Inland Revenue
Te Tari Taake

REVENUE ALERT

Diverting personal services income by structuring revenue earning activities through a related entity such as a trading trust or a company: the circumstances when Inland Revenue will consider this arrangement is tax avoidance

Issued: 29 March 2021

RA 21/01

Inland Revenue has always been concerned about arrangements involving taxpayers who arrange to effectively divert to a related entity some or all of the income they earn (or could earn) from a business or activity of supplying personal services - where it has the effect of taking advantage of lower marginal income tax rates payable by that entity and/or by family members as beneficiaries or shareholders of that entity.

Other tax-linked benefits (for example child support liabilities or student loan repayment obligations and Working for Families entitlements) may also arise under the arrangement.

This Revenue Alert has been re-issued ahead of the increase in the top marginal tax rate on 1 April 2021 and reiterates the Commissioner's view on this matter which follows the Supreme Court's decision in *Penny and Hooper v CIR* [2011] NZSC 95.

From 1 April 2021 additional reporting obligations for trusts and new information gathering rules have been introduced to assist the Commissioner to identify, in particular, any changes or increased use of trust structures to mitigate the impact of the new tax rate. However, the Commissioner considers that the principles set out in the *Penny and Hooper* decision remain of general application, regardless of the particular marginal tax rates.

REPLACES

RA 11/02: Diverting personal services income by structuring revenue earning activities through an associated entity such as a trading trust or a company: the circumstances when Inland Revenue will consider this arrangement is tax avoidance.

About Revenue Alerts

A Revenue Alert is issued by the Commissioner of Inland Revenue and provides information about a significant and/or emerging tax planning issue that is of concern to Inland Revenue. At the time an alert is issued risk assessments will already be underway to determine the level of risk and to consider appropriate responses.

A Revenue Alert will identify:

- the issue (which may be a scheme, arrangement, or particular transaction) which the Commissioner believes may be contrary to the law or is inconsistent with policy;
- the common features of the issue;
- our current view; and
- our current approach.

An alert should not be interpreted as being Inland Revenue's final position. Rather, an alert outlines the Commissioner's current view on how the law should be applied. For any alert we issue it is likely that some investigatory work has already been carried out.

If people have entered into an arrangement similar to the one described or are thinking about it, they should talk to their tax advisor for advice about tax implications and/or to Inland Revenue.

Background

There may be legitimate reasons for using entities such as trusts or companies in many business situations. The mere use of alternative business structures will not, on its own, amount to a tax avoidance arrangement. Further, the profit generated by the business may not be wholly generated by the individual and there may also be good non-tax reasons as to

why the controller of a business receives significantly less of the business' profits than would otherwise be the case.

However, where the business involves the provision of personal services, Inland Revenue is likely to examine closely any arrangement where the individual service provider (usually the real owner or controller of the business) is not receiving a significant portion of the profits derived from the business. This is particularly so where there is an absence of other business profit drivers and other non-tax reasons do not justify the level of remuneration received by the individual.

Inland Revenue's position in this regard was confirmed by the Supreme Court's 2011 judgment in *Penny and Hooper*. That decision confirms that income substantially generated by the direct personal skills, experience or labour of an individual should generally be subject to tax in the hands of that individual. The individual's contribution to the business should be properly reflected in the income returned by that individual - either through an appropriate salary or other taxable distributions to the individual.

Inland Revenue will closely examine situations where an arrangement has the effect of diverting income earned from the personal exertion of an individual but the benefit of those diverted funds is still enjoyed, directly or indirectly, by the individual or their family or associates. The focus will generally be on the most serious and artificial cases - where the arrangement results in a substantial proportion of the income generated by the business being diverted away from the individual service providers.

In many cases, taxpayers entering into these types of arrangements are also benefiting from reduced child support liabilities or student loan repayment obligations. In some cases, taxpayers are structuring their remuneration at a level that will allow them access (or greater access) to other non-income tax benefits that rely on income calculated for tax purposes.

Features

It is often a combination of factors, such as those listed below, that is of concern. Where income is generated from the supply of services provided by an individual, a combination of some or all of the following factors may result in a close look at a business structure:

1. The controller of the business arranges for an entity, such as a trading trust or company, to operate and own the business. The operating entity engages or employs the individual (or contracts for their services);
2. The business may not in substance be operated according to the terms of the arrangements entered into. This will involve examining the agreements themselves, the manner in which they are actually implemented and also whether the overall arrangement is commercial having regard to a comparison with relevant standard business practices;

3. The degree to which the individual or their family ultimately controls the entity, its economic product and cash flows from the business;
4. Whether there is a redistribution of the underlying income from the entity to the individual or to family members. This is usually via a trust but there are other mechanisms, for example, by way of employment of the family members perhaps at inflated salaries, or related party loans, or the payment of management and other service fees to associates; and
5. The extent to which, as a consequence of the arrangement, significant tax benefits are obtained e.g. where the entity and/or any beneficiaries or shareholders pay lower marginal tax rates than would have been payable by the individual, but for the arrangement.

Some arrangements may involve a restructure of an existing business. This statement will apply equally to those businesses which have been operating since commencement in a trust or company. A further factor which will be considered in a restructure is whether the business operates substantially as it did before its transfer to the related entity.

In certain circumstances, notwithstanding that all or most of the above factors may be present, the arrangement may not constitute tax avoidance. This may be because there are legitimate reasons for adopting particular business structures (such as asset protection, limited liability and business continuity). Businesses can also legitimately make decisions about whether or not, or the extent to which, profits are to be retained or distributed.

There is also nothing preventing an individual, or entities related to the individual, from owning the business and receiving distributions of profit reflecting that ownership. Further, it may be appropriate in certain circumstances for family members or related entities to receive funds from the business as:

- An employee or service provider; and/or
- An owner of capital equipment used by the business.

However, in those circumstances care needs to be taken that the relevant transactions can be commercially justified. The Commissioner will be more concerned with arrangements that have non arms-length factors present, especially where the individual service provider is not adequately remunerated for their contribution to the business. The focus will be to look at the totality of the arrangements.

Businesses need to have a valid commercial basis for the way in which profits are distributed, especially in the form of remuneration paid to individuals they employ or contract to provide services. The profits of a business will generally be driven by a combination of the following:

- *The controllers of the business' personal skill, judgement and exertion*: The more specialised and marketable those attributes are, the greater the remuneration should be;
- *The use of capital assets*: Where the business and not the individual owns significant assets that are used to generate business income, the owners of the business are entitled to an appropriate return on those assets;
- *Services provided by other staff*: Similarly, where the business employs other skilled staff, some of the business income generated can be seen as contributing to the business' profits and not the individual business controllers. The greater the number of specialist staff employed in the business, the more influential this will be;
- *Intangible assets*: Sometimes the profits of a business may also be improved through matters such as business know-how or other IP owned by the business. As with capital assets, an appropriate return on such assets can be expected by the business; and
- *Return on business risks*: This may be influenced by factors such as who has legal liability for the business or its funding. For example, who carries the reputational risk for the business, who is liable to the industry body for any wrongdoing, what insurance policies are in place, and who guarantees any borrowings. Where the business structure does little to remove those risks from the individual business controller, the individual’s overall remuneration should reflect those risks.

It is recognised that it can sometimes be difficult to determine an appropriate remuneration for the individual. There is no exact science to weighing up the extent to which the individual is responsible for the business' profit (instead of other profit drivers). However, in most circumstances, the main profit driver of a service business will be the personal skills and exertions of the controller of the business - particularly where the business does not require a great deal of capital.

In those circumstances, it is expected that the compensation received by that individual (whether by way of salary, service fees, distributions of profits or any combination of them) will be significantly more than the return received by entities associated with the business. That will be weighed against what happens to other forms of distribution from the business received by the related entities (such as loans, dividends, salaries, service fees, trust distributions etc).

Given our focus on the more artificial arrangements, and the resources available to us, we are more likely to examine arrangements where the total remuneration and profit distributions received by the individual service provider (and controller of the business) is less than 80% of the total distributions received by that individual, their family and related entities. However, this should not be relied on as a safe harbour as neither the legislation nor the Supreme Court prescribed a minimum percentage to distribute, and Inland Revenue will apply the matters discussed in the *Penny and Hooper* judgment when reviewing taxpayer arrangements.

Inland Revenue's approach focuses on the commercial reality of the business, and not on "market" salaries, or comparable industry averages. There may be particular reasons as to why an individual business controller may not be adequately remunerated in a particular year. Examples of this include:

- Adverse business conditions mean that the business' profits are down but most of those profits are still paid out to the individual service providers;
- It is financially prudent to retain some profits in the business because it is anticipated that the business may experience financial difficulties in the near future;
- The profits are set aside to acquire business assets in the next financial year; or
- The business relates to a charity and the individual receives less to ensure the charity's return is maximised.

There may be other non-tax reasons why a business may pay the individual less than an arms-length party would receive over the short-term. However, in those circumstances, we would accordingly expect to see no significant distributions being made to entities associated with the individual.

Current view: diverting personal services income

Inland Revenue considers that arrangements that exhibit a combination of the above features may constitute an avoidance arrangement in terms of ss BG 1 or GB 44 of the Income Tax Act 2007. Such cases fall outside the contemplation of Parliament.

To determine whether or not there has been tax avoidance, Inland Revenue will look at all aspects of these arrangements, including all documentation, and the actual behaviours of the persons involved.

In summary, whether or not the arrangement under consideration is a tax avoidance arrangement in relation to the tax payable on the entity's distributed profits in any given income year will depend on an examination of:

- The reality of the business' structure and how it operates commercially;
- Whether and how the profits of the business have been distributed in substance - including whether the individual and their family continue to receive the benefit of all profit distributions from the business;
- Whether the remuneration received by the individual service provider appropriately reflects the individual's contribution to the business' profit; and
- Whether there are particular non-tax reasons justifying a departure from that standard.

Options available to Inland Revenue on reconstruction include deeming all of the income to have been derived by the individual (in appropriate circumstances) or deeming that individual to have received some other amount of remuneration personally (e.g. an amount that more properly reflects the individual's contribution to the business' profits).

Inland Revenue has investigated a number of these arrangements over the years. Where we still consider, after initiating the tax disputes process, that the arrangement is tax avoidance, amended assessments will be issued which attribute some or all of the diverted income to the taxpayer, to counteract the tax benefit resulting from the use of this arrangement.

With the introduction of the increased top marginal tax rate, Inland Revenue will monitor behaviours and continue to investigate similar arrangements where there are significant tax benefits, considering both the business structures utilised and the annual decisions made around remuneration levels. Many other arrangements involving service providers share some features of the arrangements considered in *Penny and Hooper* but have their own particular characteristics. Those factors will be taken into account in any investigation, but this Revenue Alert seeks to highlight the general issues we consider relevant to such arrangements. Where the tax avoidance rules apply, steps will be taken to counteract the tax benefits obtained.

Late payment penalties and use of money interest may be applied to taxpayers who enter into the type of arrangement described in this Revenue Alert.

Shortfall penalties may also apply, although these may be reduced where a voluntary disclosure is made.

Inland Revenue would also consider imposing promoter penalties in appropriate circumstances.

If you consider that the concerns outlined in this Revenue Alert may apply to your situation, we recommend you discuss the matter with your tax advisor or with Inland Revenue and consider making a voluntary disclosure.

Authorised by Karen Whitiskie on 29 March 2021

References to consider

The following related references will assist taxpayers with determining whether their arrangement is subject to the avoidance provisions in the Revenue Acts.

Subject references: Tax avoidance

Legislative references:	BG 1 ITA 2007 GA 1 ITA 2007 GB 1 ITA 2007 GB 22 ITA 2007 GB 23 – 25B ITA 2007 GB 27 – 29 ITA 2007 GB 31-32 ITA 2007 GB 44 ITA 2007
Interpretation statements:	IS 13/01 – Tax Avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007 IS 18/02 – Taxation of trusts – income tax IS 19/02 – Income tax – attribution rule for income from personal services IS 21/02 - Income tax – calculating income from personal services to be attributed to the working person
Standard practice statements:	SPS 19/02 Voluntary Disclosures (see also booklet IR281)
Questions we've been asked:	QB 14/09 – Meaning of 'excessive remuneration' and 'excessive profits or losses' paid or allocated to relatives, partners, shareholders or directors
Revenue Alerts items:	RA 08/01 RA 10/01 RA 11/02 RA 18/01 – Dividend stripping – some share sales where proceeds are at a high risk of being treated as a dividend for income tax purposes RA 18/01a – Questions and answers
Case Law:	*Beacham v CIR* [2014] NZHC 2839, (2014) 26 NZTC 21,111 *John George Russell v CIR* [2012] NZCA 128, (2012) NZTC 20,120 *Penny and Hooper v CIR* [2011] NZSC 95, [2012] 1 NZLR 433, (2011) 25 NZTC 20,073 *Ben Nevis Forestry Ventures Limited v CIR* [2008] NZSC 115, [2009] 2 NZLR 289

Media queries

Rowan McArthur – 029 890 1251
Email - mediaqueries@ird.govt.nz