

Standard practice statement

18/01

Retrospective adjustments to salaries paid to shareholder-employees

This statement also appears in *Tax Information Bulletin* Vol 30, No 2 (March 2018) and on Inland Revenue's website www.ird.govt.nz¹.

Introduction

Standard practice statements describe how the Commissioner of Inland Revenue (the CIR) will exercise a statutory discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

In *Tax Information Bulletin* Vol 17, No 4 (May 2005), the CIR published *Standard Practice Statement 05/05: Retrospective adjustments to salaries paid to shareholder-employees* (SPS 05/05), which addressed the question of when a retrospective reduction in a shareholder-employee's salary may be made. SPS 05/05 specifically did not address the question of when a retrospective increase in a shareholder-employee's salary could be made.

Any request received by the CIR to retrospectively alter an amount of shareholder's salary involves the CIR exercising her discretion under s 113 of the Tax Administration Act 1994.

The CIR has issued *Standard Practice Statement 16/01: Requests to amend assessments*² (SPS 16/01). SPS 16/01 sets out the process that the CIR will use to consider s 113 requests³. This statement sets out the s 113 process for considering whether the circumstances are appropriate for the CIR to agree to retrospectively alter an amount of shareholder's salary, irrespective of whether this alteration increases or decreases the amount of shareholder's salary.

Unless specified otherwise, all legislative references in this SPS are to the Tax Administration Act 1994 (the TAA).

¹ Search Keywords: SPS 18/01

² Published in *Tax Information Bulletin* Vol 28, No 4 (May 2016) at page 12 and on Inland Revenue's website www.ird.govt.nz (search keywords: SPS 16/01)

³ From [32].

Application

This SPS applies from 1 April 2018 and replaces *Standard Practice Statement 05/05: Retrospective adjustments to salaries paid to shareholder-employees*. This statement should be read with *Standard Practice Statement 16/01: Requests to amend assessments* and *Standard Practice Statement 09/02: Voluntary disclosures* (or any subsequent statements issued in replacement).

Standard practice

Process used to consider section 113 requests

1. The CIR acknowledges that in a self-assessment system taxpayers will occasionally take an incorrect tax position and that correcting these positions is an integral part of tax administration. Section 113 contains a broad discretion allowing the CIR to amend assessments to ensure their correctness.

2. As stated in *Westpac Securities NZ Ltd v Commissioner of Inland Revenue*⁴ (at [65]):

...the focus of the inquiry as to whether the power was available would be centred on whether the amendment the taxpayer seeks to have made will ensure the assessment is correct when amended, even if it was also correct beforehand.

The CIR's policy is generally to use the discretion to amend assessments that are requested where the amendment will lead to the issuing of a correct assessment.

3. In undertaking this approach, the CIR breaks the exercise into phases. SPS 16/01, from [34], describes these phases in the following terms:

Phase one: An initial examination of the request. If it is clear and obvious that an error has occurred and that the error can be easily corrected, then the amendment will be made, subject to the application of phase four; the request will not have to progress through stages two and three. Conversely, if it is clear and obvious that agreeing to the request will not result in a correct assessment, the request will be declined at this phase.

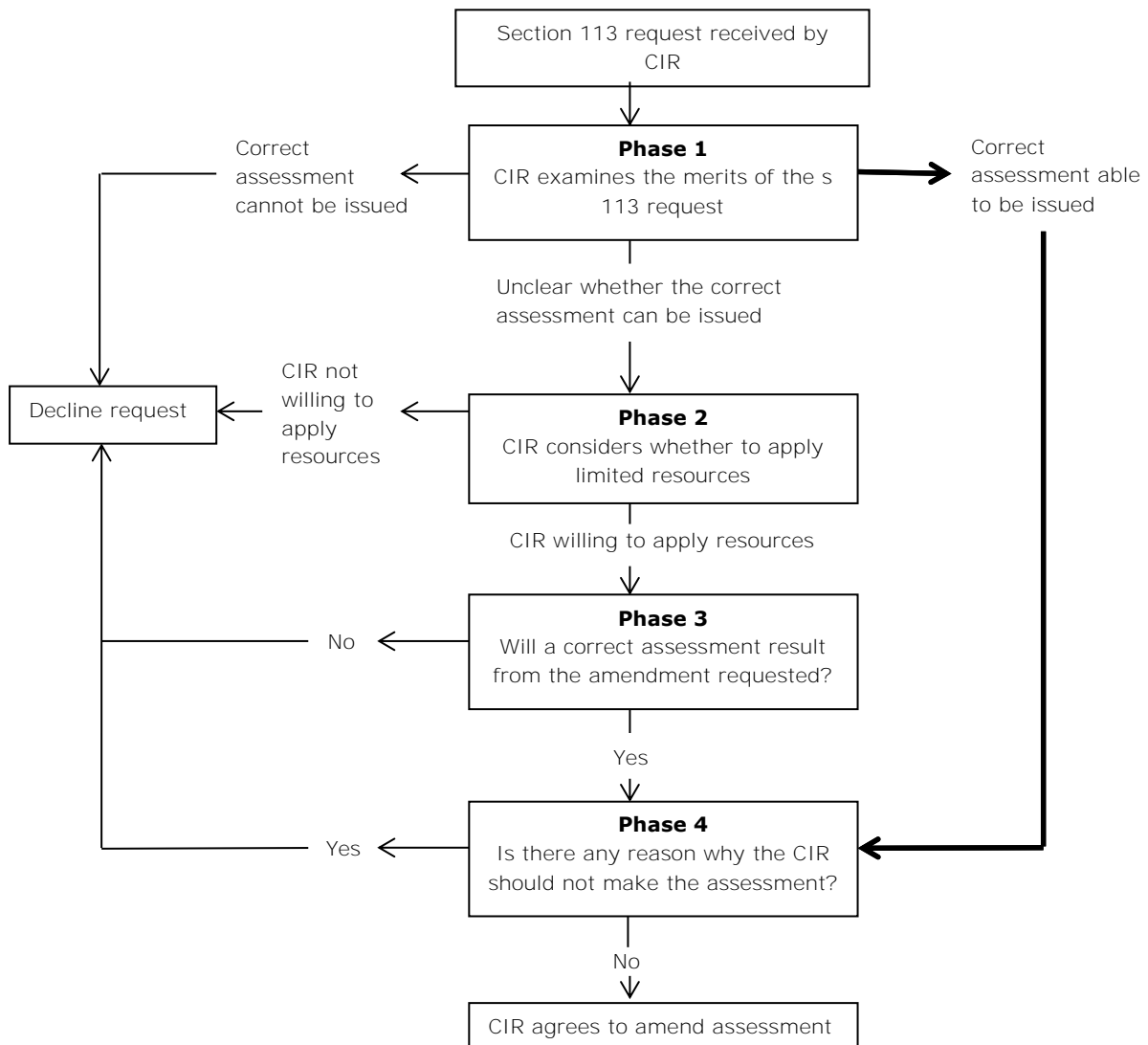
Phase two: If it is unclear whether agreeing to the request will result in a correct assessment being issued, the Commissioner will need to consider whether further limited resources should be applied to consider the request further.

Phase three: In cases where it is decided to apply further resources the Commissioner will consider whether a correct assessment will result from the requested amendment.

Phase four: Determine whether there is any residual reason (other than her limited resources) why the Commissioner should not make the requested amendment.

⁴ [2014] NZHC 3377, (2014) 26 NZTC 21-118

4. The following flowchart illustrates the progress of a s 113 request through the 4 phases:



Correct assessment able to be issued

5. The setting of the amount of a **shareholder's salary** is generally a matter of contract between a company and its shareholder(s). The contractual nature of a salary means that the inclusion of any amount of salary in the company's and shareholders respective income tax returns will allow the CIR to issue a correct assessment.
6. Where the amount of a **shareholder's salary initially agreed between the parties** is found to be in error, the CIR's **recognition of any** mutually agreed changes to correct that error will also allow the CIR to issue a correct assessment.
7. As a correct assessment can always be issued by the CIR, changes in a **shareholder's salary are an example of a s 113 request** that can be progressed from phase 1 directly to phase 4 (see arrow on right of above flowchart).

Timing and matching principles

8. Sections EA 4 and EI 9 of the Income Tax Act 2007 (“the ITA”) set out the timing and matching principles relevant to the tax consequences of shareholders’ salaries. Put simply, an amount of a **shareholder’s salary is assessable to the shareholder in the same income year as deductibility is available to the paying company**. Assessability is determined by whether, and when, an amount of salary is deductible.
9. An amount of salary does not have to have been physically paid before deductibility occurs. It is sufficient that a company is definitively committed to the expenditure⁵ even where the exact quantum of that expenditure is yet to be determined.
10. Section EA 4(3) of the ITA states that the time for paying an amount of **shareholder’s salary is:**

...the last day by which the person could file a return of income for the income year if the time for filing were extended to its maximum under section 37(5) of the Tax Administration Act 1994.
11. The fact that there is a legislative timeframe for the payment of an amount of **shareholder’s salary does not affect the CIR’s ability to correct the quantum of any shareholder’s salary where an error has occurred in calculating the amount of that shareholder’s salary** (see further at [20]–[22] below).

Considering phase four requests

12. In discussing phase 4, SPS 16/01⁶ states that where a request reaches this stage (because the CIR is satisfied that the amendment requested will lead to the making of a correct assessment) the assessment will be made unless making the assessment would undermine the integrity of the tax system. SPS 16/01 states (from [59]) that:

59. These circumstances can include, for example:

- (a) Where the request is, or is part of, a tax avoidance arrangement.
This is because, while the requested adjustment may be a correct interpretation of the law when considered in isolation, the Commissioner would not be convinced that the resulting assessment would be correct given the presence of tax avoidance. The Commissioner’s view of the law on tax avoidance is set out in Interpretation Statement *IS 13/01 – Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007*⁷
- (b) Where a taxpayer requests the Commissioner to amend an assessment from one correct tax position to another position that is also correct

When a taxpayer requests the Commissioner to amend an assessment from one correct tax position to another tax position that is also correct, the fact the original position was correct is a factor the Commissioner may take into account in deciding whether to use her discretion to make the amendment requested. As stated by Clifford J in *Westpac* at [67]:

There could be any number of valid reasons why the Commissioner may decline to exercise her discretion in situations of regretted correct tax positions including where the taxpayer appears to be gaming the system. ... The fact that Westpac, a **well resourced, sophisticated and well advised taxpayer says that it “erred”** when the relevant offset elections were made may be a proposition that the Commissioner will need to consider carefully when deciding whether or not to exercise her discretion.

⁵ *King v C of IR* (1973) 1 NZTC 61,107; [1974] 2 NZLR 190; *CIR v Glen Eden Metal Spinners Ltd* (1990) 12 NZTC 7,270.

⁶ At [59]

⁷ More information on this statement may be found on Inland Revenue’s website www.ird.govt.nz (search keywords: IS 13/01)

Two matters flow from these judicial comments. Firstly, whether a taxpayer erred in taking their original tax position is a factor the Commissioner may take into account in deciding whether to make the requested adjustment. A taxpayer could be said to have “erred” where they did not take the tax position they intended, through mistake or oversight, or the tax position they took, though technically possible and therefore already correct, was not one they would have taken if they had been in possession of all the relevant facts at that time.

If the request arises from such an oversight, it is more likely the amendment will be made than if the request is simply the result of the taxpayer changing their mind. This is because the TAA places an obligation on taxpayers to make self-assessments correctly and it is not contemplated that unlimited additional variations can be made at a cost to the Commissioner. Amendments should not be able to be made merely at will. On this basis, a request for multiple changes to tax positions will also be unlikely to be agreed to. The Commissioner may also take into account the **fact a taxpayer is “well resourced, sophisticated and well advised”, and therefore generally better equipped to be able to evidence the fact that they erred in taking their original position.**

60. To allow an amendment in these circumstances may have a **negative impact on other taxpayers’** perceptions of the integrity of the tax system, especially as they relate to the concepts of statutory timeframes⁸, certainty and their own future voluntary compliance. In these instances, the decision to not apply the discretion will be made by a senior Inland Revenue officer, with advice from the Legal and Technical Services group.

Part of a tax avoidance arrangement

13. If the CIR considers that declaring a new amount of salary was part of a wider tax avoidance arrangement, or is the arrangement, the requested adjustment will not be made for the reasons stated at [12]⁹ above.

Changing from one correct tax position to another correct tax position

14. A s 113 request will progress through phase 4, and the requested salary adjustment will be made, if a taxpayer is able to demonstrate to the CIR’s **satisfaction that they “erred” in taking their original tax position.** That is, the quantum of salary initially declared was declared in error.
15. As stated at [12]¹⁰ above, it is the CIR’s view that a taxpayer can be said to have **“erred” where they did not take the tax position they intended, through mistake or oversight, or the tax position they took, though technically possible and therefore already correct, was not one they would have taken if they had been in possession of all the relevant facts at that time¹¹.**
16. A taxpayer will need to provide the CIR with evidence that the initial salary was declared in error. It will not be enough to show that some other tax position in their tax return is in error and that, as a result of that error, they now wish to alter the amount **of shareholder’s** salary.
17. For example, in *Case U27¹²* a company’s accountant relied on incorrect information supplied to him by the company’s majority shareholder. As a result of this misinformation, the company’s profit was overstated. The company had a policy of declaring salaries at no more than the company’s profit in any year. As a result of the overstatement of the company’s profit, the amount of shareholders’ salaries was also overstated. The CIR agreed to use the s 113 discretion to correct the

⁸ *CIR v Wilson* (1996) 17 NZTC 12,512; *Charter Holdings Ltd v CIR* [2015] NZHC 2041

⁹ At 59(a)

¹⁰ At 59(b)

¹¹ See SPS 16/01 at [59(b)] and [12] above

¹² (1999) 19 NZTC 9,261

errors made in the company's income tax return, but did not agree to amend the **shareholder's salary**.

18. In finding for the taxpayer, the Taxation Review Authority held that the company was not irretrievably bound by the amount **of shareholder's salary that had been** declared in error. To find otherwise would, in the words of the Authority, be so patently unjust that a Court would only come to such a conclusion if inescapably driven to do so by binding authority or the clearest parliamentary intention. In the **Court's view, no such authority or intention existed**.
19. In *Case U27* the taxpayers were able to show that they had erred in **both** the tax positions taken to arrive at the company profit **and** the amount **of shareholder's** salary initially declared. In this circumstance it would be appropriate for the CIR to apply the s 113 discretion to correct both errors made by the taxpayer. If the Court had found that there had been no error in declaring the amount of **shareholder's salary, the CIR** would not have been bound to use the s 113 discretion¹³. See also [24] below.

How errors will be corrected

20. In correcting errors made in tax returns, s 113 contains a broad discretion allowing the CIR to amend assessments to ensure their correctness.
21. **Declaring an amount of shareholder's salary is** generally a matter of contract between a company and its shareholder. Where a shareholder and company agree that an error has occurred in quantifying the amount of salary to be declared for a year, that error can be corrected without the original contract being voided and a new contract entered into. As long as the declaration of the original salary (the salary declared in error) met the requirements of the timing and matching principles contained in ss EA 4 and EI 9 of the ITA, these sections will not impact on the ability of the CIR to correct the error.
22. Where the shareholder and company are able to provide evidence to the CIR's **satisfaction that an error has been made in the quantum of shareholder's salary** originally declared, the CIR will correct that error. For the above reasons it is not relevant whether the new salary is greater or less than the original salary that was declared.

All parties must agree

23. As the amount of shareholder salary is a matter of contract between a shareholder and a company, the CIR will not consider using the s 113 discretion to amend assessments unless both parties to that contract agree that an error has been made. Until agreement is reached, it is the CIR's **view that any dispute between** the shareholder and the company is a civil matter that is properly addressed, if necessary, through the Courts¹⁴.

Amending shareholder's salary where no error has occurred

24. Where taxpayers request that the **shareholder's salary be amended and they are** unable to provide evidence that the original salary was declared in error, any amendment to that original salary can only have prospective effect. This is made clear by Willey DCJ in *Case U27*, in which he discussed the outcome of *Case Q49* and stated, "it was simply that the company and the shareholders later repented of

¹³ See for instance, *Case Q49* (1993) 15 NZTC 5,254.

¹⁴ See for instance, *Spence v Commissioners of Inland Revenue* 24 TC 311

their bargain and sought to reverse it. No questions of restitution or rectification arose and therefore any new arrangement which they were free to enter into could only have prospective effect". See also comments made in SPS 16/01 (at [59(b)]) and at [12] above.

Examples of when the Commissioner generally will agree to adjust an amount of shareholder's salary

When the amount of company profit is shown to be in error:

25. Where:

- the CIR has agreed to use the s 113 discretion to correct an error in a **company's accounts**, or
- the taxpayer otherwise agrees that the CIR is able to correct an error in the company accounts (by signing an agreed adjustment, for instance),

the process set out in SPS 16/01 will be followed. That is, the CIR will agree to **adjust an amount of shareholder's salary previously declared, but only** where the taxpayer can also **evidence the fact that, due to the error in the company's accounts**, this amount of salary is now also in error. This could occur, for instance, in the following situations:

- The company's profit has been amended and the company and shareholder have historically agreed that all company profit will be declared as salary to the shareholder (and this agreement has not changed).
- The company's profit has been amended and the company and shareholder have historically agreed that a fixed percentage of company profit will be declared as salary to the shareholder (and this agreement has not changed).
- The company and shareholder have historically agreed that salary will only be declared out of company profits and not losses (and this agreement has not changed). Where an amendment to the company accounts sends the company from a profit to a loss situation (or vice versa), then the appropriate salary adjustment may be made.
- The company and shareholder are otherwise able to evidence that, had they been aware of the correct level of company profit, they would have declared an amount of salary that differs from that originally declared. For instance, the taxpayers may be able to successfully argue that altering the level of **shareholder's salary would be, from an accounting perspective, the most logical treatment of the salary in the circumstances.**

When the amount of company profit is not in error:

26. The CIR may agree to exercise her s 113 discretion where the company and shareholder are able to provide **evidence that the amount of shareholder's salary** shown in the company accounts (and returned as income by the shareholder) was not the amount that had been agreed at the time the salary was declared. That is, the amount of salary shown in the returns of income is factually incorrect. For example, the amount **of shareholder's salary may have been the subject of arithmetic, transposition or keying error.**

Examples of when the Commissioner will generally not agree to adjust an amount of shareholder's salary

When the amount of adjusted salary is or is part of a tax avoidance arrangement:

27. No adjustment will be made. See further at [12] and [13] above.

When the taxpayer is unable to provide evidence that the original salary declared was declared in error:

28. No adjustment will be made.

29. As no error has occurred any adjustment can only be prospective from the date that a change in salary occurred. For example, rather than an error having occurred, **the request may arise out of an intention to adjust the shareholder's salary to alter the shareholder's child support liability, to increase the shareholder's entitlement to family assistance, or to assist with the company's cash flow.** See also SPS 16/01 (at [59(b)]), and [12] and [24] above.

Not all of the parties to the contract agree that an error has occurred:

30. No adjustment will be made.

31. As the amount of shareholder salary is a matter of contract between a shareholder and a company, the CIR will not consider using the s 113 discretion to amend assessments unless both parties to that contract agree that an error has been made. Until agreement is reached, it is the CIR's **view that any dispute between the shareholder and the company is a civil matter that is properly addressed, if necessary, through the Courts.** See also [23] above.

This Standard Practice Statement is signed on 30 January 2018

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APPENDIX

Tax Administration Act 1994

Section 113 Commissioner may at any time amend assessments

- (1) **[Amendment at any time]** Subject to sections 89N and 113D, the Commissioner may from time to time, and at any time, amend an assessment as the Commissioner thinks necessary in order to ensure its correctness, notwithstanding that tax already assessed may have been paid.
- (2) **[Fresh liability]** If any such amendment has the effect of imposing any fresh liability or increasing any existing liability, notice of it shall be given by the Commissioner to the taxpayer affected.

Income Tax Act 2007

Section BD 3 Allocation of income to particular income years

...

Income credited in account

- (4) Despite subsection (3), income that has not previously been derived by a person is treated as being derived when it is credited in their account or, in some other way, dealt with in their interest or on their behalf.

Section EA 4 Deferred payment of employment income

...

Extension of payment period for shareholder-employee

- (3) For employment income paid to a shareholder-employee, the 63 day period for payment in subsection (1)(b)(i) is extended until the last day by which the person could file a return of income for the income year if the time for filing were extended to its maximum under section 37(5) of the Tax Administration Act 1994.

Section EI 9 Matching rule for employment income of shareholder-employee

Matching if company allowed deduction

- (1) If a company is allowed a deduction for expenditure on employment income that is paid or payable to a shareholder-employee under section CE 1 (Amounts derived in connection with employment), the income is allocated in the way set out in subsections (2) and (3).

Allocation to deduction year unless unexpired

- (2) The income is allocated to the income year to which the deduction allowed to the company is allocated, except for an amount equal to any unexpired portion **for the income year of the company's expenditure under section EA 4** (Deferred payment of employment income).

Allocation when no longer treated as unexpired

- (3) The remaining income is allocated to the income year or years in which the corresponding amount of **the company's expenditure on the income is no longer treated as an unexpired portion.**