction of section 2 of the Law of Property (Miscellaneous Provisions) Act 1989."*

> *That is pertinent here, substituting s 13 of the Transition Act for the statute in question in that case. The approach of Lander J in Fairey A/asia was similar.*
>
> *74 The conventional example of a conditional contract is where the contract is conditional upon some objective external event, eg, the obtaining of planning approval or Minister's consent to transfer. An option to purchase is different in character. It only becomes binding if and when a unilateral and subjective decision is made to exercise it. Even if an option can be described as a conditional contract for some purposes, it is questionable whether it can be described as an agreement for the purposes of s 13. In the event of failure to supply pursuant to an option, if the property requires a particular form of contract then the relief may be to specifically perform the agreement constituted by the exercise of option by entering into an appropriate form of contract (Niesmann v Collingridge (1921) 29 CLR 177). The difference between an option and a synallagmatic contract is referred to by Lindgren J in Sydney Futures Exchange Ltd v Australian Stock Exchange Ltd (1995) 56 FCR 236 at 299. The reasoning of Gummow J in that case concerning a commodity agreement at 270-274 provides support for the appellant's position.*

58. More recently, there has been considerable doubt caused in Queensland by the Court of Appeal's ruminations about put and call options, for the purposes of the *Property Agents and Motor Dealers Act*.

59. The Queensland Court of Appeal has held that a put option could be characterised as a "contract of sale".[12] Keane JA, delivering the principal judgment in which the balance of the Queensland Court of Appeal concurred, said:

> *At this point, however, it must be acknowledged that the put option in each case obliged Traspunt only to acquire such lots as the appellants might elect to put to it. Traspunt's obligation as purchaser was conditional on the exercise of the put option. This does not mean, however, that the option agreements did not amount to valid and enforceable contracts of sale. Indeed, there is much to be said for the view that the option agreements are properly so described, even though the obligations of the parties to buy and sell depended upon the giving of notices exercising the options* [13]

60. His Honour then referred to well known High Court of Australia authorities on the issue of the characterisation of an option, including the comments of Gibbs J in *Laybutt v Amoco Australia Pty Ltd* (above), and went on:

> *Similarly, in the present case, the put option gave the appellants the right to become the vendor.*
>
> *Further, to speak of a contract of sale is to speak of a contract to transfer property for money … Those are the essential rights and obligations which characterise a contract as a contract of sale. The option agreements provided a mechanism by which these rights and obligations could be engaged. If the appellants elect to*

12 *David Deane & Associates Pty Ltd v Bonnyview Pty Ltd* (2005) ANZ ConvR 518 at 524.

13 At p.523.

> *exercise their put option, then the form and substance of the resulting contract, including the sale price, would be determined by reference to the provisions of the option agreements. … Once the machinery conditions in the option agreements became irrelevant to the respective substantive rights of the appellants and Traspunt, the description of the arrangements in the option agreements as a contract of sale was undeniably accurate.* [14]

61. Where Keane JA refers to "the machinery conditions in the option agreements" having become irrelevant to the "respective substantive rights" of the grantee of the put option and the grantor of the put option, I take his Honour to refer to the trigger for the put option, that the Grantee had "not procured completion of contracts for the purchase of" a specified number of lots by the expiry date.[15]

62. There has been a deal of law following that decision, and frankly the position has become confused.

63. What can be said is that, in a situation where the consumer protection objectives of PAMDA are not engaged, clear drafting should avoid debate. Draft as either:

    (a) A conditional contract, where it is spelt out whether it is a condition precedent to there being a contract, or to (for example) settlement; or

    (b) An irrevocable offer for consideration, not forming an agreement till accepted

64. Why is this important?

3.1 Timing

3.1.1 If drafted as conditional agreement

65. It may not suit for there to be an immediate agreement on foot, under the shareholder agreement, for the sale of shares.

66. The time of the CGT event is date of entry into the agreement: s.104-10(3).

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14 At p.524.

15 It is also possible that His Honour is referring to the relative informality with which the parties conducted themselves, in the context of the contractual definition of the event constituting the respondent's right to commission. The judgment is not entirely clear on the point.

67. If the agreement is drafted with a condition precedent to operation of the sale, the Commissioner has accepted (depending on the particular drafting) that there is no agreement till the condition precedent is fulfilled: ATO ID 2004/668. Absent an agreement till that point, no CGT event occurs under CGT event A1.[16]

3.1.2 If drafted as options

68. The grant of an option is CGT event D1. Again, timing can be critical, and if granted under a contract an option causes CGT event D2 on date of contract: s.104-35(2). Thus it seems that ATO ID 2004/668 is relevant, and to defer the contract coming into existence it might be subject to a condition precedent to contract.

3.2 Capital proceeds

69. Kirk Wilson in "Buy/sell agreements – the CGT consequences aren't entirely clear" 2005 WTB 21 [805] perhaps says it all with the title.

70. He goes through the apparently preferred model of deferring the creation of an option, say till death (or other triggering event).

71. But on that event occurring, CGT event D2 does occur.

72. What are the *capital proceeds* for the creation of the option?

73. Wilson suggests:

    (a) " ...given that the options would have typically been granted to the parties in their personal capacity as proprietors of the business, they would presumably not be assignable without the consent of all the parties to the agreement. Therefore, it could be argued that they have a nil market value."

[16] Beware other CGT events.

(b) "On the other hand, if it were considered that the parties received no consideration for granting the options, then the same outcome would arise – namely, nil market value capital proceeds would be required to be imposed."

74. Once the option is exercised, the entire transaction merges usually in CGT event A1.

75. When the additional factor of assignment of an insurance policy (or its proceeds) is added, you get into structures where it is not safe to proceed without a private ruling

76. Buy-sell agreements have in fact become proprietary products, the intellectual property being tied up in private rulings and experience with the Commissioner of Taxation.

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