

## NEWSLETTER

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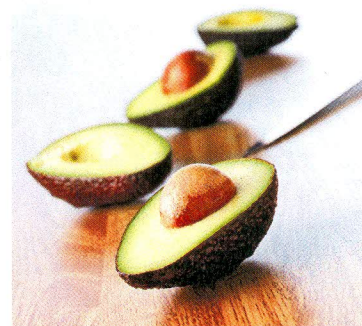
## Market Salaries – One for the Taxpayer

The controversy over whether a trust or company is required to pay a fair market salary to an associated employee has taken another turn recently. The High Court has overturned the Taxation Review Authority ('TRA') decision, which had determined that a self-employed anaesthetist had avoided significant income tax under a tax avoidance arrangement that included payment of a below market salary.

### Background

Dr White is an anaesthetist who, in 2002, worked part-time in the public and private sectors. Additionally, she held interests in two avocado orchards with her husband (through a family trust). The couple also resided on one of the orchards.

In late 2002, Dr White ceased being self-employed and incorporated a company that employed her to provide services to private patients. The company also began leasing the avocado orchards from the family trust.



The taxpayer's salary was set at the end of each year when the company's profit was determined. Due to the avocado orchard making unexpected losses, the company barely made any profit, and no salary was paid from the company to Dr White in the 2003 year and a salary of \$4,785 was paid in the 2004 year.

The judge in the TRA decision was of the opinion that:

- Dr White had entered into an artificial, contrived and uncommercial arrangement. He also agreed with the IRD's assertion that the structure was used to significantly reduce the taxpayer's tax liability from

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personal exertions, while retaining full control and benefiting from the income.

- The only reason someone would agree to take such a significant reduction in income was that the income was controlled by a related entity and was still available to them or their family in some other way.
- A fair market salary could have been paid by the company if the company had borrowed against future profits, in effect causing the company to incur tax losses to be carried forward to future years.



through the provisional tax regime, and not the PAYE system. Where this is adopted, there may be circumstances where the working shareholder does not get paid for their time due to lack of funds in the company.

The fact that the company made an unexpected loss should not make an acceptable business structure an artificial and contrived arrangement designed to avoid tax. There was no scheme to avoid tax, hence the effect of the structure minimising tax was purely incidental and therefore falls outside of the definition of tax avoidance.

### High Court Decision

The taxpayer appealed to the High Court. The High Court allowed the appeal, determining that the arrangement did not amount to tax avoidance. In contrast to the decision at the TRA, the judge found that:

- At the time the arrangement was entered into, it was not expected that the company would make a loss from its business activities. The company had no money available to pay a salary as the funds had been used to pay real (not contrived) debts.
- The closely-held company structure adopted by Dr White was used in a manner that was not inconsistent with the purpose that Parliament intended such companies to be used.
- The close-company regime specifically allows small family companies to pay tax on shareholder salaries

The judge distinguished this case from the Court of Appeal decision in *Penny and Hooper v Commissioner of Inland Revenue (2010)*, in which it was held that two orthopaedic surgeons operating through companies, and not receiving “commercially realistic salaries” had entered into tax avoidance arrangements. The distinguishing factor was that Dr White was not deliberately paid a reduced salary; the company simply did not have the funds to pay one.

The IRD have advised it is appealing the decision. In the meantime, this is a welcome decision as it provides guidance as to the limits in the Penny and Hooper decision. The taxpayers in the Penny and Hooper case have been given leave to appeal to the Supreme Court.

## Employment Relations Act: Key Amendments

Amendments to the Employment Relations Act have been passed and come into effect on 1 April 2011. The changes reflect National's policy of easing the constraints on employers. While some of the changes are only of interest to employment law practitioners, others significantly change the employment landscape.

### 90-Day Trial Period

The 90-Day Trial Period for new employees, introduced by National in 2008 for employers with fewer than 20 staff, is now available to all employers. During the trial period the employer may dismiss a new employee within the first 90 days without a right to a grievance, but only if the requirements of the legislation have been followed precisely. The trial period must be in writing at the commencement of employment, the employee must not have worked for the employer before and the employer is still obliged to be constructive and communicative in the employment relationship.



### Employment Agreements

The other significant change is that the employer is now required to keep a copy of every signed employment

agreement or, if the agreement is not signed, the draft agreement. This is due to the high number of personal grievance cases in which the Employment Relations Authority has had to make a decision without a written agreement available because it has been lost. Therefore, the onus has now been placed on the employer to keep a copy. This particular change comes into effect on 1 July 2011. Failure to produce a copy of the agreement can result in a penalty (fine) being imposed on the employer.

Other changes, that will have less impact on day to day employment interactions, are as follows:

### Test for Justifiability

In determining whether a personal grievance is upheld or dismissed, the Employment Relations Authority must apply a test as to whether or not the employer's action(s) or dismissal of the employee was justified. The test has been changed from what “a fair and reasonable employer **would** have done in all the circumstances” to what the employer “**could** have done, thus widening the options of what might be considered a ‘justifiable decision’ for an employer to have made. The test is further extended to include consideration of the

