



Penny & Hooper v IRD

The decision of the Supreme Court has major implications for all taxpayers who operate under a Company or Trust structure.

It concerns the level of salary a Company or Trust must pay its effective owners for tax purposes.

In this Newsletter we look at:

1. What the Courts said
2. What the IRD view is
3. Our reaction and recommendations.

First the background facts

- Penny & Hooper (P&H) transferred their individual orthopaedic businesses to separate companies owned by a family trust.
- When the top personal tax rate increased to 39% P&H reduced their salaries from the company (for tax purposes) and paid tax at 33% on the balance of the profit.
- P&H continued to effectively draw the full profit from the Company.

What the Courts said

- first the High Court got it right. They said there was nothing in the Income Tax Act requiring the payment of a commercial salary;
- the Court of Appeal was split 2:1 in favour of the IRD on the grounds the whole arrangement was a tax avoidance arrangement;
- the Supreme Court said there was nothing wrong with the arrangement but said paying a below market salary was tax avoidance. (They based this on a previously unheard of Australian case).

So 3 Courts, 3 different decisions for 3 different reasons. What chance does a taxpayer have????

Given the Supreme Court is, unfortunately, now the highest Court in NZ, its decision is the one that counts. In essence, the Supreme Court found there was tax avoidance because:

- a) P&H paid themselves artificially low salaries that were not commercially realistic;
- b) the reason for setting the low salaries was influenced, in more than an incidental way, by tax considerations.

The IRD View

Surprise, surprise but the IRD have completely ignored all 3 Court decisions and have instead, issued a Revenue Alert detailing their view which is as follows:

- In a service business the main profit driver is the personal skill and effort of the business owner.
- IRD expect the income taxed in the owner's name to be "significantly" more than that taxed in associated entities i.e. the Company or Trust.
- IRD are likely to examine any business where less than 80% of the business profit is taxed in the owner's name.
- Whether or not the salary paid equates to industry averages is irrelevant.

What we think

What we really think is unprintable so below is the sanitised version.

1. If you do not want to run the risk of an IRD audit and:
 - a) you operate a service business with yourself as the sole income producer, ensure at least 80% of the profit is taxed in your name;
 - b) you operate a service business that also employs staff, attribute profit to that generated by the staff and that generated by yourself and pay out at least 80% of the self generated profit - may be an expensive exercise;
 - c) you operate a business supplying goods as well as services, pay a salary to yourself which is commercially realistic.

2. If you are prepared to risk a fight with the IRD and instead follow the Supreme Court ruling, then pay a salary to yourself which is commercially realistic and ignore the 80% guideline.

A commercially realistic salary may be able to be established from either published industry data or comparison with salaries of persons doing similar work as an employee.

We also have available University of Waikato business surveys which show NZ average profit of a wide range of businesses.

While profit will be higher than a commercial salary we consider basing salary on 80% of average profit should meet that Supreme Court test of being commercially realistic.

If the salary is set on this basis then there is no question of tax to even consider, so the question of whether setting the salary was influenced by tax considerations, cannot arise.

Are there any exemptions to the need to pay either a commercial salary or the IRD's 80%?

Fortunately both the Supreme Court and IRD agree that commercial salaries need not be paid in the following instances:

- the company is in a loss situation;
- company profit is below what a normal commercial salary would be;
- the company is experiencing cash flow difficulties or expects to;
- funds are required for asset purchases, working capital etc.

But in all cases IRD would be looking at the effective level of drawings to ensure they are not excessive in relation to the salary.

Will the IRD go back and reopen prior year tax returns?

At this stage they say No, other than audits already under way which have been awaiting the P&H decision.

But don't hold your breath!!!

Certainly if you have not already filed your 2011 tax return the amount of salary needs to be reviewed in light of the above.

Given the top personal tax rate and trust tax rate are the same, do we need to even worry about this in future?

Unfortunately the answer is Yes. The IRD consider the lower company tax rate of 28% offers opportunities for tax deferral which they seem to consider (mistakenly) to be tax avoidance.

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