

Family Wages

Tax deductibility in remunerating family members

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1. Introduction

In the case of many small and medium-sized businesses it is common practice to engage children, spouses or other close relatives as employees in the business. Wages paid for work done by family members is an expense of the business and its tax deductibility must be considered like any other expense.

Under Irish tax legislation, a deduction is only available in respect of wages paid which are ‘wholly and exclusively’ for the purpose of the trade. It is typical for self-employed individuals to engage family members in the business and to pay them for work undertaken. For example, it is common practice for a spouse to be paid a sum for their involvement in the day-to-day running of the business. Such activities may include administrative duties relating to scheduling of appointments or job estimates, telephone answering, bookkeeping, banking, cleaning, etc. There should normally be little difficulty in justifying a deduction under the wholly and exclusively test for the payment of such bona fide wages to spouses, relatives or other connected employees for work actually undertaken.

However, if there is another purpose for the payment, then a deduction may not be available in respect of the full amount. In addition, if the amount paid is not a bona fide payment and commensurate with the duties actually undertaken, a deduction may not be available in respect of the ‘excessive’ amount.

This manual sets out the principles, based on case law, for determining the tax deductibility of wages paid to relatives and connected persons in the context of a trade or profession. Although the manual focuses on the tax deductibility of remunerating family members, the principles outlined below are equally applicable in relation to the payment of wages to unconnected employees.

2. General principles - wholly and exclusively

When arriving at business profits assessable to tax under Case I (trade) or Case II (profession), a taxpayer must first look to section 81 of the Taxes Consolidation Act 1997, as amended (TCA), to determine what expenses are deductible. The central test of deductibility when computing assessable Case I or II profits is whether the expense has been “*wholly and exclusively laid out or expended for the purposes of the trade or profession*”¹.

Despite the importance of this test, it has not often come before the Irish courts and therefore, there is little guidance from Irish case law as to how this phrase should be interpreted. The UK legislation contains a similar phrase which has come before the UK Courts on many occasions, sometimes on the general meaning of wholly and exclusively for the purposes of the trade and on other occasions specifically in relation to determining whether the payment of remuneration to family members is deductible. The findings in those cases may be both persuasive and instructive in an Irish context. Outlined below is an overview of the principles derived from such cases

¹ Section 81(2)(a) TCA

as well as a summary of some of the relevant UK cases dealing specifically with the deductibility of wages paid to family members.

2.1 General principles

The taxpayer's sole purpose for incurring the expense must have been for the purposes of their trade². Where a non-trade purpose is identified, then the expenditure is not allowable. The taxpayer's purpose includes his or her conscious as well as subconscious purpose³. However, a payment may be made exclusively for the purposes of the trade even though it also secures a private benefit. A merely consequential and incidental effect (as distinguished from another purpose) will not disqualify an otherwise deductible expense if the securing of the private benefit was not the object of the payment but merely a consequential and incidental effect of the payment.

Where an identifiable proportion of an expense has been laid out wholly and exclusively for the purpose of the trade, then that part will not be disallowed on the basis that the expense, as a whole, was not so laid out or expended. The expenditure must be capable of division into distinct elements, one or more of which is incurred wholly and exclusively for the purposes of the trade. An apportionment exercise should be carried out to identify the definite part of the expenditure which was incurred wholly and exclusively for the purposes of the trade.⁴ This is to be distinguished however from cases where there is more than one purpose for incurring the expenditure i.e. the expenditure has a dual purpose. If one of the reasons for the expenditure is for a non-business purpose, then the expenditure fails the test and there is no provision to allow for apportionment.

2.2 Bona fide payments

Spouses, children or other family members may assist in the running of a family business and receive payment for the work undertaken by them. Such individuals are to be treated and taxed as any other employee and the tax deductibility of wages paid to them must likewise be so considered.

Where the duties are genuinely performed, the remuneration is commensurate with the work and time devoted by them and the payment is actually received by the family member, a deduction should be available under section 81 TCA in respect of sums paid to such family members.

² *Bentleys, Stokes & Lowless v Beeson* (1952) 33 TC 491, confirmed in *Mallalieu v Drummond* [1983] STC 665

³ *Bentleys, Stokes & Lowless v Beeson* (1952) 33 TC 491, confirmed in *Mallalieu v Drummond* [1983] STC 665

⁴ The practice of apportioning expenses, such as those of a car which is sometimes used for business purposes and sometimes used for private purposes, was approved in *Caillebotte (Inspector of Taxes) v Quinn* [1975] STC 265

Example

Peter is a farmer who owns an 80 acre dairy farm with a 120 cow herd. His son Paul works full-time as a farm manager for his father and is responsible for the day-to-day running of the farm including milking, feeding, calf rearing, operating machinery and managing grassland. Paul is paid an annual salary by Peter which is commensurate with the duties undertaken by Paul and the time devoted by him to his duties on the farm. Therefore, the payment of the salary by Peter to Paul represents a bona fide payment of wages and a tax deduction is available to Peter in respect of the full amount.

2.3 Excessive remuneration

Businesses who engage family members must ensure that the remuneration is justifiable in relation to the duties performed and that the rate payable is comparable to a rate that would be paid to an independent employee with the same qualifications and experience performing the same duties. Remuneration paid to family members whose remuneration is not commercial or commensurate with the actual duties performed may be apportioned, in cases where there is an identifiable business purpose, between the portion of the remuneration laid out for trading purposes and the excess portion that was not.

Example

Alan runs a small dental practice. His 14 year old nephew, Ben helps him out for ten hours a week undertaking administrative duties in the practice and receives €50 an hour. This equates to €25,000 a year, allowing for school holidays and some overtime. Bearing in mind the applicable minimum wage for workers under 18 and the fact that Ben has no qualifications, it is considered that the hourly rate of pay to Ben exceeds the market level rates for such an employment. A deduction will therefore only be available in respect of an amount which is considered fair and reasonable having regard to the factors above.

Similarly, where remuneration is paid significantly in excess of market rates this can be indicative of the existence of a non-trade purpose. If there is a non-trade purpose for paying remuneration in excess of the commercial rate, then the full amount may be disallowable where there is duality of purpose. See paragraph 2.2 below. However, in practice Revenue will not seek to deny a deduction for the full amount where payment is made for work actually undertaken. In such circumstances, a deduction will be denied for any part deemed 'excessive' in line with the principles outlined in above.

The following material is either exempt from or not required to be published under the Freedom of Information Act 2014.

[...]

2.3.1 Case law

In the case of *Copeman v William Flood & Sons Ltd*⁵, the taxpayer company carried on a pig dealing trade. The managing director, his wife, two sons and daughter were the directors and sole shareholders. In computing its profits for the tax year in question, the company deducted a sum for directors' fees for each director. The daughter's duties mainly consisted of answering telephone enquiries, and one of the son's duties chiefly consisted of calling on farmers in order to purchase pigs.

Lawrence J held that although the sums were paid to the directors as remuneration, they were not for that reason necessarily wholly and exclusively laid out for the purposes of the company's trade. Lawrence J explained that while the Commissioners could not interfere with the company's prerogative to pay its directors whatever it thought fit, that was not the test. The test was how much of the remuneration was incurred wholly and exclusively for the purposes of the company's trade. The court therefore inferred that the sums could be divided into two distinct amounts and the allowable portion was confined to the amount considered to be commensurate with the duties performed and the responsibilities assumed. The case was accordingly referred back to the Appeal Commissioners to determine whether the sums in question, or what proportion of them, as a matter of fact, were wholly and exclusively laid out for the purposes of the company's trade.

Similarly, in *Stott and Ingham v Trehearne*⁶, a father employed his two sons in his business and paid the sons salary plus a commission equal to one third of the business profits. The eldest son had assumed entire responsibility for the business after his father's health deteriorated until the end of that year when the younger son returned from military service. In the accounts of the business, the commissions paid to the sons were shown as appropriations of their father's profit. The Commissioners decided that the sums paid were disproportionate to the values of their services. The Commissioners allowed a deduction for commissions of one tenth each, however, as in their view only that amount could be regarded as paid to the sons for services rendered in managing the business. Rowlatt J explained that the allowable remuneration was the amount expended wholly and exclusively for the trade. The Commissioners had considered all of the facts and decided that a proper deduction would be 10%. Rowlatt J decided not to disturb the Commissioners findings.

⁵ *Copeman v William Flood & Sons Ltd* [1940] 24 TC 53

⁶ *Stott & Ingham v Trehearne* [1924] 9 TC 69

2.4 Dual purpose remuneration

In determining whether expenditure is incurred wholly and exclusively for the purpose of the trade, it is necessary to have regard to what the taxpayer had in mind at the time it was incurred⁷. In cases where remuneration is paid to family members, it may be inevitable that there is an intrinsic private purpose in making the payment, notwithstanding that the non-trade purpose may be a subconscious motive. For example, a sole trader paying a son/daughter in full-time education €200 a week for undertaking an hour's work at the weekend, the main purpose of the expenditure being to maintain the child at college. The test remains that it is only the expenditure wholly and exclusively for the purposes of the trade that qualifies for a deduction. However, as outlined in paragraph 2.1, where payment is made for work actually undertaken, in practice Revenue will only seek to deny a deduction for the 'excessive' part in line with the principles outlined in paragraph 2.1 above.

2.4.1 Case law

In *Dollar v Lyon*⁸, Vinelott J affirmed the decision of the General Commissioners who had disallowed payments made by a farming couple to their three youngest children (ages 6, 8 and 10 in the tax year at issue) for work done on the family farm. The taxpayers made a practice of paying their children for help on the farm. Each child did about 15 hours work per week on the farm and was paid a weekly sum in cash. In addition, at the end of the year, the taxpayers purchased National Savings Certificates for each of them. The total expenditure represented the minimum wage at that time provided for by the Agricultural wages Act 1948 for 15 hours work per week. The taxpayers claimed to deduct the payments from their profits as expenses wholly and exclusively incurred for the purposes of their trade. The Inspector of Taxes disallowed the claim on the basis that the payments to the taxpayers' children and the investments on their behalf were essentially given out of natural love and affection and the jobs performed by the children were purely incidental to the main purpose of the payments. Vinelott J agreed with the General Commissioners that the payments were paid as 'pocket money' and were not payments made wholly and exclusively for the purposes of the taxpayers' trade.

"The question whether the payments made by Mr and Mrs Dollar were wages and so were money wholly and exclusively laid out or expended for the purposes of their farming business is a pure question of fact. It is to my mind clear that there was evidence before the commissioners on which they could have reached the conclusion that they in fact reached. It is noteworthy that all the children, whose ages were between eight and 14, were paid the same and for the same amount of work, and were paid a weekly sum in cash which was not out of the way as pocket money. Given the family circumstances, there is to my mind nothing surprising in finding healthy young children working on a family farm and getting in return pocket money on a generous scale and from time to time a present of National Savings Certificates out of the profits of the

⁷ *Mallalieu v Drummond* [1983] STC 665, HL

⁸ *Dollar v Lyon* [1981] 54 TC 459

farm without being in any sense employed or contractually entitled to any payment.”

2.5 Wages must be paid

In order for expenditure to qualify for a tax deduction, there must be actual expenditure incurred by the person in question⁹. It is essential therefore that wages must actually be paid over to the family member in order to be tax deductible. Where, in reality, the family member is merely a conduit and the wages are in fact being retained by the sole trader, then the amount will be treated as an appropriation of profit and a deduction will not be allowed.

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2.5.1 Case law

The case of *Moschi v Kelly*¹⁰ considered the deductibility of wages paid to the spouse of a director. For each of the five years to June 1945, sums were deducted in respect of wages to Mr Moschi's wife, although these amounts were not paid out but were credited to Mr Moschi's own account. The UK revenue authorities raised assessments to income tax on the profits of the company, allowing no deduction for the amounts charged as the spouse's wages. The decision to disallow the wages accrued was not based on the mere fact of non-payment. In the High Court, Donovan J upheld the Commissioners' decision that the wages were non-deductible, stating that:

“Mr Moschi was not before the Commissioners to say he had paid or intended to pay the wages; Mrs Moschi was not there to say she had or would, receive them. It was the Commissioners' duty to be satisfied, now that the matter was challenged, that these wages were genuine wages payable to Mrs Moschi, and they had no evidence before them to establish beyond doubt that proposition. On the contrary, they had evidence before them which tended to show that these moneys were paid to or at least put at the disposal of Mr Moschi himself; and they had evidence before them, too, that Mr Moschi's accounts in general were certainly not to be relied upon. There was only one course, in my judgment, the Commissioners could have followed, and that is to say they were not satisfied these were genuine wages at all. What in fact they said was that the amounts shown in the accounts as wages to Mrs Moschi are not an allowable deduction for taxation purposes, and in the circumstances neither were they.”

⁹ Peter Merchant Ltd v Stedeford (1948) 30 TC 496.

¹⁰ [1952] 33 TC 442

2.6 Illegal payments

Section 83A TCA prohibits a tax deduction, in computing the amount of any income chargeable to tax under Schedule D, for any payment the making of which constitutes a criminal offence under Irish law. The Protection of Young Persons (Employment) Act 1996 (the 'Act') makes it a criminal offence to employ a child in certain circumstances. A payment of wages to a child will not be deductible for tax purposes where an employer has been convicted of an offence under Section 3 of the Act in respect of that payment.