

COMMERCIAL e.SPEAKING

ISSUE 11 • MAY 2006

Brought to you by

LAW NORTH PARTNERS
Lawyers

Bay of Islands NZ

Law North Partners
The Meridian, 93 Kerikeri Road
Private Bag 1001, Kerikeri
Ph: 09-407 7099, Fax: 09-407 7095
E-mail: info@lawnorth.co.nz
www.LawNorth.co.nz

Welcome to the Autumn issue of Commercial e.Speaking. We hope you find the articles both useful and of interest to you. If you have any specific business or commercial topics that you would like to see covered in future issues, please get in touch with us.

Owning Your Own Destiny

- A guide to MBOs

Inland Revenue reduces penalties

- FBT and shortfalls

The Credit Reporting Privacy Code

- How will it affect your business?

Business Briefs

Costs of four weeks annual leave start this year – ACC incentives – Salary sacrifice changes in new tax legislation – Decision upholding trust in face of a sham argument – Corporate governance handbooks back

If you require any further information on any of the topics covered in Commercial e.Speaking, then don't hesitate to contact us. If you do not want to receive this newsletter, please [unsubscribe](#).



Disclaimer:

All the information published in COMMERCIAL e.SPEAKING is true and accurate to the best of the publisher's knowledge and should not be a substitute for professional advice. No liability is assumed by this firm for any losses suffered by any person relying directly or indirectly on this newsletter. Articles appearing in COMMERCIAL e.SPEAKING may not be reproduced without prior approval of the editor and credit being given to the source. ©2006. Editor: Adrienne Olsen, email: olsen@sorensengroup.co.nz



Owning Your Own Destiny

- A guide to MBOs

This is the third in a series of articles dealing with succession issues for business owners. While the first two articles dealt with the current national market and the importance of preparation when buying or selling a business, this article will focus on just one of a number of sale or acquisition strategies available – a Management Buy-Out (MBO).

What is a Management Buy-Out?

An MBO is a transaction in which a team or an individual purchases the business they intend to manage. An MBO can offer a win-win scenario for the owners and managers. The existing owner can obtain a full or partial exit from their investment at a fair price, while the new managers obtain a mechanism to leverage their extensive knowledge of the business into something more powerful – an opportunity to exercise their entrepreneurial talents and control their own destiny.

What can an MBO offer?

- An MBO can inject new energy and entrepreneurial spirit into a business and, at the same time, provide management with a significant opportunity for wealth creation
- Research indicates that private equity funded MBO teams increase company profitability on average by more than 50%, and increase investment in R&D by over 60%
- Nearly 70% of companies that have undergone an MBO increase their product range and expand into new markets.

This level of performance in an MBO can be generated because effort and results are clearly linked to personal rewards.

As the earnings of the business grow under the intensive stewardship of the MBO team, value accrues in two ways:

- Improved profitability increases the value of the core business thus increasing the value of the shares
- Debt used to fund the initial buy-out is paid down by the cash flows of the business, compounding the growth in equity value.

How can an MBO team raise the capital to buy the business?

Typically only a small proportion of the total purchase price is actually provided by management.

The purchase price for the business is generally funded by a combination of management equity, outside equity and senior debt. Too much debt however is not conducive to good business performance. Therefore, in many MBOs the role of a private equity investor is fundamental. In addition to providing the MBO team with important structuring and negotiation advice, a private equity investor such as a major trading bank can provide the additional equity required, thus maintaining a balanced capital structure.

The recipe for a successful MBO

- Strong leadership with vision, energy and a passionate commitment to succeed and grow the team's wealth
- Management as a group should be a cohesive team of committed individuals who together have produced a compelling business plan that demonstrates their competitive advantage.

MBO vs trade sale or public listing

There are some significant advantages in an MBO rather than a trade sale or initial public offering (IPO).

- An MBO offers vendors a relatively quick and clean exit compared with other methods. For example, financial investors in the MBO may require less onerous warranties and be able to complete their analysis of the business quicker knowing that management, with their extensive knowledge of the business, support the offer

Continued on page 3

Inland Revenue reduces penalties - FBT and shortfalls

Fringe benefit tax

Legislation was recently passed allowing the Inland Revenue Department (IRD) to grant a 50% reduction in shortfall penalties charged for fringe benefit tax errors. This is covered in the amendment to s141FB of the Tax Administration Act 1994.

The reduction is conditional on previous good taxpayer behaviour. The IRD will assess good behaviour after taking into account any offences for previous late tax payments under ss143-145 of the Act.

Shortfalls

New legislation now allows the IRD discretion to cancel some shortfall penalties. A new section (s 141KB) was inserted into the Tax Administration Act 1994 on 3 April 2006.

The discretion is available to taxpayers who have made a clear mistake or genuine oversight in their tax returns. The discretion may also apply if it is not appropriate the taxpayer be liable and for voluntary disclosures by the taxpayer.

This legislation applies to tax returns filed from 1 April 2003. Any shortfall penalties imposed before 1 April 2006 can be considered for write-off under this new section if an application is made before 1 October this year.

Revenue Minister Peter Dunne who introduced the legislation, stated, "I hope this [legislation] is a short term measure to reduce the harshness of the penalty in some cases. In the longer term I would like to devise solutions that address a whole range of concerns about the tax penalty rules. All changes will, of course, be subject to the usual consultative process."

Owning Your Own Destiny continued from page 2

- There are usually no escrow provisions on vendors' residual equity as can occur in the case of an IPO
- With management's private knowledge in the business, an MBO can help unlock 'hidden' value in the business for the vendors
- There is less risk to vendors of sensitive commercial information ending up in the hands of competitors in the case of an incomplete sale
- MBOs are relatively flexible processes that can accommodate the vendors maintaining a reduced stake, if desired, following the transaction. A partial MBO allows the vendors to realise a good proportion of their investment but still share in any future increased performance.

What does a private equity investor look for?

Investors look for equity investments starting at \$500,000 in individual MBOs that have a strong management team, well-defined strategies, an established and profitable business, and a commitment to creating shareholder value.

Management must be empowered to drive the business hard by having control of the day-to-day operations. The transaction will often be structured such that management holds either 100% or the majority-voting control. The focus is on empowerment. If management succeeds, then the private equity investor does too – and then you're all winners.

The Credit Reporting Privacy Code – How will it affect your business?

From 1 April 2006 credit reporters, such as Baycorp Advantage (NZ) Limited, must comply with the Credit Reporting Code 2004 (Code) when collecting, storing and disclosing credit information about a person.

Although the primary focus of the Code is to regulate the activities of credit reporters, the Code will have implications for business operators who intend using the credit reporting services provided by such agencies. This is largely because credit reporters cannot comply with many of their obligations under the Code because they do not have direct contact with the person about whom they are collecting, storing and disclosing information. Instead, it is normally the business operator who has direct contact with the person concerned. Consequently, credit reporters are unlikely to provide credit reporting services to any business until there is an agreement to collect, store and disclose credit information in a manner that will enable them to comply with the Code.

The matters on which a credit reporter may require agreement include:

- The business has told the person concerned why the credit information is being collected, from whom, to whom it is being disclosed and that the credit reporter and that person has given the necessary authorisations
- That person authorises the credit reporter to list the credit information onto its system and to supply it to other customers as part of its service. Action to take:
 - Develop written policies and procedures in respect to the use of credit reporting services, and to provide the necessary training to ensure compliance with these policies and procedures
 - Put in place effective controls over who uses those services, and how they are used
- An ability to conduct compliance checks and assist to investigate and resolve any complaints and requests for correction of credit information.

Before entering into any agreement with a credit reporter, the policies and procedures for your business should be reviewed, including trade terms or other privacy declarations, to ensure compliance with your obligations under the agreement.

The above is only a brief summary of the Code. Further general information about the Code can be obtained from the Office of the Privacy Commissioner on www.privacy.org.nz. For specific advice relating to your business, please don't hesitate to contact us.

Business Briefs

Costs of four weeks annual leave start this year

The increase in annual leave from three to four weeks took effect on 1 April 2006. Employers have to pay annual leave for four weeks, not three, on any leave earned by employees whose anniversary dates fall on or after 1 April.

Employees are not entitled to the extra leave or payment for it until after April 2007. However the moment they do become entitled to it their employer has to find the money dating back to their anniversary date in April 2006. If an employee chooses to leave their job in April 2007, their employer is obliged to pay out all their annual leave at 8% instead of 6%, back-dated to April 2006. Employees who take holidays must wait for their anniversary date in 2007 before they can begin using the extra week's leave.

ACC incentives

At 1 April 2006 the government introduced an ACC levy discount programme specifically aimed at small business employers and the self employed in the agriculture, forestry, construction, road freight transport, motor trades and inshore fishing industries. If small business owners can demonstrate that they are taking suitable steps to improve workplace safety, they will receive a 10% discount on their Employers' Account levy or their Self Employed Work Account.

Salary sacrifice changes in new tax legislation

Legislation to minimise the use of excessive 'salary sacrifice' as a means of paying less tax will be included in the taxation bill planned for introduction this month.

Finance Minister Michael Cullen and Revenue Minister Peter Dunne said, "In many cases, high-income employees 'sacrifice' their salary merely to reduce their tax. They do this by arranging a dramatic reduction in their salary in return for a proportionate increase in employer superannuation contributions, which are taxed lower than their salary."

The changes will mean that, "Most employees are taxed at about the right marginal rate on their employer superannuation contributions. The top rate of tax on employer superannuation contributions will remain at 33%, but employees on lower salaries will pay only 15 or 21%, depending on their overall income."

"Rates will be based on the total of an employee's salary or wages and employer superannuation contributions, and the accompanying thresholds for tax on employer contributions will be adjusted. The adjustments will result in the thresholds being 15% higher than personal income tax thresholds to reduce the possibility of over-taxation," the Ministers said.

Decision upholding trust in face of a sham argument

In recent case, *Official Assignee v Wilson**, the Official Assignee was unsuccessful in applying for a declaration that a trust was a sham. Despite the judge being faced with a regrettable lack of documentation, an examination of the transactions entered into by the trust did not reveal that they were a façade or false front.

There has been considerable unease in the trust industry on the extent of the sham trust argument; this decision will be encouraging.

*12.4.06, Justice Chisholm, Dunedin High Court CIV/2004/415/74

Corporate governance handbooks back

The Securities Commission's handbook, *Corporate Governance in New Zealand Principles and Guidelines - a Handbook for Directors, Executives, and Adviser*, is now again available.

There is a free download on www.sec-com.govt.nz/publications/documents/governance-principles/handbook.shtml, order copies by email on seccom@sec-com.govt.nz or phone 04-472 9830.