

# NEWSLETTER

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## Inside this edition

Market Salaries – One for the Taxpayer .....	1
Employment Relations Act: Key Amendments .....	2
GST Refund Delays .....	3
Building Depreciation Update .....	3
Snippets .....	4
Evading Student Loan Payments? .....	4
Gift Duty.....	4

## 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.

### 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



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.

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.



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

### Employment Agreements

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

resources available to the employer at the time, suggesting that there should be more flexibility for smaller enterprises.

### Union Access to Workplace

Before entering a workplace, union organisers must now get consent to do so and the employer has to respond to the request by the end of the next working day. If they have not responded within 2 working days, consent is treated as having been obtained. The employer must provide a reason for withholding consent and it cannot be withheld without good reason. A penalty can be imposed

## GST Refund Delays

The timely release of a GST refund by the IRD can be an important element of a business's cash flow, especially in today's economic climate. However, recent court decisions regarding the rules under which the IRD operate has created an unfavourable situation for taxpayers.

Simply put, the GST Act prescribes that the IRD is required to release GST refunds within 15 working days of receiving a GST return. If it is not satisfied with a return, the IRD has 15 working days to either request further information or notify the taxpayer it intends to investigate the return. However, in some situations the legislation is unclear and open to interpretation. This has been highlighted in recent cases heard in the Supreme Court and the High Court.



In *Contract Pacific Ltd v Commissioner of Inland Revenue* (CIR), which was heard in the Supreme Court, the taxpayer (an inbound tourism operator) claimed a large GST refund due to a

law change. The IRD issued a notice to investigate the return within the required timeframe of 15 working days, but a request for further information was issued more than 15 working days after the return was received by the IRD. The taxpayer argued that the information request had to be made within the 15 working days of the IRD receiving the return, regardless of whether or not an investigation had commenced.

In the above case, the Supreme Court held that as the investigation process would naturally include requests for

for unreasonably withholding consent.

### Labour Inspectors

The functions of Labour Inspectors have changed and create the opportunity for employers to receive free advice from Labour Inspectors. Their role includes supporting employers and employees to comply with the employment laws and providing them with services that will help resolve their employment problems. This means they can be invited by either party to help resolve an issue, which is most likely to be with respect to pay or leave.

information, the statutory time frame relating to requests for information did not apply. In reaching its decision the Court commented on the poor drafting of the legislation but indicated that it should be interpreted "....so that it can operate without producing perverse results which can never have been within the legislative purpose".

In *Riccarton Construction Ltd v CIR*, which was heard in the High Court, the taxpayer filed a GST return claiming a refund for the purchase of two motels. The IRD did not release the refund and requested information within 15 working days of the return being filed. Upon receipt of the information requested from the taxpayer, the IRD issued notification (more than 15 days after the return was filed) that they would be investigating the return.

The taxpayer argued that the IRD could not hold the refund as the decision to investigate was not made within 15 working days of the return being filed.

The Court held that because an information request was made within 15 working days, any decision to investigate could be deferred for another 15 working days after receiving the requested information. Consequently the IRD were entitled to hold the refund.

Practically, these decisions mean that GST refunds can be held indefinitely by the IRD provided the IRD has given the required notice to the taxpayer that it will investigate the return, or issued a notice requesting information to be provided.

Considering the Supreme Court's own admission in the *Contract Pacific* case that the legislation is poorly drafted, consideration should be given to re-writing the legislation to make it clearer. In the meantime, the decisions in the *Contract Pacific* and *Riccarton Construction* cases clearly leave the IRD with the upper hand.

## Building Depreciation Update

Legislation passed as a result of the May 2010 Budget eliminated depreciation for most buildings that had a useful life of over 50 years. After the legislation was passed there was considerable uncertainty in a

commercial context regarding what part of a structure would be classified as "building" versus "fit-out" (which can continue to be depreciated). The IRD had previously provided its view on the issue, but in a residential rental

context, and commented that the principles could also be applied in a commercial context. The principles would have favoured the classification of some fit-outs as part of a building. Stepping away from those principles, the Government has amended the Income Tax Act 2007 in favour of the taxpayer.

Specifically, the changes enacted include:

- A new definition of “building” which specifically excludes “commercial fit-out”.
- The insertion of a commercial fit-out definition, which includes an item attached to a “commercial building” that is non-structural and not part of a building’s weather-proofing.
- The insertion of a commercial building definition that captures buildings that are not primarily used as a person’s residence and specifically includes:
  - hospitals,
  - hotels, motels, inns, hostels and boarding houses,
  - certain serviced apartments,
  - convalescent homes, nursing homes, and hospices,
  - rest homes and retirement villages, from hospital care through to residential care facilities, and
  - camping grounds.



The clarification of these definitions enable items that could otherwise be considered part of a commercial building, such as internal non-load bearing walls, suspended ceilings, plumbing and electrical reticulation to be depreciated as fit-out.

Where items of fit-out are shared between both residential and commercial structures (e.g. lifts, fire protection, sewerage), the principle purpose of the building will

determine whether the fit-out is depreciable property. For example, if a building is used principally for commercial purposes, then the fit-out will be depreciable property.

If upon construction or purchase a person has not separately identified and depreciated fit-out, a new provision allows the owner of a commercial building to amortise 15% of the building’s book value at a rate of 2% straight-line per year. The building’s adjusted tax book value is reduced by any fit-out purchased and depreciated separately after the building was purchased.

The question left unanswered by the IRD is whether a person that has not separately identified and depreciated fit-out in the past can perform an analysis to determine what proportion of a building is structural versus fit-out, and start depreciating the fit-out based on the higher fit-out rates.

## Snippets

### Evading Student Loan Payments?

The IRD have been contacting student loan borrowers who are living in Australia regarding their student loan repayment obligations.

Most borrowers they have contacted have been happy to enter into arrangements to repay their loans, but several people have told Inland Revenue in no uncertain terms where to go. As a consequence, the IRD is taking around 10 test cases to court in order to recover the money.

These borrowers could face civil and/or criminal charges. Civil charges would involve a claim for the amount owed, whereas criminal charges could be up to three times this amount if they are tried for evasion of a repayment obligation.

Australia is the first country in which the IRD has sought to locate repayment evaders as it is the easiest place for the IRD to get information from. Similar action could take place in other countries in the future.



### Gift Duty

Following a review of gift duty by the Government, legislation has now been enacted which abolishes this regime.

This decision was made because the results of the review showed the compliance costs of gift duty far outweigh the revenue it collects, the protection it provides to creditors and the ‘social assistance integrity’ derived.



Gifts made after 1 October 2011 will be excluded from the definition of “gift” under the Estate and Gift Duties Act 1968.

If a person makes a gift or gifts in a 12 month period totalling more than \$27,000, and those gifts are made before 1 October 2011, gift duty will still apply.

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