Company and Trust Structures and Personal Services Income

This information is provided by Buddle Finlay for the use of NZMA and its members.

In recent times the Inland Revenue Department (the "**Department**") has committed significant resources to auditing professionals (and in particular, medical practitioners) who provide their services through company and trust vehicles. The Department's usual approach has been to ignore the myriad of different commercial reasons why a professional may have implemented such a structure, and to instead focus on the incidental tax benefits that can arise in some cases. Although such an approach was rejected by the High Court in *Penny v CIR*; *Hooper v CIR* (2009) 24 NZTC 23,406 ("***Penny & Hooper***") the Department currently ignores this case and has appealed it.

This advisory summarises the issue, the Department's current approach to it, and the conclusions reached in *Penny & Hooper*. The advisory concludes by considering how medical practitioners should deal with the current uncertainty associated with using trust and company structures in the absence of definitive guidance from the Courts or Parliament.

It is important to note at the outset that although medical practitioners have been signalled out by the Department for "special scrutiny", company and trust structures are also commonly used by other professionals for a variety of commercial reasons.

The Issue

Medical practitioners often structure their private practices through company and trust structures. The company or trust carries on the medical practice and the medical practitioner is engaged as an employee (or director). The patients contract with the company or trust, not the medical practitioner.

There are many reasons for these structures, which may differ depending on the medical practitioner and medical practice involved. They may have been established to shield the medical practitioner from personal liability to patients. The practitioner may undertake unrelated business activities in a personal capacity and wish to ensure that income from the medical practice is insulated from those activities. Certain medical practices may require significant capital assets and those assets may sit more naturally within a company or trust structure. In short, the commercial reasons for such structures are endless.

There is, however, usually a tax advantage associated with the use of company and trust structures. Most medical practitioners will pay tax at the top marginal tax rate (now 38%), whereas the tax rates applicable to companies (30%) and trusts (33%) are lower. By retaining a portion of the medical practice income in the company or trust (or by distributing that income to beneficiaries with lower marginal tax rates) rather than paying the income to the medical practitioner, a tax saving can arise.

Approach of the Department

The tax saving associated with the use of company and trust structures has resulted in the Department asserting that such structures involve "tax avoidance". Where a structure is found to involve tax avoidance it will be void against the Department for tax purposes (although such an attack by the Department has no impact on the structure's effectiveness for commercial purposes).

The Department has asserted in a number of instances that the income derived from a medical practice results from the personal exertion of the medical practitioner. Accordingly, any attempt to assign some or all of that income to another entity on a lower marginal tax rate (e.g. the trust or company) will be treated as tax avoidance.

The Commissioner's stance is based on the Taxation Review Authority decision *Case W33* (2004) 21 NZTC 11,321. That case involved a dentist that restructured the operation of his dental business through the use of a trading trust (i.e. a discretionary family trust with a corporate trustee). The taxpayer became an employee of the trust and derived employment income as a consequence, while the trading trust operated the dental practice. Most of the dental practice income was retained by the trust with the dentist receiving a relatively modest salary.

The Department asserted that the structure amounted to tax avoidance for various reasons and, in particular, noted that the structure allowed the dentist to be paid an artificially low salary. This assertion was upheld by the Taxation Review Authority. It held that although there were valid commercial reasons behind the dentist's choice of business structure, the modest salary paid to the dentist meant that the structure involved tax avoidance.

Following *Case W33*, the Department has set about challenging structures used by medical practitioners where it considers that the practitioner has been paid a "non-market" salary by the interposed company or trust. In some cases the Department has used external valuers to assist it to determine what an appropriate market value salary should be.

If a "non-market" salary is found to exist, the Department's presumption is that the structure involves tax avoidance.

Penny & Hooper

The focus in *Case W33*, and in particular its focus on non-market salaries, has received significant criticism since its release and has recently been rejected by the High Court in *Penny & Hooper*. The case involved surgeons who restructured their practices into company structures, each surgeon becoming an employee of their respective company. The shares in each company were held by family trusts.

The Commissioner made a number of arguments why the respective arrangements involved tax avoidance including that: below market salaries had been paid, significant tax benefits arose from the structures, the surgeons controlled the relevant companies and continued to live off the income derived from the medical practices, and the restructuring had no effect on the day-to-day operation of the medical practices. The Court rejected these arguments and found for the taxpayers. Importantly, the Court rejected the Commissioner's assertion that a "non-market" salary leads to an automatic inference of tax avoidance:

> I find nothing in the scheme and purpose of the Act which supports the proposition that payment of a commercially realistic salary in non arms length transactions is a general and over-riding requirement of the Income Tax Act.

The Department has stated that it does not accept *Penny & Hooper* and it is consequently appealing the decision to the Court of Appeal. The appeal is expected to be heard in early 2010. If the Department was to lose in the Court of Appeal, it is probable that it would then appeal the case to the Supreme Court. Given this, it may be some time (2 years or more) before the tax issues associated with company and trust structures are put beyond doubt.

Even then, practitioners with fact patterns different to *Penny & Hooper* will continue to live with a degree of uncertainty as to the tax effect of their structures.

Dealing with the current uncertainty

This ongoing uncertainty is simply unacceptable. Medical practitioners (and their business entities) continue to be obliged to file tax returns without knowing whether the tax positions they are adopting could be attacked by the Department at a later time. Some medical practitioners may also be hesitant to unwind existing structures as this may create an (incorrect) impression on the part of the Department that the particular structure was only implemented for tax purposes. The uncertainty is also unacceptable when one considers the significant interest (currently 9.73% per annum) and penalty consequences (up to 100%) that can ensue where tax avoidance is found to exist.

The uncertainty makes it critical for medical practitioners with company and trust structures to obtain legal advice from a tax specialist to ensure that their past tax positions are protected and their positions going forward do not unduly expose them to unnecessary risk. The position of each practitioner will be unique and it would be unwise to draw inferences from what other practitioners are/are not doing.

Where the Department has attacked trust and company structures in the past, it has not been uncommon for the Department and the practitioner to ultimately settle on the basis that approximately 70% to 80% of a medical practice's income will be attributed personally to the practitioner (in some cases the figure agreed upon has been slightly lower and in some cases slightly higher). There is no particular significance in these figures and the Department may not apply the same approach in the future. That said, it highlights the particular sensitivity that exists for those practitioners whose structures attribute less than 70% - 80% of medical practice income to the practitioner.

Need more help?

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