



Middleton Partners

CERTIFIED PRACTISING ACCOUNTANTS

“Continuing the tradition of Personal Professional Service”

Special e-Bulletin

Welcome to our *Middleton Partners e-Bulletin* covering items that may be of interest. Please read and contact our office if further information or clarification is required.

Alienation of personal services income

The alienation of personal services income (PSI) rules were introduced to effectively tax contractors, who were deriving their income from their own skills, expertise or the provision of personal services, on a similar basis as employees. The rules applied regardless of whether the contractor operated as a sole trader or through a company, trust or partnership entity.

The PSI rules apply only to personal services income. They do not apply to an independent contractor (or their entity) that is accepted as conducting a personal service business. That would include –

- independent contractors (or their entities) that contract on a results basis;
- independent contractors (or their entities) that have self assessed and satisfied one of the following tests:
 - the unrelated clients test,
 - the employment test, or
 - the business premises test;
- agents that satisfy the unrelated clients test; or
- independent contractors (or their entities) that obtained a personal services business determination from the Tax Office.

The flowchart sets out in simple terms how the PSI rules operate.

WARNING: Commencing from 1 July 2002, those contractors that were subject to the former prescribed payments system are subject to the alienation of personal service income rules for the first time. Previously, those contractors were exempted from the PSI rules if they had a PPS payee declaration in force as at 13 April 2000.

How the system works

The PSI rules, that are contained in Divisions 84, 85 and 86 of the 1997 Act, operate to limit or deny deductions for some of the business related expenses incurred by the contractor or their entity. Those taxpayers that fail the prescriptive tests (ie those that are not treated as conducting a personal services business) are required to return, as their individual income, all of the income earned from the provision of their personal services.

Entitlement to certain deductions is also limited.

Those caught by the PSI rules are specifically excluded from being treated as employees, however there are PAYG withholding obligations imposed on any entity in which they conduct their personal, service activities.

Conversely, the PSI rules do not affect any independent contractor (or any entity within which they conduct their personal services business).

WARNING: Regardless of whether a taxpayer is treated as conducting a personal services business and therefore excluded from the PSI rules, the Tax Office can still use its anti avoidance powers under Part IVA. The ATO has already indicated that it will apply its anti avoidance powers to prevent the splitting of income through the use of the taxpayer's trading entity, and the retention of personal services income in a company beyond the end of the income year. The ATO has indicated that it will be looking quite closely at personal service businesses that split income with other members of the family, especially through trusts and companies. The ATO will target those contractors that operate through interposed entities especially where there is little in the way of business infrastructure or plant and equipment used to derive the income of the entity.

Personal services income

Under the rules, income will be treated as personal services income if it is a reward for your personal efforts or skills, or if the income is derived by an entity it would mainly be such a reward if it was your income.

Section 84-5(1) of ITAA97 states:

Your ordinary income or statutory income, or the ordinary income or statutory income of any other entity, is your personal services income if the income is mainly a reward for your personal efforts or skills (or would mainly be such a reward if it was your income).

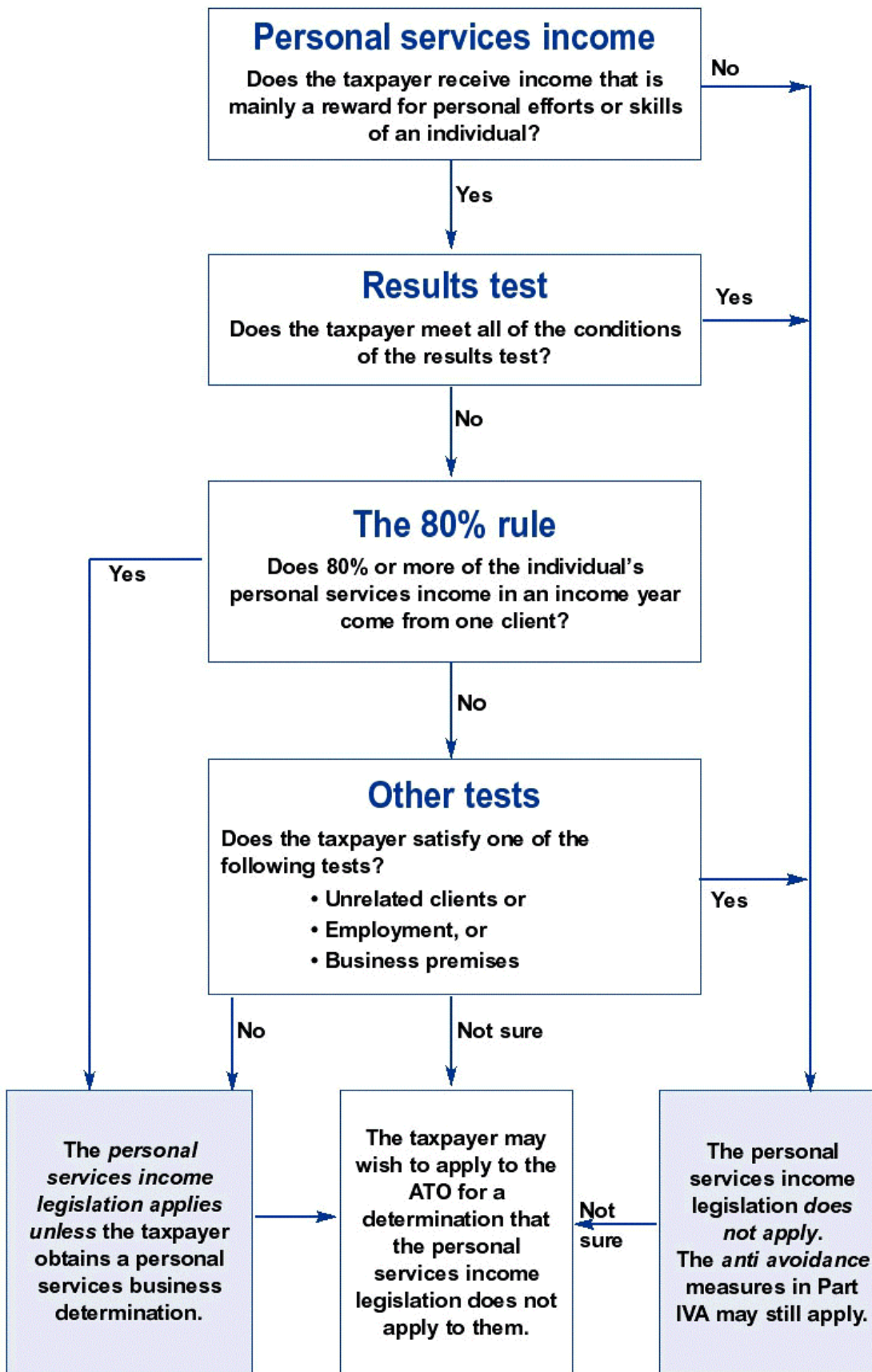
In TR 2001/7 it is stated:

Implicit in the use of the word 'mainly' is that more than half of the relevant amount of the ordinary or statutory income is a reward for the personal efforts or skills of an individual.

This is a question of fact. According to the Ruling, the reference does not preclude situations where the provision of personal services involves the use of some equipment. Where the substance of an agreement is the provision by an individual of his or her personal efforts or the exercise of his or her skills, or the production of a result from those efforts or skills, income would still be regarded as personal services income.

IMPORTANT: You are welcome to forward this e-Bulletin to friends or associates but **most importantly** please note that this e-Bulletin is not advice. This e-Bulletin is issued as a guide to clients and should only be acted upon after seeking formal professional advice.

© 2005 Middleton Partners



Further, the Ruling states that income from a business structure is not personal services income. Factors used to identify income from a 'structure' include the nature of activities, number of employees/contractors, the extent income depends on the endeavours of an individual, existence of goodwill or substantial income-producing assets, and size of the undertaking.

Income that is mainly for granting of a right to use property is not personal services income nor is income mainly for sale and supply of goods or income mainly for supply and use of assets held by an individual or a personal services entity.

WARNING: The existing Taxation Rulings that have been issued by the Tax Office dealing with the alienation of personal services income and the anti-avoidance rules under Part IVA (eg. IT 2503, IT 2639, IT 2121, IT 2330 and IT 2501) remain in force.

The ATO has announced that it intends to establish a test case program that is aimed at income splitting arrangements. It has also released a fact sheet drawing together all of the information from previous Rulings.

Results test

The primary test under the PSI rules is the results test. This test is a self assessed test and a contractor or their trading entity will be treated as a personal services business if they receive at least 75% of the personal services income for producing a result.

The following criteria must be satisfied to pass the results test –

- the contractor works to produce a result. For example, a contract to build an earth dam for a set price would be a contract for a result. In contrast the payment on an hourly basis to dig the hole is probably a contract for personal services and would not satisfy this criterion;

WARNING: It is not essential that the terms and conditions of the 'work' to be performed are specifically included in a written contract. In determining whether the contractor satisfies the results test, the custom and practice in the particular industry will be taken into account. For example, if the custom is for the contractor to rectify their work, that will be sufficient for the contract to be treated as a contract for a result. If there is any doubt, it would be wise to set out in writing the terms and conditions.

- the contractor provides the tools and equipment necessary (if any) to produce the result; and
- the contractor is (or would be) liable for the cost of rectifying any defective work.

WARNING: The 75% requirement does not include any income received by the contractor or their entity in their capacity as an employee nor as an office holder (eg. director of a company), nor income derived by religious practitioners undertaking their religious activities.

If the contractor (or their trading entity) cannot satisfy the results test, there are three other options –

- Self assess against one of the following tests. This is available only if less than 80% of the taxpayer's personal service income is derived from a single source;
 - The unrelated clients test,
 - The employment test, or
 - The business premises test;
- Apply to the ATO for a personal services business Determination. This is available regardless of whether the taxpayer derives more or less than 80% of their personal services income from a single source. For taxpayers who receive more than 80% from a single source, this is the only way to be treated as a personal services business. The ATO will only grant such a determination provided the taxpayer satisfies one of the tests listed in the first dot point; and
- Apply the PSI rules because the taxpayer is not treated as a personal services business.

EXAMPLE 1: A taxpayer owns one semi trailer and he is the only person who drives it. The income derived from driving the truck is not personal services income because it is mainly produced by the use of the truck and not mainly as a reward for the personal services of the taxpayer.

EXAMPLE 2: A taxpayer provides a computer programming service but she does all of the work involved in providing those services and uses the client's equipment and software to do the work. The income derived would be treated as personal services income as it is a reward for her personal efforts or skills.

EXAMPLE 3: A taxpayer works as an accountant for a large accounting firm. None of the firm's ordinary or statutory income is personal services income because it is produced mainly by the firm's structure and not mainly for his personal efforts or skills.

Personal services business

A contractor (or their trading entity) will be taken to have derived PSI unless he/she is treated as carrying on a personal services business by satisfying any one of the following tests –

- the results test;
- the unrelated clients test;
- the employment test; or
- the business premises test.

WARNING: Unless the individual has passed the results test, the individual (or the personal service entity) will still be required to obtain a determination from the Tax Office if 80% or more of the person's personal services income is derived from the same entity (or an associate of that entity) during the income year. If a determination is not obtained where the 80% test is failed then the individual or entity will not be treated as a personal services entity.

The unrelated clients test

To satisfy the unrelated clients test, the individual or entity must provide services to 2 or more unrelated entities (that are neither associated with each other nor the individual or personal service entity), and the services are provided as a direct result of making offers or invitations (eg. advertising) to the public at large (or to a section of the public). Services offered through labour hire companies and other such businesses that arrange to provide services directly for clients do not qualify under this test.

IMPORTANT: You are welcome to forward this e-Bulletin to friends or associates but **most importantly** please note that this e-Bulletin is not advice. This e-Bulletin is issued as a guide to clients and should only be acted upon after seeking formal professional advice.

IMPORTANT: The test must be satisfied over the entire income year if the contractor is to pass the test. The test is failed if any of the criteria is not satisfied during any part of the year.

Special rules apply to agents. The rules operate on a 'look through' basis to treat the income received from the principal as though it were earned directly from the customers of the principal. They are intended to apply to agents who bear entrepreneurial risk in the way they provide services. They do not apply to employees of the principal.

The principal beneficiaries of this change are financial planners and insurance agents who derive their income from fees and commissions.

To be subject to the new rules the agent must satisfy the following criteria –

- the agent receives income (eg. fees for service or commissions) from the principal for services the agent has provided to other individuals or entities (customers) on the principal's behalf; and
- at least 75% of that income is commissions or fees based on the agent's performance in providing those services; and
- the agent actively seeks new customers to whom the agent can provide services on behalf of the principal; and
- the agent does not provide the services to customers from premises that are owned by or in which the principal or an associate has a leasehold interest unless a completely independent commercial arrangement exists.

An agent is allowed to have a fixed remuneration such as a retainer or salary-like payment of up to 25%; however at least 75% of the agent's personal services income from the principal must be income based on the agent's performance in providing services to customers on the principal's behalf. In other words, the agent's income must be at risk. The agent must also actively seek new customers to whom they could provide services on behalf of the principal. It will be incumbent on the agent to demonstrate that they are making an active effort (eg. by advertising) to obtain customers. The active test is not satisfied by receiving referrals from the principal or allowing the principal to take all of the responsibility for obtaining customers.

The independent commercial arrangement criteria are not satisfied if any part of the services provided to the customer are performed on the premises of the principal or an associate that are not covered by a commercial arrangement.

In determining whether an agent satisfies the 80% test, the income received from the principal for providing services to the customer will be treated as income derived from the customer if the above conditions are satisfied. This is the effect of the 'look through' rule. The customers are in effect treated as customers of the agent.

The net effect of this rule is that the agent is deemed to have derived less than 80% of their personal services income from a single source for the purpose of applying the business tests. As a consequence, the agent can self assess but is not limited to the results test.

Provided the agent can demonstrate that the services provided to their customers directly resulted from making offers or invitations to the public at large or to a section of the public, the conditions of the unrelated clients test will be satisfied and the agent will be treated as a personal services business.

The following example is modified from the Explanatory Memorandum.

EXAMPLE 4: Gordon is a financial planner who holds a proper authority under the Corporations Law to act as agent for Champagne Financial Services, a licensed securities dealer. Gordon receives 85% of his income from Champagne as commissions, dependent on the level of services Gordon provides to customers of Champagne. Gordon advertises his services once a month in financial papers and in professional associations.

Champagne operates from 5 floors of an office block which they lease, and one of those floors is dedicated for Champagne proper authority holders. Gordon uses an office and has access to other facilities under a commercial agreement.

Gordon satisfies the requirements in s.87-40(1) and is consequently entitled to use the special test for agents. He would also be treated as having derived less than 80% of his personal services income from one source as he provided services directly.

Gordon satisfies the Unrelated clients test as he advertises to the public and does not receive referrals from Champagne. Gordon would be entitled to self assess as a personal services business.

The employment test

An individual will satisfy the employment test if he/she engages one or more entities (other than associates of the individual that are not individuals) during the income year, and that entity, or those entities together perform at least 20% of the market value of the individual's principal work for the year.

A personal service entity will satisfy the employment test in an income year if it engages one or more other entities to perform work (other than individuals whose personal services income is included in the entity's ordinary or statutory income or associates of the entity that are not individuals). The value of work performed by those entities must exceed 20% of the market value of the entity's principal work for the income year.

For partnerships, the value of work performed by one partner for another in generating any personal services income is taken into account.

WARNING: There are deduction restrictions that apply to payments to associates. Only amounts that specifically relate to work that associates have undertaken as part of the principal work in earning the personal services income are deductible.

Principal work is the work essential to generating personal services income (eg. a bricklayer's principal work would be bricklaying services). Principal work does not include the personal services entity's own administrative work.

Both an individual and a personal service entity will also satisfy the employment test if they have one or more apprentices for at least 50% of the income year.

The business premises test

The business premises test will be satisfied by either an individual or personal service entity if at all times during the income year they maintain and use business premises at which the individual or entity mainly conducts activities from which personal services income is gained or produced, and that are –

- used exclusively by the individual or personal service entity to produce their personal services income;

IMPORTANT: You are welcome to forward this e-Bulletin to friends or associates but **most importantly** please note that this e-Bulletin is not advice. This e-Bulletin is issued as a guide to clients and should only be acted upon after seeking formal professional advice.

- physically separated from any other premise that is used for private purposes by the individual or personal service entity or any of their associates defined in s.318 of ITAA36 which includes –
 - a relative;
 - a spouse;
 - a partner or a partnership of which you are a partner ;
 - a trust of which you are a trustee or a beneficiary, or
 - a company which you control;
- physically separated for the premises of any of their clients (or associates of those clients) for whom they provide services.

IMPORTANT: The test must be satisfied over the entire income year if the contractor is to pass the test. The test is failed if any of the criteria is not satisfied during any part of the year.

TIP: Government departments and agencies are not treated as associates of each other.

Tax Office Determinations

The Tax Office is empowered to issue written Determinations. The effect of the Determination is that the individual or entity will be regarded as conducting a personal services business during the period of the Determination.

For individuals and entities, the Tax Office cannot issue a Determination unless it is satisfied that the individual meets, or has met, in the income year the Determination has effect, the following criteria –

- either or both the business premises test or employment test ; and
- apart from unusual circumstances, any one of the 3 tests could be satisfied (or the ATO is satisfied that any of those tests will be met in future income years); or
- the individual's personal services income was derived from activities that satisfied either of the above 2 conditions.

The Tax Office can also make a Determination if the following conditions are satisfied –

- the personal services entity's service contract involves producing a result; and
- the personal services entity supplies plant and equipment, or tools of trade needed to produce that result; and
- the personal services entity is liable for the cost of rectifying any defect in the work performed; and
- 80% or more of personal services income could reasonably be expected to be from the same entity or the same entity and its associates.

In determining whether the entity meets the above requirements, the Tax Office can have regard to whether it is the custom or practice (in the particular industry) for those conditions to occur, when work of that particular kind is performed by an entity other than an employee.

When Determinations have effect

The Determination (or variation of it) has effect from the day specified in the notice (or if no date is specified, the date of the notice). It ceases to have effect at the earliest of when –

- any condition of the notice is not met; or
- the Taxation Office revokes the Determination; or
- the period for which the Determination has effect has come to an end.

The Taxation Office must revoke the Determination if no longer satisfied there are grounds for the Determination to have effect.

Applications for a Determination must be made on the approved form and the Tax Office has 60 days to respond. If a decision is not made within that time, the applicant can request the Tax Office to treat the application as having been refused. Any application for a Determination (or a variation of a Determination) that is refused by the Tax Office is a reviewable decision and the applicant has the right to object against that decision.

Impact if taxpayer caught by PSI rules

The PSI rules only affect the income tax treatment of personal services income. They do not have any GST effect. If the personal services income is paid to a company, trust or partnership, that income is still the personal services income of the individual.

For income tax purposes the PSI rules do not affect the legal, contractual or workplace arrangements. Further, the individual will not be treated as an employee. For taxpayers who cannot satisfy the tests or have not obtained a PSB Determination from the ATO, many of their deductions will be limited or denied.

Where an individual is treated as having earned personal services income there will be a limit on the type and amount of income tax deductions to which they will be entitled. Broadly, the deductions available to persons earning personal services income will be limited to those that would have been allowable as if that person was an employee.

EXAMPLE 5: A person who works as an independent architect for one firm and who fails the PSB tests would not be conducting a personal services business and as such would not be entitled to claim a deduction for the cost of travelling from home to the client's business premises. The cost of a home office would be allowed, but the claim would be limited to heat, light and power plus consumables and depreciation on plant and equipment.

No claim would be allowed for interest or any other occupancy expenses. The extent of the claims for expenses incurred in gaining the personal services income would be limited to those claims allowed to an employee undertaking similar work.

Claims would continue to be deductible (Division 85-10) for the cost of –

- gaining work (eg. advertising, tendering, and quoting for work);
- insuring against loss of your income or earning capacity (eg. sickness, accident and disability insurance);
- liability insurance (eg. public liability and professional indemnity insurance);
- engaging an entity that is not an associate to perform work;
- engaging an associate to perform work that is a principal part of the work from which you gain your personal services income (Warning: There are limitations on the amount that can be claimed);

IMPORTANT: You are welcome to forward this e-Bulletin to friends or associates but **most importantly** please note that this e-Bulletin is not advice. This e-Bulletin is issued as a guide to clients and should only be acted upon after seeking formal professional advice.

- superannuation contributions for yourself (or your dependants in the event of death);
- workers compensation premiums and similar payments required under the law, or payments to an employee for work related travel; and
- meeting your obligations, or exercising rights, under GST law.

Claims for payments to associates are limited. As a general rule, payments to an associate are only deductible to the extent that they relate to engaging your associate to perform work that forms part of the principal work for which you gain or produce your personal services income.

Deductions are specifically not allowed (Div 85-20) for all other payments to associates, with the exception of superannuation contributions if an associate's work forms part of the taxpayer's principal work. The deduction available is limited to the amount necessary to avoid paying the superannuation guarantee charge (ie. 9% in 2004/05) based on that component of the associates 'salary' that is deductible to you.

Claims are not allowed for the following for your own residence or the residence of your associate –

- rent;
- mortgage interest; and
- rates or land taxes.

Entities

The rules not only affect individuals who are operating as sole traders, they also affect those who are conducting their operations through another entity (eg. company, partnership or trust whose ordinary or statutory income includes the personal services income of one or more individuals).

Unless the person is carrying on a personal services business (PSB) the income of the entity from rendering personal services (excluding any GST component) will be treated as the individual's personal services income unless it is paid as salary and wages.

The effect of the new rules is to prevent individuals from reducing or deferring their income tax liabilities, or alienating their personal services income through interposed entities.

WARNING: It is possible for an entity to derive both personal services income and non-personal services income (eg. interest, rent, dividends etc.). These new rules do not affect any non-personal services income.

Also, any GST that has been collected by the entity is excluded from the calculation of a person's personal services income. GST is neither assessable income nor exempt income.

In calculating the amount of income in an entity that must be treated as the personal services income of an individual, the entity is entitled to claim certain deductions and the new rules contain a formula to ensure that the extent of those deductions can never be greater than the amount of the income.

Step 1: Work out the amount of deductions allowed (other than entity maintenance deductions) against the personal services income.

As general rule a personal services entity can only claim deductions for expenses that relate to the earning of the individual's PSI. In broad terms this means that only those expenses that would be deductible to an individual are also deductible to the entity. In general terms, deductions allowed include –

- car expenses where there is no private use component (ie. used solely for income earning purposes);
- car expenses where there is private use. In this case the claim is limited to the expenses (including FBT) on only one car. If there is more than one car involved then the entity is entitled to a claim in respect of only one of those cars. The entity must choose which car. Once made that election applies until the car is disposed of. Where no deduction can be claimed, no FBT is payable;
- superannuation contributions for the person whose PSI is included in the entity's ordinary income;
- superannuation contributions for associates, but the amount is limited to the SGC (ie. 9% in 2004/05) rate applicable if that individual performs the entity's principal work (ie. 20%). If less than 20%, there is no deduction;
- payments to associates but the claim is limited to the amount that specifically relates to work they have undertaken; and
- other payments incurred in gaining the individual's assessable income (eg. depreciation on plant) provided the income is returned in the individual's tax return. The exception to this rule is where the entity carries on a personal services business.

Step 2: Work out the entity maintenance deductions.

Each of the following is an entity maintenance deduction –

- any fee or charge payable for opening, operating or closing an account with a financial institution;
- any tax-related expenses (allowed under s.25-5);
- losses or outgoings incurred in preparing or lodging any document under the Corporations law; and
- any fee payable to an Australian Government agency for any licence, permission. Approval, certification etc granted or given under a Australian law.

Step 3: Work out the entity's assessable income for the income year from non personal services income sources.

Step 4: Subtract Step 3 from Step 2. (Note: This step is designed to ensure that entity maintenance deductions are first deducted from non-PSI income.)

Step 5: If the amount in Step 4 is greater than NIL, the amount of the reduction is the aggregate of Steps 1 & 4.

Step 6: If the amount under Step 4 is less than NIL, the amount of the reductions is limited to the amount in Step 1.

Where multiple individuals derive personal services income through an entity, the reduction allowed under Step 4 must be apportioned in accordance with the amount of PSI income earned by each person.

If the above calculation results in a loss (ie. the individual's personal services income is less than the deductions allowed) then that loss is an allowable deduction in that income year. Any unused loss is able to be carried forward (s.86-27).

An individual is able to deduct a net PSI loss from other income (the loss is calculated according to SS.86-27 and 86-87 of the ITAA 1997).

IMPORTANT: You are welcome to forward this e-Bulletin to friends or associates but **most importantly** please note that this e-Bulletin is not advice. This e-Bulletin is issued as a guide to clients and should only be acted upon after seeking formal professional advice.

The entity will have until the 14th day after the end of the PAYG payment period in which to pay the income (excluding any GST component) as salary to the individual, otherwise it is treated as the PSI of the individual.

- the entity should issue a Payment summary - personal services attributed income (the summary can be prepared at the time of preparing the entity's return form);
- the individual taxpayer's copy of the payment summary should be attached to their return form and attributed personal services income amounts; and
- the Tax Office's copy of the payment summary, accompanied by a PAYG payment summary statement, should be forwarded to the Tax Office as soon as possible after completion, but no later than the lodgment of the tax return.

EXAMPLE 6: The taxpayer's company has derived \$120,000 of income that has been directly derived through the personal services of the taxpayer.

The company is entitled to claim \$50,000 of deductions (ie. superannuation contributions paid to a complying superannuation fund) (Step 1). The company is entitled to entity maintenance deductions (ie. lodgement fees and tax agent fees) of \$3,000 (Step 2). The company has also separately derived investment income of \$20,000 (Step 3). As Step 4 (ie. Step 2 less Step 3) is less than NIL, Step 5 is not applicable.

The company is entitled to a reduction of only \$50,000 (ie. the Step 1 amount). Consequently, the taxpayer's personal services income is \$70,000 (ie. \$120,000 less \$50,000).

EXAMPLE 7: In Example 6, if the amount of other income (ie. Step 3) was \$2,000, the company would have been entitled to a reduction of \$51,000 (being the amount in Step 1 (ie. \$50,000) plus the difference between Step 3 and Step 2 (ie. \$3,000 less \$2,000). In that case, the taxpayer's personal services income would have been \$69,000 (ie. \$120,000 less \$51,000).

EXAMPLE 8: In Example 7, if another person also derived \$180,000 personal services income in the company, the entitlement to a reduction for each person would need to be calculated in accordance with each person's personal services income. In the case of the taxpayer in Example 6, the reduction would be 40% (ie. \$120,000/\$300,000) of the Step 4 amount of \$1,000 (being that taxpayer's share of total personal services income).

The balance would be allowed as a reduction for the second individual.

Once an entity has calculated the amount of income to be included as PSI of an individual that amount is excluded from the calculation of the entity's assessable or statutory income. That income is treated as if it never existed in the hands of the entity. In that way the entity is neither taxed on that income nor is it required to take it into account when claiming losses.

Where an entity makes a payment of salary or wages to an individual before the end of 14 July of income that would have been treated as PSI, then that payment is treated as having been received by the individual in the previous income year. The individual must include that amount in their assessable income for that preceding income year.

Where this occurs the entity is still required to remit any PAYG withholding tax on the basis of the actual payment date and not the deemed receipt date.

Foreign personal services income

Taxation ruling TR 2005/3 concerns foreign tax credits to an individual where foreign tax is paid by a personal services entity.

The ruling applies to –

- individuals who have provided personal services through a resident company that is a personal services entity in a foreign country and foreign tax has been paid by the personal services entity or the individual's personal services income; and
- personal services entities referred to above.