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# **A Tax Journey from Sole Trader to Company Director Webinar - Is It Business or PSI Chris' Early Test**

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### 1 Overview

- 1.1 Meet Chris, an IT contractor who started out with nothing more than an Australian Business Number and a laptop, and ended up running his own company. Along the way he hit every tax roadblock in the book: personal services income and lost deductions, questions about when to incorporate, how to pay himself once he did, and the hidden Division 7A dangers of loans and private drawings.
- 1.2 First up, the big question quickly arose: was he really running a business, or was his income caught by the Personal Services Income (**PSI**) rules?
- 1.3 This session uses Chris's journey to show how the PSI tests work and why they matter. It covers:
  - (a) How Chris determined whether his contracting fees were PSI or business income, and why the distinction mattered.
  - (b) The process for applying the PSI tests and deciding if he qualified as a Personal Services Business (**PSB**).
  - (c) Chris's Pay As You Go (**PAYG**) withholding and reporting obligations once PSI was identified.
  - (d) The Australian Taxation Office's (**ATO**) current compliance approach in relation PSB's and the general anti avoidance provisions (**Part IVA**) (including PCG 2024/D2).
  - (e) A case study from Chris's first year: working almost entirely for one client, compared to variations on how the outcome changed once adding multiple clients.
- 1.4 References to the following terms have the following meanings:
  - (a) ITAA 1936 – *Income Tax Assessment Act 1936* (Cth).
  - (b) ITAA 1997 – *Income Tax Assessment Act 1997* (Cth).



## 2 Some background and context

- 2.1 It is useful to appreciate the context behind the introduction of the PSI rules in 1999/2000.
- 2.2 Prior to the introduction of the PSI rules, arrangements were entered into where PSI generated by individuals were received by 'an interposed entity rather than directly by the individual who performs the services'. Such income may then *'be retained in the entity and either taxed at the lower rate available to the entity and/or diverted to associates, allowing a lower rate of tax to be paid on that income. The use of interposed entities is also seen by some taxpayers as creating an entitlement to a range of deductions which would not be available to an individual providing the same services as an employee.'*<sup>1</sup>
- 2.3 The PSI rules were introduced to provide certainty in relation to the taxation consequences for taxpayers in receipt of PSI. Such arrangements do not seek to affect any commercial or contractual obligations; and were not intended to impact on genuine business undertakings. Instead, the arrangements were sought to *"achieve a consistent taxation treatment for personal services income irrespective of the structures in place to receive that income."*<sup>2</sup>
- 2.4 At that point in time, no specific rules existed to address the adverse revenue implications that arose because of the alienation other than the existing general anti-avoidance provisions of ITAA 1936.<sup>3</sup>
- 2.5 Accordingly, without PSI rules required the ATO to apply the general anti-avoidance provisions at the time on a case by case basis. Despite this, a variety of arrangements that had the effect of enabling the alienation of PSI were successfully challenged utilising the general anti-avoidance provisions.
- 2.6 The following Taxation Rulings summarised the various arrangements considered to fall within the operation of the general anti-avoidance provisions.

### ***Taxation Ruling IT 2121***

- 2.7 This ruling outlined the ATO position following the decision of *Tupicoff v Commissioner of Taxation* 84 ATC 4851 (**Tupicoff Decision**).
- 2.8 The Tupicoff Decision can be summarised as follows:
- (a) The taxpayer in that case was a life assurance agent who restructured his activities so as to become an employee of a family trust.
  - (b) Thereafter, the trust received the commissions formerly paid to the taxpayer who was paid a salary by the trustee.
  - (c) The balance of the income in the trust was distributed to family members.
  - (d) In determining that section 260 ITAA 1936 (the general anti-avoidance provisions at the time) was applicable to the arrangement, the Federal Court noted:  
*"... it is not possible objectively to discern any significant business or commercial purpose in the taxpayer's arrangements. Indeed careful attention seems to have been given to the retention of as much as possible of the pre-existing arrangements. The taxpayer retained his status as an accredited representative approved by National Mutual Life Association of Australia Limited ("National Mutual") and as*

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<sup>1</sup> Paragraph 1.6 Explanatory Memorandum, *New Business Tax System (Alienation of Personal Services Income) Bill 2000*, *New Business Tax System (Alienated Personal Services Income) (Tax Imposition) Bill (No. 1) 2000*, *New Business Tax System (Alienated Personal Services Income) (Tax Imposition) Bill (No. 2) 2000*

<sup>2</sup> Ibid at Paragraph 1.14

<sup>3</sup> Ibid at Paragraph 1.12

*such he preserved for himself his existing benefits in superannuation, medical, accident and sickness funds conducted by National Mutual. Likewise he appears to have retained for the company the benefit of his existing bonus entitlements.”*

- 2.9 IT 2121 accordingly flagged arrangements with the following characteristics as potentially falling within the scope of the general anti-avoidance provisions:
- (a) A taxpayer has ceased employment on one day and arrived at the former employer's premises the following day to do the same work, not as an employee of the former employer but as an employee of a family trust that has contracted to provide the taxpayer's services to the former employer.
  - (b) A form of the arrangements commonly encountered involves a taxpayer who had been deriving salary and wage income forming a family company of which he and his wife are directors and the company becoming a trustee of a family trust of which the taxpayer's wife and children are beneficiaries.
  - (c) The family company, in the capacity of trustee, engages the taxpayer as an employee.
  - (d) The trustee will then negotiate with the taxpayer's former employer for the provision of the taxpayer's services to the former employer.
  - (e) The amount which would otherwise be paid to the taxpayer as salary and wages will be paid to the trustee who, in turn, will pay the taxpayer a salary which is generally much lower than he had previously received and distribute the balance to family members according to the trust arrangements.
  - (f) Alternative arrangements may involve a company rather than a family trust.

***Taxation Ruling IT 2330***

- 2.10 This ruling outlined the ATO position following the decisions of multiple cases (known as The Doctors' Cases) *Commissioner of Taxation. v. Gulland, Watson v. FCT and Pincus v. FCT* 85 ATC 4765.
- 2.11 The Doctors' Cases exhibited the following characteristics that resulted in the High Court holding that the general anti-avoidance provisions (again, being the old section 260) apply:
- (a) Each case involved a medical practitioner who had conducted a medical practice either alone or in partnership.
  - (b) The medical practitioner established a unit trust the units in which were held by the trustee of his family trust.
  - (c) The trustee of the unit trust acquired the medical practice and thereafter employed the medical practitioner on an agreed salary.
  - (d) As a result of the arrangements fees which would otherwise have been paid directly to the medical practitioner or to the partnership were paid to the unit trust.
  - (e) The trustee of the unit trust paid the medical practitioner an agreed salary and was then in a position to distribute the remainder to unitholders, i.e. effectively to the families of the medical practitioner.
  - (f) The arrangements had the effect of splitting with family members the income upon which the medical practitioners might otherwise have been liable to tax with a consequent reduction in the amount of tax payable.



- 2.12 The ruling restates the ATO's position (noting prior to the introduction of the PSI rules) that income derived from personal services cannot be split from the individual performing the work.
- 2.13 Notwithstanding the introduction of the PSI rules, IT 2330 remains a ruling referred to by the ATO in it's recent rulings.



### 3 Personal services income provisions

- 3.1 The personal services income provisions (**PSI provisions**)<sup>4</sup> operate to:
- (a) deny various deductions against personal services income (**PSI**);<sup>5</sup> and
  - (b) attribute any 'personal services income' (that is income derived as a reward for one's personal efforts or skills)<sup>6</sup> from a trust or company entity (**personal services entity**) to the individual performing the work.<sup>7</sup>
- 3.2 Specifically, if the PSI provisions apply, the following deductions may not be claimed by a sole trader:
- (a) amounts incurred in the course of producing income if the income is not payable to the sole trader as an employee and the sole trader would not be able to deduct such amount as an employee – that is, the only deductions able to be claimed would be those that an employee is eligible to claim;<sup>8</sup>
  - (b) amounts of rent, mortgage interest, rates or land tax in relation to the sole trader's residence to the extent it relates to the gaining of personal services income;<sup>9</sup>
  - (c) payments made to an associate or their superannuation fund to the extent the payment relates to gaining personal services income other than where the associate performs work that forms part of the sole trader's principal work (in effect, this provision denies the claiming of amounts paid to an associate for administrative services);<sup>10</sup>
- 3.3 An exception applies to the above where the sole trader is conducting a personal services business.<sup>11</sup>
- 3.4 With respect to a personal services entity (as is the case for Chris), the entity cannot deduct an amount to the extent it relates to gaining or producing an individual's personal services income **unless**:
- (a) the individual could have deducted the amount under this Act if the circumstances giving rise to the entity's entitlement to deduct the amount had applied instead to the individual (note the above restrictions that apply if the personal services entity does not conduct a personal services business); or
  - (b) the entity receives the individual's personal services income in the course of conducting a personal services business.<sup>12</sup>
- 3.5 PSI means such income as a reward for an individual's personal efforts or skills,<sup>13</sup> but does not include such income associated with materials or products. Therefore, where the circumstance of such personal services entity is that they can show the income is predominantly a result of the sale of goods, such income may not be considered PSI.

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<sup>4</sup> Divisions 84 to 86 ITAA 1997

<sup>5</sup> Division 85 ITAA 1997 where the taxpayer is an individual and Division 86 ITAA 1997 where the taxpayer is a company or trust structure

<sup>6</sup> Section 84-5 ITAA 1997

<sup>7</sup> Division 86 ITAA 1997

<sup>8</sup> Section 85-10 ITAA 1997

<sup>9</sup> Section 85-15 ITAA 1997

<sup>10</sup> Sections 85-20 and 85-25 ITAA 1997

<sup>11</sup> Section 85-30 ITAA 1997

<sup>12</sup> Section 86-60 ITAA 1997

<sup>13</sup> Section 84-5 ITAA 1997



- 3.6 The following are examples of income that are considered PSI:
- (a) salary or wages;
  - (b) income of a professional person practising on their own account without professional assistance;
  - (c) income payable under a contract which is wholly or principally for the labour or services of a person;
  - (d) income derived by a professional sportsperson or entertainer from the exercise of their professional skills; and
  - (e) income derived by consultants; for example, computer consultants or engineers from the exercise of personal expertise.<sup>14</sup>
- 3.7 Taxation Ruling TR 2022/3 provides a detailed summary as to what constitutes PSI, specifically, income that is **mainly** a reward for an individual's personal efforts or skills.
- 3.8 Where income comprises of PSI and other sources of income (such as income from the supply or sale of goods or use of income-producing assets), then it will only be considered PSI where more than half of the income received is associated with being a reward for the personal efforts and skills of an individual.<sup>15</sup>
- 3.9 Examples contrasting the intermingled nature of such PSI and income from other sources can be noted through the following Examples of TR 2022/3:
- (a) Example 1: *"Andre is a plumber who operates as a sole trader. He receives a contract to fix a blocked toilet and repair 3 leaking taps. He charges \$25 for materials and \$225 for his labour. The total of the invoice is \$250. This income is Andre's PSI as it is mainly a reward for his personal efforts and skills."* Note how a substantial portion of the invoice relates to his labour.
  - (b) Example 2: *"Judy is an information technology (IT) consultant who provides systems analysis services through her company, J.I.T. Pty Ltd, which enters into a contract with Rich Computer Co to provide Judy's consultancy services. The income J.I.T. Pty Ltd receives from Rich Computer Co is PSI as it is income generated from Judy's labour where more than 50% of the payment is a reward for her labour."* Note how such services does not involve the supply or sale of goods as part of Judy's services.
  - (c) Example 3:
    - (i) *"Reindeer Pty Ltd has 3 sources of income, as indicated in its financial statements:*
      - *income from consultancy work performed by its sole director, Ms Rudolph*
      - *rent received on real property, and*
      - *interest.*
    - (ii) *The income from consultancy work is PSI as the income is mainly a reward for the personal efforts and skills of Ms Rudolph. The rental and interest income is received as a result of holding assets (property and cash) and therefore is not PSI."*

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<sup>14</sup> Tax Ruling TR 2022/3 (**TR 2022/3**) at paragraph 3

<sup>15</sup> Ibid at paragraph 37



- (iii) Notwithstanding the personal services entity derives different sources of income, such income attributable to PSI should accordingly fall within the PSI rules.
  - (d) Example 4:
    - (i) *"Jack is an experienced backhoe operator. His family company, Jack & Jill Pty Ltd, owns a 10-tonne truck and a backhoe. Jack & Jill Pty Ltd enters into a contract with the Main Roads Department to dig trenches for laying sewerage pipes. The contract specifies that Jack & Jill Pty Ltd supplies a tractor with a backhoe and other special attachments, together with a licensed backhoe operator to work at specific locations.*
    - (ii) *Jack transports the backhoe on the truck to various construction sites at the request of the Main Roads Department. He then uses the backhoe to dig the trenches. The contract requires Jack & Jill Pty Ltd to provide specific plant and equipment to do the work. Without the backhoe and the truck, Jack & Jill Pty Ltd would not be able to gain or produce income.*
    - (iii) *Taking into account the significant size, value and uniqueness of the asset required to be supplied and the relative contribution of the asset compared to the personal service in generating the relevant income, the amount that is invoiced to the Main Roads Department is mainly for the cost of supplying the truck and the backhoe, and is not mainly for the efforts and skills of Jack. The income is therefore considered to be for the supply and use of income-producing assets and is not PSI."*
    - (iv) In contrast with Example 1, a significant value of the income is derived through the use of substantial equipment (as opposed to plumbing taps).
  - (e) Example 5: *"Grace is a carpenter who operates a partnership with her spouse, Chris. Grace designs and constructs bespoke furniture and sells it through the partnership via the internet and at trade fairs. The payments made to the partnership are for the sale of the furniture rather than Grace's personal efforts or skills. The income derived by the partnership is not PSI."*
  - (f) Example 7: *"Clare is an IT consultant who operates through a partnership with her spouse, Ralph, to provide IT services. Ralph does not engage in any of the principal work of the partnership (that is, IT activities), although he provides minor administrative assistance. The partnership has no significant assets, no employees or other workers and has not generated any significant goodwill. The income is not derived from the business structure of the partnership. As Clare is performing all the principal work of the partnership, the income derived by the partnership is Clare's PSI as it is mainly a reward for her personal efforts and skills."*
- 3.10 It is important to consider the substance of contractual arrangements in determining what sources of income are aggregated for the purposes of determining whether the income is **mainly** for a person's reward.
- 3.11 Further, the deriving of income through chains of personal services entities will not avoid the operation of the PSI rules.





## 4 Being a Personal Services Business

- 4.1 As outlined above, being a personal services business (**PSB**) will mean that the PSI provisions do not apply to the sole trader or personal services entity.<sup>16</sup>
- 4.2 In order to be considered a 'personal services business', the taxpayer only needs to meet one of four following tests.<sup>17</sup>
- 4.3 The relevant tests include:
- (a) the results test – where it can be shown that the income was for the production of a result among other requirements;
  - (b) the unrelated client test – where it can be shown that the income was derived from unrelated clients and as a product of the PSE making offers or invitations to the public at large;
  - (c) the employment test – where it can be shown that a portion of the income generated by a business structure is through the use of persons 'employed' or engaged with a business structure (not related to the key business owner/associated persons); or
  - (d) the business premises test – where it can be shown that a business structure runs the business through a separate business premises.
- 4.4 It is not required to meet more than one of above four tests to be considered a personal services business.
- 4.5 While only one of the tests needs be satisfied, it may be preferable in the long term for the PSE to meet more tests (i.e. to reduce the likelihood of a future restructuring of the business falling within the general 'anti-avoidance' arguments).
- 4.6 The PSI provisions are tested on an income year by income year basis. As such, so long one of the tests are satisfied in an income year (it can be a different test each year), the PSE will be considered a personal services business.
- 4.7 If none of the tests are able to be satisfied, then steps can be taken to obtain a personal services business determination from the ATO.<sup>18</sup>
- 4.8 TR 2022/3 provides a comprehensive summary of the ATO's position in relation to the application of the PSI provisions and is recommended reading for a summarised position. Notwithstanding TR 2022/3, each test is considered below.

### Results test

- 4.9 The results test requires that in an income year, a PSE derives at least 75% of its PSI as follows:
- (a) it is income for producing a result (**first limb**);
  - (b) the PSE is required to supply its own tools of trade to perform the work (**second limb**); and
  - (c) the PSE is liable for the cost of rectifying any defects (**third limb**).
- 4.10 All three limbs must be satisfied to qualify for the results test.

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<sup>16</sup> Sections 85-30 and 86-15 ITAA 1997

<sup>17</sup> Section 87-15(1)(c) ITAA 1997

<sup>18</sup> Sections 87-15(1)(a) and 87-15(1)(b) ITAA 1997

- 4.11 In determining whether any of above requirements have been met in any particular case, regard must be had to any “custom or practice” (when work is performed by persons who are not employees) in relation to the matters to which the particular criterion relates. That is, what is standard practice for a business the PSE’s circumstance to be required to supply its own tools of trade to perform their work.
- 4.12 In relation to the first limb:
- (a) although the question on what is ‘income for producing a result’ has been subject to considerable case law, the crux of this limb is whether the PSE is being paid on the basis of achieving a result;
  - (b) in particular:
 

*[64] The words “producing a result” require something more than obtaining a payment reward for providing ongoing personal skills and efforts to enable another party...to produce a contracted for result to their clients. Consistent with the recognized indicia of the independent contractor, the words “for producing a result” require that the personal services income of the individual...was paid to him as the contract quid pro quo for producing a result and was not paid until and unless the result was produced.<sup>19</sup>*
  - (c) there is case law to suggest that invoicing on an hourly basis can satisfy the results test, specifically:
 

*[24] We note that in the context of s 87-13(3)(a) it is not how your fee is calculated, but what you are paid for, that is important. It is possible for a person who is contracted to produce a result to choose to charge hourly rates as the means of remuneration, without altering the fact that payment is made for producing a result. In saying this, we are mindful of the comment of Allsop J in IRG at [43] that the method of payment may be important – but there is nothing in what his Honour said to suggest that a fee based on time spent will necessarily exclude the possibility of being paid “for producing a result.”<sup>20</sup>*
  - (d) importantly, the question is ‘What is the income for? And answer to that question will depend on the income-earner’s responsibilities to its clients; or put another way, what does he have to do to satisfy the obligations he has under agreement with the client, and to justify payment?’.<sup>21</sup> Having clear ‘milestones’ agreed prior to the commencement of the work will assist in evidencing such arrangements.
- 4.13 In relation to the second limb, the PSE must provide the necessary equipment and tools to complete the required work. In considering what equipment and tools are required to be supplied, consideration must be made as to the equipment and tools commonly used by others understanding the same line of work. That is, the PSE must provide the necessary equipment and tools themselves - they cannot be given the tools and equipment.
- 4.14 Where the nature of work does not require any plant, equipment or tools of trade, then this condition will be met.<sup>22</sup>
- 4.15 Regarding the third limb, it can be sufficient that there is a contractual liability to meet the cost of defective work. This is only possible if there is in fact a risk of liability for the PSE. In

<sup>19</sup> Paragraph 64 *Skiba v FCT* [2007] AATA 1705

<sup>20</sup> *Taneja v FCT* [2009] AATA 87

<sup>21</sup> *Ibid* at [25]

<sup>22</sup> TR 2022/3 at paragraph 86

particular, the PSE will need to show that they are required to rectify defects at their own cost (not at the cost of the client). Appropriately drafted agreements may assist to evidence such satisfaction of the third limb.

4.16 TR 2022/3 provides additional commentary on what it means to satisfy each of the requirements. Specifically:

- (a) Regarding 'the income is for producing a result':
  - (i) *"In contracts that are for producing a result, **payment is usually made for a negotiated contract price to achieve a specified outcome... payment is made when the contractually specified results have been fulfilled.** A contract price for achieving a specified result **may be calculated by reference to an estimated number of hours applied to an hourly rate...** What needs to be considered is whether the contract price is for achieving a specified result and not merely payment for the hours worked."* – paragraph 84.
  - (ii) *"**The essence of the contract must be to achieve a result and not to do work.** The fact that a sole trader or PSE is required to complete identifiable tasks is not the same as achieving a contractually specified result if those tasks merely form part of the work being paid for on an ongoing basis."* – paragraph 85.
  - (iii) *"The condition will not be satisfied merely because the contract states that the contract is for producing a result. Consideration should be given to the substance of the arrangement between the sole trader or PSE and the service acquirer and what the sole trader or the PSE is actually being paid for."* – paragraph 86.
- (b) Regarding the supply of plant and equipment – "To satisfy the second condition, the sole trader or PSE must supply any plant and equipment or tools of trade needed to do the work that produces the result and which a service acquirer would expect the sole trader or PSE to provide or which the sole trader or PSE is contractually required to provide" – paragraph 87.
- (c) Regarding liability to rectify defects:
  - (i) *"To satisfy the third condition, the sole trader or PSE is, or would be, liable for the cost of rectifying any defects in the work. There is no requirement that they actually perform the work which rectifies the defect, so long as they are liable for the cost of rectifying any defect in the work performed."* – paragraph 90.
  - (ii) It is noted that professional indemnity insurance is an indicator to suggest that the entity is liable for rectification but will not be determinative on this issue (see paragraph 93). Rather, it is crucial that the entity bears the cost of rectification of defects where required.

4.17 TR 2022/3 also considered various examples on whether the results test is satisfied (paragraph 195 to 209) and distinguishes between a consultant of which '*[p]ayment is made upon submission of a fortnightly invoice which includes a time sheet certified by a government department officer*' (paragraph 201) compared to those circumstances where:

- (a) Example 17:
  - (i) *A government department enters into a contract with Consultant Co for the provision of services by an individual who is nominated in the contract. The*



*terms and conditions of the contract are that the individual is paid an hourly rate and works for a maximum of 8 hours per day. Departmental officers provide direction as to the required tasks and the manner in which they are to be performed. The individual is provided with an office, stationery and a desktop computer, and uses the department's computer system, software and data for carrying out the required tasks. He also uses his personal laptop to assist him in his tasks but is not required by the department to use it. If the work performed by the individual is unsatisfactory, the department is entitled to terminate the contract, but the company is not required under the contract to rectify any defects in the work performed. Consultant Co is a PSE because its income includes the PSI of the individual who does the work.*

(ii) *Applying the conditions of the results test:*

- the income is for doing work and not producing a result, as the PSE is entitled to payment for each hour the individual works for the department with no risk of making a loss as a result of undertaking the work*
- the PSE is not required to supply the plant, equipment or tools of trade needed to perform the work, even though the nominated consultant uses his personal laptop to assist him in his tasks*
- the department is entitled to terminate the contract for unsatisfactory work, but the PSE does not have any liability to rectify any faulty work done by the individual.*

(iii) *All conditions must be satisfied for the results test to be met. In this example, none of the conditions are satisfied and the results test is not met. A sole trader or PSE engaged in these circumstances does not satisfy the results test.*

(b) Example 18:

(i) A government department enters into a contract with Consultant Co for the provision of services by an individual who is nominated in the contract. The terms and conditions of the contract are that the individual is required to develop a product for use on the department's IT system in accordance with functional specifications provided by the department. **The contract specifies a fixed amount by way of payment to Consultant Co for the development of the product**, which is required to be produced within 12 months of the commencement of the contract. **Instalments of the contract price are payable upon achievement of specified milestones.** From time to time, the individual uses departmental equipment to access the department's IT system. However, the development work is undertaken primarily on the individual's own equipment located at her business premises. If the final product does not satisfy the functional specifications, the contract requires the work to be rectified and permits the department to seek damages from Consultant Co if not rectified. Consultant Co is a PSE because its income includes the PSI of the individual who does the work. [emphasis bolded]

(ii) Applying the conditions of the results test:

- the income is for producing a result as the contract requires performance of a specific task that produces an outcome or result; payment is not made until*



*the work is completed, although instalments are payable upon the achievement of particular specified milestones or outcomes*

- *any relevant assets and equipment required to perform the work are to be provided by the PSE; the need to access the department's IT system by using their equipment is incidental to the development of the product*
- *the contract requires the PSE to produce a product that complies with the functional specifications of the department; if the individual does not meet those specifications, further work without additional payment would be required and the department would also be able to seek a remedy in damages.*

4.18 Other Examples from TR 2022/3 includes:

- (a) Example 19 (results test not met) – where *“Payment is made upon submission of a fortnightly invoice which includes a time sheet certified by a government department officer....f Mick is required to remedy defects in the work he has performed, this is done in the normal course of his work and the time taken to fix the defects would be subject to payment at the usual hourly rate, with no penalty.”*
- (b) Example 20 (results test met) – where *“The contract price is based on installation of the duct work in accordance with those plans and any changes are subject to the variation clauses in the contract.”* – paragraph 205:
- (c) Example 21 (results test met) – *“John is paid a set amount at the end of the contract, once the report has been finalised and presented.”* – paragraph 208.

4.19 In evidencing that the above limbs are met, any contracts entered into by the PSE should be reflective of the above requirements.

### **80% test**

4.20 Where the results test is not met, the PSE may still be considered a personal services business provided any one of the remaining three tests are met.

4.21 In this regard, addition to the following requirements that must be met for each respective test, the PSE must also meet the 80% test component.

4.22 In particular, if more than 80% of the PSE's PSI comes only from one client, then this test will not be satisfied and the remaining three tests cannot be met.<sup>23</sup>

4.23 Therefore, the PSE is required to have 80% of its PSI coming from more than PSE if the following alternative tests are to be satisfied.

4.24 If during an income year, the PSE does not have 80% of its PSI coming from more than one client, then none of the following three tests cannot be satisfied.

### **Unrelated Clients Test**

4.25 In order to satisfy this test, in addition to the 80% test the PSE must demonstrate that in the relevant income year:

- (a) the PSE produces income from providing services to two or more entities that are not associates; and

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<sup>23</sup> Section 87-15(3) ITAA 1997



- (b) the services are provided as a direct result of making offers or invitations (e.g. advertising) to the public at large or to a section of the public to provide the services.
- 4.26 In dealing with unrelated clients, the PSE's clients cannot be associates of one and another.
- 4.27 In addition to having unrelated clients, it is necessary to consider whether the services provided are as a direct result of the PSE advertising to the public at large or to a section of the public to provide such services.
- 4.28 'Direct result' has been ruled as a case it is a 'proximate cause of the payment'. Therefore, there must be a direct link between the PSE advertising the relevant services to the public and as a result of that specific advertising, the PSE is contacted to undertake the services, as advertised.
- 4.29 Generally, clients acquired through word-of-mouth referrals would not satisfy this test because the clients are obtained through private relationships and personal contacts rather than by making offers to the general public.
- 4.30 However, there is case law, which accepts that where a business offers highly specialised services such that a public offer of services could only be made to a 'limited number of players', then general advertising would be inappropriate. In that case, the taxpayer's key employee's regular personal contact with the relevant companies to assess their needs and the opportunity to provide the highly specialised services via word-of-mouth and personal recommendations from others in the industry constituted the 'making offers or invitations to provide services' to a section of the public. As a consequence, the taxpayer met the unrelated client test.
- 4.31 TR 2022/3 provides the following comments in relation to the services being a direct result of making offers or invitations to the public:
- (a) *"To meet this condition, the offer or invitation must be the reason that the sole trader or PSE obtained the work from the client and there must be a direct causal effect between the offer or invitation and obtaining the work"* – Paragraph 99
- (b) Where labour-hire firms or similar intermediaries are involved, the condition may not be met (see paragraphs 101 and 102).
- (c) *"An offer or invitation is made to 'the public at large' where any interested member of the public is capable of accepting it. An offer or invitation to 'a section of the public' is made in situations where only a select group is chosen to whom the invitation is made. Making an offer or invitation to a section of the public could include offering to provide services to one entity in certain circumstances; for example, in relation to competitive tenders"* – Paragraph 103.
- (d) *"A word-of-mouth referral is not generally considered to satisfy the requirements of the unrelated clients test. A word-of-mouth referral is when a sole trader or PSE is offered work because of a recommendation from a previous client or industry contact. However, offers made by word of mouth in a very specialised or niche industry where there are only a very small number of potential service acquirers may, in limited circumstances, meet this condition."* – Paragraph 104.

#### **Employment test**

- 4.32 To satisfy the employment test, in addition to the 80% test the PSE must show that it:



- (a) engaged one or more entities (other than associates of the PSE that are not individuals) to perform the work; and
  - (b) the engaged entities together perform at least 20% of the PSE's work for the year.<sup>24</sup>
- 4.33 This test is also satisfied if the PSE has for at least half the relevant income year, one or more unrelated apprentices.<sup>25</sup>
- 4.34 TR 2022/3 provides detail on how the '20%' value is calculated at paragraphs 118 to 124.

***Business premises test***

- 4.35 To satisfy the business premises test, in addition to the 80% test the PSE must at all times during the relevant income year, maintain and use a business premises:
- (a) from which the PSE mainly conducts activities from which PSI is gained;
  - (b) which the PSE has exclusive use;
  - (c) that are physically separate from any premises that the PSE or any associate of the TR 2022/PSE uses for private purposes; and
  - (d) are physically separate from the premises of the entity which the PSE (and from the premises of any associate of you or the PSE) are providing services to.<sup>26</sup>
- 4.36 There are various key considerations, however, to meet this test.
- 4.37 Exclusive use requires either ownership or occupancy under a lease. The existence of a licence agreement will not satisfy the need for 'exclusive use' which requires exclusive possession (which includes the ability for the holder to determine who may or may not enter the premises).<sup>27</sup>
- 4.38 PSI must also be derived whilst on the premises. Having a premise in which non-PSI activities are conducted will require at least 50% of the activities conducted at the premise to be for the production of PSI.

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<sup>24</sup> Section 87-25 ITAA 1997

<sup>25</sup> Section 87-25(3) ITAA 1997

<sup>26</sup> Section 87-30 ITAA 1997

<sup>27</sup> TR 2022/3 at paragraphs 140 and 141



## 5 Chris' PAYG withholding and reporting obligations

- 5.1 Where the personal services income rules apply, Division 13 of Schedule 1 *Taxation Administration Act 1953* applies to “ensure the efficient collection of income tax (and other liabilities) on any personal services income included in an individual's assessable income under Division 86 of the *Income Tax Assessment Act 1997* by:

(a) putting personal services entities receiving alienated personal services payments in a position similar to their position if amounts were withheld from the payments under Division 12; but

(b) doing so in a way that enables them to comply with their obligations without having to withhold amounts separately from each payment.”<sup>28</sup>

- 5.2 In determining the amount of tax a PSE must pay, the method statement is to be used.<sup>29</sup>

### *Method statement*

*Step 1. Identify the payments that the personal services entity makes to the individual during the period mentioned in paragraph (1)(b) that are withholding payments covered by section 12 - 35.*

*Step 2. Identify the amounts that:*

*(a) are included in the individual's assessable income under section 86 - 15 of the Income Tax Assessment Act 1997 ; and*

*(b) relate to alienated personal services payments the entity receives during that period.*

*Step 3. Work out the sum of all the amounts that Division 12 would require the entity to withhold in respect of that period if both of these were taken into account:*

*(a) the payments identified in step 1; and*

*(b) the amounts identified in step 2, as if they were payments of salary covered by section 12 - 35.*

*Step 4. Work out the sum of all the amounts withheld under section 12 - 35 from the payments identified in step 1.*

*Step 5. Subtract the sum under step 4 from the sum under step 3.*

- 5.3 An example of the applicable of the above method is as follows:

- (a) For the PAYG payment period of 1 April 2001 to 30 June 2001, NewIT Pty. Ltd. received amounts totalling \$18,000 that were Ron's personal services income. NewIT does not conduct a personal services business.

<sup>28</sup> Section 13-1 Schedule 1 *Taxation Administration Act 1953*

<sup>29</sup> Section 13-5(2) Schedule 1 *Taxation Administration Act 1953*





- (b) During the period, NewIT paid Ron \$3,000 in salary. This is a withholding payment covered by section 12-35 (step 1).
- (c) \$15,000 of the amount NewIT received is included in Ron's assessable income under section 86-15 of the Income Tax Assessment Act 1997 (step 2).
- (d) If NewIT had paid the \$15,000 in salary to Ron within 14 days after the end of the PAYG payment period, the amount that NewIT would have had to withhold under Division 12 on the total amount of \$18,000 would have been \$4,000 (step 3).
- (e) NewIT withheld \$500 from the salary payment of \$3,000, as required by section 12 - 35 (step 4).
- (f) On the basis of these facts, the amount NewIT must pay to the Commissioner (step 5) is:  
\$4,000 minus \$500 equals \$3,500



## 6 ATO's compliance and general anti-avoidance rules approach

- 6.1 Despite the PSI provisions making it clear that being a personal services business operates such that the PSI rules do not apply; the potential for the general anti-avoidance provisions (Part IVA) remains a factor to be considered for practitioners (particularly as the previously mentioned Tax Rulings, made prior to the introduction of the PSI rules, have not been withdrawn).
- 6.2 Whilst it is outside the scope of this paper to consider the Part IVA provisions in detail, it is noted that the application of such provision may result in the ATO seeking to look through arrangements, transactions and 'schemes' which are entered into with the dominant purpose of obtaining a tax benefit.
- 6.3 The ATO has (as of 11 November 2025) issued two Practical Compliance Guides (one finalised – PCG 2021/4; and one in draft – PCG 2024/D2) in relation to the potential application of Part IVA in relation to PSI that is income split or retained.
- 6.4 Of relevant for Chris is PCG 2024/D2 that seek to apply to any PSE that does not mainly generate its income from a business structure. In contrast, PCG 2021/4 seeks to outline the ATO position where a PSE holds substantial income-producing assets or a number of employees, or both.

### **PCG 2024/D2**

- 6.5 As outlined earlier in the paper, the ATO has adopted the view that Part IVA may apply to PSI applied to income splitting or the retention of profits.<sup>30</sup>
- 6.6 It is important to appreciate that being a personal services business will not prevent the potential application of Part IVA.
- 6.7 While PCG 2024/D2 does not undertake a detailed guidance on when Part IVA would apply to income splitting or retention of profit circumstances; the guidelines provides examples of arrangements that would fall within the low-risk or higher-risk categories.
- 6.8 Regarding low-risk arrangements, PCG 2024/D2 notes that such arrangements contain features that are viewed by the ATO as not having to apply compliance resources to review the arrangement.<sup>31</sup>
- 6.9 In contrast, higher-risk arrangements are those where there exists a higher risk of a tax benefit being obtained by the individual practitioner.
- 6.10 The relevant indicators are summarised as follows.
- 6.11 Low-risk indicator include the following:<sup>32</sup>
- (a) Where net PSI is distributed to the individual whose personal efforts or skills generated the income and taxed at their marginal rate.
  - (b) The remuneration received by the individual is substantially commensurate with the value of their personal services.
  - (c) Remuneration is paid to an associate for bona fide services related to the earning of the PSI if that amount is reasonable for the services provided by them.

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<sup>30</sup> PCG 2024/D2 at paragraph 5 (PCG 2025/5 at paragraph 6)

<sup>31</sup> PCG 2024/D2 at paragraph 29 (PCG 2025/5 at paragraph 33)

<sup>32</sup> PCG 2024/D2 at paragraph 35 (PCG 2025/5 at paragraph 40)



- (d) There is a timing difference between the earning of the PSI and the distribution of net PSI to the individual for reasons outside the control of the individual and PSB or where the delay can be explained by circumstances not attributable to tax. This creates only a temporary deferral of tax to a following income year.
- (e) The PSB makes a superannuation contribution on behalf of the individual, who is an employee of the PSB, for the purposes of providing a superannuation benefit.
- (f) There is a temporary retention of profits to acquire an asset for a clear commercial purpose.

6.12 Higher-risk indicators include the following:<sup>33</sup>

- (a) The net PSI is distributed to another entity so that it is taxed at an overall lower rate than if the individual had received the income directly.
- (b) The remuneration received by the individual is less than commensurate with the value of their personal services.
- (c) The PSB does not distribute any income to the individual who provided the actual services.
- (d) The net PSI (or a part thereof) is split with an associate of the individual, thereby reducing the overall income tax liability.
- (e) Remuneration is paid to an associate (or a service trust) that is not commensurate with the skills exercised or services provided by the associate.
- (f) The net PSI is retained in the PSB. In most cases, the retained funds are subsequently made available to the individual for their personal use, however, the mere fact that PSI is retained is a sufficiently higher-risk indicator.

6.13 It should be noted that while the *'Guideline does not establish an acceptable level of income splitting, the degree to which PSI has been diverted away from the individual is a relevant factor in consideration the application of Part IVA, and whether the dominant purpose of the taxpayer is entering into the arrangement is to obtain a tax benefit'*.<sup>34</sup>

6.14 Examples provided by PCG 2024/D2 that involve income splitting or the retention of profit that are deemed high risk includes:

- (a) Example 7 (*PCG 2025/5 at Example 10*) – where PSI income is split between the individual and her partner and two adult beneficiaries.
- (b) Example 8 (*PCG 2025/5 at Example 12*) – where 5% of the PSI income received (\$20,000 out of \$400,000) is retained by the trading company before being lent out on a Division 7A compliant loan for private purposes.
- (c) Example 9 (*PCG 2025/5 at Example 13*) – where approximately 20-25% of the PSI income received (\$85,000 out of \$350,000/\$400,000) is paid out to the individual and her spouse.
- (d) Example 10 (*PCG 2025/5 at Example 14*) – where PSI income was distributed from a discretionary trust to an entity with carry forward losses.

6.15 Examples of low-risk arrangements involve net PSI being distributed to the individual performing the work.

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<sup>33</sup> PCG 2024/D2 at paragraph 35 (*PCG 2025/5 at paragraph 40*)

<sup>34</sup> PCG 2024/D2 at paragraph 36 (*PCG 2025/5 at paragraph 41*)



**Addendum: PCG 2025/2**

- 6.16 Shortly after the finalisation of this paper and recording, the ATO finalized PCG 2024/D2 as PCG 2025/5.
- 6.17 The above section has been updated to include a reference to the PCG 2025/5 paragraph number in *italics*.
- 6.18 Whilst much of the above commentary in relation to PCG 2024/D2 remains applicable, additional guidelines were included.
- 6.19 Specifically:
- (a) Paragraph 11 noted that while *“Part IVA can apply to any higher-risk arrangement, the materiality of the PSI diverted will always be a relevant factor we consider when deciding whether to review an arrangement or pursue Part IVA”*. The ATO notes that arrangements with substantial distributions or payments to lower-taxed persons and entities will attract a higher level of compliance resources; and that provided genuine attempts are made to move into a low-risk arrangement by 30 June 2027 – no compliance resources will be applied to those persons.
  - (b) Paragraphs 16 and 17 includes additional commentary regarding the application of PCG 2025/2 in relation to spousal partnerships.
  - (c) Table 1 of Paragraph 40 is updated to clarify that the following circumstances can reflect a low-risk arrangements (the additional commentary is italicized):
    - (i) *“There is a timing difference between the earning of the PSI and the distribution of net PSI to the individual, either for reasons outside the control of the individual and PSE or where the delay is explained by circumstances not attributable to tax. This creates only a temporary deferral of tax to a following income year.”*
    - (ii) *“There is an intention to temporarily retain the profits for working capital purposes, such as to fund business operations or acquire an asset for a clear commercial purpose, and that intention is carried out.*
- 6.20 To reflect the additional commentary acknowledging further circumstances that reflect lower risk transaction, Examples 7 to 9 of PCG 2025/2 provides new examples of PSB retaining profit in the following circumstances:
- (a) Example 7: where a web designer retained \$15,000 out of \$75,000 PSI income in order to ensure interest costs and wages in the following financial year could be paid amidst a downturn in her industry. The business had originally obtained a \$50,000 business loan to acquire initial assets on commencement of the business.
  - (b) Example 8: where an IT specialist retains \$11,000 out of \$76,000 PSI income in order to cover start-up costs due to the uncertainty of the new business obtaining new clients in the following financial year. Example 8 also includes an alternative position where the retained profit continues to be retained for no sound reason, thereby attracting a higher risk consideration of whether Part IVA should apply.
  - (c) Example 9: where a landscaper operates a business through a company with his father as an equal shareholder. As the father originally provided an initial investment in the landscaper’s business, the retention of a portion of the net profit may be considered as a return on investment (depending on whether the amount of



net profit distributed is considered disproportionate to the investment risk undertaken.

- 6.21 In addition, PCG 2025/5 Example 11 includes a higher risk arrangement whereby an electrician operating a PSB pays himself wages of \$189,000 during the 2024-25 income year out of a total of \$215,000 of eligible income to be paid to him. The example acknowledges a variation (albeit unhelpfully) where the electrician is paid an amount commensurate with the work performed equating to a salary of \$200,000 whilst paying the remaining amount as a bonus at the end-of-year.



## **7 Case study**

7.1 The below case study will be considered during the webinar presentation.

### ***Year One***

- 7.2 After giving it some thought, Chris decided to resign from his job, incorporate a company, obtain an Australian Taxation Number and buy a laptop.
- 7.3 Luckily, Chris' employer was keen to keep Chris involved with the business whilst a replacement was being sourced; and offered Chris a part-time, four-days a week contract for a year.
- 7.4 Having taken out professional indemnity insurance, as well as purchasing his own equipment; Chris believed he was in the clear from the PSI rules applying.
- 7.5 Not considered, however, was that Chris was merely paid an amount each fortnight, never varying regardless of what came up during the course of his day.

### ***Year Two***

- 7.6 Things have been going well for Chris.
- 7.7 Delighted with Chris' value, his old employer asked Chris to stay on two-days a week mentoring the incoming employee. In addition, he passed Chris' details onto other business owners who have taken to contracting Chris for three-days a week.
- 7.8 Chris still gets paid a fixed amount each fortnight from each particular client; and he is still managing to get through the work with just himself.
- 7.9 Despite the amount of work having grown, Chris is managing working out of the spare room at home.

### ***Year Three***

- 7.10 It goes without saying, a job done well is a job well done.
- 7.11 Chris' business has flourished and he has hired a recent graduate to help Chris out two-days a week.
- 7.12 Chris' payment terms still haven't changed, but given the great word-of-mouth, Chris has decided to market his services through a website and making offers through tendered processes with the business within the industry he assists with (after all, there are only so many businesses within the industry).
- 7.13 Through his website, he has managed to secure work with five different businesses for the year.
- 7.14 As Chris has employed a graduate, he decided to enter into a yearly contract with a co-working space to use a hot desk or two.

### ***Year Four***

- 7.15 Chris' tenders have managed to secure a large multi-year contract.
- 7.16 As a result, Chris has hired extra help; and given the size of the project; Chris has broken down the work into attainable and determinable tranches.
- 7.17 In the contract for work, clear expectations and milestones are set such that an invoice will only be raised once work has been met to those targets. The contract requires Chris to rectify any deficiency in the work at no additional cost.



## **8 Disclaimer**

- 8.1 This paper covers legal and technical issues in a general way. It is not designed to express opinions on specific cases. It is intended for information purposes only and should not be regarded as legal advice. Further advice should be obtained before taking action on any issue dealt with in this paper.

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