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## DOES MY COMPANY NEED TO PAY ME A MARKET SALARY?

The IRD cases against Penny & Hooper have significance because of the way IRD is intending to apply the principles to common business structures.

The overriding general principle is that diversion of income from personal exertions to a person/entity at a lower tax rate is tax avoidance for which interest and heavy penalties will be imposed.

IRD's expectation is that individuals will receive a market salary from their company unless there are good commercial reasons not to do so e.g. the company's need for capital investment or the business being in financial difficulties.

If investigated by IRD it may be necessary to prove that a market salary has been paid or prove the good commercial reasons not to do so. It would be prudent to assess a market salary each year and if applicable document any reasons for not paying a market salary. An IRD investigation could arise many years after the event.

Notwithstanding the above there is no law that requires a market salary to be paid. IRD's stated focus is not on a market salary but instead the expectation that ordinarily 80% of profits which are distributed by salary or dividends should be attributed to the individual whose exertion generate the profits.

This is a so-called safe harbour, i.e. if 80% of the profits are distributed to the individual then no investigation will be made by IRD.

The IRD has not given any guidance as to how you make that assessment where for example there are two or three shareholder employees and where some of the profits are derived from the exertions of non-shareholder employees or from utilisation of capital assets.

Until future IRD rulings or court cases clarify the position it would be wise to document the reasons why 80% of the profits have not been allocated to the owners undertaking the personal exertions in the business each year and to retain the documented reasons in case of future investigation by IRD.

Although the IRD is likely to look more closely at those offering professional services, we would suggest that tradesmen should not think they will be immune to an investigation. For example payment by the company of excessive amounts to other family members such as a spouse "doing the books".