Let’s chat

Personal services income (a summary) – September 2021

With:

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Information provided is general in nature; precise application depends on specific circumstances

Some history

- Historically – professionals were only able to provide services personally or through a partnership of individuals
- Gave rise to service entity vehicles and *Everett assignments*
  - TR2006/2
  - *Kelly's case*
- Things change – corporate structures

Old IT rulings

- IT 25 – Incorporation of Medical Practices (1981)
  - ATO no issue where incorporation is ‘*to do nothing more than reduce the amount of income a doctor may earn by the amount of an appropriate superannuation cover*
- IT 2024 – Incorporation by Professional Persons – Physiotherapists (1983)
  - No issue where incorporation could be explained as an ‘ordinary commercial practice
  - Withdrawn following IT 2503
- IT 2121 – Income Tax: Family Companies and Trusts in Relation to Personal Exertion (1984)
  - Applying section 260 (old Part IVA)
  - Para 11: ‘*In the view of this office all of these arrangements may be characterised as arrangements entered into primarily or principally or predominantly to avoid liability for income tax by means of the splitting of income. They are not explicable as ordinary business or family dealings*

Old IT rulings

- IT 2330 – Income Tax: Income Splitting (1986)
  - Following *Gulland, Watson and Pincus*
  - Denying taxpayers the ability to restructure their professional practices in an attempt to alienate income from personal exertion
- IT 2503 – Income Tax: Incorporation of Medical and Other Professional Practices (1988)
  - Para 9: *'The retention of profits in the practice company is generally not acceptable'*
  - Reserving right to apply Part IVA
- IT 2504 – Income Tax: Capital Gains: Application to Disposals of Partnership Assets and Partnership Interests (1989):
  - Regarding Everett assigns subject to CGT

Old IT rulings

- IT 2639 – Income Tax: Personal Services Income:
  - Distinction between income derived from personal exertion, and income derived from the 'income yielding structure of a business'
  - Some rules of thumb:
    - 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 service
    - Income derived by the practice company or trust will not be income from personal services, and therefore outside of the scope of IT 2503, if the practice company or trust has at least as many non-principal practitioners as principal practitioners
    - If the practice company or trust has fewer non-principal practitioners than principal practitioners, then whether the entity derives income from personal services will still need to be determined by considering the following factors:
      - Nature of taxpayer's activities
      - Extent to which the income depends upon the taxpayer's own skill and judgment
      - Extent of the income producing assets used to derive the income
      - Number of employees and others engaged

Personal services income rules

- 2001
- ITs not withdrawn
- Result from review which found evidence of taxpayers operating like an employee but through a structure in order to claim deductions that were not ordinarily available to an employee
- Introduction of personal services income regime
  - Applied to limit the ability of individuals to claim business deductions, or use an interposed entity to split income where business income largely generated by the efforts or skills of the individual
  - Bright-line tests that could be applied whether an entity carrying on a Personal Services Business and therefore treat income as derived by the entity
  - Personal services business determination

Personal services income

- PSI as income a mainly (over 50%) result of an individual's personal effort or skills
- Does not include income from:
  - supply or sale of goods
  - generated from income producing assets
  - granting a right to use property (licence to use software)
  - generated by a business structure
- PSI applies regardless if income is for doing work for a result – however, not PSB tests
- PSI does not make the individual an employee for other purposes

Personal services entity

- Defined as a partnership, company or trust that derives PSI of one or more individuals
- PSI derived by PSE generally attributable to the individuals unless the PSE is carrying on a PSB

Personal services business

- Individual or entity carries on a PSB where individual or PSE:
  - Satisfies one of the PSB tests
  - Obtains a PSB determination

Results test

- At least 75% of the individual PSI meets the following three conditions:
  - Income paid to achieve a specified result or income
  - Provide the necessary tools or equipment to complete the job
  - Liability to fix defects in the work
- Applies even if 80% or more of income derived from a single source

Unrelated clients test

- Individual or PSE must derive less than 80% of income from a single source
- Two or more clients who are not associates of each other or of the individual or PSE earning the PSI
- Services are provided as a result of making direct offers to the public, or a section of the public:
  - Closed offers
  - Public at large
  - LinkedIn
  - Labour hire firm/placement agency (not met)

Employment test

- Individual or PSE must derive less than 80% of income from a single source
- Must have employees or sub-contractors who perform at least 20% of the market value of the principal work, being the main work of the individual that generates the PSI
  - Does not include administrative duties
  - Apprentice for at least half the year

Business premises test

- Individual or PSE must derive less than 80% of income from a single source
- Must:
  - Lease or own business premises
  - Use premises mainly (more than 50%) for personal services work of the individual
  - Have exclusive use of the premises
    - Licence/mere possession not sufficient
    - Not reception and waiting rooms do not cause failure, provided office space is exclusive
  - Have premises that are physically separate from private residence of individual and the business address of clients and associates

Passing a PSB

- Where PSI tests met, then PSI rules will not apply to deny deductions or deem income to have bene derived by the person providing the personal services
- Commissioner still wary and ITs exist with now additional commentary
  - TA 2013/3
  - Safe Harbour Guidelines
  - PCG 2021/D2

TA 2013/3

- Partnership of individuals restructuring to partnership of discretionary trusts
- Issues included:
  - the practice carrying on in the same way as it had been before restructure
  - Salary/remuneration considerably lower than income they formerly derived or would have derived if they had been a partner

Assessing the Risk

- Allocation of profits within professional firms (2014)
- Safe Harbor:
  - Equivalent remuneration
  - 50% entitlement
  - 30% effective tax rate
- Meet more for less risk
- Withdrawn on 14 December 2017

PCG 2021/D2

- Meet two gateways:
  - Commercial rationale (arrangement must be commercial)
    - Genuine commercial basis
    - Appropriately documented of commercial purpose
    - No contradiction – asset protection not a reason if arrangement doesn't give asset protection
    - Actions follow documents
    - More complex than it should be? (see paragraph 40)
  - High-risk features (circumstances cannot contain high-risk features)
    - Financing arrangements that are non-arm's length
    - Exploitation between accounting standards and tax law
    - Arrangements where partner assigns a portion of a partnership interest
    - Multiple classes of shares and units held by non-equity holders
- Failure to meet makes arrangement higher-risk

PCG 2021/D2

- Risk assessment table

Risk assessment factor	Score					
	1	2	3	4	5	6
(1) Proportion of profit entitlement from the whole of firm group returned in the hands of the IPP	>90%	>75% to £90%	>60% to £75%	>50% to £60%	>25% to £50%	£25%
(2) Total effective tax rate for income received from the firm by the IPP and associated entities [6]	>40%	>35% to £40%	>30% to £35%	>25% to £30%	>20% to £25%	£20%
(3) Remuneration returned in the hands of the IPP as a percentage of the commercial benchmark for the services provided to the firm	>200%	>150% to £200%	>100% to £150%	>90% to £100%	>70% to £90%	£70%

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- Risk zones

Risk zone	Risk level	Aggregate score against first two factors	Aggregate of all three factors*
Green	Low risk	£7	£10
Amber	Moderate risk	8	11 & 12
Red	High risk	£9	£13

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Income of the firm that is not personal services income

- 30. This Guideline only applies where an IPP has received an amount of income from a practice which generates its income from a business carried on in a business structure that is not subject to the PSI regime.

- 31. For the purposes of determining whether income earned by an IPP from a professional practice is PSI, the ATO will continue to apply the views set out in its existing rulings.[3]

Part IVA and this Guideline

- 32. We consider that Part IVA of the ITAA 1936 may apply to schemes which are designed to ensure that the IPP is not appropriately rewarded for the services they provide to the business, or receives a reward which is substantially less than the value of those services. Where an IPP attempts to alienate amounts of income flowing from their personal exertion (as opposed to income generated by the business structure), the ATO may consider the application of the anti-avoidance provisions under Part IVA.

- 33. The application of anti-avoidance provisions depends on a broad survey of the circumstances in each case. Just because a Gateway is not satisfied, or the arrangement is in the higher risk zone (red zone), does not necessarily mean Part IVA applies. The relevance of failing a Gateway, or being in the red zone (or the amber zone), is that the Commissioner is likely to give closer scrutiny to the arrangement, including a deeper consideration of whether anti-avoidance provisions apply

Some comments

- No general principle at tax law regarding ‘alienation of income’
- PSI rules/Part IVA only cover
- Owner of (legitimate) business should be able to decide (barring any law) how much to receive
- Crucial PSI rules are met as without them, laws aren’t even cleared
- PCG 2021/D2 should be viewed as guide on approach ATO will adopt using Part IVA

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