



Trust eSpeaking

The IRD takes a scalpel to surgeons' trading structure

The Court of Appeal delivered, in early June, the much anticipated decision of *CIR v Penny and Hooper*¹ which has been touted as having wide-ranging implications for persons who carry on business through company/trust structures. In a 2-1 majority decision the court struck down the arrangement on the grounds of tax avoidance enabling the Commissioner to reconstruct the arrangement to nullify its tax benefits.

The case involved two surgeons who practised in their own names prior to the increase in the top personal tax rate to 39 cents in 2000. After the increase in the tax rate the surgeons restructured their businesses whereby each was employed by companies owned by their family trusts. The companies paid the surgeons salaries much lower than they had previously received as well as providing other benefits resulting in tax saving. In Mr Hooper's case his personal income was reduced from about \$650,000 to \$120,000 pa and in Mr Penny's case from \$302,000 to \$100,000. The structures 'sheltered' the majority of the surgeons' income from the top tax rate which resulted in a tax saving of 6 cents in the dollar.

In the High Court the Commissioner focused on the failure of each company to pay a 'market salary'. However, the court rejected this argument because the tax laws do not prescribe any requirement to pay a 'market salary' and the trading structure was a legitimate choice available to the surgeons.

On appeal to the Court of Appeal the Commissioner broadened the scope of his attack and the court agreed, but delivered a carefully worded judgment by applying the established hallmarks of tax avoidance being artificiality, contrivance and lack of commercial reality. The court stressed that each case must be decided on its own facts, in particular failure to pay a market salary does not of itself equate to tax avoidance and there was nothing improper about the use of a company/trust structure. The court also stated it would not expect the Commissioner to intervene in marginal cases or if legitimate commercial reasons existed for paying non-market salaries. However on the evidence the court found the salaries paid were commercially unrealistic and the level of control exercised by the surgeons formed part of a pretence to avoid the top tax rate.

There is no word yet on whether this case will be appealed to the Supreme Court.

As a practical response, directors/trustees may wish to review trading structures to ensure they do not exhibit the negative features of the Penny/Hopper structure and that objective commercial reasons underlie any personal services income diverted through trading structures. However given the recent alignment of the trust rate and top personal rate the decision will be of limited significance in the future. Also the reduction in the company tax rate will only present opportunities for a timing difference between the imposition of the company and personal tax rate.

If you require further information or would like to talk with us about the implications in the case above, please do not hesitate to contact us.

Our thanks to nsaTax for help in providing this commentary.

¹ CA201/2009