NEWSLETTER

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IRD WINS FINAL ROUND AGAINST PENNY AND HOOPER

The recent dispute involving Messrs Penny and Hooper has come to an end with the Supreme Court decision finding in favour of the IRD. The Supreme Court upheld the Court of Appeal's view that the setting of commercially unrealistic salaries constituted tax avoidance.

Penny and Hooper were both orthopaedic surgeons trading in their personal capacity, but restructured their businesses to trade through companies, owned by family trusts. The companies employed the surgeons for substantially less than what they had been earning prior to the restructure. However, their work load and the nature of work did not change. The Supreme Court stated that while the structures used were valid business structures, the yearly setting of a non-commercial salary constituted tax avoidance.

In response to the finding the IRD has provided guidance, in the form of Revenue Alert *RA 11/02,* on circumstances in which it considers tax avoidance would arise.

Based on the Revenue Alert, the IRD will look into all aspects of an arrangement, in order to come to a conclusion on whether or not diversion of personal income through other entities, such as companies and trusts, amounts to tax avoidance. The Alert identifies the following factors as being relevant:

- The commercial reality of the service provider's business structure,
- How profits have been distributed in substance and whether the employee and their family benefit from all profit distributions,
- Whether the remuneration paid to the individual providing the service adequately reflects their contribution to the business' profits,

- Whether there are other reasons, apart from tax, for justifying departure from the norm.

The Alert also identifies situations where a below market salary could be justified, as follows:

- To fund planned capital expenditure,
- To retain profits within the business to provide for future financial difficulties,
- Where profits are down, but most of the profits are still distributed to the service providers, or
- The business relates to a charity and the individual receives less to maximise the charity's return.

The IRD acknowledge other situations may arise in which it would not be possible to pay a market salary. However, if a business cannot afford to pay a market salary, the IRD would equally expect that it could not afford to make significant distributions (such as dividend payments) to associated entities.

Amongst accounting practitioners the heart of the Penny and Hooper case has been the question of whether private companies, which derive income from personal services performed by its employees, need to pay those employees a market salary. However, the Revenue Alert indicates the IRD may not stop at requiring a fair market salary. The IRD has stated that it is:

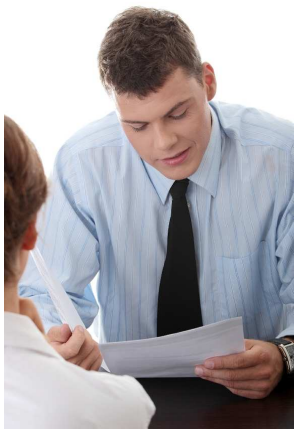
"more likely to examine arrangements where the total remuneration and profit distributions received by the individual service provider is less than 80% of the total distributions received by the controller, his/her family and associated entities."

Paying a commercially realistic salary may not necessarily satisfy the IRD, as the IRD's focus appears to be on the amount of income received by the service provider as a proportion of the total distributed. It is generally understood that disclosures to IRD are being handled centrally to ensure taxpayers are treated consistently.

TEST CASE FOR JUSTIFIABLE DISMISSAL

Last year the Government amended the Employment Relations Act ('the Act'), which included significant changes to Section 103A, the test of justification of a dismissal or action of an employer.

The test changed from what "would" a fair and reasonable employer have done in all the circumstances, to what "could" they have done, thus shifting the test from a specific action to a range of possible actions.



In addition, the test was required to take into consideration the resources available to the employer, whether the employer had raised the concerns with the employee and given them an opportunity to respond, and whether they had genuinely considered the response.

The amendment came into effect in April this year and has now been tested in the Employment Relations Authority ('the Authority') in the case of *Sigglekow v Waikato District Health Board*. This is an important case as it sets the benchmark for subsequent cases (that is until one is referred to the Employment Court for a judgement that carries higher legal authority).

Mr Sigglekow was a psychiatric nurse with the DHB working in a secure ward with patients who have histories of criminal and mental health issues. He suffered a heart attack and after some weeks off started returning to work with progressively more shifts.

There were some incidents where Mr Sigglekow was allegedly sleeping during his afternoon shifts (which run to 11pm). He was spoken to about some of these incidents but not formally warned. He was dismissed in April for serious misconduct, of sleeping on the job. Mr Sigglekow took a personal grievance for unjustified dismissal.

The Authority examined the new test for justification and then stepped back to consider the other pertinent sections of the Act, relevant case law, and organisational contracts and policies. This process brought another 35 points into consideration in determining whether or not the action was justified.

In particular the Authority explored the duty of good faith from Section 4 of the Act and the requirement, when considering termination of employment, to give the employee access to, and an opportunity to comment on, information relevant to the decision.

It found that the dismissal was unjustified because the employer had been inconsistent in not dealing with the earlier incidents more severely, had failed to conduct a full and fair inquiry into the incidents and had failed to put before Mr Sigglekow (and therefore seek his response to) all the information that was relevant to the decision.

The first test case to go to the Employment Court about the 90 Day Trial Period (*Smith v Stokes Valley Pharmacy 2009*) was also assessed against the good faith section and was found to be unjustified because the employee had not had all the relevant information put before her nor been given an opportunity to respond. Similarly, the recent judgement in *Massey University v Wrigley and Kelly*, on redundancy processes was based on the good

faith provisions and the need to provide all information relevant to the decision to the employee. Clearly, the good faith requirements are still a very important part of the process and cannot be circumvented when termination is being considered, irrespective of the reason.

GST – WHAT IS A SUPPLY?

To quote the GST Act, GST is a charge "on the supply of goods or services". The definition of "supply" is therefore one of the most important factors to consider when determining whether GST applies to a transaction. A recent trend has emerged in which businesses are re-visiting the GST treatment of transactions and are identifying payments received for supplies that did not take place or are not for "supplies" under the GST Act. Examples of these types of situations include:

- cancellation fees
- break fees or early termination fees (e.g. a customer defaults under a contract or exercises an option to exit from a contract before its term is completed)
- no shows
- enrolment fees
- event cancellations

Businesses (for example gyms, education providers and hotels) should analyse these types of transactions to determine if they receive payments that are not consideration for the supply of a good or service. If these circumstances exist, specific GST advice should be obtained to determine the treatment of any retrospective receipts, and how to treat these receipts going forward. It may be possible to approach the IRD for a refund of over-paid GST.

Adding to the debate, a recent Australian case, *Qantas Airways Ltd v Commissioner of Taxation (2011),* has also considered the question of what constitutes a supply. The Qantas case involved transactions where customers had paid for a flight and then subsequently cancelled or did not turn up for the booking, and did not receive a refund. Qantas completed GST returns which claimed back the GST previously paid to the Australian Tax Office (ATO) for the flights not used by customers, and not refunded by Qantas.

The full Federal Court of Australia found in favour of Qantas. The Court stated "the actual travel was the relevant supply, and if it did not occur there was no taxable supply", this is "the essence, and sole purpose of the transaction".

In a co-incidental development, new legislation has been introduced that stipulates GST is to apply to late payment fees. The IRD has stated that such fees should have the same treatment as prompt payment discounts, i.e, amounts with or without discount are subject to GST.

Over 25 years after GST was introduced, the question of what transactions are subject to GST is still being debated. This is all the more reason for businesses to spend some time and make sure GST is not unnecessarily being paid to the IRD.

MIXED USE ASSETS – IRD ISSUES PAPER

As part of the 2011 Budget, the Government signalled that it would be looking closely at the way taxpayers were claiming deductions for expenditure relating to assets that are used for both income earning purposes and personal enjoyment (so called 'mixed use assets'), such as holiday homes and yachts. Following on from this announcement, the IRD has released an officials' issues paper on the subject.

The IRD is concerned that taxpayers are inappropriately claiming deductions for the periods when the assets are not in use. The IRD has categorised expenditure in relation to mixed use assets as follows:

1. Amounts relating only to the income earning use of the asset, e.g. advertising,
2. Amounts relating to the private use of the asset, e.g. repair of a window of a holiday home broken while being used privately,
3. Amounts incurred when the asset is used neither for personal enjoyment or deriving income, e.g. costs to put an asset into storage.

Some types of expenditure will fall into all three categories, such as annual insurance premiums.

The first two types of expenditure are clearly deductible and non-deductible, respectively. However the treatment of the third type is not as clear. The officials' issues paper sets out two possible approaches to determining the deductibility of the third type of expenditure.

TWO-OUTCOME APPROACH

This approach applies a single test to determine if the asset is income-focused or privately focused. If the following three criteria are met, all costs apart from those costs relating to personal use will be deductible. If one of

the criteria is not met then only those expenses relating to actual income-earning will be deductible.

1. The asset must be used to earn income for more than 62 days a year, and
2. Private use must be less than 15% of the income earning use of the asset, and
3. There are genuine efforts to earn income for all non-use periods for which the asset can reasonably be used, evidenced by advertising at market rates etc.

THREE-OUTCOME APPROACH

To accommodate assets that are used to earn significant income, but are also subject to a reasonable level of private use, this option provides a third outcome under which expenses for non-use periods are claimed on a proportionate basis. To claim all expenses, except those relating to personal use, all of the following criteria must be met:

1. The asset must be used to earn income for more than 62 days a year, and
2. There are genuine efforts to earn income for all non-use periods for which the asset can reasonably be used, evidenced by advertising at market rates etc., and
3. Private use is less than 10% of the assets income earning use.

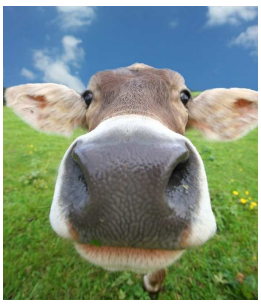
If either of the first two criteria are not met, only expenses relating to income earning use will be deductible. If the first two criteria are met but personal use is more than 10% then the expenses that relate to the non-use periods will be apportioned.

It is expected that the new rules would apply to land and other assets that have a cost of $50,000 or more, that are unused for at least two months of the year and are rented on a short-term basis. Assets owned by individuals, partnerships, close companies, qualifying companies, look-through companies and particular types of trusts will be subject to the new rules.

Draft legislation is likely to be introduced once the consultation process is completed.

Snippets

LIVESTOCK VALUATION ELECTIONS



Under the current legislation, it is easy to swap between the Herd Scheme and National Standard Cost (NSC) livestock valuation methods. An officials' issues paper has been released focusing on the Government's concerns about farmers having the ability to switch between the methods to derive tax-free gains when livestock values are increasing, or tax-deductible write-downs when livestock values are decreasing.

Government officials have suggested that the following changes be made:

- Once a farmer has elected to use the Herd Scheme, the election is irrevocable, or
- Livestock election timeframes be altered to reduce advantages that can be acquired by farmers under the existing election framework.

Under the first alternative, any election would survive transfers between associated persons, to remove the ability to work around the changes by using multiple entities.

Lastly, the IRD proposes that the ability to use certain valuations, when trading ceases, should also become more restrictive.

Submissions on this paper closed on 30 September 2011.

If you have any questions about the newsletter items, please contact us, we are here to help