Inland Revenue
Te Tari Taake

19 March 2019

QUESTION WE'VE BEEN ASKED

QB 19/01

What are the requirements for claiming tax deductions for payments to family members for services?

This Question We've Been Asked (QWBA) is about claiming tax deductions for payments to family members for services. It will be of interest to those paying family members for services from a business or other income earning activity.

Key provisions

Income Tax Act 2007, ss DC 5, GB 23 and GB 25. Note: Legislative references are to the Income Tax Act 2007 unless otherwise stated.

Key terms

Your business means any business or other income earning activity carried on by you on your own account, in partnership, or through a company.

Close company means a company controlled by five or fewer natural persons.

Partner means civil union partner or a de factor partner

Spouse means a married partner

Question

What are the requirements for claiming tax deductions for payments to family members for services?

Answer

To claim a tax deduction for payments to family members for services:

- the family member must provide services to your business;
- the amount paid must not be excessive; and
- if the family member is your spouse or partner, you must have the Commissioner's prior approval for a deduction unless you run your business through a company.

Explanation

1. You cannot split the income you earn between your family members for income tax purposes. To claim a tax deduction for payments to a family member for services, the family member must provide services to your business and the amount paid must not be excessive. You must not pay the family member more than what you would pay a non-family member for the same services. In addition, if the family member is your spouse or partner, you must have the Commissioner's prior approval for a deduction unless you run your business through a company.

2. This QWBA replaces three items:

   - "Wages paid to spouse who cooks for permanent employees—deductibility" *Tax Information Bulletin* Vol 6, No 1 (July 1994): 5;

- "Details to be supplied to Inland Revenue when seeking a deduction for payments to spouse" *Tax Information Bulletin* Vol 6, No 7 (December 1994): 2-3; and
- "Reasonable wages—payments to spouse" *Tax Information Bulletin* Vol 7, No 7 (January 1996), 28.

Family members

3. Family members are:

- your spouse or partner;
- your parents, children, sisters, brothers, grandchildren, and grandparents and the spouses and partners of those persons;
- your spouse or partner's parents, sisters, brothers, grandchildren, and grandparents;
- yours and your spouse or partner's adoptive parents, adopted siblings, children, and grandchildren;
- the trustee of a trust that any of these people has or can benefit under.

Family member must provide services to your business

4. You must be able to show that the family member provided services to your business. This is even if you have the Commissioner's prior approval to deduct the payment (see [9]-[17]). Depending on the circumstances, the types of evidence that might be relevant include:

- a wage book or diary (manual or electronic) recording the dates, hours worked, and nature of the services provided by the family member;
- a vehicle log book recording the dates and nature of business travel undertaken by the family member and other documentation supporting the purpose of the travel such as invoices for parking and other services or goods acquired or provided on the dates travelled;
- copies of any PAYE payment information;
- an employment contract or contract for services;
- if the family member is an independent contractor or otherwise in business on their own account, invoices detailing the nature and extent of the services provided;
- bank statements or other documents showing the amounts you paid to the family member for the services provided.

Payments must not be excessive

5. The amount paid must not be excessive for the services the family member provides. This includes where you have the Commissioner's prior approval for a deduction and subsequently the amount you pay your spouse or partner, or the hours they work, or the nature of the services they provide changes (see [9]-[17]). If the amount paid is excessive, the Commissioner may reallocate the income of the business based on what is considered reasonable and, in the case of a company, treat the excess as a dividend derived by the family member (ss DC 5(3), GB 23, GB 24, and GB 25).

6. The Commissioner considers payments to family members for services to be excessive when the amount paid is more than a reasonable amount for the services provided. This is explained in "QB 14/09: Income tax – meaning of 'excessive remuneration' and 'excessive profits or losses' paid or allocated to relatives, partners, shareholders or directors" *Tax Information Bulletin* Vol 26, No 9 (October 2014): 22.

7. Exemptions may apply in the case of:

- contracts of employment, engagement, or partnership meeting certain requirements (s GB 24);
- an adult employed substantially full-time in the business of a close company and who manages or administers the company, provided the amount they are paid is not influenced by their relationship with a shareholder or director (s GB 25(3)).

8. The exemptions are explained in QB 14/09 at [20] and [52].

Commissioner's prior approval

9. If the family member is your spouse or partner, you must have the Commissioner's prior approval for a deduction, unless you run your business though a company (s DC 5–see [11]). Approval is required whether you pay your spouse or partner a salary or wages, a commission, or another amount for services.

10. Approval may be granted only if:

- the Commissioner considers the payment is for services rendered;
- the services are not domestic services or otherwise services connected with the home, although, if you are a farmer, the Commissioner may approve a deduction for amounts you pay your spouse or partner to cook for farm employees;
- the services are provided in earning income from your business;
- a deduction for the payment has not been claimed.

11. Section DC 5 provides:

> DC 5 Payments to spouses, civil union partners, or de facto partners: services
>
> *No deduction without approval*
>
> (1) A person is denied a deduction for a payment to their spouse, civil union partner, or de facto partner for services without the Commissioner's approval.
>
> *When Commissioner can give consent*
>
> (2) The Commissioner may approve the deduction only if—
>
> (a) the Commissioner considers that the payment is for services rendered; and
>
> (b) the services are not domestic services or otherwise services connected with the home; and
>
> (c) the payment is incurred by the person exclusively in deriving their assessable income; and
>
> (d) the approval is granted before the deduction is claimed.
>
> *Relationship with section GB 23*
>
> (3) This section is overridden by section GB 23 (Excessive remuneration to relatives).

Link with subpart DA

(4) This section overrides the general permission.

12. You may apply for approval to deduct payments you have already made during an income year. You have up until the time you file your tax return to get approval. However, it may be a good idea to apply before you start paying your spouse or partner. The Commissioner cannot backdate approval after a deduction has been claimed in your tax return. Even if the amount paid is not excessive, a deduction claimed without prior approval is denied and your spouse or partner will still need to treat the payment as income.

13. You must make a new application for approval if you increase the amount you pay your spouse or partner. Otherwise, you do not have to make a new application for approval every year.

14. To apply for approval, you need to send the Commissioner details of:

- the nature of your business;
- full details of the services your spouse or partner provides;
- the average number of hours your spouse or partner works each week and the number of weeks worked each year;
- if others provide the same services to your business as your spouse or partner, details of the services the others provide and the payments you make for them; and
- the amount you pay your spouse or partner and how the amount is paid (for example, at regular intervals or periodically or by crediting an account).

15. Whether your spouse or partner provides services as an employee or independent contractor, similar details are required. Send the details to Inland Revenue using your preferred method of contact (see Inland Revenue's website for contact details: www.ird.govt.nz).

16. The Commissioner will grant approval if satisfied the payments are for services rendered and if the other requirements of s DC 5 are met (see [10]).

17. If you run your business through a company, prior approval is not required to deduct payments to your spouse or partner for services. However, services must be provided and the amount paid must not be excessive.

Examples

18. The following four examples explain how the law applies.

Examples

Example 1 – Payments made to spouse or partner for services

Year 1

Jan carries on a business as a florist. Jan employs spouse Sam to help with deliveries during weekends. Jan keeps a diary and records the hours Sam works and the deliveries Sam performs and pays Sam a market wage. Jan deducts PAYE and ACC premiums and pays the net amount to Sam electronically at the end of each month.

At the end of the income year, before filing an income tax return, Jan applies to Inland Revenue for approval to deduct the payments made to Sam. Inland Revenue grants approval for Jan to deduct the wage paid to Sam because:

- Jan supplies the required details about Sam's employment to Inland Revenue;
- the services Sam provides are not domestic services and Jan incurs the payment exclusively in deriving assessable income;
- the payments are not excessive compared with the amount of wages paid to delivery drivers performing similar kinds of deliveries.

Jan files an income tax return claiming a deduction for the payments.

Year 2

In the next income year, Sam agrees to do bookwork for Jan's business as well as helping with deliveries. Jan increases Sam's wages for the additional hours and services Sam provides. Jan does not get Inland Revenue's approval to deduct the increased payment before filing an income tax return claiming a deduction.

A new application for approval is required because the increase in Sam's wages is due to additional hours and services Sam provides. A deduction for the increased payment is not allowed because Jan did not receive Inland Revenue's prior approval. Sam must still treat the increased payment as income.

Example 2 – Amounts paid to children

Talla and Filo operate a dairy farm in partnership. They employ their 13-year old son to help on the farm and pay him monthly. Talla and Filo advise their son helps with milking, weed control, calf rearing, bringing in cows for milking, and farm maintenance about 10 hours per week.

Talla and Filo keep a wage book for other employees. However, it does not contain any record of work done by their son. Without wage book entries or other evidence to support the work done by their son, Talla and Filo have not shown they are entitled to deduct the amounts they pay him. Their son must still treat the amounts Talla and Filo pay him as income.

Example 3 – Amount paid by company to director and shareholder's partner

Jed carries on a printing business through his company Zeb Ltd. Jed works full time in the business. His civil union partner Soul is primarily responsible for their four children. Zeb Ltd employs Soul and pays him fortnightly. Zeb Ltd files its tax return claiming a deduction for the amount paid to Soul. Soul files his tax return including the amounts received from Zeb Ltd as income.

During an audit, Inland Revenue asks what services Soul provided to the business. Jed responds with a list of tasks, including preparing GST returns, banking, issuing invoices, taking phone inquiries and following up debtors. Jed has kept a diary of the hours Soul spent preparing Zeb Ltd's GST returns. However, neither the diary nor any other available evidence shows Soul having undertaken any of the other tasks.

Zeb Ltd is allowed a deduction for a reasonable portion of the amount paid to Soul, based on the nature and value of services Soul has provided. The excess will be treated as a dividend derived by Soul as he is related to Zeb Ltd's director and shareholder Jed.

Example 4 – Amount paid by real estate agent to spouse

Ashley is a licensed real estate agent. Ashley employs de facto partner Mel, a licensed salesperson. Mel assists Ashley with open homes, phone inquiries, cold calling and other real estate agency work. Ashley does not pay Mel a regular wage but shares real estate commissions from property sales with Mel.

Ashley and Mel file income tax returns for the year:

- Ashley returns real estate commissions received as income and claims a deduction for the amount paid to Mel.
- Mel returns the amount received from Ashley as income.

Ashley has not obtained Inland Revenue's prior approval to deduct the amount paid to Mel. Therefore, Ashley cannot deduct the share of commission paid to Mel.

References

Subject references

Deductions

Income tax

Payments for services

Relatives

Legislative references

Income Tax Act 2007: ss DC 5, GB 23, GB 24, GB 25

Other references

"Details to be supplied to Inland Revenue when seeking a deduction for payments to spouse" *Tax Information Bulletin* Vol 6, No 7 (December 1994): 3.

"QB 14/09: Income tax—meaning of 'excessive remuneration' and 'excessive profits or losses' paid or allocated to relatives, partners, shareholders or directors" *Tax Information Bulletin* Vol 26, No 9 (October 2014): 22.

"Reasonable wages—payments to spouse" *Tax Information Bulletin* Vol 7, No 7 (January 1996), 28.

"Wages paid to spouse who cooks for permanent employees—deductibility" *Tax Information Bulletin* Vol 6, No 1 (July 1994): 5.