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Standard practice statement ED0190: Retrospective adjustment to salaries paid to shareholder-employees

Introduction

1. The Law Society welcomes the opportunity to comment on Exposure Draft *ED0190 Retrospective adjustments to salaries paid to shareholder-employees* (Exposure Draft).
2. In general, the Law Society agrees with the approach set out in the Exposure Draft. In particular, it is important that the Exposure Draft applies to retrospective adjustments for both increases and decreases to a shareholder's salary. However, the Law Society has concerns regarding both the narrow scope of the Exposure Draft and its potential misapplication in practice by Inland Revenue.

Comments

Reference to underlying matching principle

3. Currently, paragraphs 6 to 8 of the Exposure Draft simply treat the setting of shareholder salary as a matter of contract law and fail to recognise the matching principle, which underpinned the Commissioner's current policy in SPS 05/05 *Retrospective adjustment to salaries paid to shareholder employees*.
4. It is common practice for a closely-held company to pay all or most of its taxable profit in each income year as remuneration to working proprietors. In other words, the purpose of the shareholder/employee contract will often be to match the shareholder salary and the company's net profit.
5. Even before the quantification of that profit is possible, the law requires that the company has incurred a deductible expense (and the proprietor has derived an equivalent remuneration). This was confirmed by the Court of Appeal in *CIR v Glen Eden Metal Spinners Ltd* (1990) 12 NZTC 7,270 which has now effectively been codified in section EA 4(3) of the Income Tax Act 2007.
6. Significantly, in reaching that decision, the majority of the Court of Appeal explained that:
"The legal principles are clear. An expenditure is incurred in an income year although there has been no actual disbursement if in that year the taxpayer is definitively committed to that expenditure (King v C of IR (1973) 1 NZTC 61,107; [1974] 2 NZLR 190). There must be an ascertained liability but it is not necessary to constitute a definitive commitment that that liability is indefeasible: the taxpayer is equally committed whether or not its present liability may subsequently be diminished or avoided by the action of others."

7. This statement recognises not only that the quantum of the shareholder salary may not yet be determined but also presumes a matching between the company and its shareholders. Accordingly, the Law Society recommends that the Exposure Draft recognise that where there is an error in the company's income tax return and, as a result, the shareholder's salary, the matching principle as acknowledged in *Glen Eden Metal Spinners* applies.

Narrow interpretation of *Westpac Securities NZ*

8. At paragraph 12, the Exposure Draft explains:

"... the Commissioner'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 time."

9. However, the Exposure Draft then continues at paragraph 13:

"A taxpayer will need to provide evidence that the initial salary was declared in error. It is not 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."

10. The Law Society considers that the decision in *Westpac Securities NZ Ltd v Commissioner of Inland Revenue* [2014] 26 NZTC 21-118 decision is correct. In *Westpac Securities NZ* the only "error" identified was that foreign tax credits available to the taxpayer were not claimed – yet the High Court upheld the taxpayer's claim that the lack of "error" in the original return did not preclude the exercise of the Commissioner's discretion under section 113.
11. The Law Society submits that paragraph 13 of the Exposure Draft amounts to an incorrect and narrow interpretation of *Westpac Securities NZ* and should be amended to recognise the matching principle. In most instances, the rationale for requesting a retrospective adjustment to shareholder salary is not that the quantum of that salary was originally incorrect, but that subsequent reassessment of the company's profit necessarily requires a corresponding adjustment to the remuneration of the proprietor.
12. Notably, where the matching principle is not applied, there can be unexpected (and unforeseeable) adverse consequences. For example, the Law Society is aware of an instance where a company was inadvertently claiming tax deductions for private expenditure incurred by the proprietor. When this error was disclosed to Inland Revenue, rather than treating these private amounts as retrospective adjustments to the proprietor's shareholder salary, these amounts were instead treated as deemed dividends, with no imputation credits attached. This in turn created unexpected (and unforeseeable) adverse consequences for the company's imputation credit account, with that deemed dividend affecting the company's benchmark dividend ratio.
13. Alternatively, if the amounts of those private purchases were treated as advances by the company to the proprietor, they would have resulted in that shareholder's current account becoming overdrawn, which would then have created unexpected fringe benefit tax consequences.
14. As it is presumably not the Commissioner's intention to create further discrepancies as a result of the company's reassessment, the Law Society submits that the Exposure Draft should specify that in most instances, retrospective amendment to the shareholder salary is the more appropriate tax consequence for both the company and the proprietor.

Application of the Contractual Mistakes Act 1977

15. Section 6 of the Contractual Mistakes Act 1977 provides that relief can be granted under section 7 of that Act where there is a mistake by one party which is known to the opposing party or is common or mutual. In broad terms, there must be a material mistake which influenced the decision to enter into the contract – the mistake goes to a material term of the contract. A mistake in relation to the interpretation or implementation of the contract is not a mistake in relation to the contract.
16. The errors identified in paragraph 23 of the Exposure Draft are concerned with errors in relation to the calculation of an agreed term of a contract. As the mistake is in relation to the implementation of the contract, section 7 of the Contractual Mistakes Act 1977 cannot apply. In these circumstances, the Commissioner would not need to void the contract and replace it with a new one; she merely has to give effect to the original terms agreed upon by the parties by acknowledging that the calculation was incorrect in the first instance.
17. The Law Society recommends that the Exposure Draft is amended to recognise that where the matching principle applies, the Contractual Mistakes Act 1977 may not necessarily apply.

Adjustment from net loss to net profit

18. The Law Society is aware of a recent example of Inland Revenue refusing a request for an adjustment of shareholder salary to ensure matching following a voluntary disclosure with respect to deductions wrongfully claimed by a company. In that instance, the adjustment to the company's tax position took it from a small net loss (with no shareholder salary being paid) into a net profit. In previous years, where a profit had been generated, a shareholder salary had been paid.
19. The reason given for the refusal was that both SPS 05/05 and the Exposure Draft applied only to permit retrospective adjustments to the quantum of shareholder salary that had been originally returned, but did not allow a retrospective shareholder salary where no such salary was originally returned (because the company had suffered a net loss). Inland Revenue advised that, as those particular circumstances were not addressed in either SPS 05/05 or the Exposure Draft, no retrospective adjustment to shareholder salary would be permitted.
20. Accordingly, the Law Society recommends that the Exposure Draft make explicit provision for the factual circumstances outlined above whereby a retrospective shareholder salary may be permitted even when no salary was originally paid in that year (because a company had previously returned a net loss). Provided the factual circumstances set out in paragraph 23 of the Exposure Draft are met, an original shareholder salary of "nil" should be able to be retrospectively amended to give effect to the contractual intention of both the company and the proprietor.

Type of evidence

21. Paragraph 26 of the Exposure Draft provides that no adjustment will be made when the taxpayer is unable to evidence that the original salary was declared in error. This applies in both the scenario when the company profit is shown to be in error and when the company profit is not in error.
22. The Law Society recommends the Exposure Draft provide specific examples of the types of evidence which may be sufficient to satisfy the Commissioner that the matching principle should apply when the amount of company profit is in error. In practice, shareholder employment agreements are seldom evidenced in writing. In these circumstances, it is not clear whether evidence of historic computations would be sufficient or if some more formal

agreement between employee, shareholder and directors (bearing in mind that these will be often be the same person), affidavit or resolution would be required.

Non-tax consequences

23. At paragraph 27, the Exposure Draft expressly excludes retrospective adjustments to shareholder salaries where the request arises out of an intention 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.”
24. While the Law Society does not oppose the rationale for those exclusions, it should be made clear that those non-tax consequences should not preclude the retrospective adjustment of shareholder salary where the other criteria (in paragraphs 23 or 24) are still satisfied. So if the taxpayer satisfies the other criteria in the Exposure Draft, then the retrospective adjustment should be allowed under the Exposure Draft, even though the effect of that adjustment to the proprietor would include those non-tax consequences.

Requirement for agreement by “all parties”

25. At paragraph 29, the Exposure Draft requires that “all parties” agree to the shareholder salary adjustment.
26. The Law Society agrees the retrospective change cannot be made without the agreement of both the company and shareholder concerned, notwithstanding the possible application of section 89C(k) of the Tax Administration Act 1994. However, the Law Society submits that the Exposure Draft should specify that this requirement applies separately to each proprietor for their respective share of the company's profit and not to all the proprietors collectively. It would be both impractical, and potentially a breach of the individual secrecy requirements in section 81 of the Tax Administration Act 1994, for the Commissioner to require the consent from all proprietors before making a retrospective adjustment to any of the proprietor's shareholder salary.

Reference to SPS 09/02 – Voluntary Disclosures

27. As the Exposure Draft also refers to retrospective adjustments that increase a shareholder’s salary, it should make reference to *SPS 09/02 – Voluntary Disclosures*.

Conclusion

28. This submission has been prepared with the assistance of the Law Society’s Tax Law Committee. If you wish to discuss this further please do not hesitate to contact the committee convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967), jo.holland@lawsociety.org.nz).

Yours sincerely



Kathryn Beck
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