

Associate Firms Service



Supreme Court rules on *Penny and Hooper v Commissioner of Inland Revenue*

In a unanimous decision released today the Supreme Court has found in favour of the Commissioner in the *Penny and Hooper* tax avoidance case. The judgment upholds the previous Court of Appeal decision, which overturned the High Court decision in favour of the taxpayers.

The key question for the Court was whether operating a surgical practice through a company owned by a trust constituted tax avoidance in circumstances where the surgeons performed the same work at a reduced salary for the company as they had performed in their own name prior to incorporation.

The Supreme Court's decision

The Supreme Court held:

- The structure adopted by each taxpayer, in itself, was lawful. Further, there was nothing unusual or artificial in a taxpayer causing a company under his control to employ him on a salaried basis.
- Tax avoidance can be found in an individual step of a wider arrangement. That step, when taken, can make the wider arrangement a tax avoidance arrangement. Where a particular step is done repetitively, such as in this case by the annual setting of the salary levels, the step may or may not amount to tax avoidance depending on its purpose or effect on each occasion (ie, a salary could be artificially low, ie, tax avoidance one year, and not in the next).

- The existence of the personal services attribution rules does not preclude the operation of the general anti-avoidance provisions in the Act.
- Their Honours accepted the taxpayers' contention that there was no concept of a commercially realistic salary to be found in the Income Tax Act and that family transactions are not based on market valuations. However, what the Act does require of taxpayers is that they should not structure their transactions with a more than merely incidental purpose of obtaining a tax advantage unless that advantage was in the contemplation of Parliament.
- It is appropriate for the Commissioner to examine whether a salary has been set at a certain level on a commercial basis or for family reasons. If the salary is not commercially realistic or, objectively, is not motivated by a legitimate (non-tax) reason, it will be open to the Commissioner to assert that it is, or is part of, a tax avoidance arrangement.

Analysis

This case confirms the Commissioner's view that where the amount of salary paid is artificially low, it may constitute tax avoidance. It also provides useful guidance as to when avoidance would not be involved, such as when retaining funds for capital expenditure or where the company is experiencing financial difficulties. We expect that Inland Revenue will publish further guidance on the application of the decision in the near future.



This decision reinforces the importance of documenting the reasons businesses are making particular decisions. In any situation where there is a reduction in tax relative to an alternative or prior position, taxpayers need to be able to justify that this is the result of a genuine commercial decision, and not the result of a tax objective in itself, unless, such as in the case of the PIE regime, that tax objective is clearly contemplated by Parliament.

When setting salaries in close companies, taxpayers should have regard to the factors identified as concerning to Inland Revenue' in Revenue Alert 10/01 (released after the Court of Appeal's decision):

- Taxpayers arrange for an entity, such as a trading trust or company, to operate the business. That entity engages or employs them (or contracts for their services) in return for either no remuneration or for remuneration set at an artificially low level – artificial in that the remuneration does not reflect what a reasonable person in that situation would expect to earn from that activity, having regard to the specialist skills of the taxpayer, other factors that contribute to the success of the business (eg, capital assets or employees) and of course the profits actually generated.
- Where the business has been transferred, whether the business operates substantially as it did before its transfer to the entity.
- Whether the business is operated according to the terms of the arrangements entered into. This includes examining the agreements themselves, the manner in which it is actually implemented and also whether the arrangement is commercial having regard to a comparison with relevant standard business practices.
- The degree to which they or their family ultimately control the entity, its economic product and cash flows from the business.
- 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 the employment of family members or related party loans or the payment of management and other service fees to associates.
- The relative significance or materiality of non-tax reasons for structuring their particular affairs in the manner they have done relative to the personal attributes of the taxpayer.
- The extent to which, as a consequence of the arrangement, significant tax benefits are obtained, eg, where the entity and/or any beneficiaries or shareholders pay lower marginal tax rates than would have been payable by the taxpayer, but for the arrangement.

We understand that Inland Revenue is pursuing approximately 35 cases similar to Penny and Hooper. We recommend that you advise your clients conservatively when setting salaries in closely held structures similar to Penny's and Hooper's – this could involve determining the level of salary that a third party would require, or find acceptable, in the same situation as your client.