

LEGISLATION NOTE

PRE-INCORPORATION CONTRACTS: SECTION 42(A) OF THE COMPANIES AMENDMENT ACT (No 2) 1983

I. Introduction

Last year the Companies Amendment Act (No 2) 1983 was considered in relation to ultra vires and directors' duties (RJC Partridge (1984) 5 AULR 73). This year we continue our analysis of the amendment with a consideration of its effect upon pre-incorporation contracts.

It sometimes occurs that persons concerned in the formation of a company cause contracts to be entered into with third parties ostensibly by the company or on its behalf, but in fact before the company has been formed. We will see that the common law solutions to the problems posed by pre-incorporation contracts have not always been satisfactory. We will then investigate to what extent these inadequacies have been overcome by the Companies Amendment Act (No 2) 1983.

II. The Common Law

Until a company is incorporated it has no separate legal existence and hence can neither sue nor be sued on any contracts allegedly made on its behalf. In *Kelner v Baxter* (1866) LR 2 CP 174, a case involving a pre-incorporation contract, Erle CJ drew upon the law of agency. Where the promoters of a prospective company enter into a contract on its behalf before its incorporation, the company cannot after incorporation ratify the contract, for a fundamental element of ratification is the existence of the principal at the time when the contract was originally entered into. We will later delve more fully into the requirements of ratification and its effects. It is sufficient to note at this point that at common law ratification of a pre-incorporation contract is not possible.

The surest way for a company to be bound by an agreement entered into before its incorporation is for it to execute a new contract in the terms of the previous one. It seems that such a contract may occasionally be inferred from acts done by the company which are "necessarily referable" to the making of a new contract: *Howard v Patent Ivory Co* (1888) 38 Ch D 156.

Other ways have been sought to enforce pre-incorporation contracts. The Contracts (Privity) Act 1982 has recently been considered. In *Palmer v Bellaney* (noted in [1984] NZ Recent Law 230) Hardie-Boys J,

after considering s4 and s8 of the Act, held that its effect was to confer on the company the right to enforce a pre-incorporation contract.

Often, then, a third party will have no remedy against the company; under what circumstances may he look to the agent/promoter? Pre-incorporation contracts frequently include a provision that if after incorporation the company adopts the agreement the liability of the agent under the agreement shall determine and that if the company does not adopt the agreement within a specified time either party may rescind it. In the absence of such a saving provision we must look to the illogicalities contained in two cases.

At the one extreme we have the English case of *Kelner v Baxter*; at the other, the Australian case of *Black v Smallwood* (1966) 117 CLR 52. In *Kelner v Baxter* at the time of contracting both parties to the contract were aware that the company was not yet incorporated. In such a situation, regardless of whether the agent for such company signs in the capacity as agent or trustee for the company to be formed, or whether he signs as "director" or other officer of the company itself, a presumption of personal liability is irresistible so long as a presently binding contract is intended, because all parties know the company is not yet in existence: *Marblestone Industries v Fairchild* [1975] 1 NZLR 529, 542 per Mahon J.

In *Black v Smallwood* the company was mistakenly believed to exist. The purported contract had been made, not by persons professing to act on behalf of a non-existent company but by persons professing to be directors of an existing company. Because of the mistaken belief of the parties that the company was incorporated there could be no imputed intention that the persons signing as directors should be personally liable. However, it was suggested by Mahon J in *Marblestone Industries* (at 542) that the ratio decidendi of *Hawkes Bay Milk Corporation Ltd v Watson* [1974] 1 NZLR 236 is preferable: where a company is mistakenly believed to exist then the mutual intention of all signatories is to make a contract with the company alone, and the persons signing on behalf of the company cannot be liable on a "contract" which is in fact a nullity.

To summarise, if the promoters purport to contract on behalf of the company they are personally liable (*Kelner v Baxter*) but where the proposed company is the purported contracting party, then no contract comes into existence and neither the company nor the promoters can sue or be sued (*Black v Smallwood*, *Newborne v Sensolid (GB) Ltd* [1954] 1 QB 45).

It is upon this background of common law that the Macarthur Committee recommended in paragraph 109 that:

- (a) any contract or other transaction purporting to be entered into by the company prior to its formation (*Black v Smallwood*) or by any person on behalf of the company prior to its formation (*Kelner v Baxter*) may be ratified by the company after its formation, and thereupon the company shall become bound by and entitled to the benefits thereof as if it had been in existence at the date of such contract or other transaction and had been a party thereto, and that

(b) prior to ratification by the company, the person who purported to act in the name of the company or on its behalf shall in the absence of express agreement to the contrary be personally bound by the contract or transaction and shall be entitled to the benefit thereof.

Thus, enter s42A of the Companies Amendment Act (No 2) 1983.

III. The Legislation

(a) Subsection (1)

Subsection (1) provides that the section shall apply to both contracts purporting to be made by a company before its incorporation (the *Black v Smallwood* situation) and contracts made by a person on behalf of a company before and in contemplation of its incorporation (the *Kelner v Baxter* situation). Hence the technical common law distinction between the two lines of cases has apparently been removed. It will later be argued, however, that the distinction may still be relevant to certain narrow fact situations.

(b) Subsection (2) and the importation of the common law

Subsection (2) provides that:

Notwithstanding any enactment or rule of law, a contract to which this section applies may be ratified within such period as may be specified in the contract, or if no period is specified, then within a reasonable time after the incorporation of the company in the name of which, or on behalf of which, it has been made. A contract so ratified shall, upon ratification, be valid and enforceable as if the company had been a party to the contract when it was made.

The rule of law to which it refers, and consequently abolishes since the only cases that supported it were cases of unincorporated companies, is of course the rule that requires that the ratifying principal must be in existence at the time when the agent purports to act on his behalf.

The term "ratification" is used. Since it is not defined in the legislation and is a term of art, it necessarily imports the learning developed at common law. A realisation of the interplay between the law of agency and the legislation is central to an understanding of the application of s42A. Consequently, we must look in some depth at the prerequisites for ratification.

Before doing so, however, a brief discussion of what ratification is will be useful. The requirement for ratification arises when an agent/promoter contracts on behalf of a principal (the unincorporated company) at a time when the relationship of the principal and agent does not exist; such relationship of course cannot obtain at that time since the principal is not yet in existence. Subsequently however, the principal on whose behalf, though without whose authority the agent has acted, accepts the agent's act and adopts it just as if there had been a prior authorisation by the principal to do exactly as the agent has done. This is a result made possible by subsection (2). The effect of such ratification was explained by Lord Sterndale in *Koenigsblatt v Sweet* [1923] 2 Ch 314, 325:

When once you get a ratification it relates back; it is equivalent to an antecedent authority; when there has been ratification the act that is done is put in the same position as if it had been antecedently authorised.

Now let us consider some of the prerequisites for ratification, and the way in which they affect the application of s42A.

(i) *Disclosure of the existence of a principal:*

Firstly, consider the following problem. An agent/promoter (A) contracts with a third party (T). However, at the time of contracting, although A has the intention of acting on behalf of an unincorporated company (P), such intention is not disclosed to T, and it appears as though A is acting for himself. Can P upon incorporation ratify the contract entered into by B with T? Although subsection (1)(b) does not contain any express requirement of such knowledge on the part of T, it is submitted that upon the basis of the law concerning ratification, P cannot subsequently ratify. This is shown by the case of *Keighley Maxted v Durant* [1901] AC 241. The point is that if a person purports to contract as principal, though with the intention, or indeed the full confidence that some other person will take it off his hands, that other party can neither gain rights nor undergo liabilities through any purported ratification. If the relationship of principal and agent is to exist, and affect the rights of third parties, such relationship must be based upon the knowledge and joint intention of all concerned, for as stated by Lord Macnaghten (in *Keighley* at 247):

Civil obligations are not to be created by, or founded upon, undisclosed intentions.

This of course must be read in the light of the doctrine of the undisclosed principal. This doctrine, however, can only be applied to permit ratification by an undisclosed principal where a person purports to contract as principal but has in the background a real principal whose authority he currently enjoys. In that case there is an agency existing at the date of the contract which is susceptible of proof, and a repudiation of which by the agent would be fraudulent. To summarise, where the agent/promoter purports to act for himself, though actually intending to act for an unincorporated company, the latter cannot ratify. The only possible exception to this rule is by the use of estoppel: *Spiro v Lintern* [1973] 3 All ER 319.

(ii) *Identification of the principal:*

Let us now consider another pre-condition of ratification that must apparently be met before s42A(3) can operate, namely, that the principal must be capable of being ascertained at the time when the agent professes to act on his behalf: *Watson v Swann* (1862) 11 CB(NS) 736. The problem arises when an agent/promoter (A) enters into a contract with a third party (T) who is aware that A is contracting on behalf of an unincorporated company (P) (thereby distinguishing *Keighley*). How much must T know about P in order that P may subsequently ratify the contract? In *Watson v Swann* Willes J said:

It is not necessary that [the principal] should be named; but there must be such a

description as shall amount to a reasonable designation of the person intended to be bound by the contract.

The purpose of this rule is that from the description given by the agent of his principal the third party can appreciate with whom he is contracting and hence he can decide whether or not to continue with the transaction and become contractually bound to the identified principal.

Although *Watson v Swann* appears to go against the suggestion, it is submitted that there is no good reason why the principal should not be able to ratify in any circumstance (assuming the other requirements have been met) where at least the existence of the principal is disclosed. Surely if a third party is willing to continue with a transaction knowing only that the agent acts on behalf of "a principal", and the principal subsequently ratifies, the third party should be held liable. In effect the third party is saying that he is prepared to contract notwithstanding the absence of identification; in such a case it seems likely that he would be estopped from denying that the identification of the principal was not material to him.

Even if this argument is not accepted it appears at least arguable that this prerequisite of ratification may not be applicable to the peculiar circumstances of pre-incorporation contracts, for we are dealing with a principal which by reason of its non-existence is clearly difficult to describe or identify.

If neither of these attacks against *Watson v Swann* prevails then it must be decided when the principal will be reasonably or sufficiently described. It is submitted that the amount of description necessary must be considered in the light of the purpose of the rule which, as already mentioned, is so that the third party can rationally decide whether or not to contract. The amount of description that is necessary for such purpose is surely dependent upon the type of contract. If, for instance, the third party was negotiating a long term contract to provide the unincorporated company with exclusive selling rights, the former would wish to know a great deal about the principal. Thus, it is submitted that the amount of description required must be decided upon the facts of each case and no strict rule can be successfully formulated.

Another problem may arise when at the time of contracting with the third party, the agent gives the name and address of the proposed company, a list of intended directors or other information relating to its proposed structure and operation, and subsequently upon incorporation some of these particulars are different. How much difference can there be before the company after incorporation is unable to ratify, upon the basis that it is a different principal than that described in the contract? This problem will have to be addressed by the courts if and when it arises. By considering each case on its facts the opportunity would be left open for the court to take into account matters such as a third party clearly engaging in speculation.

(iii) *Revocation prior to ratification:*

What is the position of the parties pending ratification? Consider the

following problem. A third party (T) makes an offer to an agent/promoter (A), which A (without authority of course, since the company is not incorporated), accepts on behalf of an unincorporated company (P). T subsequently purports to revoke his offer which now looks less attractive.

Later, upon incorporation, P ratifies A's acceptance. T's revocation cannot be effective, for the doctrine as to the retrospective action of ratification is applicable, and A is put in the same position as if he had had authority to do the act at the time of its performance: *Bolton Partners v Lambert* (1889) 41 Ch D 295. The rule appears to have merit since if the principal is incorporated and subsequently ratifies, the third party gets exactly what he expected and should not be allowed to escape from the contract. He can also sue the principal. Further, if the principal is not incorporated or does not ratify the third party can sue the agent for breach of warranty pursuant to subsection (4) (see below).

There are two primary exceptions to this rule. If the agent agrees with the third party to cancel anything that has been done before ratification by the principal, the doctrine does not apply: *Walter v James* (1871) LR 6 Ex 124. Secondly, the rule does not apply if the contract is made subject to ratification, for in such circumstances the offer is conditional and there is no binding contract until ratification of the agent's acceptance: *Watson v Davies* [1931] 1 Ch 455. This interpretation is possible where the third party has an intimation of the limitation of the agent's authority: *Warehousing & Forwarding Co of East Africa v Jafferli & Sons* [1964] AC 1.

Thus, it is submitted that the *Kelner — Smallwood* distinction is still relevant, for where the third party knows that the agent has no authority because the company is not incorporated (*Kelner v Baxter*) *Bolton* will not apply, whereas if the third party is ignorant of the company's unincorporated state (*Black v Smallwood*) *Bolton* will apply.

(iv) *Ratification within reasonable time:*

It is noted that where no period is specified in the contract, ratification must be within a reasonable time after the incorporation of the company (subsection (2)). The measure of the reasonableness of the time depends entirely upon the circumstances of the case: *In re Portuguese Consolidated Copper Mines Ltd* (1890) 45 Ch D 16.

(c) *Subsection (3) — what constitutes ratification:*

Subsection (3) provides that a contract may be ratified by a company in the same manner as a contract may be made by a company under s42 of the Companies Act 1955. Consequently, a company may ratify a contract in writing, orally, or under seal.

Under the general law of agency, as recognised by the Macarthur Committee (para 106), ratification may be either express or implied. Ratification will be implied where the conduct on the part of the principal shows clearly that he has approved and adopted what has been done on his behalf. The principal must do some positive unequivocal

act which indicates ratification. Consider the following example. An agent enters into a contract with a third party whereby goods are supplied to the principal. Although the principal does not expressly ratify the contract, it may fail to return them, dispose of them as its own, or perhaps use them. Under the general law of agency any of these forms of conduct may well amount to implied ratification. However, there is no provision for ratification by implication under s42A. This is in contrast with the Canadian Federal legislation which provides for ratification by "any action or conduct signifying its intention to be bound by the contract". It has been suggested by Russell in his article "The Companies Amendment Act (No 2) 1983" [1984] NZLJ 132 that such a provision may be a little vague. It was there suggested that in the interests of clarification a provision could be included deeming the company to have ratified whenever it had received substantial benefits or there had been substantial performance by the contracting party under the contract, unless the contracting party in performing the contract had reasonable grounds for believing that the company would not ratify it. Yet there would seem to be little danger in incorporating a provision similar to that contained in the Canadian legislation, for we are able to retain the learning contained in the law of agency, as summarised earlier. However, it is admitted that a similar result can be obtained under our legislation, for the third party could bring an action against the company that has benefited from the contract, pursuant to subsection (6) (see below).

(d) *Subsections (4), (5) and (6) — remedies:*

Under subsection (4), the person who purports to make the contract in the name of, or on behalf of, the company is presumed to have warranted that the company will be incorporated and subsequently ratify the contract within such period as may be specified in the contract, or if no period is stated, then within a reasonable time. If the company is not incorporated or does not subsequently ratify the contract then the person purporting to make the contract is liable in damages in the same amount as would be recoverable in an action against the company for damages for breach by the company of the unperformed obligations under the contract as if the contract had been ratified and cancelled (subsection (5)).

Two points are worth noting at this stage. Firstly, the damages are assessed *as if* the contract had been ratified and cancelled. This does not appear to import a consideration of s9 of the Contractual Remedies Act 1979 since that section provides for remedies in addition to damages where the contract has in fact been cancelled (cf New Zealand Law Society "Recent Developments in Company Law" 1984).

Secondly, let us assume that although a company is incorporated, its assets are worthless or that it becomes immediately insolvent. Subsection (5) provides that the measure of damages for breach of warranty is equal to the value of the third party's recourse to the principal, and consequently damages in either of these situations would be merely nominal

(see *Lewis v Nicholson* (1852) 18 QB 503, 507). Indeed theoretically it may be possible to prove only nominal damages where the company has not even been incorporated, if it could be shown that the company would have been insolvent if it had come into existence. This problem would have been avoided if the Act had merely provided for the agent to be personally liable on the contract in the absence of ratification (as in, for example, the Canadian legislation).

Subsection (6) provides that if a company is incorporated but does not subsequently ratify the contract, any party to the contract (i.e. agent or third party) may apply to the High Court for an order directing the company to return any property acquired pursuant to the contract to that party, or for any other relief in favour of that party respecting any such property, as the court thinks fit, whether or not an order has been made that damages be recovered from the person who made the contract in the name of or on behalf of the company before its incorporation. It is proposed to investigate the practical effects of subsections (4), (5) and (6) by reference to a variety of fact situations, all of which assume that the company has not ratified the pre-incorporation contract. We shall first investigate the subsections with respect to contracts executed by the third party.

1. Assume that the incorporated company (P) has the goods. The third party (T) could bring an action against P for the goods to be returned, for the price of those goods, or indeed any other order (subsection (6)). T may recover from P who has benefited from the contract, a particularly attractive proposition where, for example, the agent is insolvent. Instead, or in addition, T could bring an action for breach of warranty against the agent (A) (subsections (4), (5)).

A may be able to recover from P the value of any benefit which P obtained as a result of the contract (subsection (6)).

2. A has the goods. T can bring an action against A pursuant to subsections (4) and (5). If A should keep the goods rather than return them, it would appear that the damages would be equal to the price; in effect A would be getting the benefit of contract.

The next two fact situations relate to executory contracts.

1. A does not wish to receive the goods. T may bring an action for breach of warranty against A (subsections (4), (5)).

2. A wishes to receive the goods. This fact situation could arise in one of two ways.

(i) A enters into a contract with T for the purchase of a commodity X, the contract price being \$1000. P is either not incorporated, or for some reason does not wish to ratify. Subsequently the market price of X increases to \$2000 and A wishes to obtain the benefit of the contract.

(ii) A enters into a contract with T for the sale of a commodity Y, in which it is proposed P will deal, at a contract price of \$1000. P is either not incorporated, or for some reason does not wish to ratify. Subsequently the market price of Y falls to \$500, and A wishes to obtain the benefit of the contract.

Under the common law, assuming a *Kelner v Baxter* type situation, the contract is binding upon the persons who signed it. That is, they are both able to sue and be sued upon it. Consequently, A would be able to take the benefit of the contract in either of the above situations.

It is noted that the damages against the agent to which the third party would be entitled under subsection (5) are the same as if there was merely included a provision that the agent is entitled to the benefits and subject to the liabilities under the contract (assuming no ratification), such as contained in the Canadian Federal legislation, since in both cases the damages are for breach of contract. However, in the latter case it is also clear that the agent may enforce the contract if he so desires, a result which is by no means unfair since the third party had intended and expected to be bound to that contract at that price. But is this result achievable under s42A? Should the result be achievable, the agent could take the benefit whether contracting in the *Kelner v Baxter* or *Black v Smallwood* situation (subsection (1)). However, there appears to be nothing in the legislation permitting the agent to take the benefit.

The question thus arises whether the omission from the Companies Act was intentional or accidental. If it was intentional then all the rights and liabilities of the contracting parties are contained within the legislation itself. If it was accidental then it is submitted that we must revert to the common law, and of course inevitably the irrational distinctions contained in *Kelner* and *Smallwood*. That is, whether the agent can take the benefit will depend upon the terminology employed in the contract. The fact that the explicit recommendation of the Macarthur Committee (para 109(b) cited earlier) and the Canadian Federal legislation upon which the New Zealand legislation was based were not followed, and that the language of subsection (5) suggests that damages will always be payable in the absence of ratification (for if the agent took the benefit there would be no damages), are factors perhaps pointing towards an intentional omission. Of course the extent to which these considerations may be taken into account by a court is itself problematic (see Burrows "Statutory Interpretation in New Zealand" (1984) 11 NZULR 104).

In summary, in New Zealand it at least appears arguable that the *Kelner-Smallwood* distinction remains relevant where the agent wishes to take the benefit of a pre-incorporation contract.

(e) *Subsection (7)*:

Subsection (7) provides that even if after incorporation the company ratifies the contract then, in addition to or in substitution for any order which may be made against the company for breach of contract, the court may make such order for the payment of damages or other relief against any person by whom that contract was made in the name of, or on behalf of the company, as the court considers just and equitable. Thus, where a company has ratified a contract but has no resources there may be recourse to the agent upon application by the company, the other contracting party, or on the court's own motion. A just and

equitable result may thereby be achieved where, for example, the agent, who controls the company, has been considerably enriched by the transaction. Consequently, even after ratification the agent is potentially liable for any breach of contract by the company. This potential liability can be avoided, however, where the company upon incorporation enters into a new contract with the third party upon the same terms as the old. In such a case there has been no ratification and accordingly subsection (7) cannot apply.

(f) *Subsection (8):*

Subsection (8) provides that where a company after incorporation enters into a new contract in the same terms as, or in substitution for, a contract made by its agent before incorporation and where the latter contract has not been ratified, the liability of the agent for breach of the implied warranty contained in subsection (4) is discharged.

IV Conclusion

The legislation has clearly succeeded upon two fronts. Firstly, a company may, upon incorporation, ratify a pre-incorporation contract; secondly, the technical *Kelner* and *Smallwood* distinction has for most purposes been removed.

Should the company not ratify or indeed not be incorporated, the third party has actions available pursuant to subsections (4), (5) and (6). We have seen, however, that a problem may arise where the agent wishes to take the benefit of an unratified contract. It is also important to appreciate that the process of ratification necessarily draws into consideration a number of technical requirements developed by the common law.

— *Malcolm Hurley.*

FRINGE BENEFIT TAX: INCOME TAX AMENDMENT (No 2) ACT 1985.

I. Introduction

The Income Tax Amendment (No 2) Act 1985, having effect from 1 April 1985, has served to further complicate the work of those professional advisers who are involved in the minimisation of their respective clients' liability to tax. The complexities inherent in the statute arise not by virtue of that statute's tinkering with the current body of tax law, but because of its creation of an entirely new genus of impost — fringe benefit tax.

Fringe benefit tax is not an entirely unheralded innovation. As long ago as 1967, when the New Zealand Taxation Review Committee tabled its findings on suggested tax reforms (the Ross Report), it was noted that there was a groundswell of dissatisfaction aimed at those

employees who were materially benefiting from the provision by their employers of company cars, low-interest loans or other perquisites.

Indeed, in the last two decades it has not been unusual to find two employees engaged in the same occupation, receiving the same level of compensation for services rendered, but paying widely divergent amounts of tax. The cause of this discrepancy was often attributable to one of the employees receiving the tax-free use of a company car as a result of his "remuneration package".

This situation was seen as a breach of one of the principles associated with the development and maintenance of a nation's revenue collection system, namely, that those receiving like benefits should be taxed alike. Unfortunately, the definition of "allowances" has long been an obstruction in the tax collector's gullet, impeding the digestion of legislation which would ensure adherence to the principles of revenue collection and the further lining of the nation's coffers.

The mesh of the tax net is universally seen as expansive, but a comprehensive workable definition of employment-related allowances or fringe benefits has been viewed by earlier New Zealand governments as unattainable, thus leaving a gap through which potentially assessable income could escape.

II Part XB Income Tax Act 1976

The passing of Part XB of the Income Tax Act 1976 on 23 March 1985 was an attempt by the Government to prevent non-taxable benefits being provided partly in lieu of salary by assessing those benefits to tax and ensuring that the tax is itself not deductible as an expense.

However, rather than assessing the recipient of the benefit, which would have had the effect of correcting the type of inequity outlined earlier, Part XB charges the provider of the benefit. The accepted principles of revenue collection continue to be violated in so far as those receiving like benefits continue to pay different amounts of tax.

For political reasons, making the employer (rather than the employee) liable to fringe benefit tax does have certain advantages. To charge employees with the tax would result in a significantly lower yield to the Consolidated Fund. This is firstly because of the way fringe benefit tax would have to be levied to accord with the progressive nature of our personal income tax structure and secondly, because there are too few employees at present who have sufficient uncommitted net income available for the payment of another tax.

It is suggested that had employees been charged with the payment of fringe benefit tax (by the inclusion of fringe benefit as part of the definition of monetary remuneration), the tax, by administrative necessity, would have had to be payable at each respective taxpayer's marginal tax rate. Given that the marginal tax rate applicable to a person on the current average weekly wage is 33 per cent, which is considerably less than the current fringe benefit tax rate of 45 per cent, to levy fringe benefit tax on employees would yield little more than 70 per cent of the

amount which the Government now expects to reap by charging employers with the tax.

Two less demonstrable advantages in having fringe benefit tax charged to employers are firstly, that calculation of the amount of tax payable and associated record-keeping will involve a supreme effort in terms of clerical input, and that such tasks could be seen to be more efficiently accomplished by employers. Secondly, employers, by virtue of their definition in s336N of the Act, are those who are already liable to make source deduction payments. Faced with the obligations relative to the PAYE system, many employers would have already evolved an adequate infrastructure which could be readily adapted to cope with fringe benefit tax.

Part XB of the Income Tax Act 1976 focuses on three forms of fringe benefit: the provision of a company car, the provision of credit at concessionary rates of interest, and discounted goods and services. Other employee benefits which are not already classed as assessable income under the somewhat clarified wording in s65(2)(b) of the Act may be caught by the wide words of paragraph (e) of the definition of "fringe benefit" in s336N(1) of the Act ". . . by which any benefit of any other kind whatever . . ." is assessable to fringe benefit tax.

It is suggested that the new definition of "monetary remuneration", inserted as s65(1B), confirms the view that the Courts have taken of the previous law on this point. In *Stagg v CIR* [1959] NZLR 1252 and *Sixton v CIR* (1982) NZTC 61 it was held that where the non-cash allowance was provided by the employer, that benefit was not taxable in the hands of the recipient if it was not readily convertible into cash. Many such perks which previously escaped the tax net have been fairly caught by Part XB.

To suggest, as many accountants recently have, that the term "monetary remuneration" has the effect of stripping the tax-free status from many allowances, is surely to misconstrue the plain words of s65(1B) and to allow the Inland Revenue Department a double tax take. Fortunately, Parliament has taken care not to allow an employer to pay fringe benefit tax on an allowance which is correctly assessable in the hands of the recipient employee.

III. The Company Car

The use of a company car has long been viewed by many employees almost as a birthright. Certainly the unlimited use of somebody else's car, at their expense, represents a major financial advantage to an employee and as such has warranted the most attention in Part XB. Rather than countenance the administrative horror which would have resulted if the tax had been levied on the actual benefit derived (based on mileage) by an employee from the use of a car, the Act opts for a global application of the arbitrary rate of 24 per cent per annum on the cost of the vehicle as being the value to the employee of the company car. If the car is not available for domestic use by the employee on every day of the year, then a proportionate charge will be made. The Inland

Revenue Department concedes that there may be occasions when the arbitrary sum calculated above does not represent the actual benefit to the vehicle's user. The benefit cannot be so great when the employee is charged with garaging and cleaning the vehicle, and accordingly the employer may be able to elicit from the employee the appropriate quarterly cost of such attention to the vehicle, this sum being deducted from the "value" of the benefit when calculating the employer's liability to tax.

Much of the legislation deals with the intricacies of whether a car is a "work-related vehicle" or what amounts to an "emergency call". If a vehicle makes an emergency call it is deemed not to be available for private use. Similarly, a "work-related vehicle" used for certain purposes may escape liability to fringe benefit tax in respect of its use when such a vehicle is not used for any private purpose other than travelling to and from work whilst the employer's name is permanently fixed to the vehicle. It is widely acknowledged that the latter requirement is of little moment as nowhere in the section is mention made of the size or location of the employer's nameplate; it may even appear in small lettering underneath the bonnet!

The income tax system at large relies heavily on standardised and regularised record-keeping; the fringe benefit tax is no exception. The Inland Revenue Department has recently issued a booklet (IR 409A) advising employers of their obligations in respect of the new tax, particularly their duties in the area of record-keeping. Most of these duties would appear to be straightforward, but if the employer claims that an employee's mode of transport is properly classed as a "work-related vehicle" then the employer will need to furnish the Tax Department with a "record of periodic checks" undertaken by the employer to ensure that the vehicle is not being used privately. Inquiries made of the Tax Department at Auckland reveal that the Department does not expect on-site inspections to be mandatory, but would be happy to receive excerpts from the vehicle's travel log tied in with evidence of the distance the employee has to travel directly to work. The Department does not therefore expect to see dark-coated people peering into garages in the small hours of the morning. Nevertheless, the whole exercise is likely to give rise to an air of mistrust between workers and management.

IV. Employment-related loans

The area which should cause the least concern to employers is the taxation of those fringe benefits which take the form of "employment-related loans", this term being widely defined to include all manner of credit facilities except trade credit. The fringe benefit component of the credit facility has been viewed as the amount by which the actual rate of interest payable on the loan falls short of current market rates. The deemed current market rate or "prescribed rate" which applies to the 12 months from 1 April 1985 is 20 per cent. Thus, if a loan were now made to an employee in the course of that person's employment at the

rate of 6 per cent per annum, the employer is liable to pay fringe benefit tax each quarter on the sum of the differences between the notional daily interest (calculated at the prescribed rate) and the actual rate of interest being charged to the employee.

Fortunately, it was recognised at an early stage that where the interest rate may not be reviewed under an employment-related loan which was granted prior to 1 April 1985, application of the prescribed rate of 20 per cent would result in the unduly heavy taxation of those who may have been paying market interest rates at the time the obligation was incurred. Lending on the latter basis cannot be seen to encompass any element of fringe benefit and therefore one of a range of "non-concessionary" interest rates appropriate to the year in which the loan obligations were incurred is substituted for the prescribed rate. The employer is then subject to a lesser liability for the tax.

All other categories of employee perquisites, including goods and services provided to the employee at reduced rates, are intended to be subject to fringe benefit tax. However, the value of the fringe benefit inherent in discounted goods and services (and transactions other than the provision of company cars or loans) is very difficult to quantify or substantiate. Parliament has valiantly attempted to deal with this problem and has in sub-sections (4) and (5) of s336O produced a code as to the valuation of such benefit. Theoretically, the sub-sections are a commendable gesture, but practically and logistically they will cause considerable problems, particularly in terms of the need for record-keeping.

V. Exemptions

It was largely because of perceived problems in the area of record-keeping that a blanket exemption from the taxation of "other" benefits of \$50.00 per quarter per employee was granted. Although I have referred to the \$50.00 exemption as a blanket provision, it is quite clear from the legislation that the exemption must be applied in respect of an individual employee, and not globally over the employer's workforce. It is suggested therefore, that the introduction of the exemption has done little or nothing to reduce the administrative burden on the employer. The value of all fringe benefits conferred will still need to be quantified so as to show whether the employer has or has not incurred a liability to fringe benefit tax in respect of each employee.

Further exemptions of note are those allowed to charities (but not in respect of those charities' business undertakings) and the exclusion of on-premise benefits, recreational club membership fees, medical insurance premiums and certain types of entertainment allowances. All are outside the scope of Part XB.

Before Part XB was passed it was widely believed that a further category of exemption would apply to benefits received by employee shareholders in a proprietary company. However, no such exemption became law and it falls to an analysis of the rest of Part XB to determine whether a person in this situation who receives employment-

related benefits is *prima facie* liable to fringe benefit tax.

The key to solving this problem is found in the definition of employee as being one who has, will or is now receiving remuneration from which PAYE has been deducted. Abnormal income problems in many of these companies have ensured that any remuneration emanating from the company has always been paid free of PAYE deductions.

It would seem, therefore, that many executive shareholders employed by companies have in the past steered clear of PAYE and may coincidentally avoid a collision with fringe benefit tax deductions. The extent of this abuse has only recently been drawn to the attention of the overseers of Part XB and it may be that we could expect the definition of employee to be broadened to ensure a greater exposure to tax.

VI. Avoidance

Although I have refrained from mentioning methods of avoidance of fringe benefit tax, I do wish to note the rather clever anti-avoidance provisions covered in s366X. That section, being supplementary to the general anti-avoidance provision in s99, focuses on the type of arrangement which could easily have been employed to circumvent Part XB. Essentially, under s336X the Commissioner can deem any party to an arrangement to avoid fringe benefit tax to be the employer. So, if two banks agree to lend the other's employees funds at artificially low interest rates, the Department would be able to assess each of the banks to fringe benefit tax on the value of the benefits conferred.

To round off this terse survey of Part XB, those people who prefer not to pay their tax on time (and play the money market instead), should take special heed of s336U which is a remarkably heavy-handed approach to the assurance of national punctuality. Rapidly compounding 10 per cent penalty charges on late fringe benefit tax payments can give rise to an effective "borrowing rate" of 33.1 per cent per year, rising to over 60 per cent for an 18 month term.

VII. The Future

The full economic impact of the imposition of fringe benefit tax is not yet apparent. The reaction of many corporate employers has been to continue to supply the same benefits to their staff, pay the tax, and then pass the tax on to the consumer by way of increased prices.

Some of the more enlightened employers have adopted substitution techniques to the advantage of their employees and themselves. This involves no more than acknowledging that part of a person's salary package is the benefits gained from the use of a company car or finance or services. Fringe benefit tax is payable, but there is a substantial cash flow advantages inherent in paying quarterly fringe benefit tax as opposed to monthly PAYE.

In every case the level of substitution will depend on the personal circumstances of the employee. Of particular concern to an employer who

is considering the viability of such a scheme will be the effect on pay relativities, whether an employee has sufficient discretionary spending power and whether reduction of the cash element of income will jeopardise the employee's other commitments.

At the time of writing, goods and services tax had only just appeared on the horizon. With it may come substantial alteration to personal income tax rates and the restructuring of corporate taxation, resulting in the modification of many schemes for the avoidance of fringe benefit tax, which are now being hatched. For that reason, a cautionary finger should be waved at all those who are contemplating entrance into long-term schemes for the minimisation of their exposure to fringe benefit tax.

VIII. Conclusion

Although not superbly drafted, Part XB of the Income Tax Act 1976 does appear to accomplish what its sponsors intended it to do — boost taxation revenue. If the legislators had seriously intended Part XB to resolve the inequity which had arisen through the commonplace provision of employee benefits, then the tax could have been levied on employees, despite the administrative and political disadvantages of doing so.

— *David Nicoll*

THE WHANGAREI REFINERY EXPANSION PROJECT DISPUTES ACT 1984

Background

The National Government had identified itself with the Marsden Point refinery expansion project by including the project in its "Think Big" strategy. The Government then had the distressing experience of watching the project become entangled in an apparently endless series of problems, the most publicised of which were industrial.

The problem at the time of enactment was that, while other issues seemed to have been resolved, a significant number of expansion site workers were unwilling to forgive the action of eight scaffolders who had worked on during a period of confrontation, despite the best efforts of their workmates to get them to stop. Thus there came about the forlorn state of affairs described in the Act's preamble:

Whereas work on the expansion of the Whangarei Refinery at Marsden Point is effectively at a standstill: And whereas it is in the public interest that work on the expansion of that refinery be resumed as soon as possible. . . .

The Act dealt with the status of the eight scaffolders, ordered a resumption of work, imposed restraints on strikes and lockouts, and

created a criminal offence of picketing the site. It is noteworthy in several respects. This note examines five such aspects:

1. The short lifespan of some of its provisions.
2. The naming of the eight scaffolders.
3. The placement of the burden of proof on defendants.
4. The manner of obtaining remedies for breaches.
5. Similarities with the 1951 waterfront strike regulations.

The Law with the short shelf-life

Section 3(1) of the Act says in part:

Every person who was, on the 24th day of May 1984, employed as a project worker, . . . shall . . . report for work on the 21st day of June 1984.

Section 4(1) says in part:

Where a person to whom s3(1) of this Act applies reports for work on the 13th day of June 1984, . . . that project employer.

(a) Shall allow that person to resume normal work. . . .

Comment

It was once suggested (flippantly) that there should be a degree paper called "Ephemeral Law". It would teach no substantive law at all but would instead imbue the skills of memorising in all its detail the stream of highly specific ad hoc laws which have controlled New Zealand's economic and industrial life during the last decade. Once each measure was repealed or revoked, the successful ephemeral lawyer would be able instantly to erase it from the memory, thus clearing the brain cells for the next load of legislative minutiae.

The suggestion contemplated all the wage, price, rent and other control measures and their numerous short-lived amendments. It might well have had in mind this Act, passed on 12 June 1984. Two days later the provisions cited above were almost entirely a spent force — surely a high point in ephemeral law. Such a short-life presented an ideal chance for Parliament to enact self-repealing legislation. But perhaps the crisis of the day pushed any long range thinking to one side. Thus unless Parliament intervenes, the law, which is always speaking, will still be speaking to our successors late in the next century about what to do on the 13th day of June 1984.

The Naming of the Scaffolders

Section 2(3) of the Act states in part:

. . . the terms and conditions of employment of each project worker . . . shall be deemed to include . . .

(a) A condition that the project worker accepts the employment . . . of all or any of the eight scaffolders known as Adrian Hoeymans, Robert Smith, Colin Cooper, Ian McLean, Peter McGilp, Bernard McIntyre, John Kenyon and Danny James Findlayson:

(b) A condition that the project worker will not engage in any intimidatory or dangerous conduct towards the scaffolders. . . .

Comment

It is rare nowadays for a public general Act to deal with the status of named individuals. Occasionally a Judge of the High Court or of the Court of Appeal is re-appointed after retirement or the term of office of one is extended. At the opposite end of the social spectrum, in the days of outlawry Parliament would pronounce a named individual an outlaw by means of a Bill of Attainder. His property was forfeited and “his blood was said to be corrupted.” (See *Hinde — NZ Law Dictionary* (2nd ed) at 25). This provision is effectively the reverse: it declares to fellow workers at Marsden Point that the scaffolders’ blood is definitely *not* corrupted and that their persons and property ought to be respected. And all workers on the site are “deemed” to have accepted it.

This is an instance of a useful trick in sticky industrial situations — the lifting or re-allocation of responsibility. Undoubtedly a fair number of workers at the site did *not* accept what the Act deemed them to have accepted. But following its enactment they could point to it and say, “We still think the scaffolders are a nasty lot but the Government has landed us with them.” By taking an apparently coercive measure, the Government allowed the parties to blame it, while quietly reversing out of the blind alleys into which it had previously charged. The trick is not new. New Zealand’s first Chief Industrial Mediator, the late Phillip Cranston, was a fine exponent. He cleared many a logjam and saved many a face in circumstances which were mercifully obscured behind a bland announcement that “The parties have accepted a recommendation of the Mediator.”

For a government, coercive measures carry a high risk. If the bluff works, the voters will think it a courageous government that subdued the forces of chaos. If it collapses, the voters will think it was a reckless administration bent on provoking the labour movement into a confrontation. While some may debate the refined civil rights issues, many more probably apply a pragmatic test: Did it work on the day? Everyone can supply an answer to that sort of question from the depths of their respective political prejudices. For that is the way all good opinions on industrial matters are formed.

The Burden of Proof on Employees

Section 2(3) includes another “deeming” provision — that each project worker is deemed to have accepted a condition that the worker:

- (iii) Will not without reasonable excuse (the proof of which shall lie on him) refuse to perform work.

The employee also carries the burden of proof in s6(1) (duty to comply with terms of employment) and s7(1) (worker who fails to report not entitled to unemployment benefit).

Comment

In enacting legislation which imposes penalties it is always better for Parliament to lean against placing the burden of proof on the defen-

dant. There is a fairly well-defined category of areas in which strict liability is often imposed for policy reasons relating to enforcement (eg drug and public health offences), but industrial relations is not in that category and it is submitted that there is no good reason for it being added to the list.

In this Act, the only redeeming feature is that most workers would not be caught by the "burden of proof" provisions. Nevertheless, workers who are union officials, committee members or delegates would be caught by some of these provisions, notably in s9 where the maximum penalty is \$3,000. Workers having no office or other special status in a union would probably wriggle through gaps in the penal provisions without too much trouble.

For example, in s6(1) there is a duty that:

Every project worker shall comply with the obligations imposed on him by the terms and conditions of his employment.

But for the ordinary worker there appears to be no penalty for failing to comply with the terms and conditions of employment. Section 8 provides a penalty for "striking" (not defined) but short of that, a matching penal provision cannot be identified. Penal provisions generally are discussed below.

The Recovery of Penalties

Penalties are recoverable exclusively in the District Court: s10(1). Procedures are as under the Industrial Relations Act, ss151 and 157 with the necessary modifications. Furthermore, the only persons given an express power to bring an action to recover penalties are parties on the opposite side to the defendant in a dispute.

Comment

The great hazard of penal provisions in industrial law is the prospect that attempts to enforce them will threaten any shaky truce, to the detriment of both sides. Sometimes (as in the 1974 hydrofoil manning dispute) attempts at enforcement will widen the dispute beyond anyone's expectation. At other times, enforcement will be a lingering embarrassment, as was the case when the Department of Labour was left with the job of attempting to prosecute several hundred Southland freezing workers after a dispute at the Ocean Beach works. With the prospect of clogged courts and his departmental officers pursuing freezing workers forever, the Secretary of Labour announced that his department would not continue the actions. Inevitably he was criticised as having stepped into the political arena to help the Government out of a spot of bother.

The lesson of Ocean Beach is to be seen in the Marsden Point legislation: official agencies are kept out of the enforcement process. Only parties can lob legal grenades at each other. And that means that he who pulls the pin will himself fall uncomfortably close to the shrapnel.

Comparison with 1951 Waterfront Strike Regulations

The only criminal provisions in the Marsden Point legislation relate to picketing. They follow closely, but not exactly, the language of regulation 14 of the Waterfront Strike Emergency Regulations 1951 and are contained in s11(2) which provides:

Where in the opinion of a sergeant the presence of any person on or in any place is intended or likely to influence any other person —

- (a) To contravene any provisions of this Act; or
- (b) To refrain from or cease working in or in connection with the expansion of the Whangarei Refinery at Marsden Point, —

the sergeant may give to the first-mentioned person such oral directions as the sergeant considers necessary in the circumstances, including a direction to remove himself forthwith from that place where he then is to such reasonable distance as the sergeant considers necessary, or both a direction to remove himself and a direction to remain at such reasonable distance from that place as may be specified by the sergeant.

A conviction for a breach of this requirement carries a maximum \$1,000 fine or three months of imprisonment: subsection (5).

It is also interesting to compare the provisions covering assistance to strikers. First, the 1951 regulations, regulation B:

Every person commits an offence against these regulations who — . . . makes any payment or contribution to or for the benefit of any workers who are parties to a declared strike.

Then s8(4) of the 1984 Act:

Every person who incites, instigates, aids or abets a breach of this section, or who incites, instigates, or *assists any person* who has struck or locked out in breach of this section *to continue to be a party to the strike or lockout* shall be liable. . . .

Penalties range from \$300 for a worker to \$3,000 for a union, association or employer.

Comment

It is submitted that the 1984 provision, by virtue of the words “or assists any person . . . to continue to be a party to the strike or lockout . . .” would catch a wider range of activities than its 1951 counterpart. At the time of enactment there were some who suggested that a donation of food to the family of a striking worker would constitute a breach of s8(4). That interpretation is by no means fanciful but two factors would weigh against its being a necessary consequence of the section:

1. The courts would look for clear and unambiguous words before holding that Parliament had so seriously abridged the freedom of the subject. Section 8(4) does not clearly and unambiguously lead to such a result.
2. Again, penalties under s8 are available only at the suit of an opposite party to the dispute. It would be a brave and foolish project employer who would seek to exact a penalty in the circumstances.

— Brian Stephenson.