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## Personal Services Income: where to from here?

### **Abstract**

In Australia, the regime for the taxation of Personal Services Income (PSI) has suffered from being complex, unclear and uncertain, leading to poor compliance with the rules. Personal services income is defined as a reward for, or the result of, one's personal efforts. Prior to the introduction of the regime, the tax system was plagued with a major inequity: it was possible for individuals to reduce their tax liability by alienating their PSI to an associated company (or other legal entity) and by claiming inappropriate 'business' deductions. This article reviews the current interpretation of the PSI rules, evaluates the Board of Taxation and the Henry Review findings and suggests an approach that reduces the potential application of Part IVA.

### **Keywords**

Personal services income, Henry Review, Part IVA

## PERSONAL SERVICES INCOME: WHERE TO FROM HERE?

TOM DELANY\*

In Australia, the regime for the taxation of Personal Services Income (PSI) has suffered from being complex, unclear and uncertain, leading to poor compliance with the rules.<sup>1</sup> Personal services income is defined as a reward for, or the result of, one's personal efforts.<sup>2</sup> Prior to the introduction of the regime, the tax system was plagued with a major inequity: it was possible for individuals to reduce their tax liability by alienating their PSI to an associated company (or other legal entity) and by claiming inappropriate 'business' deductions. This article reviews the current interpretation of the PSI rules, evaluates the Board of Taxation and the Henry Review findings and suggests an approach that reduces the potential application of Part IVA.<sup>3</sup>

### INTRODUCTION

Horizontal equity requires that taxpayers in similar situations are taxed in a similar manner and that transactions of similar economic substance are taxed similarly ... a tax system that tolerates significant levels of avoidance cannot be equitable and can be expected to fall into disrepute as the community witnesses the unfair outcomes.<sup>4</sup>

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<sup>1</sup> The Board of Taxation, Report to the Assistant Treasurer, Australian Government, *Post Implementation Review into the Alienation of Personal Services Income Rules* (2009) ('The Board of Taxation Report') [http://www.taxboard.gov.au/content/content.aspx?doc=reviews\\_and\\_consultations/alienation\\_of\\_personal\\_services\\_income\\_rules/default.htm&pageid=007](http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/alienation_of_personal_services_income_rules/default.htm&pageid=007) at 1 February 2012.

<sup>2</sup> Australian Taxation Office, 'Personal service income essentials' (2012) [www.ato.gov.au/menulink.aspx?44894](http://www.ato.gov.au/menulink.aspx?44894) at 1 February 2012.

<sup>3</sup> Dr Ken Henry, Review Panel, 'Australia's Future Tax System: Report to the Treasurer' ('Henry Review') (2009) [http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs\\_reports.htm](http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm) at 1 February 2012.

<sup>4</sup> Commonwealth, 'Review of Business Taxation: A Tax System Redesigned' (1999) <http://www.rbt.treasury.gov.au>, accessed 18<sup>th</sup> November 2010, Overview section of the document, [31] - [33]. The Review of Business Taxation recognised that reform was needed to enhance economic performance, and a well-functioning taxation system must be seen to be operating fairly, efficiently and transparently. It should provide certainty, be as simple as possible, with low compliance costs. The system must have integrity

This extract from the Review of Business Taxation indicates the perceived inequalities within the Australian Tax System. The Review found that one such inequality included the alienation of personal services income (PSI), as existed in the tax arrangements at that time. The Review considered that it was a fundamental principle that income derived from the personal exertion of an individual cannot be alienated.

## BACKGROUND

Prior to the introduction of the PSI rules<sup>5</sup> the primary concerns that arose from using an interposed entity (such as a company, partnership or trust) to derive PSI included:

1. The ability of the taxpayer to deduct a greater range of deductions when using an entity when compared with not using such an entity;
2. The ability of the taxpayer when using an entity to share the PSI with other parties (the presence of progressive tax rates makes it beneficial to split income with taxpayers who have a lower marginal rate of tax);
3. The ability of the taxpayer when using a company as the interposed entity to cap the rate of tax at the company tax rate (currently 30%), and defer the derivation of income by individuals from the company, until a time when the related individuals have a lower rate of tax; and
4. A greater entitlement to a range of income-tested government payments and a potentially reduced liability to other obligations such as higher education contribution charges (HELP), Medicare levy, superannuation surcharge and child support payments.

These attributes raised concerns that there was a significant attack on the income tax base. In addition, the use of such strategies meant that employees undertaking substantially the same work and receiving similar remuneration would be paying significantly more tax compared to taxpayers engaged in such strategies. The ability of taxpayers to alienate their income indicated a need to remove this aspect of horizontal inequity within the tax system.

The Review acknowledged the use of interposed entities may be motivated for reasons other than tax avoidance. Such reasons included an increasing tendency of service recipients to engage independent contractors and corporate entities rather than employees, and the asset protection benefits associated with using an interposed entity. The Review recognised the commercial imperatives motivating the use of

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and be neutral as between taxpayers.

<sup>5</sup> *Income Tax Assessment Act 1997* (Cth) ('ITAA 97') div 84-87.

interposed entities and did not seek to place a limitation on their use. Instead, the Review limited its recommendations to protecting the revenue base which was perceived to be at significant risk from the use of interposed entities.

## REVIEW RECOMMENDATIONS

The objective of the Review Recommendations was to improve the horizontal equity of the tax system by:

1. Requiring persons providing personal services to include the PSI that was alienated to the personal services entity (PSE)<sup>6</sup> in their own income in the year the income was derived;
2. Clarifying that the PSE or personal services provider can only claim deductions equivalent to the level of deduction that an employee undertaking similar activity would be able to claim; and
3. Require that the entity maintenance expenses be offset in the first instance against non-PSI, and only in a situation where there are excess entity maintenance expenses over non-PSI to offset them against PSI.

Legislation giving effect to the Review's recommendations was introduced in the New Business Tax System (Alienation of Personal Services Income) Bill 2000. The new legislation is contained in Part 2-42 or Divs 84 to 87 of the *Income Tax Assessment Act 1997* (ITAA 97).

### Personal Services Business Tests

A taxpayer will be able to avoid the operation of the PSI rules where the income is derived as part of a personal services business (PSB). There are four tests to determine eligibility to be classified as a PSB. Taxation Ruling TR 2001/8 at paragraph 27 states:

You will not be within the alienation measure and can self-assess accordingly, if you come within ONE of the following four situations:

You satisfy the 'results test', that is:

- (a) You work to produce a result(s); and
- (b) You provide the tools and equipment necessary (if any) to produce the result(s); and
- (c) You are liable for the cost of rectifying any defective work.

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<sup>6</sup> A company, partnership or trust to which an individual has alienated their personal services income is a personal services entity (PSE).

OR

None of your clients pays you 80% or more of your personal services income in the year of income and you have two or more unrelated clients (who were obtained as a result of you making offers to the public at large or to a section of the public).

OR

None of your clients pays you 80% or more of your personal services income in the year of income and

(d) You engage an individual(s) or an unrelated entity(ies) to perform 20% or more (by market value) of the principal work (ie the work that generates the personal services income) or;

(e) You employ an apprentice for at least half the year

OR

None of your clients pays you 80% or more of your personal services income in the year of income, and you exclusively use business premises that are physically separate from your home, or from the premises of the person for whom you are working.

If you cannot satisfy any of these four tests and 80% or more of your personal services income comes from one source, you may be able to obtain a personal services business determination (PSBD) from the Commissioner. This determination will certify that you are conducting a personal services business. You may also apply for a PSBD if you are uncertain whether you satisfy any of the tests. If the Commissioner is satisfied that you are entitled to a PSBD, you will not be subject to the alienation measure. The Commissioner can make a determination based on further grounds, regardless of whether he or she is satisfied that the individual meets any of the personal services business tests.

### **Residual Application of Part IVA**

The general anti-avoidance provisions of Part IVA of the *Income Tax Assessment Act 1936* (ITAA 36) may still apply to cases of alienation of PSI that fall outside the alienation measure, or where an entity receives a PSBD.<sup>7</sup> For example, an entity may satisfy the results test and so be classified as a PSB, but the dominant purpose of using the entity could be to get a tax benefit. Therefore, Part IVA may still need to be considered despite the fact that the PSI rules did not apply to attribute the income to the individual performing the personal services. Where Part IVA applies the

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<sup>7</sup> *Income Tax Assessment Act 1997* (Cth) s 86-10.

Commissioner may cancel the tax benefit and attribute the income to the person performing the services. In essence, the same outcome would be achieved through the use of Part IVA as would have occurred if the PSI attribution rules had applied.

The Explanatory Memorandum to the PSI rules stated that,<sup>8</sup> 'applying Part IVA has to be on a case by case basis which is labour intensive and an inefficient use of ATO resources'. In other words, if a personal services arrangement falls within the PSI rules, and the income is attributed to the individual providing the personal services, then there will be a reduction in the need to rely on the very labour intensive application of Part IVA. However, Part IVA may still need to be considered where entities are classified as a PSB. The question then is whether the PSI rules have really achieved their objective of simplifying the law and improving the horizontal inequity.

There is a considerable body of authority supporting the potential application of Part IVA to PSI derived by an entity, where that income is not paid to the individual who performed the services that generated that income.<sup>9</sup> Essentially, the Commissioner can be successful in applying Part IVA to a PSI situation, but the task is not necessarily simple, given each case requires individual attention.

## OPERATION OF THE NEW PSI RULES

The PSI legislation makes it clear that an entity or individual falling within the PSI rules would be limited to deductions available to an individual. Regarding the alienation of income, the Explanatory Memorandum provides that:

apart from the existing general anti-avoidance provisions of Part IVA of the Income Tax Assessment Act 1936 (ITAA 36), there are no specific rules to address the adverse revenue implications which can result when alienation occurs. The courts have held that Part IVA can be used to counter alienation practices.<sup>10</sup>

The Explanatory Memorandum further states that the anti-alienation measures of the new law (where PSI is attributed to the individual generating that income) would reduce or eliminate the need to apply Part IVA. Paragraph 1.13 of the Explanatory Memorandum provides that:

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<sup>8</sup> Explanatory Memorandum, Income Tax Assessment Bill 1997 (Cth) 1.12.

<sup>9</sup> Tom Delany 'Part IVA and Tax Reform' (2005) 1(2) *Journal of Australasian Tax Teachers' Association* [http://eprints.usq.edu.au/238/1/11\\_Delany\\_JATTA\\_vol1\\_no2.pdf](http://eprints.usq.edu.au/238/1/11_Delany_JATTA_vol1_no2.pdf) at 1 February 2012.

<sup>10</sup> Explanatory Memorandum, Income Tax Assessment Bill 1997 (Cth) 1.12.

The rules proposed, in so far as they apply to alienation practices, should produce a similar outcome as that obtained from the application of Part IVA.

This appears to suggest the new PSI measures are sufficiently comprehensive to deal with the alienation of income, and that reliance on Part IVA will be substantially reduced as a result of the PSI rules. However, this statement is only true to the extent that the PSI rules apply, whereas where the PSI rules do not apply then Part IVA will still need to be considered.

In essence, where a PSB is in existence then the new rules: do not attribute the income to the individual providing the personal services; do not specifically restrict the availability of deductions or the ability of the individual splitting their PSI with their associates; and do not prevent the tax rate being capped at the corporate tax rate of 30%. For this reason, it is highly desirable for an individual or entity to be classified as a PSB under the PSI rules. Satisfying Part IVA is another matter.

### **Personal Services Income**

To fall within Part 2-42 ITAA 97, PSI must be generated. Section 84-5 defines PSI as income (whether ordinary or statutory income) that is gained mainly as a reward for the personal efforts or skills of an individual. Income that is gained by an entity (eg, a company, partnership or trust) for the personal efforts or skills of an individual will still be PSI. By reason of this definition, income which is:

- ancillary to an entity supplying goods or granting a right to use property; or
- principally generated by assets an entity holds;

is not PSI as it is not paid mainly as a reward for an individual's personal effort. Rather, it is paid mainly as consideration for the provision of the goods or due to the use of an asset.

The reference in subsection 84-5(1) to income that is 'mainly' a reward for the personal efforts or skills of an individual requires a determination as to the substance of the contractual arrangements between the relevant parties. Whether the provision of the personal effort or skills of an individual to a service acquirer is the principal component of a contract will depend on the contractual terms and conditions.

### ***Commissioner's Guidance – Personal Services Income***

Prior to the introduction of the new PSI legislation, the Commissioner sought to rely on a number of Australian Taxation Office Taxation Rulings and the general anti-avoidance rules in Part IVA. Taxation Ruling IT 2639 provided the Commissioner's opinion on what constituted PSI. The Commissioner indicated that the definition of PSI in the ruling would be relevant to the interpretation of:

- Taxation Ruling IT 2503 (Incorporation of medical and other professional practices).<sup>11</sup>
- Taxation Ruling IT 2121 (Family companies and trusts in relation to income from personal exertion).<sup>12</sup>
- Taxation Ruling IT 2330 (Income splitting).<sup>13</sup>

Taxation Ruling IT 2639 clarifies that income from the business structure refers to income other than income from personal services.<sup>14</sup> Income derived by a firm or practice which has substantial income producing assets, or many employees, or both, is more likely to be generated from the income yielding structure of the business rather than from the rendering of personal services.

In discussing the factors relevant to determining whether an amount is PSI, IT 2639 acknowledged that establishing what constituted PSI was a question of fact and degree to be determined in the circumstances of each case.<sup>15</sup> The Ruling also recognised that income may be generated from a number of sources and it should only be the income that has its source from the personal services of the taxpayer that should be classified as PSI. Other income should be apportioned and treated separately.<sup>16</sup> The Ruling further states that if a practice company or trust has at least as many non-principal practitioners as principal practitioners, then income is considered to be derived from the business structure. Accordingly, it would not be PSI.<sup>17</sup> This is a useful rule of thumb because it is an easy test to apply.

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<sup>11</sup> It deals with the incorporation of a practice company to take over the activities of a professional practice but is concerned only with those practice companies where income flows directly or predominantly from the rendering of personal services by the professional practitioner. Incorporation here is acceptable if it does nothing more than reduce the professional's income by the amount of an appropriate superannuation cover.

<sup>12</sup> It deals with income splitting arrangements by which individuals try to split their personal services income among family members by diverting it to a family company or trust. It regards these arrangements as ineffective for income tax purposes under s 260 or Part IVA of the *Income Tax Assessment Act 1936* (ITAA 36).

<sup>13</sup> It is also concerned with the income tax consequences of income splitting arrangements involving trusts and the transfer of income producing assets or the purported transfer of income from the rendering of personal services.

<sup>14</sup> Australian Taxation Office (ATO), 'Taxation Ruling IT 2639' (1991) [7] <http://law.ato.gov.au/pdf/pbr/it2639.pdf> at 1 February 2012.

<sup>15</sup> *Ibid* [8].

<sup>16</sup> *Ibid* [9].

<sup>17</sup> *Ibid* [10].

### ***Taxation Ruling TR 2001/7***

Taxation Ruling TR 2001/7 provides further guidance on what constitutes PSI and explains the meaning of PSI contained in Div 84 of Part 2-42 ITAA 97. It states that the alienation measures only apply to income earned 'mainly' from the provision of an individual's labour or skills (PSI) rather than being generated by: the use of assets; the sale of goods; the granting of a right to use property; or by a business structure. In addition, the alienation measures will not apply where the income is earned in the course of conducting a PSB.<sup>18</sup>

While an overall determination may class income as PSI, some contribution may still come from assets. Examples may include the use of a motor vehicle or computer by a consultant in providing their personal services. Of course there will normally be costs associated with the acquisition and use of these tangible assets for which a tax deduction will normally be available.<sup>19</sup> As a result, the net contribution of these assets towards the net PSI of the taxpayer will be ameliorated.

By contrast, where a contribution to the generation of PSI has come from non-tangible assets such as intellectual property or goodwill that are owned or controlled by the PSE (or other persons), these assets will generally not give rise to any tax deductibility while these assets are used to generate PSI.

### **Identifying Other Contributors to Income**

If the PSI rules enabled the separation of income into that received from personal services and that received from other sources, then it would only be necessary to attribute the income solely from personal exertion to the individual performing the services. The other income could be retained in the entity and taxed within the entity or distributed to persons other than the individual performing the services. Despite the recognition that some contribution to PSI may come from the use of assets, the PSI rules in Part 2-42 ITAA 97 do not make any adjustment for the presence of these other contributions. This will be the natural consequence of accepting the definition of PSI as being mainly from the personal exertion of an individual. However, it may be possible, depending on the nature of the contractual arrangements, to separate out the income that has come from items other than the personal services of an individual.

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<sup>18</sup> ATO, 'TR 2001/8: What is a personal services business' (2001) <http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR20018/nat/ato/00001> at 1 February 2012.

<sup>19</sup> Expenses such as interest, depreciation and repairs may be deductible.

The starting point in this dissection is paragraph 24 of Taxation Ruling TR 2001/7 which states:

the use of 'mainly' in the definition means that the income referred to needs to be 'chiefly', 'principally' or 'primarily' a reward for the provision of the personal efforts of, or for the exercise of the skills of, an individual.

This clarifies that when using tools of trade, depreciating assets or other ancillary assets, they will not be allocated a separate return. The relevant question is then, at what point should these assets be attributed a separate return? Paragraph 27 of Taxation Ruling TR 2001/7 refers to the commercial substance of the arrangement, to determine if only one supply is being made, where it states:

whether or not payments are mainly a reward for personal efforts or skills is determined having regard to the commercial substance of the arrangements between the parties. Where the commercial substance of the arrangement is that there is one set of obligations (different components of which are integral or common to each other) they are looked at together.

If only one supply of personal services is being made in accordance with a single commercial arrangement, then all income derived from that activity is likely to be PSI. However, where separate obligations exist, then the income can be segregated into its components, as suggested in paragraph 28 of Taxation Ruling TR 2001/7:

this is contrasted with the situation where the contract deals with obligations which are completely separate and distinct, in which case each is, in substance, the source of the separate amounts of income.

Separation of the different income streams is easier where the contractual documentation treats the supplies as separate and the relevant invoices show the separate amounts for the different services. However, where there is no contractual separation of the supplies, and the relevant invoices do not show a separate value for the different supplies, then it would be more difficult to maintain the argument that there are discrete supplies. Paragraph 29 of Taxation Ruling TR 2001/7 may provide support for a separate reward for the use of assets or other items even if the contractual documentation does not identify separate supplies:

the meaning of personal services income is wider than that which might otherwise be the case under the common law, but it **does not** include income that is mainly (emphasis added):

- from an entity supplying goods or granting a right to use property;
- generated by assets an entity holds; or
- generated by the business structure.

To rely on paragraph 29, it would be necessary for the entity providing the personal services to attribute a value to these other contributions. At the very least, it should be done at the invoicing process even if no separate supplies are shown in the contractual arrangement. The ability to show a reward for the non-personal service contributions to the overall income would support an argument that this component is not subject to attribution in accordance with Part 2-42 of ITAA 97. More substantial support for this approach would be generated where the other contributions are significant and easily identifiable.

A number of factors may contribute to the income of a notional employer (PSE) in addition to the services of an individual, including:

1. There may be a contribution from depreciating assets used in the business;
2. There may be a contribution from other tangible and intangible assets owned by the PSE;
3. There may be a contribution from the sale of trading stock or consumables in the delivery of personal services on which there is a separate profit component;
4. The PSE may own valuable contracts which enable the individual providing the personal services to derive a higher net return from the use of their skills;
5. A component of the fees charged may incorporate a mark-up for additional commercial risks such as the risk of being sued or the risk that the PSE will not be paid for the services provided. Even where appropriate insurances are held, the risk of personal loss for a contractor is significantly higher when compared with an employee;
6. The location of the premises out of which the PSE is operating may give a significant commercial advantage as they may be very convenient to its customers. This convenience in itself would be making a separate contribution to the income of the entity;
7. Service recipients are more inclined to pay a higher amount for short-term contracts and the higher amount would be to compensate for the short-term nature of the contract rather than the actual personal services performed; or
8. The PSE may employ one or more part-time staff (professional and administrative support) and these staff members make a contribution to the overall income of the PSE.

## POST IMPLEMENTATION REVIEW

In October 2009, the Board of Taxation provided a report to the Assistant Treasurer following its post-implementation review into the alienation of the PSI rules.<sup>20</sup> The Board considered whether the rules had been effective in achieving the goals of greater equity and neutrality in taxing income from personal services. The key issues before the Board were to establish if the legislation is having its intended effect and whether its implementation can be improved. The Board's key findings were:

1. The alienation of the PSI rules had gone some way to achieving their intention of improving integrity and equity in the tax system;
2. However, the extent of improvement, in the Board's view, was inadequate; and
3. The difficulty in applying the rules and associated uncertainty, together with a limited level of compliance activity by the ATO, had diminished their efficacy in achieving their policy intent.

The Board acknowledged the rules were intended to reduce the Commissioner's reliance on Part IVA to deal with tax avoidance through the alienation of PSI. The large number of taxpayers who assess themselves as a PSB means that the Commissioner continues to need to rely on Part IVA to a considerable extent. The report indicated that taxpayers are also uncertain about the circumstances that would trigger the application of Part IVA once they have passed one of the PSB tests.

### ATO Compliance Activity

In relation to the potential application of Part IVA to income generated by a PSB, the ATO has issued a number of publications including a publication entitled *General anti-avoidance rules and how they may apply to a personal services business*.<sup>21</sup> In addition, the ATO has continued to work with tax professionals in developing guidelines as to the potential application of Part IVA to income generated by a PSB. For example, the National Tax Liaison Alienation of Income Group has issued a discussion paper on the alienation of income and Part IVA. It received significant input on that paper.<sup>22</sup> In

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<sup>20</sup> The Board of Taxation, 'Post-implementation review into the alienation of personal services income rules: A review to the Assistant Treasurer '(2009), *Commonwealth Government*, [http://www.taxboard.gov.au/content/content.aspx?doc=reviews\\_and\\_consultations/alienation\\_of\\_personal\\_services\\_income\\_rules/default.htm&pageid=007](http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/alienation_of_personal_services_income_rules/default.htm&pageid=007) at 1 February 2012.

<sup>21</sup> <<http://www.ato.gov.au/content/37495.htm>>.

<sup>22</sup> The paper has not been finalised to date and so has not been released publicly.

November 2010, the Attorney-General's Department published a discussion paper on improving the operation of the anti-avoidance provisions in Part IVA.<sup>23</sup>

The courts have also considered the PSI rules in determining whether a PSB exists. Most cases were decided between 2004 and 2008 with fewer being decided in 2009 and 2010, which suggests that the law is now more settled in this area.<sup>24</sup>

Accordingly, the ATO could implement more expansive compliance activity. However, as indicated, the ATO compliance activity may only be efficient to the extent that taxpayers identified are subject to the PSI rules. Regarding those taxpayers satisfying the PSB requirements, the ATO will have to consider applying Part IVA with its associated constraints.

### **Board of Taxation Recommendations**

The Board of Taxation Report made the following recommendations:

1. Providing some third party information to assist the ATO in monitoring compliance with the rules by introducing a reporting obligation, which could be supplemented by introducing a withholding obligation;
2. Addressing the alienation of income by entities deriving PSI by extending the attribution rules to PSB;
3. Clarifying and simplifying the deduction provisions;
4. Clarifying the rules around who is affected by the rules, possibly by implementing the tests of 'employee like manner' as originally recommended by the Ralph Report; or
5. Introducing a deemed labour income approach which would focus on distinguishing that part of an entity's income that is derived from an individual's labour from the part that is a return to their business assets or capital.

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<sup>23</sup> Assistant Treasurer, 'Improving the operation of the anti-avoidance provisions in the income tax law' (Working paper, 2010)  
<http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1901> at 1 February 2012.

<sup>24</sup> Examples of cases include – *Re Scimitar Systems Party Ltd v Deputy Commissioner of Taxation* [2004] ATTA 720; *Re Dibarr Party Ltd v Federal Commissioner of Taxation* [2004] ATTA 1030; *Re Skiba v Federal Commissioner of Taxation* [2007] ATTA 1705; *Re Dixon Consulting Party Ltd v Federal Commissioner of Taxation* [2006] ATTA 186.

### ***Recommendation 1***

The objective of Recommendation 1 is to assist with poor compliance and, in particular, getting the payer to report that a payment for personal services has been made. Paragraph 5.18 of the report states: ‘the reporting obligation could arise when a business makes a payment for the provision of labour services’.

The first observation that can be made is that reporting would only apply to business taxpayers and so, by definition, payers not carrying on a business would not have to report. Clearly, the recommendation would only provide partial reporting of all payments made. The report itself critically analyses this recommendation and highlights some positive aspects of this approach, while also identifying aspects that would make this recommendation difficult to apply. For example, paragraph 5.20 states:

it may be difficult for a payer to know whether the labour service that they acquired was provided as personal services income or whether it was provided through a business structure. If the reporting obligation is to apply too broadly, it could result in unnecessarily high compliance costs for payers compared to the compliance risk associated with personal services income.

Part of this recommendation included imposing a withholding obligation on payers. But the report is hesitant to implement such an obligation. At paragraph 5.27, it states:

the Board has not sought to design a withholding system. It only recommends that the option of withholding be considered as part of the broader options to generate third party information to assist compliance.

It is amazing that, despite the difficulties in applying this recommendation, the Board of Taxation put it forward as one of its final recommendations.

### ***Recommendation 2***

Recommendation 2 has more appeal. It builds on the existing PSI rules and the work done to date. It would retain and build on the current legislative structure and supporting educational and administrative guidance provided by the ATO. Paragraph 5.50 outlines the Board’s thoughts:

a next step would be to amend the existing alienation of the personal services income rules so that personal services income earned through an entity is attributed to the individual or individuals who provided the services. That is, this approach would apply the current attribution regime in the alienation of the personal services income rules to all taxpayers in receipt of personal services income, not only those who do not meet any of the tests to be a personal services business.

Under this approach, PSBs would be entitled to a greater range of deductions, while at the same time the residual PSI would be attributed. This approach may more effectively achieve the objectives of taxing PSI in the hands of the person providing the personal services, rather than currently relying on the high compliance Part IVA regime. Paragraph 5.52 makes this point: 'this option would address one of the key areas of current uncertainty, the interaction with Part IVA'.

This approach would essentially attribute PSI derived by a PSB to the individual service provider. Of course, given that the activity has satisfied the requirements to be classified as a PSB, it is more likely that the net income from the income earning activity has both personal services attributes and income derived from business assets and a business structure. The Board acknowledges this point in paragraph 5.53:

this approach may place more pressure on the distinction between income derived from personal services and income derived from a business structure.

It is recommended that a model be developed in which both the return from the use of capital and the return labour are determined. Then, the pure return from labour may be attributed to the individual who performed the personal services.

### ***Recommendation 3***

Recommendation 3 calls for a clarification of the deduction rules. In addition, the report calls for an expansion of the deductions available to non-PSBs for payments to associates in relation to non-principal work. The clarification of the deduction rules would be welcome and the expansion of the amount of deductions available to non-PSBs for non-principal work would bring more equity into the system. Currently, it would appear that a non-PSB has to employ a non-associate to undertake non-principal work in order to get a deduction. The Board, in making its recommendation, uses the following framework in paragraph 5.60:

as part of this option, the rules would allow a deduction for a payment to an associate incurred for the purpose of deriving assessable income that is made on an arm's length basis and can be regarded as being commercially in line with the level and skill of the actual work being undertaken.

This approach would remove the current inequity that exists for non-PSB entities where payments are made to associates without creating leakage of net PSI to family members above the commercial return for the services provided by the associates.

### ***Recommendation 4***

Recommendation 4 calls for the clarification as to who is captured by the rules, and replaces the current PSI focus with tests to determine whether a person is operating

in an employee-like manner. The Board stated this was what the Ralph Report originally recommended, but did not provide any significant support in its report for this recommendation. In fact, at paragraph 5.52, the Board concluded that using a PSI approach does not impinge on the Ralph Report recommendations:

... moving to a focus on personal services income rather than 'employee like' for the purposes of addressing alienation is not a departure from the current policy.

In other words, the report does not provide sufficient support for its recommendation that the focus of the PSI rules should be on an employee-like manner model and confirms that the current focus on PSI is not inconsistent with the Ralph Report's objectives. On the basis of this analysis, the recommendation is redundant.

### ***Recommendation 5***

Recommendation 5 calls for a deemed labour income approach where the income derived from PSI is determined separately from the return on business assets or capital. This recommendation has significant similarities with recommendation 2 discussed above.

### **Summary of Board's Position**

In summary, this analysis of the Board of Taxation's recommendations concludes that:

1. The drawbacks from implementing a third party monitoring and reporting regime would out-weigh any positives from this approach;
2. Extending the attribution rules to personal service businesses may assist in achieving the objectives of the PSI rules but that the attribution should only apply to the income that is exclusively personal services income;
3. Clarifying the deduction provisions would be welcome, in addition to extending deductibility of commercial payments to associates who perform non-principal work;
4. The Board does not provide sufficient support for its recommendation to revise the PSI rules and introduce an 'employee-like manner' test and so this recommendation is not supported by the author of this article; and
5. The introduction of a deemed labour income approach may assist in achieving the objectives of the PSI rules.

Consistent with the terms of reference, the Board recommended that its options be considered further in the context of the Review of Australia's Future Tax System headed by Dr Ken Henry.

## HENRY REVIEW RECOMMENDATION

In his 2009 report, Dr Ken Henry and his team called for changes to the taxation of PSI. Recommendation 10 states:

consideration should be given to a revised regime to prevent the alienation of personal services income that would extend to all entities earning a significant proportion of their business income from the personal services of their owner-managers, whether in employee-like or non-employee-like cases. This regime may also apply an arm's length rule to deductions arising from payments to associates to ensure deductions reflect the value of services provided.<sup>25</sup>

The Henry Review is calling for a revised regime to ensure that PSI is not alienated from the person performing the services. In contrast with the Board of Taxation's recommendations, there is little detail or direction as to how this revision should take place. Accordingly, in the absence of specific direction, it seems the Henry Review does not disagree with the revisions suggested by the Board of Taxation. The Henry Review specifically calls for an arm's length rule for payments made to associates. This could be seen as support for the Board of Taxation's Recommendation 3, where it called for the deductibility of commercial or arm's length payments made to associates.

## THE STORY SO FAR

Where the PSI rules apply,<sup>26</sup> there is a restriction on the amount of deductions available, and the income is attributed to the person providing the personal services. In essence, the following objectives of the PSI rules have been satisfied when income is not generated by a PSB:

1. Taxpayers cannot deduct a greater range of deductions when using an entity when compared with not using such an entity;
2. Taxpayers cannot use an interposed entity to share the PSI with other parties;

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<sup>25</sup> Dr Ken Henry, Review Panel, 'Australia's Future Tax System: Report to the Treasurer' ('Henry Review') (2009), Chapter 12, available: <[http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/papers/Final\\_Report\\_Part\\_1/chapter\\_12.htm](http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/papers/Final_Report_Part_1/chapter_12.htm)>.

<sup>26</sup> *Russell v Commissioner of Taxation* (2011) 190 FCR 449 confirms PSI rules are an anti-avoidance provision.

3. Taxpayers cannot use an interposed entity to cap the rate of tax at the company tax rate (currently 30%) and defer the derivation of income by individuals from the company until a time when the related individuals have a lower rate of tax; and
4. Taxpayers cannot access a greater range of income-tested government payments and a potentially reduced liability to other obligations such as higher education contribution charges (HELP), Medicare levy and superannuation surcharge and child support payments.

By contrast, those taxpayers classified as a PSB, outside the scope of income attribution in the PSI rules, may not completely satisfy the original objectives of the PSI regime, in the following manner:

1. Taxpayers may be able to use an interposed entity to share the PSI with other parties to the extent that Part IVA does not apply;
2. Taxpayers may be able to use an interposed entity to cap the rate of tax at the company tax rate (currently 30%) and defer the derivation of that income by individuals from the company to the extent that Part IVA does not apply; and
3. Taxpayers may be able to access a greater range of income-tested government payments and a potentially reduced liability to other obligations such as higher education contribution charges (HELP).

This analysis would appear to indicate that the objectives of the PSI rules have been satisfied where the activity is not considered to be a PSB. The Board of Taxation in its report indicated that, of those entities reporting they derived PSI, only 27% of them were subject to the PSI rules. Therefore, it may be asserted that the objectives of the PSI rules have been satisfied to that extent.<sup>27</sup> By contrast, the number of entities earning PSI that reported themselves to be a PSB was 73%. It is likely this figure contributed to the Board's conclusion that the PSI rules were only partially successful in ensuring that PSI is taxed to the person generating that income.

## THE WAY FORWARD

To satisfy the objective that PSI should be taxed to the individual generating that income, the threshold requirement should be that it is only pure PSI attributed in this

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<sup>27</sup> The Board of Taxation, 'Post-implementation review into the alienation of personal services income rules: A review to the Assistant Treasurer' (2009), *Commonwealth Government*, [2.35], [http://www.taxboard.gov.au/content/content.aspx?doc=reviews\\_and\\_consultations/alienation\\_of\\_personal\\_services\\_income\\_rules/default.htm&pageid=007](http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/alienation_of_personal_services_income_rules/default.htm&pageid=007) at 1 February 2012.

manner. The earlier discussion on the definition of PSI clarified that, where there are other identifiable contributors to the generation of the income (assets, goodwill, support staff, etc), an appropriate return should be allocated to those contributions. This should be separated from the gross income derived to determine the residual pure PSI. It may be difficult to value contributions made by these other business assets in all cases. Therefore, it may be necessary to approach the problem from the perspective of valuing the particular contribution from personal services, in association with the other contributions.

### **Benchmark Remuneration**

To determine the discrete contribution from the personal services of an individual to the income of a PSB, it would appear appropriate to establish a benchmark remuneration standard for different types of income earning activities. This is what the Board of Taxation called for in Recommendation 5, where it suggested a deemed labour income approach would enable the pure PSI amount to be determined.

#### *Determining benchmark remuneration*

If a benchmark remuneration amount were to be established, the question is: who should determine the benchmark amount for a particular type of income earning activity? The obvious choices would be the taxpayer or the ATO. If individual taxpayers were to prepare individual benchmarks, this would give rise to significant compliance costs for individual taxpayers to research and prepare their own benchmark. There is likely to be substantial duplication of effort by individual taxpayers where taxpayers in a similar industry prepare separate benchmarks. For example, all civil engineers in the mining industry would most likely have to do similar work to arrive at a similar conclusion. In addition, where the ATO disagreed with individual benchmarks, the administrative costs associated with litigating the variation between the individual benchmark and the ATO position may be immense.

One approach would be for the ATO to develop the remuneration benchmarks and make them available to taxpayers and their professional advisers. An example of existing ATO prepared benchmarks are the small business benchmarks,<sup>28</sup> which are

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<sup>28</sup> ATO, 'Small Business Benchmarks' (2012) <http://www.ato.gov.au/businesses/pathway.aspx?pc=001/003/102&alias=businessbenchmarks> at 1 February 2012.

Performance benchmarks have been developed using information on income tax returns and activity statements. Performance benchmarks help you to:

- compare your business performance with others in your industry
- check you have correctly recorded all of your income, particularly cash income.

Performance benchmarks contain several ratios to help you compare and check your own business performance. The ratios for a particular industry may include:

accessible on the ATO website. The ATO suggests that the use of ATO established small business benchmarks create more equity and fairness by creating a universal benchmark for a particular industry or business type. To ensure overall fairness, it should still be possible for taxpayers to determine their own benchmark, provided that the benchmark has been determined objectively.

Remuneration benchmarks prepared by the ATO may achieve efficiency, reduce compliance costs, and ensure a consistent benchmark standard is developed for a particular industry or PSI type. For example, the ATO could undertake research to determine benchmark remuneration for professional engineers, and sub-classify the different types of engineers into civil, mechanical, project management, electrical, etc. A further sub-classification could be based on the industry type in which the engineer works or the location of employment. Guidance on classification and remuneration for each industry would be available from labour hire firms.

Once prepared, this benchmark information would then be freely available to taxpayers providing personal services in a particular industry or sub-category within that industry. The information would enable taxpayers providing personal services the opportunity to determine how their level of financial performance compares to the industry benchmark.

The relevant data in developing the remuneration benchmarks would be the comparable total remuneration received by an employee with similar skills performing similar tasks. The benchmark remuneration would include the full remuneration package of a comparable employee. It would consist of salary, superannuation, annual leave and any fringe benefits provided. It is likely that a particular remuneration benchmark would indicate a range within which a comparable employee may be remunerated. For example, benchmark remuneration for a civil engineer working in the road construction industry may have a range of \$90,000 to \$120,000. In addition, where a civil engineer provides personal services on a part time basis, then the income from that fractional contribution would enable the benchmark remuneration to be adjusted accordingly.

The benchmark remuneration is unlikely to include entitlements to long service leave, sick leave or potential redundancy or termination payments. The rationale for excluding these amounts from the remuneration benchmark is because a comparable

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- cost of goods sold to turnover
  - cost of materials to turnover
  - labour to turnover
  - rent to turnover
  - motor vehicle expenses to turnover.

employee will not derive these amounts until the occurrence of a particular event, including taking long service leave, falling ill, or employment termination. It is recognised also that there is no tax deduction available to an employer until these amounts are actually paid.<sup>29</sup> To include these amounts in a benchmark remuneration would create an unrealistic benchmark, where the person providing the personal services may be assessable on income for which their PSE would not be entitled to a tax deduction.

The excess of net income of the PSE over the benchmark remuneration is not PSI. Accordingly, is not required to be taxed in the hands of an individual. Therefore, it can be retained or distributed to the owners of the PSE (in the case of a company), or distributed to the beneficiaries of a discretionary trust. Providing that the normal requirements of Part IVA, and any other provisions are not contravened, the income should be able to be retained within the entity or distributed to the owners of the entity.

The actual contribution from personal exertion to the income of a PSB could be determined by a combination of valuing the contribution from other assets and sources (with the remainder being the contribution from personal exertion). Alternatively the contribution of personal exertion itself could be valued through the use of benchmark remuneration.

### *Practical Considerations with Benchmark Remuneration*

Having calculated benchmark remuneration for a particular occupation, and calculated the contribution of assets and other parties to the income of the PSB, it may be that the calculated benchmark remuneration is greater than the actual amount of pure PSI generated by the PSB.

The reason for a lower level of PSI in the PSB may result from a number of factors including:

1. A higher level of overhead and administrative costs associated with operating a business having only one person when compared to a business with a similar level of overhead but a greater number of staff to apportion that overhead;

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<sup>29</sup> Section 26-10 ITAA 97: you cannot deduct under this Act a loss or outgoing for long service leave, annual leave, sick leave or other leave except:

- (a) an amount paid in the income year to the individual to whom the leave relates (or, if that individual has died, to that individual's dependant or legal personal representative); or
- (b) an accrued leave transfer payment that is made in the income year.

2. A sole operator may be limited in the range of contracts they can take on because many of the contracts may require a team of two or more to be most efficient;
3. Part of a highly skilled sole operator's time may be consumed by lower level tasks such as answering the phone, dealing with administrative issues and sundry tasks that could easily be performed by a person who is less skilled; and
4. A sole operator may be in the growth phase of their business without an established client base and it may take time for the sole operator to develop a business that would enable them to get the best return for their time and the other contributors to the income.

As a result of these factors (and others), if the PSE has generated an amount less than the benchmark remuneration level, only this lesser amount of pure PSI generated would constitute PSI.

### **Evolution of a Business**

Sole operators operating through a PSE may have a particular evolutionary track. These may result in the sole operator continuing to operate on their own through their PSE and, if they cannot establish themselves as a PSB, all PSI will be attributed to them. In contrast, the sole operator using a PSE may evolve to a point that the income earning activity is considered to be a PSB. If the sole operator's commercial activity evolves to a stage where their PSE no longer derives PSI because the income is generated mainly from the services of more than one person or a return from the use of assets, then the PSI rules would no longer apply. The net income of the business could then be retained in the PSE (if a company), distributed to the owners of the business (company shareholders), or to the beneficiaries of a trust.

### **THE CURRENT STATE OF PLAY**

The Federal Government, while acknowledging the recommendations of the Board of Taxation and the Henry Review, has indicated that it is in no hurry to make any changes to the current PSI rules. In other words, tax practitioners and their clients may continue to live with uncertainty in relation to the potential application of Part IVA to entities classified as a PSB. Notwithstanding that no action may be taken in the near future to change the PSI rules, we can glean a number of things from the recent deliberations of the Board and the Henry Review that may assist in limiting the exposure of PSBs to the application of Part IVA.

Part IVA applies where, having regard to the matters listed in s 177D(b)(i) to (viii), it could be concluded that a person who entered into, or carried out, a scheme, or part

of a scheme, did so for the purpose of enabling the taxpayer to obtain a tax benefit in connection with the scheme.<sup>30</sup> The most likely tax benefit in a PSI environment is when an individual, using an entity to derive PSI, receives substantially less income than they would have received if they provided the services in their individual capacity as an employee or contractor.

The challenge to activities classified as a PSB is demonstrating there is no tax benefit derived by the individual taxpayer (no diversion of PSI). If no tax benefit exists, then Part IVA does not apply. If a PSB remunerates the individuals performing the work to the extent of their contribution to the income of the PSB for those personal services, the potential application of Part IVA will be avoided. Any income derived by the PSB from other factors does not have to be attributed to the same individual.

## **CONCLUSION**

The objectives of the PSI rules to have PSI taxed in the hands of the individuals generating that income were partially satisfied through the PSI rules. Through a combination of valuing the contribution of personal exertion using benchmark remuneration and the contribution from the use of assets, employee(s) and other items, a pure return on personal services may be determined. In the absence of legislative change to the current PSI rules, a demonstrated effort to distribute the pure return from personal exertion to the individual who generated it would significantly limit the potential application of Part IVA.

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<sup>30</sup> Sections 177A-177H of the ITAA 36.