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Mr Keith James
Post Implementation Review into the Alienation of Personal Services Income Rules
The Board of Taxation
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Dear Keith

Post Implementation Review into the Alienation of Personal Services Income Rules

The Taxation Institute of Australia (**Taxation Institute**) welcomes the opportunity to comment on the Board of Taxation's (**Board**) post-implementation review of the alienation of personal services income rules (**PSI Rules**).

The Taxation Institute understands that the Board's intention in undertaking this review is not to reopen debates about the merits of the policy intent of this measure. The "terms of reference" for this review require the Board to consider the extent to which the PSI Rules:

- give effect to the policy intent, with compliance and administration costs commensurate with those foreshadowed for the measure;
- are expressed in a clear, simple, comprehensible and workable manner;
- avoid unintended consequences of a substantive nature;
- take account of actual taxpayer circumstances and commercial practices;
- are consistent with other tax legislation; and
- provide certainty.

The Taxation Institute's submission below addresses the issues outlined above.

1. Policy intent

The policy objective of the PSI Rules as stated in the Explanatory Memorandum to the New Business Tax System (Alienation of Personal Services Income) Act 2000 (ie the Act that introduced the PSI Rules) is to improve the integrity of the tax system by addressing:

- the capacity of individuals and interposed entities (providing personal services of an individual) to claim higher deductions than employees providing the same or similar services; and
- the alienation of personal services income through an interposed entity.

Generally, the Taxation Institute considers that the PSI Rules are achieving their objectives and giving effect to the stated policy intent. However, there are some areas in which the Taxation

Institute considers that the PSI Rules are not giving effect to the policy intent and hence not achieving their objectives. These areas are discussed in detail below.

2. Clear, simple, comprehensible and workable manner

The Taxation Institute has concerns regarding the lack of clarity and certainty regarding some aspects of the PSI Rules. Further, the Taxation Institute considers that certain legislative amendments or the provision of further guidance by the Australian Taxation Office (**ATO**) would make the PSI Rules clearer and assist in increasing compliance with the PSI Rules. These issues are discussed below.

Personal services income

The term “personal services income” is defined as income that is “mainly a reward for your personal efforts or skills (or would mainly be such a reward if it was your income)” (refer s 84-5). The definition requires a determination as to whether the income, if it was derived by an individual, would be mainly a reward for that individual's personal efforts or skills rather than being generated by the use of assets, the sale of goods, or by a business structure (refer paragraph 22, Taxation Ruling 2001/7).

The difficulty in applying this definition is determining when income is derived from the efforts and skills of an individual as opposed to income generated from a business structure. In this regard, uncertainty commonly arises in relation to professional sportspeople and professional directors.

Although not a case related to the PSI Rules, the recent High Court decision of *Spriggs v Commissioner of Taxation* and *Riddell v Commissioner of Taxation* [2009] HCA 22 illustrates the uncertainty that can arise for professional sportsmen in relation to the distinction between income from personal efforts and a business structure.

Another example where it is difficult to distinguish between income from personal efforts and income from a business structure relates to professional directors that have multiple directorships. It is unclear whether the PSI rules should apply to each directorship individually or whether the taxpayer can argue that the totality of their directorships represents a business structure and therefore is outside the PSI Rules.

The ATO has provided some guidance in Taxation Ruling TR 2001/7. However, the Taxation Institute recommends that more guidance be provided on this issue by the ATO. Further, the Taxation Institute consider that it would be preferable to amend the PSI Rules to include a specific legislative provision regarding when income is from a business structure.

Unrelated client test

The Taxation Institute considers that there is uncertainty regarding the application of the “unrelated clients test” where the public offer test is being relied on (refer s 87-20(1)(b)). It is often unclear whether an offer has been made “to the public at large”. Members of the Taxation Institute have expressed concern that the ATO is taking an overly narrow interpretation of this test which is not supported by the legislation, rulings or case law. Accordingly, the Taxation Institute recommends that further guidance be provided in relation to the application of this test.

3. Avoids unintended consequences

The Taxation Institute considers that certain legislative amendments would address unintended outcomes or outcomes which are contrary to the policy intent of the PSI Rules arising and thereby improve the effectiveness of the PSI Rules.

In this regard, the Taxation Institute considers that the application of the “results test” leads to unintended outcomes that are not consistent with the policy intent of the PSI Rules. The results test is one of the primary tests for determining whether the PSI Rules apply.

The ATO has produced little guidance about the effect of the “results test”. The most recent judicial commentary on the results test is the Administrative Appeals Tribunal (**AAT**) decision in *Taneja v Commissioner of Taxation* [2009] AATA 87. The AAT found that the taxpayer was being paid at the time spent at hourly rates and as a consequence did not pass the results test.

The Taxation Institute does not consider that the fact that a taxpayer may be paid for time spent precludes the finding that the taxpayer could be engaged to produce a result. There are many industries (eg construction, engineering and mechanics) where it is industry practice to determine remuneration for projects based on hourly rates. The fact that a taxpayer may be paid an hourly rate should not preclude a finding that the results test applies.

The results test as defined in section 87-18 does not specify what kind of a “result” is needed to pass the test. The result could be any numbering of things, including the production of a letter of advice, repair of an asset, performance of a medical procedure or creation of intellectual property. For each activity that might involve personal exertion, there is a result that is likely to eventuate from that personal exertion. Hence, the “result test” is a broad test.

The potentially broad interpretation of “result” is one factor that allows taxpayers to “opinion shop” (this is discussed below, refer section 6). Further, the Taxation Institute considers that the difficulty in defining the “result” is one reason why the PSI Rules are not operating as effectively as intended.

Accordingly, the Taxation Institute considers, as with the definition of personal services income, the results test in section 87-19 should contain several examples to assist in the interpretation of the provision.

Business Premises test

The Taxation Institute considers that the Courts have taken a very narrow approach in relation to the application of the business premises test. For example, in the case of *Dixon Consulting Pty Limited v Commissioner of Taxation* [2007] AATA 1786, a very narrow interpretation of exclusive use of business premises was taken. The Taxation Institute considers that further guidance needs to be provided regarding the interpretation of this test.

4. Takes account of circumstances & commercial practices

The Taxation Institute considers that legislative amendments to certain areas of the PSI Rules to take into account specific circumstances and commercial practices would be consistent with the general policy intent of the PSI Rules. These areas are discussed below.

Payments to associates

If an individual, company, trust or partnership is within the PSI Rules, payments to associates are not deductible except in certain circumstances (see section 85-20). This is the case even where the payments to associates are at arm’s length and represent market value. The Taxation Institute considers that these rules fail to take into account the particular circumstances of taxpayers and industries and should be reconsidered.

PSB determinations

The Taxation Institute considers that the criteria to obtain a personal services business determination does not contemplate someone winding down from a previously large business to servicing a few select clients (see s 87-60). The criteria specified in subsections 87-60 (3A), (3B),

(5) & (6) are focused on start up businesses or businesses effected by some form of unforeseen unusual circumstance which generally includes a natural disaster. However, the criteria do not take into account service providers that are “winding down” their activities in contemplation of their retirement. The Taxation Institute submits that they should.

Entity maintenance deductions

The Taxation Institute considers that section 86-20 concerning the deductibility of entity maintenance deductions fails to take into account the particular circumstances of taxpayers and industries. Step 4 of the method statement requires the entity maintenance deductions to be offset first against non personal services income and then the balance to be offset against personal services income maximising the amount that is attributed back to the personal services income provider. The Taxation Institute does not consider that that formula is appropriate in the circumstances.

Although, in many cases taxpayers may establish structures that can have the purpose of providing additional tax benefits that are “reversed” under the PSI Rules, more often than not the creation of a structure through which services are provided is driven by the “notional employer” seeking to avoid the payment of costs. If the taxpayer falls in the latter category where the requirement for a structure is not as a result of a choice by the taxpayer, the Taxation Institute considers that these circumstances should be taken into account when applying the PSI Rules. Further, the Taxation Institute considers that the entity maintenance deductions ought to be treated like any other deduction.

Provision of all necessary plant and equipment

The results test in section 87-18 and the definition of personal services income is affected by whether the taxpayer provides plant and equipment or tools of trade needed to perform work. It is common in many industries (eg IT and the provision of professional advice) for all plant and equipment, typically a computer, to be provided for reasons of security.

The Taxation Institute considers that these provisions fail to take into account the particular circumstances of taxpayers.

The Taxation Institute’s members have expressed the view that the cost of the provision of the plant and equipment provided by the “notional employer” is usually factored in to the payment of the remuneration. Again, the Taxation Institute does not consider that the results test should be failed merely because the taxpayer does not provide plant and equipment for proper commercial reasons.

Treatment of knowledge workers

The Taxation Institute understands from its members that it is common for taxpayers to be contracted to produce a result where the result depends on the use of the taxpayer’s intellect in certain industries (eg lawyers, doctors, dentists, IT professional). The Taxation Institute considers that the personal services business tests (particularly the results test) fail to take into account the particular circumstances of taxpayers. In this regard, knowledge workers (ie workers who produce intangible property or provide advice or services using their intellect) seem to be disadvantaged under the PSI Rules as compared to workers who produce tangible property.

The Taxation Institute considers that this is a policy issue that needs to be addressed. It has been the experience of members of the Taxation Institute that the ATO often takes the view that the use of an individual’s intellect results in the income being characterised as personal services income. The Taxation Institute does not think that this result will be appropriate in all circumstances – it will depend on the circumstances of the taxpayer involved and the industry practice.

Many businesses provide “intellectual” capacity and services to other businesses. The fact that there is effort and skill of individuals involved in the provision of services should not preclude the

application of the results test or any other tests used for determining whether an entity carries on a personal services business.

For example, where a tailor creates a suit of clothing, the tailor exercises intellect in the application of their skill to create the clothing. The fact that the tailor creates clothing versus a tax advisor producing a letter of advice should not alter the analysis. Both the tax practitioner and the tailor are carrying on businesses in their own right. Consequently, the PSI Rules must take into account the application of the results test as well as how the application of the personal services income test fits within a service type business. As stated above, the Taxation Institute considers that the PSI Rules need to be amended to take account of this issue.

PSBs with payments from one source

The PSI Rules do not take into account situations where a taxpayer legitimately carries on a business of providing services or goods to the world at large but receives their income primarily from one source.

The example that resulted in the specific agency provisions contained in section 87-40 were financial advisors that provided financial advice under a principal's financial services dealers licence who received their commission from the licence holder. Similarly, insurance agents and brokers and stock brokers also come within that category.

Central to the requirement of section 87-40 is that the taxpayer must be an agent of the principal that pays the agent for the services provided by that agent to other entities on the principal's behalf.

In the case of the financial advisor acting as an agent of a principal that holds a financial services dealers license or an insurance agent or broker, the principal agency relationship is more readily established. However, in the case of a medical practitioner that receives the bulk of their income from the provision of Medicare benefits from the Government, the medical practitioner would technically fail the 80-20 rule. Further, they could not avail themselves of the agency exception because they are not an agent of the Government that pays Medicare benefits.

The Taxation Institute considers that the requirement of principal and agent in section 87-40 ought to be removed and does not consider that any mischief would result from the removal of the requirement of a principal and agency type relationship. The taxation Institute considers that if a taxpayer provides services to third parties as part of the ordinary business activities of the taxpayer, the fact that the taxpayer receives most of their income from one source should not be relevant for the purposes of applying the PSI Rules.

6. Provides certainty

The lack of clarity regarding some aspects of the PSI Rules (refer section 2 above) and the failure to consider particular taxpayer circumstances (refer section 3 above) has lead to uncertainty in relation to the application of the PSI Rules.

To enhance the certainty of the PSI Rules, there needs to be transparency in the administration of the PSI Rules by the ATO. There also needs to be on-going education/guidance material available to tax practitioners advising on this area. This should assist in increasing compliance and reducing the incidence of "opinion shopping" by taxpayers.

In this regard, some of the Taxation Institute's members have expressed the opinion that this uncertainty has lead to situations where clients have "*opinion shopped*" amongst tax professionals (ie because the uncertainty provides room for different advisers to give different opinions).

The Taxation Institute submits that on going assistance should be given to tax practitioners to assist in the compliance with the provisions to prevent clients from trying to seek a more favourable opinion on the application of the provisions from another practitioner. The Taxation

Institute points out that for some time after the commencement of the PSI Rules, many practitioners were not clear on how the PSI Rules applied. The ATO had applied a significant amount of resources to assist in the education of tax practitioners.

In relation to transparency of administration, the Taxation Institute notes that many of our members have expressed concerns regarding the application and administration of the PSI Rules by the ATO. Members have reported many examples where ATO audits and reviews have resulted in the ATO taking different views to those taken by practitioners who have used ATO material for guidance. The Taxation Institute considers that this issue should be reviewed. If practitioners are frequently reaching a different conclusion regarding the application of the PSI Rules based on the legislation, case law and their interpretation of ATO material, it has to be acknowledged that there may be an issue with the guidance that is being provided.

To conclude, the Taxation Institute considers that there needs to be constant ongoing communication with taxpayers, the "notional employers", and with tax practitioners to understand the effect of the provisions and the potential sanctions. Although the ATO has provided many such publications, the Taxation Institute considers that new publications ought to be issued on a regular basis especially in high risk industries.

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If you require any further information or assistance in respect of our submission, please contact Joan Roberts on 03 9611 0178 or the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours sincerely

Joan Roberts
President