



Chat Legal Pty Ltd  
ABN 64 621 391 553  
letschat@chatlegal.com.au  
PO Box 74, Underwood, QLD 4119  
<https://chatlegal.com.au>

# Let's chat

PSI, PSB and Part IVA – October 2024

With:

Darius Hii – Tax and estate planning lawyer; Chartered Tax Advisor; and Director at Chat Legal

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



# Overview

- Taken from the perspective of health practitioners\*
- Pre-PSI cases
- PSI legislation
- Post-PSI ATO guidance
- Personal view?



# Doctor cases

- *Gulland, Watson and Pincus*
- 3 separate cases from the 80s
- Related to restructuring of arrangements from individual medical practices to the use of family trusts and unit trusts (as well as the introduction of service entities)
- ATO challenged arrangements via section 260 (the old Part IVA)
- ATO won in all 3 circumstances, largely due to the fact the only thing that changed was the introduction of new entities to split income away from the Doctors
- Often cited as a reason why Doctors cannot retain/split PSI



# Old ATO rulings

- IT 2121 (published 1984)
  - Delivered following the judgment of *Tupicoff v FCT* 84 ATC 4367.
  - Deals with the situation where a taxpayer is an employee one day but the next resigns and contracts with their previous employer through their associated entity in much the same way as they had during their employment, save the underlying contract of engagement.
  - The taxpayer then is paid a salary by their associated entity, but at a much lower rate than what they previously worked for. The rest of the income is then split with other family members whether via director fees or distributions.
  - The Ruling also states that the same principals can apply in the absence of a former employee arrangement, if the arrangement is essentially an employee-like one where the associated entity is not operating a business.



# Old ATO rulings

- IT 2330 (published 1986)
  - Delivered following the Doctor cases
  - Strongest suggestion that income from personal services cannot be split from the individual in paragraph 34.
  - Paragraphs 37 to 39 acknowledges that professional practitioners may earn income from a business structure.
- IT 25 (published 1981) and IT 2503 (published 1988)
  - Outlined scenarios when ATO will not have an issue of medical practitioners incorporating
  - Circumstances generally to enable superannuation contribution
  - Rulings noted if any income retained, such amounts retained should be paid as a franked dividend to the Doctor the following income year



# Old ATO rulings

- IT 2639 (published 1991)
  - 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



# Things to note

- At this point (pre-2000):
  - No fixed law stating personal exertion cannot be separated from the individual
  - Many of the cases that the ATO won related to circumstances where the general day-to-day transactions did not change; but as a result of a restructure, the way the income was tax changed
  - Way to attack such arrangements was through the old 'Part IVA' provisions which is the general 'tax benefit' anti-avoidance provision. Often difficult as it requires a case-by-case analysis



# PSI legislation

- Enacted with effect from 1 July 2000
- Skiba and FCT [2007] AATA 1705 at [35]:
  - **It is clear in the Tribunal's view that Part 2-42 was considered necessary because Part IVA was not an efficient way of dealing with the problem of alienation of personal exertion income. Part IVA was thought to be an ad hoc means of dealing with the problem because its provisions must be applied by the respondent on a case-by-case basis.** By contrast, Part 2-42 (which gave effect to the Ralph Report Recommendation 7.2) deals systemically with alienation of personal services income, meaning there was no need for the respondent to have recourse to Part IVA in such cases." [Emphasis added]
- *If there was a law stating personal exertion income could not be separated from the individual – what's the purpose of the PSI provisions*





# PSI legislation

- Will not go through legislation/ATO rulings in detail, however:
  - The taxpayer must determine if the income they have derived is PSI. If not, the PSI legislation does not apply.
  - If the income is PSI, the tests for a Personal Services Business (**PSB**) need to be worked through. If any of these tests is satisfied, the PSI legislation does not apply. However, even if the PSI legislation has no application, a PSE or sole trader that conducts a PSB may still be subject to the anti-avoidance provisions contained in Part IVA of the ITAA36
  - If none of the PSB tests is satisfied, unless the taxpayer makes a request to the Commissioner for a Personal Services Business Determination (PSBD) which is successful, the taxpayer will be denied certain business-like deductions (on the basis there is no business) under Divisions 85 and 86, and may have PAYGW obligations



# PSI legislation

- Ensure PSB tests reviewed per the legislation
- Do not just rely on the 'name' of the test in determining whether test is met or not
- E.g.
  - Results test requires more than just income for results based performance
  - Unrelated clients test requires more than just having unrelated clients
  - Employment test requires more than just having employees
  - Business premises test requires more than just having a business premise
- TR 2022/3 the most recent ATO summary of how the PSI rules operate
- *\*Time permitting, TR 2022/3 walkthrough\**



# So you are a PSB

- PSI legislation does not apply
- Consider if the general Part IVA provisions apply
- Consider the following slides containing ATO commentary as to Part IVA



# So you are a PSB

- TR2022/3 at [14]
  - *A PSE or sole trader that conducts a PSB may still be subject to the anti-avoidance provisions contained in Part IVA of the Income Tax Assessment Act 1936 (ITAA 1936).<sup>16</sup> Part IVA gives the Commissioner the power to cancel a 'tax benefit' that has, or would but for section 177F of the ITAA 1936, be obtained by a taxpayer in connection with a scheme to which Part IVA applies. This power is found in subsection 177F(1) of the ITAA 1936. Regard must be had to the individual circumstances of each case in making a determination under section 177F of the ITAA 1936 to cancel a tax benefit. Part IVA of the ITAA 1936 may apply to the sole trader or PSE that conducts a PSB involving an income-splitting arrangement where the dominant purpose is to obtain a tax benefit resulting from the alienation or the splitting of the PSI of the sole trader or the individual undertaking the work for, or on behalf of, the PSE.*



# So you are a PSB

- TR 2022/3 at [75]
  - *If one of the tests is met in an income year, the PSI rules will not apply to the PSI of the test individual in that income year. However, Part IVA may still apply to income splitting or retention of profits arrangements where the dominant purpose is to obtain a tax benefit for the individual whose personal efforts or skills generated the income.*



# So you are a PSB

- TR 2022/3 at [161] and [162]
  - *In deciding whether the PSB and test individual has engaged in income splitting in order to gain a tax benefit, the following considerations may be relevant:*
    - *whether the salary or wages paid to the test individual is commensurate with the skills exercised or services provided, and with the income received by the PSB for those services*
    - *whether the PSB distributes income to associates and does not distribute income to the test individual who provided the actual services, and*
    - *whether the salary or wages paid to associates by the sole trader or PSB is not commensurate with the skills exercised and services provided, and the income received by the sole trader or PSB is for services performed by the test individual.*
  - *An example of a situation where there may be income splitting to which Part IVA could apply would be where an independent contractor (conducting a PSB through an interposed entity) is paid less than the contracted price for their work and the profit made as a result of paying less than the contracted price is distributed to the contractor's relatives who are on a lower marginal tax rate or accumulated in the interposed entity and taxed at a lower marginal rate of tax.*



# So you are a PSB

- TR 2022/3 at Example 41
  - Jason operates business through a trust and generates \$120,000 of income
  - He has deductions of \$25,000 and pays himself \$50,000 with the remaining \$45,000 split between his wife and children
  - Jason's trust meets the PSB test by satisfying the results test
  - [269]...*However, in this case, the Commissioner would consider the application of Part IVA to cancel the tax benefit. Part IVA would apply if, having regard to the matters in subsection 177D(2) of the ITAA 1936, it would be concluded that there was a dominant purpose of enabling Jason to obtain a tax benefit by splitting the income. This would require a detailed consideration of all the circumstances. A likely conclusion would be that the dominant purpose of the arrangement is income splitting to which Part IVA applies*



# So you want to tax plan

- Can't have an entity purely for tax
- There needs to be a reason for the entity
  - Want to grow a business
  - Want to expand a business
  - Want to ensure a safety net
- Can't just swap across to an entity without a good reason
  - Changes to circumstances v nothing changes





# PCG 2021/4

- [13] *Overall, schemes which are designed to ensure that the IPP is not directly rewarded for the services they provide to the business, or receives a reward which is substantially less than the value of those services, are considered high risk by the ATO. Where an IPP attempts to alienate amounts of income flowing from their personal exertion (as opposed to income generated by the business structure), the Commissioner will consider applying the anti-avoidance provisions under Part IVA or other integrity rules - see paragraphs 36 to 38 of this Guideline.*



# PCG 2021/4

- [36] – [38]
- *36. We consider that Part IVA 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 in order to reduce the tax payable on their overall economic return. 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.*
- ***37. 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 attention to the individual facts and circumstances of the arrangement, including a deeper consideration of whether anti-avoidance provisions apply.*
- *38. Where an audit team is considering the potential application of Part IVA, there are various procedures and safeguards that the ATO has put in place to ensure a consistent approach to Part IVA, including the General Anti-Avoidance Rules (GAAR) panel. Reference should be had to Law Administration Practice Statement PS LA 2005/24 Application of General Anti-Avoidance Rules.*



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# PCG 2024/D2

- Note in draft – wait to see what comes out once finalised
- Consider the social media comment feedback
- Consider annotated copy of PCG 2024/D2



# Tree-map

- Is Practitioner an employee?
  - If Yes – Declare all income
- Is the income the Practitioner or their related entity derives mainly from PSI?
  - If No – PSI legislation does not apply
- Does the Practitioner/related entity conduct a PSB?
  - If No – Certain deductions denied, PAYGW obligations may result and all income to be declared.
- Consider application of Part IVA regarding any income retention/splitting:
  - Consider Part IVA factors
  - Consider PCG and risk matrix (noting different PCGs arise for allocation of professional profit firms and general personal services businesses)

# Contact details

## Darius Hii

Tax and estate planning lawyer; Chartered Tax Advisor; and Director at  
Chat Legal Pty Ltd

[darius@chatlegal.com.au](mailto:darius@chatlegal.com.au)

0403923374