Fact sheet: Shareholder remuneration

Shareholder Remuneration and the Penny & Hooper decision

The Penny & Hooper decision is widely regarded as a landmark case and has generated a great deal of discussion as to its implications for other businesses.

Synopsis of the Penny & Hooper decision

The Supreme Court decision in Penny and Hooper v CIR was decided in favour of the Commissioner of Inland Revenue (CIR) and concluded that the setting of artificially low salaries amounted to tax avoidance.

Briefly, Penny and Hooper were two orthopaedic surgeons who practiced under their own names, each earning taxable income of between $600k and $850k a year.

They restructured their businesses into companies with a family trust owning most of the shares. They provided their services to the companies for which they were paid salaries of between $100k and $120k each year. The balance of the company's income was then declared as dividends to the family trust.

The surgeons were then able to draw on the funds from their trust and did so regularly. Tax of between $20k and $30k a year was saved by having the profits after salaries taxed at the trustee rate rather than at the surgeon's individual top personal tax rates.

Inland Revenue used its reconstruction powers under the tax avoidance legislation to assess them with what they considered to be an appropriate level of income for the services they performed, rather than the artificially low salaries paid to them.

The court found that tax savings were a "more than merely incidental" reason for the salaries being fixed at a low level and upheld the Commissioner's reallocation of the income from the trusts back to the individuals who performed the services.

Inland Revenue's response

Inland Revenue has issued a Revenue Alert RA 11/02 setting out their current view on how the law should be applied following on from the Penny & Hooper decision.

Where income is generated from the supply of services provided by individuals, a combination of some or all of the following factors may result in IRD looking more closely at the business structure:

1. The controllers of the business arrange for an entity, such as a trading trust or a company, to operate and own the business. The operating entity engages or employs them (or contracts for their services);

2. Where the business has been transferred, the business operates substantially as it did before its transfer to the operating entity;

3. The business may not in substance be operated according to the terms of the arrangements entered into. This includes examining the agreements themselves, the manner in which they are actually implemented and also whether the overall arrangement is commercial having regard to a comparison with relevant standard business practices;

4. The degree to which the individual service providers or their family ultimately control the entity, its economic product and cash flows from the business;

5. Whether there is a redistribution of the underlying income from the entity to the person or to family members, usually via a trust but there are other mechanisms, for example, by way of employment of the family members perhaps at inflated salaries, or related party loans or the payment of management and other service fees to associates; and

6. The extent to which, as a consequence of the arrangement, significant tax benefits are obtained e.g. where the entity and/or any beneficiaries or shareholders pay lower marginal tax rates than

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would have been payable by the taxpayer, but for the arrangement.

Inland Revenue recognises that there may be valid commercial reasons why the service providers are not adequately remunerated, such as:

- Adverse business conditions mean that the business' profits are down but most of those profits are still paid out to the individual service providers;
- It is financially prudent to retain some profits in the business because it is anticipated that the business may experience financial difficulties in the near future;
- The profits are set aside to acquire business assets in the next financial year; or
- The business relates to a charity and the individual receives less to ensure the charity's return is maximised.

For these reasons, Inland Revenue would not then expect to see much in the way of distributions being made to shareholders as dividends.

How does this affect you?

Inland Revenue actively reviews businesses providing professional services to determine whether they fall foul of the Penny & Hooper decision, and it is fair to say they do so with a fair amount of rigour and enthusiasm! Inland Revenue's starting point is that 80% of profits should be paid out as salaries to the individual service providers.

Inland Revenue is entitled to go back at least 4 years without having to consider the time bar.

Where assessments are amended, the increased tax, use of money interest, and possibly a shortfall penalty, will be payable. However, it may be possible to reduce or avoid shortfall penalties if the taxpayer makes a full voluntary disclosure.

If Inland Revenue undertakes an audit without the benefit of a voluntary disclosure, they could impose shortfall penalties which could be as high as 100% (or 50% if there have been no previous shortfall penalties imposed) of the extra core tax that is payable, in addition to the income tax payable and Inland Revenue interest that would be charged.

Our Recommendation

If you would like to discuss your arrangements further, please contact us as soon as possible. If you consider that your entities could **potentially** be the target of such an Inland Revenue review, we would like to meet with you to consider the impact of the Penny & Hooper decision on your circumstances. We will need to discuss the level of salaries paid historically, determine whether these are in fact "market" based, and consider what action, if any, should be taken.

We can undertake a shareholder remuneration review for you and advise you on your position.

Last reviewed on 3 March 2021

Important: Clients should not act solely on the basis of the material contained in this article. Items herein are general comments only and do not constitute nor convey advice per se. Changes in legislation may occur quickly. We therefore recommend that our formal advice be sought before acting in any of the areas. This article is issued as a helpful guide to our clients and for their private information. Therefore it should be regarded as confidential and should not be made available to any person without our prior approval.

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