WHAT IS THE PENNY AND HOOPER CASE?

A BATTLE THROUGH THE COURTS

Ian Penny and Gary Hooper were both orthopaedic surgeons in Christchurch and both restructured their respective business structures from a sole trader to an employee working for an incorporated company. This had the effect of reducing their tax bill by tens of thousands of dollars per year due to the fact that the taxation rate for an individual was 39%, whereas for a company it was only 33%.

However, the salaries of the surgeons under the new structure were substantially less than their previous incomes when they were sole traders. This resulted in 2012, in Hooper's situation, out of total company income of $567,000 he was only paid a salary of $120,000, and Penny out of $832,000 a salary of $100,000.

The tax department recognises that there may be legitimate reasons for a taxpayer to structure its affairs in such a way, but as they deemed the salaries as "artificially" low (i.e. below market price), they deemed it as a tax avoidance arrangement, making the surgeons liable for the extra amount in tax.

THE DEFINITION OF TAX AVOIDANCE

A tax avoidance arrangement is as follows: "Tax avoidance arrangement means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly:

(a) Has tax avoidance as its purpose or effect; or

(b) Has tax avoidance as one of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the purpose or effect is not merely incidental"

Penny and Hooper did initially successfully defend this matter in the High Court. The IRD then successfully overturned this decision on appeal to the Court of Appeal, and had the previous ruling reversed.

THE FINAL OUTCOME

The IRD's current view is that if less than 80% of the business profits are not paid out as salary to the people who generated that income from the business for their own services then you could be at risk.

WHO DOES THIS AFFECT?

The medical profession is certainly a target. However anyone who offers professional services through a company or Trust structure and works in that entity could also be at risk. To determine if this is likely to affect you, check whether the following applies:

1. Do I provide personal/professional services through a company or trust structure?
   — i.e. doctor, dentist, management consultant, etc.
2. Do I take less than 80% of the profit as personal income?
3. Is my personal income from the trust or company lower than some of my employees?
4. Do I generate a significant portion of the company or trusts revenue?
5. Are there less than 5 employees in the business?

If you answer yes to any of the above questions you could be at risk from a review from the IRD.

WHAT SHOULD I BE DOING TO PROTECT AGAINST THIS?

Have your structures reviewed now!

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