PARMELIA
PARTNERS

Client Newsletter

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Do you need an agreement with your business partner?

Going into new business with other people is exciting and can be extremely rewarding. A formal agreement can set the ground rules and stop owners getting caught out if things don't quite go as well as planned.

Whether your firm is structured as a partnership or a company, you and your business partners need to agree on the terms of your professional relationship. This will be a partnership agreement, a shareholders' agreement or, where you are operating a trading trust, a unitholders' agreement.

There are many businesses out there that do operate without this agreement, however if you decide that it would be prudent to have one, the agreement can set out salient points, such as:

- the agreed responsibilities of each participant in the operation of the business

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Do you need an agreement with your business partner? *continued*

- what contribution each participant is bringing into the business — skills, know-how, access to funding and connections
- profit and loss sharing formulae
- consequences of failure to deliver one's responsibilities
- future funding options
- exit mechanisms
- decision making process, including day-to-day business operations and internal matters, such as the remuneration of directors (where there is a company structure), reinvestment of dividends/profits into the business
- short and long term business plans, and
- procedures when one participant becomes incapacitated or dies.

WHAT TO EXPECT IF YOU CHOOSE NOT TO HAVE ONE

All relationships start with a "honeymoon" period where everything looks rosy, and everyone puts in their best efforts to make a combined vision a reality. When partners have their blinkers on to create a firm from scratch, they put 100% effort towards a clear common goal.

This common goal, however, may morph into a slightly different creature for individual partners over time. The once clear common goal can become blurry and takes on a different meaning to different partners. Disagreements can surface about how the firm is being run and future plans for the firm, and these can affect the priorities of the business on a day-to-day basis.

It's difficult enough to gain or just maintain market share in today's market, so no business owner can afford the time to deal with internal disputes with partners. These disputes are not only time consuming, but are emotionally draining for everyone involved.

WHAT CAN GO WRONG?

Below are some examples of problems that business owners encounter:

- a major participant whose asset to the business is his/her skills in the trade/profession decides to set up shop in competition but refuses to relinquish his/her shares in the original business
- a shareholder/partner refuses to inject much needed funds into the business and its expansion is put on hold
- a director refuses to attend board meetings, which makes it impossible for the remaining director(s) to make time-sensitive decisions
- directors refuse to disclose company books to shareholders
- minority shareholders hold out on a potentially profitable sale of the business
- disputes regarding the valuation of shares/interests in the business when a party seeks to sell out
- a partner/director wants to spend more time with family and cash in on his/her efforts, but there is no ready market for a portion of an interest in the firm and pressure is placed on the other partner(s)/shareholders to sell the whole business
- a director misuses information for his/her own benefit to the detriment of the company
- one partner/director takes up the role of major "fee earner" and the others focus more on business development, and so the question arises as to what is a "fair" split of income/profits, and
- one partner/shareholder is offered a premium for the firm, but the other partners/shareholders hold out with some refusing to consider a sale.

WHAT HAPPENS THEN?

Without a partnership, shareholders' or unitholders' agreement, the parties cannot refer to an agreed way to resolve the dispute. The only resort is to apply for a court order to achieve a desired outcome.

Court orders can be sought for (and this list is not exhaustive):

1. the dissolution of a partnership
2. the winding up of a company
3. injunctions to prevent a party from dealing with the assets of the business
4. directions as to the conduct of the company's affairs, or
5. one shareholder to purchase the other's shares/interests at a price to be determined by the court.

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Alerts, not alarms

Every now and then you might read or hear about a "taxpayer alert" being issued by the ATO. Taxpayer alerts are the ATO's "early warning" signals to the public about a certain area of concern – it could be about fraudulent schemes, or dodgy investments, or perhaps about a tax minimisation tactic that the ATO has been made aware of and knows will get people into trouble.

Taxpayer alerts are the mechanism by which the ATO lets the general public know that there could be a problem, or a higher risk than usual, in an area of tax planning. It's the taxman's version of those "kangaroos next 10km" road signs, or "black spot" intersection signs.

If you do an internet search of "taxpayer alerts", the search engine will most likely take you to an ATO "legal database" that lists more than 100 taxpayer alert documents, grouped into years and going back to 2002.

The alerts are written principally to let people know about emerging issues that are of concern, and spell out what's under scrutiny (it could be a tax scheme or arrangement, or particular transaction). The alerts should also highlight the aspects that most worry the ATO.

Not every potential concern makes it to being the subject of a taxpayer alert. Nor is it the case that every item that is mentioned in an alert ends up being a real problem. Further examination can uncover a simple benign matter that is of no concern whatsoever. And if this is the case, a notification will be issued to let everyone know.

The sort of features that may lead to an alert being triggered, or at least a concern raised, will typically include:

- Arrangements that seem contrived
- No real underlying business purpose
- An economic return that seems to rely largely on the tax benefit
- Mechanisms in place for exiting an arrangement before income is generated
- Passing income through a tax-exempt body such as a charity
- Schemes involving tax havens.

The taxpayer alerts are not law and are also not to be confused with the ATO's "public rulings". But once investigations are done and consideration is made about where the ATO stands on an issue, a "ruling" or a "determination" will be made and distributed, or an alert will be withdrawn if it's subsequently found not to be of concern to the ATO. Generally a notification will be published either way.

Where a subsequent tax ruling has been issued or a decision has been made, the alert will have a link to that.

Anyone who is thinking about entering into a scheme or tax arrangement that ends up being the subject of a taxpayer alert can ask for a formal determination from the ATO, or request a private ruling on the issue (although the ATO does not always have to issue a private ruling). A taxpayer alert should also name the tax officer involved, so you can contact that officer for advice or ask us to do this for you.■

Investment tax issues you need to be aware of

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Investors must consider a range of tax laws dealing with income, assets and deductions. Even that term ”income", the meaning of which most of us would assume, can take on nuanced shades of meaning when considered in regard to investment. For example, investment income earnings such as dividends and interest are typically considered ordinary income. Franking credits, net capital gains and net trust distributions are "statutory" income.

Ordinary income is typically income that is regular, periodic or recurrent. Returns on property such as interest, rent or dividends are considered ordinary income. Statutory income is income that is not ordinary income but is recognised as income because of a provision of the tax law (such as the circumstances mentioned above).

Taxpayers with investments have been found to occasionally make some common mistakes when preparing their income tax returns, including, but not limited to, the following:

- cash management trust income is often declared in the income tax return as interest rather than a trust distribution. Cash management trusts distribute net income in the same manner as other trusts. A statement should be obtained at year end from the financial service provider indicating the gross distribution and any management fees deducted attributable to the tax year
- listed investment trust dividends often include a listed investment company capital gain. A deduction is available to investors that have access to the CGT discount rate. The deduction is equal to 50% of the capital gain for individuals and trusts and 33$\frac{1}{3}$% for superannuation funds
- trust distributions often record the taxable distribution on the annual tax statement using the 50% CGT discount. However the statement may not accurately reflect an investing taxpayer's investment structure and period of ownership. Make sure that:
    - you have held the asset for at least 12 months
    - you are eligible to use the 50% CGT discount rate, and
    - the capital gain is grossed up in the tax return before the discount is applied.

Also be aware that those who receive franked distributions often fail to consider the "holding period rule" when determining their entitlement to franking credits. The holding period rule requires you to continuously hold shares "at risk" for at least 45 days (90 days for certain preference shares) to be eligible for the franking tax offset.

A related issue is where taxpayers often incorrectly apply the "small shareholder exemption" to entities other than individuals when determining eligibility to franking credits. Under the small shareholder exemption the holding period rule does not apply if your total franking credit entitlement is below $5,000.

Also, investors often fail to adjust the cost base of their units in a unit trust or managed fund for tax deferred distributions received.

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Investment tax issues you need to be aware of *continued*

OTHER ISSUES

There are certain other tax issues facing those in receipt of investment income — not every investor, but enough to warrant keeping an eye on the following issues just in case they may affect your tax outcome.

Promoter penalties

Penalties apply to promoters of tax avoidance and tax evasion schemes, otherwise known as tax exploitation schemes. The rules impose substantial penalties to individuals and corporations that market a scheme and receive consideration in respect of that marketing.

While promoter penalties do not apply to investors in a particular scheme, any tax benefits realised by investors can potentially be cancelled by the ATO's anti-avoidance rules.

Foreign tax issues

In some instances, investments by residents in one country made in another country may be taxed in both countries (subject to any "double tax agreement" between the relevant countries). To prevent double taxation, Australian taxpayers are entitled to claim a non-refundable foreign income tax offset for foreign tax paid on an amount included in their assessable income, referred to as a "double-taxed amount" for the purposes of this tax offset.

The foreign tax offset is limited to the lesser of foreign income tax paid and the "foreign tax offset cap". The cap is calculated by determining the Australian tax payable on the taxpayer's double-taxed amounts. As an alternative to calculating the cap, the taxpayer can choose to use a $1,000 minimum cap.

Goods and services tax

Share traders are generally not required to register for GST. Although share traders are carrying on an enterprise, because GST turnover is defined to exclude "input taxed" supplies (generally share sales are input taxed), the requirement to register will only exist if taxable supplies from other sources exceed the $75,000 GST registration threshold. Where an enterprise is being carried on, an investor can register for GST voluntarily where the registration threshold is not met. However, there may be limits on the refund of input tax credits for financial supplies.

Losses

Current year income losses arising from the negative gearing of investment income can generally be offset against other current year income. If current year income is insufficient to fully use the investment losses, income losses may be carried forward to be offset against future income subject to certain loss rules (such as for a trust or company). Capital losses may only be offset against capital gains. If there are insufficient capital gains in a year to absorb a capital loss, the excess capital loss may also be carried forward and used in later years.

Non-resident withholding

Non-residents are not required to provide a TFN to investment bodies as TFN withholding rules do not apply. However, they will need to advise the investment body that they are a non-resident.

Non-residents are subject to non-resident withholding tax on specified types of income. Withholding tax is payable on interest, unfranked dividends, royalties or fund payments to non-resident unitholders of managed funds. Generally the payer is responsible for withholding, reporting and remitting the amounts to the ATO.

Records and substantiation of expenses

Taxpayers are required to keep records for taxation purposes for five years. Typically the records to be retained include receipts, accounts, property records and other documents that relate to assessable income (for example, PAYG payment summaries, interest and dividend statements). Failure to keep records may attract a penalty from the ATO.

Tax file number (TFN)

Australian taxpayers in receipt of investment income who lodge returns with the ATO are allocated a TFN. Non-resident investors from a country that has a double tax agreement with Australia will have withholding tax deducted at the applicable tax rate, which is typically lower than for residents of a country with which Australia has no double tax agreement. An Australian TFN is not required if the investment income relates to interest, dividends or royalties or certain managed fund distributions. Non-residents in receipt of this type of income do not usually prepare an Australian tax return. This differs from investments in other types of income, such as income from real property where a TFN and tax return are required.

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Investment tax issues you need to be aware of *continued*

Tax file number withholding

Investment bodies such as banks are required to withhold tax from investment earnings where the taxpayer does not quote a TFN or Australian business number. TFN withholding tax is refundable on provision of a valid TFN or on lodgement of the income tax return.

NOTE: Closely-held trusts (including a family trust) need to withhold amounts from trust distributions at the top marginal tax rate where beneficiaries have not provided a TFN to the trustee by the time of the entitlement. The trustee is required to report to the ATO the TFN details of beneficiaries who become presently entitled to trust income.

Wash sales

A wash sale is an arrangement in which essentially the same asset is sold and immediately repurchased, or where an asset is sold to an associated taxpayer such as a spouse or family trust so that, broadly, the investor's economic position is unchanged. Where the dominant purpose of a "wash sale" is to crystallise a capital loss, the ATO indicates that its "Part IVA" may be applied to deny a deduction for the loss. (Basically, Part IVA is an umbrella clause in the tax rules so that the ATO can deny a tax benefit where an arrangement is entered into with the obvious sole or dominant purpose of gaining that benefit.) ■

Do you need an agreement with your business partner? *continued from page 2*

More often than not, parties cannot agree on the way forward and hence any court order obtained will only seem to serve the purpose of one of the parties, rendering the parting of ways less than amicable.

Needless to say, initiating proceedings in courts involves legal costs to obtain advice, and most important of all, your business is left in limbo while you are sorting out your issues with your business partner who now has more important concerns/interests than the business that you created together.

It is invariably the remaining shareholders/partners/unitholders who want to continue with the business in such instances who will suffer the most.

While no-one can anticipate all dispute scenarios that can crop up, it's always best to have the ground rules set right with your business partners before taking the leap together.

NEXT STEPS

It is worthwhile spending the time with your potential business partners to discuss at least the following:

1. the vision, mission and values of the business (sounds cliché, but really these underpin all business decisions to be made)
2. the initial set up costs, ongoing financial requirements
3. marketing plans to create your niche in the market, put your services in front of your target audience to elicit engagement and response
4. possible strategic alliances with other professionals
5. whether employees will be recruited and, if so, pro forma terms need to be averted to
6. the partners' respective roles in the business, perhaps setting initial KPIs
7. remuneration of the partners
8. contingency plans when one or more partners become incapacitated
9. create "liquidity" by setting out exit procedures
10. have tag-along and drag-along clauses so that the business/company can be sold upon the occurrence of a triggering event
11. business succession planning
12. restraints that will apply upon termination of the relationship, and
13. how the business will be valued upon termination (a valuer or a firm can be nominated in the agreement).

Once the foundation of the professional relationship is laid out, the agreement should be documented and signed by all parties.

No one wants to think that a partnership will sour or that anyone's focus will shift from the common goal and doing what's best for the business. However, there's rarely anything that's guaranteed in business. Putting an agreement in place straight up could save a lot of time, cost and emotional drain down the track. ■

Consumers compensated by financial institutions still need to consider tax

With the ongoing financial services Royal Commission, and likely future cases brought before various courts for compensation — or indeed the present building of class action lawsuits on the back of various revelations to come out of the Royal Commission — the ATO has felt the need to run over the rules (as they stand) regarding the taxation of compensation paid to individuals for advice from financial institutions.

The ATO says that taxpayers will need to consider certain tax consequences if they have personally received compensation from a financial institution because they:

- received advice from the institution that was found to be inappropriate, or
- paid for advice that they did not receive.

The ATO says the tax treatment of the compensation depends on what the compensation is being paid for, and how an investor holds (or held) the investments.

A compensation payment can include some or all of:

- compensation for loss on an investment
- a refund or reimbursement of fees
- interest.

The compensation may relate to multiple investments, with different amounts of compensation granted against each one. The ATO says an individual will generally be required to consider the tax consequences of each compensation amount separately.

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COMPENSATION FOR LOSS ON AN INVESTMENT

You may receive compensation for a loss amount if the value of your investments is lower than it would have been if you had received appropriate advice. There are different tax treatments depending on whether the compensation relates to investments you have disposed of or existing investments.

COMPENSATION FOR INVESTMENTS YOU HAVE DISPOSED OF

When an investor disposes of an investment, a capital gain or loss may be realised, which is generally reported in the financial year the asset was disposed.

The compensation can be treated as additional capital proceeds relating to the disposal of those investments. If you have more than one investment, you will be required by the ATO to apportion the additional capital proceeds to each disposal.

Most investors will be Australian residents for tax purposes, so if the compensation relates to investments held for at least 12 months you will be entitled to the 50% CGT discount. You may therefore need to request an amendment to your tax return to reflect the additional capital proceeds if the compensation relates to disposing of investments in a previous financial year.

Consumers compensated by financial institutions still need to consider tax *continued*

COMPENSATION IN RELATION TO EXISTING INVESTMENTS

If you have been compensated for investments you still own, you need to reduce either the cost base or the reduced cost base by the compensation amount received, depending on whether you make a loss or gain when you dispose of the investments. Also it may be necessary to apportion the compensation amount where it relates to more than one investment.

REFUND OR REIMBURSEMENT OF ADVISER FEES

A compensation payment may include an amount that is a refund or reimbursement of adviser fees. The tax treatment of this amount depends on whether you claimed a deduction for the adviser fees in your tax return.

DEDUCTION CLAIMED FOR ADVISER FEES

If a deduction was claimed for the adviser fees in a tax return, the amount received as a refund or reimbursement will form part of your assessable income in the year it was received.

DEDUCTION NOT CLAIMED FOR ADVISER FEES

If there was no deduction claimed for the adviser fees, the refund or reimbursement does not form part of assessable income. However, where the adviser fees were included in the cost base or reduced cost base of any investments made, you must reduce the cost base and reduced cost base by the amount of the refund or reimbursement.

The cost base and reduced cost base are used to calculate capital gains or losses when an investor disposes of an investment. ATO advice is to report the resulting capital gain or loss in the tax return for the year in which you dispose of the investment.

If you dispose of these investments and have returned any resulting capital gain or loss in a previous income year, you may need to amend your tax return for that year.

INTEREST COMPONENT

The interest component is assessable as ordinary income, and should be included in your tax return in the financial year it was received.

EXAMPLE FROM THE ATO: INVESTMENTS HELD INDIVIDUALLY

Noel paid $2,000 to a financial institution for investment advice in May 2010. Following that advice Noel invested $100,000 in a high risk-high growth investment fund. The investment fund performed poorly and Noel disposed of the investment for $70,000 in January 2015.

Noel had claimed a deduction for the advice in his 2009-10 tax return. CGT event A1 happened when Noel disposed of all the investments in his portfolio. Noel included a capital loss of $30,000 in calculating his net capital gain in his 2014-15 tax return.

The financial institution reviewed the advice given to Noel and determined that the advice was inappropriate for his circumstances as he should have been advised to invest in a more conservative portfolio.

In 2018 the financial institution offered Noel compensation of $40,000 in respect of the advice. The payment included compensation of $30,000, a refund of the adviser fees of $2,000 and an interest component of $8,000. Noel accepted the offer of compensation in June 2018.

Noel treats the $30,000 compensation for loss amount as additional capital proceeds received for the investments. Noel recalculates his capital loss for 2014-15, reducing it to nil. Noel will need to amend his 2014-15 return with the new calculation.

As Noel had claimed a tax deduction for the adviser fees in his 2009-10 tax return, the $2,000 refund of those fees is included in his assessable income in his 2017-18 tax return. He will also include the $8,000 interest component in his 2017-18 tax return.■

This information has been prepared without taking into account your objectives, financial situation or needs. Because of this, you should, before acting on this information, consider its appropriateness, having regard to your objectives, financial situation or needs.