



cullings is the newsletter of
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Structuring your labour through a company – tax avoidance?

We get a lot of queries from people who are considering providing their labour through their own company.

There can be many reasons for this doing this. One of the reasons for doing this is to achieve a tax saving due to the significant differential between the company tax rate and the top personal tax rate (30% as opposed to 38%).

The recent decision of *Penny v Commissioner of Inland Revenue* provides guidance on whether this may amount to tax avoidance. It is a mainstream commercial issue that is faced by many thousands of small businesses in New Zealand.

Background

Mr Penny is a specialist orthopaedic surgeon. He restructured his private practice into a company structure in 1997 (well before the personal tax rate reached 39% – and now 38%). He became the sole shareholder of Penny Orthopaedic Services Limited (POSL). His family trust was the owner of the shares in Orthopaedic Surgical Consultancy Limited (OSCL). Mr Penny owned the premises that he conducted his practice from. He leased this to POSL and then sold it to his trust. He sold his practice to POSL for approximately \$150,000 (including \$100,000 for goodwill). A couple of months later OSCL purchased the practice from POSL for approximately \$1.5 million (including goodwill of \$1 million). This two-stage process was part of a single restructuring plan.

The day to day work arrangements remained essentially the same. Patients looked to him personally for their well-being. His letterhead was unchanged, but invoices were issued in the name of the company. Each year a salary was fixed (essentially by Mr Penny) and Mr Penny returned that amount as his income

from private practice. The fees paid by patients formed income for OSCL and that income after deduction of expenses (including Mr Penny's salary) returned at taxable income by OSCL. The trust, as sole shareholder in OSCL, received fully imputed dividends from OSCL each year and the dividends were substantially retained as Trustee income, and returned as such to Inland Revenue.

The salary received by Mr Penny was considered by Inland Revenue to be well below a market salary, and when coupled with the overall restructuring the payment of a below market salary amounted to tax avoidance. Mr Penny accepted that he was paid well below a salary he would otherwise have earned, but argued that there was no requirement in the *Income Tax Act* (the Act) to pay a market salary.

Outcome

Justice McKenzie first examined each part of the arrangement. Then he stood back and viewed the overall arrangement to consider whether there was tax avoidance.

The short answer is that the Judge concluded that there had not been tax avoidance.

On the issue of fixing a salary at below market value, the Judge concluded that there was nothing in the Act that supports Inland Revenue's contention that payment of a market salary is required in non-arm's length transactions.

The Judge similarly dismissed Inland Revenue's contention that his earnings should have been returned as personal income based on the ultimate receipt of the income by Mr Penny, first through OSCL and then through his trust.

Importantly, the Judge was not prepared to accept that the choice a taxpayer has as to how

they legitimately may operate under the Act is tax avoidance in the absence of any specific indication in the Act as to when that choice may or may not be made.

The Judge also made some useful observations:

- The adoption of a corporate form involves a commercial decision that involves no element of artificiality or contrivance. Mr Penny had a genuine motive for adopting a corporate structure.
- The tax advantage ultimately acquired by Mr Penny arises from the differential between the company tax rate and the top personal tax rate. The fixing of those rates by Parliament indicates a clear intention that tax is to apply differently to companies and individuals.
- There is no principle that requires personal services income derived from the personal exertions of an individual to be taxed as income of that person.
- There is no principle that prevents a choice made by a person to provide their "profession trade or calling"

through a corporate structure controlled and operated by that individual.

He commented that:

A very wide range of professions, trades and callings may be conducted as businesses. Generally speaking, the proprietor of a "one-man" business has a choice whether to conduct that business as a sole trader or through a company (or perhaps some other entity) Any principle that a particular category of business income can only be derived only by individual taxpayers would have to be clearly prescribed in the legislation.

Unfortunately, the Commissioner has appealed the decision. However, *Penny* forms part of the basis for an acceptable interpretation to adopt in relation to structuring your business (relevant to penalty imposition).

Peter Cullen's latest *Dominion Post* articles can be viewed online at www.cullenlaw.co.nz/dompost.html