

QUESTION WE'VE BEEN ASKED QB 14/09

INCOME TAX – MEANING OF “EXCESSIVE REMUNERATION” AND “EXCESSIVE PROFITS OR LOSSES” PAID OR ALLOCATED TO RELATIVES, PARTNERS, SHAREHOLDERS OR DIRECTORS

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Question We've Been Asked (QWBA) is about ss GB 23, GB 24, GB 25 and GB 25B. It explains the meaning of “excessive remuneration”, “excessive profits or losses” and “excessive amount arising from the application of the look-through company rules” when they are used in those four sections.

During a review of the *Public Information Bulletin* and *Tax Information Bulletin* series published before 1996, four items were identified that deal with the issue of “excessive remuneration”. This QWBA updates and replaces:

- “Wages paid to son during holidays” *Public Information Bulletin* No 29 (February 1966)
- “Excessive remuneration paid to shareholders or relatives of shareholders” *Public Information Bulletin* No 115 (November 1981)
- “TRA decisions – *Case J53* (1987) 9 NZTC 297 or *Case 94* (1987) 10 TRNZ 709 – Directors’ Fees” *Public Information Bulletin* No 164 (August 1987)
- “Family partnerships: Commissioner’s ability to reallocate profits and losses” *Tax Information Bulletin* Vol 7, No 2 (August 1995).

The Public Information Bulletin review has now been completed, see “Update on Public Information Bulletin review” *Tax Information Bulletin* Vol 25, No 10 (November 2013).

Question

1. When is the payment of remuneration or allocation of profits or losses considered to be excessive for the purposes of ss GB 23 to GB 25B?

Answer

2. Any remuneration, profits or losses will be considered excessive where:
 - the amount paid is more than a reasonable reward for the services provided by a relative;
 - the share of partnership profits or losses exceeds the value of the contributions made by the partner;
 - the amount paid by a close company exceeds a reasonable reward for the services provided by a shareholder or director, or was influenced by the **person’s relationship with a shareholder or director**; and
 - the amount allocated under the LTC rules to a relative (aged under 20) who owns an effective look-through interest in an LTC exceeds a reasonable amount having regard to the value of their contributions by way of services, capital and any other relevant matters.
3. Generally, remuneration such as salary or wages incurred in deriving income is deductible. However, ss GB 23 to GB 25B are specific anti-avoidance provisions that the Commissioner can invoke where she considers that:
 - excessive remuneration or income has been paid to a relative (s GB 23);
 - **a partner’s share of partnership profits** or losses is excessive (s GB 23);

- excessive remuneration has been paid by a close company to a shareholder or director, or a relative of a shareholder or director (s GB 25); and
 - excessive income is allocated under the LTC rules to a person (aged under 20) who owns an effective look-through interest in an LTC where a relative of the person also owns an effective look-through interest in the LTC (s GB 25B).
4. The purposes of these provisions are to prevent taxpayers reducing their income tax liability by allocating excessive payments to relatives and others, and to prevent the streaming of excessive losses to relatives to reduce their income tax liability. The amount considered excessive is either not deductible or reallocated.
 5. Where excessive remuneration or income is paid to a relative, shareholder or director, **or a partner's share of partnership profits** or losses is excessive, ss GB 23, GB 25 and GB 25B allow the Commissioner to reallocate the income or losses based on what is considered reasonable.
 6. However, there are exemptions to ss GB 23 and GB 25. Section GB 23 does not apply if a genuine contract of employment or partnership satisfies the conditions set out in s GB 24. Similarly, s GB 25 does not apply if the conditions in s GB 25(3) are met.

Explanation

7. Generally, remuneration such as salary or wages incurred for the purpose of deriving income is deductible. However, when excessive remuneration has been paid to a relative, shareholder or director, ss GB 23 to GB 25 allow the Commissioner to reallocate the excessive amount based on what is reasonable. Section GB 23(3) **similarly allows the Commissioner to reallocate a partner's share of partnership profits or losses** when they are excessive. Section GB 25B allows the Commissioner to reallocate an excessive amount allocated to a relative who is aged under 20 under the look-through company (LTC) rules.
8. Broadly, the purpose of these provisions is to prevent taxpayers from reducing their income tax liability by allocating excessive remuneration, payments, profits or losses to relatives and others.
9. This QWBA is about the specific anti-avoidance provisions dealing with excessive remuneration and allocations of profits and losses in ss GB 23 to GB 25B.

Meanings of key terms

10. Sections GB 23 to GB 25B refer to "excessive" in the context of excessive "income", "remuneration" and "losses". These sections also refer to the Commissioner's ability to reallocate income or losses based on whether these amounts are "reasonable". Section YA 1 defines the terms "income" and "loss". The Act does not define the terms "excessive", "remuneration" and "reasonable".

Ordinary meanings of "excessive", "remuneration" and "reasonable"

11. The *Concise Oxford English Dictionary* (12th edition, Oxford University Press, 2011) provides the following ordinary meanings of the words "excessive" "remunerate" and "reasonable":

excessive ▶ **adj.** more than is necessary, normal, or desirable.

remunerate ▶ **v.** pay for services rendered or work done.

reasonable ▶ **adj.** **1** fair and sensible. ... **3** as much is appropriate or fair; moderate.

12. Based on the dictionary meanings, **the ordinary meaning of “excessive remuneration”** is “more than is necessary or normal for the services rendered or work done”. The meaning of “reasonable” is **“fair and sensible” or “as much as is appropriate or fair”**. The Commissioner can reallocate **“excessive remuneration”** based on what is **“reasonable”**. The Commissioner considers an amount of remuneration **“reasonable” if it is** appropriate or fair for the services provided.
13. This QWBA explains **the Commissioner’s ability to reallocate excessive remuneration, profits or losses** under ss GB 23 to GB 25B. This QWBA discusses the legislation and case law and provides examples to help readers understand the application of the law. The examples cover:
- Paying excessive income or remuneration to a relative – s GB 23(1) and (2);
 - Allocating excessive profits or losses to a partner in a partnership – s GB 23(3);
 - Paying excessive remuneration to a shareholder or director (including a relative of a shareholder or director) – s GB 25; and
 - Allocating excessive income from an LTC to a relative aged under 20 under the LTC rules – s GB 25B.

Who is a “relative”?

14. **“Relative”** is defined in s YA 1. **In summary, a “relative”** is someone who is connected with another person by:
- coming within the second degree of a blood relationship (eg, a sister and brother are within the second degree of a blood relationship; a parent and child are within the first degree);
 - being married (or in a civil union or de facto relationship) and including when one person is married to a person who comes within the second degree of a blood relationship with the other person (eg, a brother and his **sister’s** de facto partner; a daughter and her mother-in-law);
 - being adopted as a child by that person, or being adopted as a child by someone who comes within the first degree of relationship with that person (eg, a parent and their adopted child, or an adopted child and the son of the adopting parent);
 - being the trustee of a trust that a relative has benefited under or is eligible to benefit under.
15. In the definition of LTC, **“relative”** means a person connected with another person in a manner described in any of the first three bullet points above.

Excessive income or remuneration paid to a relative – section GB 23(1) and (2)

16. Section GB 23(1) applies when a person who carries on a business or undertaking employs or engages a relative and the Commissioner considers that the remuneration paid to the relative is excessive for the services they provide. This provision also applies when the person who employs or engages is a company (other than a close company – see s GB 25(1)) and the person receiving the excessive remuneration is a relative of a director or shareholder in the company.

17. Section GB 23(2) similarly applies to a person (person A) who carries on a business in partnership and the partnership employs or engages a relative of person A to perform services for this business. If person A is a company, s GB 23(2) applies if the person employed or engaged is a relative of a director or shareholder of that company and the Commissioner considers that the remuneration paid to the relative is excessive. This provision also potentially applies to a person who owns an effective look-through interest for an LTC, if the LTC employs a relative of that person.
18. In summary, the focus of these provisions is on excessive remuneration paid to relatives for services rendered. Sections GB 23(1) and (2) cover situations where the person carrying on the business or undertaking is a:
- natural person;
 - company (but not a close company);
 - partnership; or
 - LTC.
19. If excessive remuneration is paid to a relative, s GB 23(4) allows the Commissioner to **reallocate the income among the parties "as the Commissioner considers reasonable"**. In applying s GB 23(4) and (6), the Commissioner may take into account the nature and extent of the services the relative provides, the value of contributions made by the respective partners, and any other relevant matters.
20. However, s GB 23(1) and (2) does not apply if the contract is a **"genuine contract" under** s GB 24. Section GB 24(2) provides an exemption if there is a genuine contract of employment, engagement or partnership (see para [36] for discussion of s GB 24 as it applies to partnerships). For a contract of employment or engagement to be treated as a genuine contract under s GB 24(2), the following conditions must all be satisfied:
- the contract is in writing and signed by all parties;
 - the person employed or engaged was aged 20 years or over when the contract was signed;
 - the contract is binding for at least three years;
 - the person employed or engaged has control over their income under the contract; and
 - no part of the income or share of profits derived by the relative or company (of which the relative is a shareholder or director) is a disposition for inadequate consideration.
21. The Court of Appeal considered a corresponding provision to s GB 24(2) (s 106(6) of the Land and Income Tax Act 1954) in *CIR v Lilburn* [1960] NZLR 1,169. The court determined that for an employment contract to be a genuine contract of employment, it must satisfy all of the conditions stated in s GB 24(2). If the contract did not satisfy all the conditions, then it did not come within the s GB 24 exemption for a genuine contract – notwithstanding that it might be genuine in every other way. In *Lilburn* there was no genuine contract of employment because the contract was not binding for at least three years.

22. The following cases provide further guidance on when remuneration paid to a relative is excessive. Judge Barber considered the issue of excessive wages paid to a relative in **Case L64** (1989) 11 NZTC 1,374. His Honour applied the equivalent to s GB 23 and refused to allow the taxpayer to deduct \$100 wages paid to his five-year-old son for two weeks' work on a building site. His Honour said that it was unreal to regard a five-year-old as providing services sufficient to justify any sort of payment.
23. In **Case J24** (1987) 9 NZTC 1,140 one of the issues Judge Bathgate considered was the deductibility of **wages paid to the taxpayer's children** and whether they were excessive. His Honour stated (at 1,147) that the key issue was **"the nature and extent of the work done, rather than the identity of the person who does that work"**. In **Case J24** the amounts paid by the objector to his children would have been reasonable, **if they "equated to an amount the objector would have to pay for an adult to do that same work, or to what it would have cost him, had he been paid wages for his work in his business"** (at 1,148). Judge Bathgate regarded this as a commercially sound and practical method for calculating the appropriate wages. However, the taxpayer was unsuccessful in obtaining a deduction for reasons other than the wages being excessive.
24. In **Case F108** (1984) 6 NZTC 60,072 one of the issues Judge Barber considered was whether the Commissioner was correct in disallowing a substantial amount of a **taxpayer's claim for a deduction for wages. The wages were paid to the 17-year-old daughter of the two principal shareholders and directors of the taxpayer company.** Based on the hours worked and wages received, his Honour concluded that the \$2.48 an hour the daughter was paid was a reasonable rate of pay based on the **daughter's age** and the type of work she carried out.

Summary of cases on excessive remuneration paid to a relative

25. The key focus is on the nature and extent of the work the relative carries out. Any remuneration paid should be based on the nature and extent of the work undertaken by the relative. Whether remuneration is reasonable may depend on **the relative's age and the type of work carried out (Case F108)**. The appropriate remuneration may be determined using an industry standard for doing the same type of work or calculated using a commercially acceptable method (**Case J24; Case F108**). It is unrealistic to claim a deduction for payments made to very young children because they are unlikely to be able to perform any useful work (**Case L64**). Where there is a genuine contract of employment or engagement under s GB 24(2), the Commissioner cannot reallocate any remuneration paid to the relative (**Lilburn**).
26. Based on these cases, the Commissioner reiterates the criteria she will consider for determining a reasonable payment for services rendered as set out in **Tax Information Bulletin** Vol 7 No 7 (January 1996):
- The nature of the services and the circumstances in which they will be or are performed.
 - The knowledge and skills required to carry out the services, including any particular qualifications.
 - The amount of payment that the person carrying out the duties would be paid by another independent employer for like services.
 - The locality where the duties are being performed.
 - The amount the taxpayer would be prepared to pay an arm's length employee undertaking similar duties.

Example 1 – Wages paid to daughter and son working in family business

27. Mary and Bob operate a dairy as a family business. At the end of the 2013 income year, Mary and Bob claim a deduction for \$20,000 wages paid to their children, Caroline aged 17 and David aged 5, for working in the dairy.

Are the wages paid to Caroline and David deductible?

28. The Commissioner will allow a deduction for wages Mary and Bob paid to Caroline provided the wages are reasonable based on the nature and extent of the work she carried out. For example, if **Caroline's wages** are consistent with the industry standard for similar work performed in a dairy, the Commissioner is likely to allow a deduction. However, the Commissioner is likely to disallow any additional amount paid on the basis that the remuneration is excessive. It is up to Mary and Bob to be able to show the Commissioner that the wages paid to Caroline are reasonable for the work that she performs. Evidence showing how the amount of **Caroline's wage was set may be useful.**
29. The Commissioner will not allow a deduction for wages paid to David. The **Commissioner's** view is that children as young as five are unlikely to be able to perform any useful work.

Example 2 – Wages paid to daughter working in family business

30. Ted runs an accountancy business from an office in his home. He employs his 13 year-old daughter Lucy to clean his office (but not the rest of the house) and do filing every Saturday. This generally takes Lucy around four hours and she is paid \$18 per hour. **Ted seeks to deduct Lucy's wages from his income.**

Are the wages paid to Lucy deductible?

31. In this case, Lucy is relatively young. Also, some of the work she is being paid to undertake (cleaning) and the location of the work (home) mean the work might be seen as a normal household chore. When these factors are present, the Commissioner is likely to consider the arrangement more carefully.
32. The onus is on Ted to show the Commissioner that the wages paid to Lucy are reasonable for the work she carries out. If Ted can show that \$18 per hour is a **reasonable amount to pay an arm's length employee with Lucy's knowledge and skills** to undertake cleaning and filing, then he will be entitled to a deduction. Evidence showing that Lucy would be paid a similar amount for providing the same services to a third party would assist with this. As would evidence showing that Ted would have to pay a similar amount for someone else to perform the services to the same standard.

Excessive profit or losses allocated to a partner in a partnership – section GB 23(3)

33. Section GB 23(3) applies when two relatives carry on business in partnership and the **Commissioner considers that a partner's share of partnership profit or losses** is excessive. Section GB 23(3) also applies if one partner is a company and another partner is a relative of a director or shareholder in that company.
34. Under s GB 23(4), where the Commissioner considers that a **partner's share of partnership profits or losses** is excessive, the Commissioner may allocate the profits or losses among the partners based on what the Commissioner considers reasonable.

35. Section GB 23(6) sets out the matters the Commissioner may take into account when applying s GB 23(3) to a partnership. These are the value of the contributions made by the respective partners, by way of services, capital or otherwise and any other relevant matters.
36. As noted above at para [20], s GB 24 provides an exemption to s GB 23(3) where a contract of partnership is genuine. Under s GB 24(2), a contract of partnership is treated as a genuine contract if:
- the contract is in writing and signed by all partners;
 - all partners were aged 20 years or over when the contract was signed;
 - the contract is binding for at least three years (the contract may be dissolved for the reasons set out in ss 36 and 38 of the Partnership Act 1908, which provide for the dissolution of a partnership for reasons such as death, bankruptcy or dissolution by the court); and
 - each partner has control over their share of profits and real liability for their share of losses.
37. The courts have considered the reallocation of partnership profits or losses between partners. In **Case B45** (1976) 2 NZTC 60,394, the Chairman, Lloyd Martin, considered whether the Commissioner was correct in reallocating income between partners in a farming partnership. In this case, no written contract of partnership existed. The partners were a farmer and the trustees of a family trust that farmed land in partnership. The partners owned the land as tenants-in-common in equal shares. The farmer bailed livestock to the partnership. He also worked for the partnership and received a management fee. After the management fee was deducted from **the partnership's** income the profits from the partnership were allocated equally between the partners. However, the Commissioner considered that the amount allocated to the trustees was excessive.
38. In considering the allocation of partnership profits, the Chairman took into account the contributions by the partners, which included the value of land provided by the trustees, livestock bailed by the farmer, and the value of the services the farmer provided. These services were as a working partner who was responsible for the farming operation. The Chairman also noted that the farmer did not receive any payment for the bailed livestock for the first 12 months of the agreement. The Chairman disagreed with the Commissioner and concluded that after deducting a reasonable management fee **for the farmer's services** and subtracting allowable deductions, it was reasonable for the balance of profits to be divided equally among the partners. This was consistent with the contributions of the partners, the partnership accounts and was in accordance **with "ordinary commercial practice in the case of a partnership"** (at 60,405).
39. In **Case M65** (1990) 12 NZTC 2,368 the taxpayer and his wife were insurance consultants for a life assurance company. They carried on their consultancy business in a formal partnership. Relevantly, the husband declared two-thirds of the partnership commission income in his income tax return and the wife declared one-third. This was consistent with what the court concluded that the partnership agreement had intended.
40. Judge Bathgate also noted that the two-thirds and one-third allocation of profits between the husband and wife partners correctly reflected the contributions by the partners by way of services and capital. In other words, the contract of partnership was not a sham and could not be challenged in any other way as not being a genuine partnership contract. As a result, the Commissioner could not reallocate the **taxpayers' income**.

41. In **Case S2** (1995) 17 NZTC 7,012 there was no partnership agreement. The taxpayer and his wife were joint owners and partners in a rental property. From 1989 to 1992, all rental losses were allocated to the husband. However, the Commissioner reallocated the losses equally between the husband and wife.
42. **The taxpayer's accountant put forward three** arguments why the husband should be able to use all of the losses. First, the husband and wife were joint owners of the rental property and they could choose how to divide the profits or losses. Secondly, on the basis that the husband and wife were partners there was no reason why they could not allocate all of the profits or losses to the husband. Finally, as an alternative, the rental losses could be allocated by using the original property investment contributions, which were 80% by the husband and 20% by the wife.
43. Judge Barber acknowledged that there was a partnership in existence in terms of s 5 of the Partnership Act 1908, which sets out rules for determining whether a partnership exists. Further, he noted that under s 27(a) of the Partnership Act 1908 there is a presumption that, in the absence of a partnership agreement, the partners are entitled to share equally.
44. However, his Honour also stated that the Income Tax Act 1976 set out the criteria for the Commissioner to consider (the equivalent to s GB 23(6)) and concluded (at 7,016):
- The husband and wife "could not allocate profits or losses each year solely to their best tax advantage."** Although the wife may have initially contributed 20% of the money used to fund their property investments, this was not determinative. Other factors such as a joint liability under the mortgage and subsequent contributions from the wife indicated that **the husband and wife were equal owners and partners.** [Emphasis added.]
45. Because the husband and wife were equal owners and partners, it was appropriate to share the losses equally between them.

Summary of partnership cases

46. Where there is no partnership agreement, partnership profits and losses should be divided equally between the partners following the presumption under s 27(a) of the Partnership Act 1908 (**Case S2**).
47. **When considering whether a partner's share** of profits or losses is excessive, the Commissioner may also take into account the capital contributions of the partners as shown in any agreement, including when a partner has made assets available to the partnership. This may include taking into account any payments received for the use of these assets. The Commissioner may also consider services provided by each partner, including responsibilities undertaken, special skills or expertise, work done, and time spent on partnership business (**Case B45**). Where there is a genuine contract of partnership under s GB 24(2), the Commissioner cannot reallocate any amounts attributed to the partners (**Case M65**).

Example 3 – Excessive profits or losses allocated to partner

48. June and her husband Jim are partners in a partnership that owns several rental properties that have been operating at a loss. An agent manages the rental properties because June has a full-time job and Jim is retired. They do not have a partnership agreement. In **June and Jim's** partnership return for the 2013 income year, the losses are allocated on the basis of 75% to June and 25% to Jim. This allows June to offset a greater proportion of the losses against her employment income, which is higher than Jim's **pension**.

Can the Commissioner apply section GB 23 to reallocate the losses?

49. Yes – the Commissioner can apply s GB 23 to reallocate the losses. Under s 27(a) of the Partnership Act 1908, there is a presumption that partners share profits and losses equally. Any different allocation between June and Jim would need to be justified based on the criteria in s GB 23(6) and the principles developed by the courts. Partners in a partnership cannot allocate profits or losses to obtain a tax advantage. As a result, the Commissioner would reallocate the losses on a 50–50 basis.
50. However, if June and Jim had a genuine contract of partnership that satisfied the conditions in s GB 24(2), the **partnership's** profits and losses could be allocated in terms of that contract.

Excessive remuneration paid to a shareholder or director (including a relative of a shareholder or director) – section GB 25

51. Section GB 25 applies when the Commissioner considers that a close company has paid excessive remuneration for services to a person who is a shareholder or director of the company. This provision also applies to excessive remuneration paid to a relative of a shareholder or director of the company. Where a close company pays excessive remuneration, s GB 25(2) treats the excess as a dividend paid by the company and derived by the shareholder or director.
52. However, an exemption to s GB 25 applies if the criteria in s GB 25(3) are met:
- the service provider is an adult employed substantially full-time in the business of the company and who manages or administers the company;
 - the amount provided to the service provider is not influenced by their relationship with a shareholder or director; and
 - the service provider is resident in New Zealand.
53. In *Case J53* (1987) 9 NZTC 1,297 (at 1,297) Judge Barber considered that determining whether remuneration was excessive required a focus on the nature and extent of the services the directors provided to the company:
- The directors attended to all their statutory duties as prescribed under the Companies Act. From time to time they executed company documents and prepared reports for the Statistics Department. In line with their responsibilities they met with their professional advisors at least three times a year. The husband made capital improvements to the farm, thereby increasing the **company's assets**. The wife kept the day-to-day company accounts. Some of the work performed by the husband could be considered work as a lessee while other work was as a director.
54. **Judge Barber's view was that the remuneration paid to the directors was not excessive given the nature of the services they provided and responsibilities they undertook on behalf of the company. His Honour said they were entitled to be "remunerated in a fair manner" (at 1,301).**
55. In *Case J99* (1987) 9 NZTC 1,560, Judge Barber considered whether the Commissioner was correct in reallocating income that was paid to the wife of a shareholder-director. Both the husband and wife were shareholders, directors and employees of the taxpayer construction company.
56. In the year in question, the company allocated its net profit as shareholder salaries paying both the husband and wife a salary of \$37,109 each. The Commissioner considered that the amount paid to the wife exceeded a reasonable amount for the services she provided.

57. Judge Barber agreed that the **wife's salary** was influenced by her relationship with her shareholder-director husband and related to the profits of the company. In deciding on a reasonable salary for the wife, his Honour focused on the true worth of her services. This included comparing the husband's and wife's services provided to the company. **The wife's salary was reduced to \$28,000 with the excess being treated as a dividend paid by the company to her.**
58. In *GS Mathews (Chemist) Ltd; Troon Place Investments Ltd v CIR* (1995) 17 NZTC 12,175, the main issue for the High Court was whether remuneration paid to the shareholders of two close companies (GS Mathews (Chemist) Ltd and Troon Place Investments Ltd) was excessive. One company was a retail chemist and the other a property investment company. A husband and wife owned the shares in both companies.
59. The taxpayer companies paid the husband and wife shareholders substantial remuneration for the 1990 and 1991 income years. However, during this time the husband and wife were on an extended overseas trip and had left the companies in the hands of managers. Although they were overseas, the husband and wife were involved in the management of both companies, at least to some extent, by staying in contact with their managers. The shareholders also investigated other business opportunities while overseas.
60. For GS Matthews (Chemist) Ltd, Tompkins J concluded that nothing limited the court to considering only services rendered by the shareholders during the time they were away. His Honour concluded that the remuneration paid to the shareholders was reasonable based on the results achieved by the pharmacy as a result of the business and entrepreneurial skills of the shareholders during the preceding years as well as their contributions during 1990 and 1991.
61. When considering whether remuneration paid to shareholders is excessive, the **services rendered by the shareholders can be considered "in a broad and reasonable way"**. This may include considering the value of a shareholder's contribution in previous years, if it has provided an on-going benefit to the company. Previous salaries paid to shareholders may be relevant when determining whether a subsequent salary is excessive.
62. Troon Place Investments Ltd was a property investment company whose sole source of income was from rents earned from leasing commercial premises. In the 1990 and 1991 income years, it paid shareholder remuneration of \$27,494 and \$34,062 respectively. However, the Commissioner considered this remuneration excessive and reassessed these amounts based on an estimate of the number of hours the shareholders worked for Troon Place Investments while they were overseas.
63. Tompkins J **agreed with the Commissioner's assessment based on the hours the shareholders worked for the company while overseas.** He noted that the property investment company was not in the same category as GS Mathews (Chemist) Ltd. This was because the sole source of income was rents rather than the entrepreneurial and business skills of the shareholders.

Summary of shareholder and director remuneration cases

64. **Remuneration paid must be based on the "true worth" of the services provided and not an arbitrary figure based on the company's profits (Case J99).** The reasonableness of fees must be based on the nature and extent of the services provided by the shareholder or director to the company (**Case J53**).

65. Remuneration must not be based on a relationship with a shareholder or director (*Case J99*). When determining whether remuneration paid to shareholders is excessive, the services rendered by the shareholders can be **considered "in a broad and reasonable way"**. This may include the value of a shareholder's contribution in previous years if it has provided an on-going benefit to the company (*GS Mathews (Chemist)*).

Example 4 – Excessive remuneration to shareholder or director

66. Sue and her husband Peter are 50-50 shareholders in a close company, ABC Ltd. **Sue works full time in the business. Peter stays at home with the couple's** children during the week, but works 5 hours cleaning the company offices every Saturday. During the 2013 income year, ABC Ltd paid Sue and Peter a salary of \$70,000 each. ABC Ltd has claimed the payment of these salaries as a deduction.

Are these salaries deductible to ABC Ltd?

67. The Commissioner cannot reallocate the salaries if the conditions in s GB 25(3) are met. **On the basis that both Sue and Peter are residents, Peter's first** difficulty in having the exemption apply to him is that he does not work substantially full-time in the business. In addition, Sue and Peter would need to show that the salaries paid were not influenced by their relationship to each other as shareholders (ie Peter would have to show that his salary was not influenced by his relationship to Sue as a shareholder of ABC Ltd and vice versa). Any salaries paid must be based **on the value of the shareholder's contributions to the company**. In determining whether the salaries paid are influenced by Sue and **Peter's relationship to each other as shareholders the Commissioner will consider** the nature and value of the services Sue and Peter provided to the company. **In this case, it is likely that Peter's salary has been influenced by his relationship** with Sue, as his salary appears to be significantly out of proportion to the services that he is providing to the company. In such a case, the amount of the excess will be treated as a dividend paid by ABC Ltd to Peter.

Excessive allocation of income from a look-through company to a relative aged under 20 – section GB 25B

68. Section GB 25B concerns LTCs. It is an anti-avoidance provision aimed at preventing excessive income from being diverted to owners aged under 20. Section GB 25B applies when two or more people who are relatives own look-through interests in an LTC. This provision applies when excessive income is allocated to a relative aged under 20 under the look through company rules.
69. Section HB 1(4) states that an LTC's activity is treated as being carried on by persons **holding "effective look-through interests" in the LTC**. This means income and deductions are generally passed on to the LTC's owners in proportion to their ownership interest in the LTC. Section GB 25B applies where the Commissioner considers that the application of the standard methods of calculating a look-through interest in s HB 1 results in excessive income being allocated to a relative aged under 20. Section GB 25B(2) allows the Commissioner to reallocate the **owner's** effective look-through interests based on what is considered to be reasonable. When applying s GB 25B, s GB 25B(3) provides that the Commissioner may consider:
- the nature and extent of the services rendered by the relative;
 - the value of the contributions made by the respective owners, by way of services, capital or otherwise; and
 - any other relevant matters.

Example 5 – Excessive allocation of income or deductions from a look-through company to a relative aged under 20

70. May and Adam each own 50% of the shares in an LTC. They both gift 10% of the company's shares to Dan, their five-year-old son, who then owns 20% of the shares. As a result, they allocate 20% of the LTC's income to Dan.

Can the Commissioner reallocate the amount paid to Dan?

71. Section GB 25B(2) allows the Commissioner to reallocate effective look-through interests if income allocated to a relative aged under 20 is considered excessive. Section GB 25B(3) sets out the criteria the Commissioner may take into account when considering whether the income is excessive. These criteria are the nature and extent of the services rendered and the value of the contributions made by May, Adam and Dan by way of services, capital or otherwise. These criteria are similar to those for partnerships in s GB 23(3). The Commissioner's view is that cases that consider partnership income where there is no contract of partnership, such as **Case B45** and **Case S2**, assist when determining the nature and extent of the services rendered by each owner with an effective look-through interest and for valuing the contributions made by the respective owners.
72. Given that it is unlikely that Dan has provided services and he has provided no capital contributions to justify receiving 20% of the LTC's income, the Commissioner will regard this allocation as excessive. The Commissioner can reallocate the amount paid to Dan by treating his look-through interests as being held by May and Adam.
73. For further information, see "Changes to the qualifying company rules and introduction of look-through company rules" *Tax Information Bulletin* Vol 23, No 1 (February 2011).

Relationship between this QWBA and Penny and Hooper case

74. The Commissioner notes that there are similarities between the subject matter considered in this QWBA and the Supreme Court decision in **Penny and Hooper v CIR** [2011] NZSC 95. The relationship between the two is explained below.
75. This QWBA is about the specific anti-avoidance provisions dealing with excessive remuneration and allocations of profits and losses in sections GB 23 to GB 25B. **Penny and Hooper** considered the issue of diverting personal services income.
76. The concepts of excessive remuneration and diverting personal services income both involve attempting to shift income from a key individual through whom the business earns income. For excessive remuneration, the focus is on whether the remuneration diverted to other individuals is reasonable given the services rendered by the other individuals. The specific anti-avoidance provisions may apply where the amount paid is excessive compared to the contribution to the business by the relevant individual.

77. In *Penny and Hooper*-type scenarios, the focus is on the income diverted from the key individual to associated entities, and generally through to other related individuals. The Supreme Court addressed the issue of diverting personal services income in *Penny and Hooper* under the general anti-avoidance provisions. For the Commissioner's view of the general anti-avoidance provisions in ss BG 1 and GA 1 see "IS 13/01: Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007" *Tax Information Bulletin* Vol 25, No 7 (August 2013). For information about diverting personal services income, see 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" *Tax Information Bulletin* Vol 23, No 8 (October 2011). The principles in this QWBA are not intended to be applied to *Penny and Hooper*-type scenarios.

References

Legislative references

Income Tax Act 2007: ss DA 1, GB 23, GB 24, GB 25, GB 25B, HB 1, YA 1 ("close company", "company", "director", "effective look-through interest", "income", "look-through company", "loss", "partnership", "relative" and "shareholder")

Related rulings or statements

"Update on Public Information Bulletin review" *Tax Information Bulletin* Vol 25, No 10 (November 2013).

"IS 13/01: Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007" *Tax Information Bulletin* Vol 25, No 7 (August 2013).

"Changes to the qualifying company rules and introduction of look-through company rules" *Tax Information Bulletin* Vol 23, No 1 (February 2011).

"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" *Tax Information Bulletin* Vol 23, No 8 (October 2011).

"Reasonable wages - payments to a spouse" *Tax Information Bulletin* Vol 7 No 7 (January 1996).

Subject references

Deductibility
Excessive allocation of income from a look-through company
Excessive remuneration paid to a relative, shareholder or director or to a relative of a shareholder or director
Excessive share of partnership profits or losses

Case references

Case B45 (1976) 2 NZTC 60,394
Case F108 (1984) 6 NZTC 60,072
Case J24 (1987) 9 NZTC 1,140
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Case S2 (1995) 17 NZTC 7,012
CIR v Lilburn [1960] NZLR 1,169
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