optimal
Business Services

NEWSLETTER

Issue 4
November 2011 – January 2012

INSIDE THIS EDITION

IRD WINS FINAL ROUND AGAINST PENNY AND HOOPER

The recent dispute involving Messrs Penny and Hooper has come to an end with the Supreme Court decision finding in favour of t he IRD. The Supreme Court upheld the Court of Appeal's view that the setting of commercially unrealistic salaries constituted tax avoidance.

Penny and Hooper were both orthopaedic surgeons trading in their personal capacity, but restructured their busines ses to trade through companies, owned by family trusts. The companies employed the surgeons for substantially less than what they had been earning prior to the restructure. Howev er, their work load and the nature of work did not change. The Supreme Court s tated that while the structures used were v alid business structures, the yearly setting of a non-commercial salary constituted tax avoidance.

In response to the finding the IRD has prov ided guidance, in the form of Revenue Alert *RA 11/02,* on circumstances in which it considers tax av oidance would arise.

Based on the Rev enue Alert, the IRD will look into all aspects of an arrangement, in order to come to a conclusion on whether or not div ersion of personal income through other entities, such as companies a nd trusts, amounts to tax avoidance. The Alert identifies the following factors as being relevant:

- The commercial reality of the service provider's business structure,
- How profits hav e been distributed in substance and whether the employee and their famil y benefit from all profit distributions,
- Whether the remuneration paid to the individual providing the service adequately reflects their contribution to the business' profits,

- Whether there are other reasons, apart from tax, for justifying departure from the norm.

The Alert also identifies situations where a below market salary could be justified, as follows:

- To fund planned capital expenditure,
- To retain profits within the business to provide for future financial difficulties,
- Where profits are down, but most of the profits are still distributed to the service providers, or
- The business relates to a charity and the individual receives less to maximise the charity's return.

The IRD acknowledge other situations may arise in which it would not be possible to pay a market salary. However, if a business cannot afford to pay a market salary, the IRD would equally expect that it could not afford to make significant distributions (such as dividend payments) to associated entities.

Amongst accounting practitioners the heart of the Penny and Hooper case has been the question of whether private companies, which derive income from personal services performed by its employees, need to pay those employees a market salary. However, the Revenue Alert indicates the IRD may not stop at requiring a fair market salary. The IRD has stated that it is:

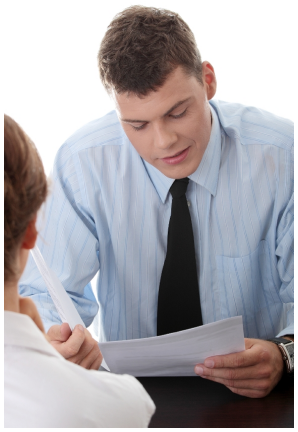
"more likely to examine arrangements where the total remuneration and profit distributions received by the individual service provider is less than 80% of the total distributions received by the controller, his/her family and associated entities."

Paying a commercially realistic salary may not necessarily satisfy the IRD, as the IRD's focus appears to be on the amount of income received by the service provider as a proportion of the total distributed. It is generally understood that disclosures to IRD are being handled centrally to ensure taxpayers are treated consistently.

TEST CASE FOR JUSTIFIABLE DISMISSAL

Last year the Government amended the Employment Relations Act ('the Act'), which included significant changes to Section 103A, the test of justification of a dismissal or action of an employer.

The test changed from what "would" a fair and reasonable employer have done in all the circumstances, to what "could" they have done, thus shifting the test from a specific action to a range of possible actions.



In addition, the test was required to take into consideration the resources available to the employer, whether the employer had raised the concerns with the employee and given them an opportunity to respond, and whether they had genuinely considered the response.

The amendment came into effect in April this year and has now been tested in the Employment Relations Authority ('the Authority') in the case of *Sigglekow v Waikato District Health Board*. This is an important case as it sets the benchmark for subsequent cases (that is until one is referred to the Employment Court for a judgement that carries higher legal authority).

Mr Sigglekow was a psychiatric nurse with the DHB working in a secure ward with patients who have histories of criminal and mental health issues. He suffered a heart attack and after some weeks off started returning to work with progressively more shifts.

There were some incidents where Mr Sigglekow was allegedly sleeping during his afternoon shifts (which run to 11pm). He was spoken to about some of these incidents but not formally warned. He was dismissed in April for serious misconduct, of sleeping on the job. Mr Sigglekow took a personal grievance for unjustified dismissal.

The Authority examined the new test for justification and then stepped back to consider the other pertinent sections of the Act, relevant case law, and organisational contracts and policies. This process brought another 35 points into consideration in determining whether or not the action was justified.

In particular the Authority explored the duty of good faith from Section 4 of the Act and the requirement, when considering termination of employment, to give the employee access to, and an opportunity to comment on, information relevant to the decision.

It found that the dismissal was unjustified because the employer had been inconsistent in not dealing with the earlier incidents more severely, had failed to conduct a full and fair inquiry into the incidents and had failed to put before Mr Sigglekow (and therefore seek his response to) all the information that was relevant to the decision.

The first test case to go to the Employment Court about the 90 Day Trial Period (*Smith v Stokes Valley Pharmacy 2009*) was also assessed against the good faith section and was found to be unjustified because the employee had not had all the relevant information put before her nor been given an opportunity to respond. Similarly, the recent judgement in *Massey University v Wrigley and Kelly*, on redundancy processes was based on the good

faith provisions and the need to provide all information relevant to the decision to the employee. Clearly, the good faith requirements are still a very important part of the process and cannot be circumvented when termination is being considered, irrespective of the reason.

GST – What is a Supply?

To quote the GST Act, GST is a charge "on the supply of goods or services". The definition of "supply" is therefore one of the most important factors to consider when determining whether GST applies to a transaction. A recent trend has emerged in which businesses are re-visiting the GST treatment of transactions and are identifying payments received for supplies that did not take place or are not for "supplies" under the GST Act. Examples of these types of situations include:

- cancellation fees
- break fees or early termination fees (e.g. a customer defaults under a contract or exercises an option to exit from a contract before its term is completed)
- no shows
- enrolment fees
- event cancellations

Businesses (for example gyms, education providers and hotels) should analyse these types of transactions to determine if they receive payments that are not consideration for the supply of a good or service. If these circumstances exist, specific GST advice should be obtained to determine the treatment of any retrospective receipts, and how to treat these receipts going forward. It may be possible to approach the IRD for a refund of over-paid GST.

Adding to the debate, a recent Australian case, *Qantas Airways Ltd v Commissioner of Taxation (2011),* has also considered the question of what constitutes a supply.

The Qantas case involved transactions where customers had paid for a flight and then subsequently cancelled or did not turn up for the booking, and did not receive a refund. Qantas completed GST returns which claimed back the GST previously paid to the Australian Tax Office (ATO) for the flights not used by customers, and not refunded by Qantas.

The full Federal Court of Australia found in favour of Qantas. The Court stated "the actual travel was the relevant supply, and if it did not occur there was no taxable supply", this is "the essence, and sole purpose of the transaction".

In a co-incidental development, new legislation has been introduced that stipulates GST is to apply to late payment fees. The IRD has stated that such fees should have the same treatment as prompt payment discounts, i.e, amounts with or without discount are subject to GST.

Over 25 years after GST was introduced, the question of what transactions are subject to GST is still being debated. This is all the more reason for businesses to spend some time and make sure GST is not unnecessarily being paid to the IRD.

Banking Relationships

With economic activity picking up, many small to medium sized businesses are re-assessing their banking relationships.

The banking relationship for many of these businesses has been tumultuous during the last few years where the financial performance of the business has deteriorated, breaching banking covenants and thereby causing the bank to take a closer look at the activities of the business and how it is being run.

This is not to say that banks have not been supportive but more that the relationship between the bank and the company has been tested.

Depending on how 'at risk' the business is, the relationship may be managed on a more formal basis by the bank's at risk division. This is a different relationship to the normal banking relationship, which would ordinarily exist during better times.

With an improvement in the economic landscape and improved financial performance, it may be worthwhile to review your banking relationship as a whole and determine whether or not your business is getting what it wants out of that relationship, or if there is a better alternative. A number of banks have come up with different products in recent times that may provide greater flexibility. A new relationship may also allow a different perspective to be brought to the table.

Like any service provider, banks need to provide good client service. If as a business owner, and a recipient of that service, you are not happy with how you are being

treated it may be worth testing the offerings of the other banks in conjunction with an honest discussion with your current bank to identify what is the best option for your business going forward. It is often at these times that the most change in banking relationships occurs. This can be dictated by different degrees of risk and exposure that certain banks want in particular industries. For example, in a farming context, one bank may wish to increase their exposure to the farming industry, whereas another may want to decrease it.

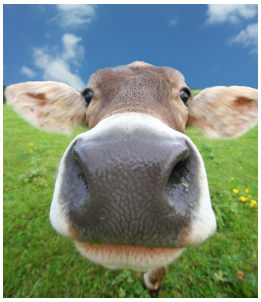
It would also be wise to negotiate hard in relation to covenants and guarantees. Ensuring covenants are not unduly restrictive, nor securities over personal assets oppressive, will ensure a better working relationship. While both these factors protect the bank, they often constrain the ability for businesses to grow. If you intend to enter into a dialogue with a new bank you should be well prepared, this demonstrates that you are in control of your business and know your funding requirements. To assist the bank in gaining an understanding of your business you should be equipped with a recent business plan, annual financial statements, key performance indicators (such as gross profit margin, inventory turnover, creditor and debtor aging), budget and cashflow forecasts and a year to date profit & loss statement and balance sheet.

Entering into dialogue with another bank to test the market should be undertaken on a fair basis and probably should not be undertaken unless the business is ultimately prepared to move banks. If trust has been lost in the existing banking relationship, often this is difficult to repair and a change may often be best for both parties.

Snippets

Livestock Valuation Elections

Under the current legislation, it is easy to swap between the Herd Scheme and National Standard Cost (NSC) livestock valuation methods. An officials' issues paper has been released focusing on the Government's concerns about farmers having the ability to switch between the methods to derive tax-free gains when livestock values are increasing, or tax-deductible write-downs when livestock values are decreasing.



Government officials have suggested that the following changes be made:

- Once a farmer has elected to use the Herd Scheme, the election is irrevocable, or
- Livestock election timeframes be altered to reduce advantages that can be acquired by farmers under the existing election framework.

Under the first alternative, any election would survive transfers between associated persons, to remove the ability to work around the changes by using multiple entities.

Lastly, the IRD proposes that the ability to use certain valuations, when trading ceases, should also become more restrictive.

Submissions on this paper closed on 30 September 2011.

Eat Drink and be Merry, for Tomorrow we Pay More Tax

As the country looks forward to over-indulging at Christmas and through the summer, it is worth sparing a thought for the Danish who, from 1 October, have been forking out more to buy food with more than 2.3% saturated fat, such as dairy and meat products.

Said to be the first tax of its type in the world, the Danish Government is reported to have introduced the tax in order to reduce cardiovascular disease, obesity, and diabetes.

The tax was approved by 90% of the Danish Parliament, but consumers are not happy with the price increase to items such as butter and cheese.

The tax is charged at 16 DKK (approximately NZ$3.70) per kilogram of saturated fat on foods with more than 2.3% saturated fat. The tax will increase a pack of butter by the equivalent of about 55 cents and a burger by 20 cents. The week leading up to the increase saw consumers stocking up on food that will be subject to the tax.

If you have any questions about the newsletter items, please contact us, we are here to help