

Conclusions from Penny & Hooper...

The key point to take away from the recent Penny & Hooper decision is not to push the boundary when restructuring. The Supreme Court plainly felt that both Messrs Penny & Hooper did just that by lowering their salaries to less than 20% of amounts they had previously earned, whilst ensuring the balance attracted the lower rate of tax applicable to companies. Quite possibly, had their salaries been set at higher levels and in turn had the tax advantages been made less significant, the IRD might not have challenged them or the Supreme Court might have looked favourably on them.

What level of salary is appropriate?

That question presupposes that use of a company as a means to deliver personal services is acceptable.

A key finding from Penny & Hooper is that use of a company for those services is perfectly acceptable. So what level of salary is appropriate?

Neither the Tax Act nor the Supreme Court answers that question. The IRD's view appears to be that salaries in situations such as these must be no less than 80% of the Company's profit. If that is accepted then effectively the salary level established at the start of a year would need to be topped up either during the year or at the end of the year for any escalation in the company's profit for the year. Realistically, something less than 80% should also be acceptable but the greater the departure from this threshold, the greater commercial justification is needed.

Alternatives

Alternatives going forward are easily managed. My suggestion is to set salary levels at the start of the year based on the previous year and to adjust them as appropriate and as necessary to keep to or to approach the 80% threshold mentioned above. Where they are set at less than 80% of the company's profit, the reasons for doing so should be properly recorded together with some assessment of the impact this will have on the company's economic position. That latter point is important because it is the company's economic position that justifies retaining a portion of its profits.

Alternatives going backwards are not so easily managed. One alternative is to make a voluntary disclosure to the IRD thereby obtaining automatic 50% reduction in penalties (available in most cases, but not all). Taxpayers who value certainty in their tax positions may well be attracted to that alternative. Regardless of your own philosophical stance in these respects, to anyone likely affected by all this, I would be happy to consider where you stand and advise you on the best way forward.