9 April 2021

Debra Masterton
Individuals and Intermediaries
Australian Taxation Office

By email: Deb.Masterton@ato.gov.au

Dear Debra,

Draft Taxation Ruling TR 2021/D2 Income Tax: personal services income and personal services businesses

CPA Australia and Chartered Accountants ANZ represent over 200,000 professional accountants in Australia and New Zealand. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

Draft Taxation Ruling **TR 2021/D2 Income tax: personal services income and personal services businesses** (**the draft Ruling**) provides a consolidated and updated ATO view on the application of personal services income (**PSI**) to an individual or entity and is intended to replace Taxation Rulings **TR 2001/7** and **TR 2001/8**.

The personal services income (**PSI**) rules are complex and the draft Ruling is helpful as it highlights the factors for taxpayers and advisers to consider and provides multiple examples. We make the following general comments:

- The draft Ruling would benefit from further discussion about what is PSI where different individuals are involved, and confirmation that an amount of income will either be PSI or not (with no apportionment or dissection) if more than 50% of the income was a reward from the personal efforts and skills of an individual.
- We question the view in paragraph 41 of the draft Ruling that considers one set of obligations and all the income derived from performing those obligations is either PSI in its entirety or not, particularly as no authority is cited.
- The commentary under "Determining whose personal services income it is" needs further elaboration, particularly around the comment that the PSI generated under the contract is wholly attributable to the test individual, even if the PSE engages another individual to assist the test individual with principal work.
- The draft Ruling suggests that a personal services entity (**PSE**) self-assess the four personal services business (**PSB**) tests "in relation to each test individual", indicating that a PSE may conduct a PSB in relation to some individuals who derive PSI through that entity, and not conduct a PSB for others. This view should be made clear and elaborated upon in the ruling.
- The "producing a result" element of the results test is one of the main areas of confusion and misunderstanding in the PSI rules and we recommend the ruling provide more a detailed explanation.

- We recommend that comments related to PSI in draft Law Companion Ruling *LCR 2018/D7 Base rate entities and base rate entity passive income* are included in the final ruling.
- We are concerned that the comments and example regarding Part IVA of ITAA 1936 requires further detail before concluding that Part IVA could apply.

More detailed responses are contained in the Attachment.

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Yours sincerely,

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Attachment

1. The numerous and succinct examples in the draft Ruling are very useful and it would further assist taxpayers and advisers if the ATO developed more detailed case studies that follow the examples to their conclusion.
2. Paragraph 23 of the Ruling states that it "clarifies the ATO view to take account of several judicial decisions which have further clarified the law since the issue of those earlier Rulings." We recommend that these court decisions be listed in this section and some commentary included on how the respective decision clarified the law, particularly where the court decisions have resulted in the ATO modifying its views. This will help inform tax practitioners what is different in this Ruling compared with the two rulings TR 2001/7 and TR 2001/8 and not leave them second guessing what has changed.
3. We note the draft Ruling does not cover the attribution process in Division 86[1] nor does it address the effect of Division 85 on deductions at all and the interaction of the two (i.e. the note to s 86-60(a) explains that deductions available to entities in relation to PSI are also restricted in the same way as Division 85 where there is no PSB being conducted).
4. The **Compendium of comments** for the draft Law Companion Ruling *LCR 2018/D7 Base rate entities and base rate entity passive income* contains some useful comments under issue 48 regarding the interaction of the attribution of personal services income to an individual and calculating whether the PSE meets the 80% threshold of Base Rate Entity Passive Income in determining whether it is a Base Rate Entity. We recommend these comments be incorporated in the final ruling for personal services income.
5. We note footnote 16 to paragraph 16 states that the guidelines for determining whether the income from a practice company or trust is from a business structure are not intended to form a binding part of the Ruling when finalised. This should be clearly stated in paragraph 37 rather than hidden in a footnote. As the guidelines are located in the binding part of the Ruling, one could easily mistake the guidelines as binding on the Commissioner.
6. Greater detail in the draft Ruling about what is PSI where different individuals are involved would be beneficial. Example 12 highlights this issue and should be expanded upon.
    - 6.1. Why is the income Kim's PSI rather than David's PSI where David does more than 50 per cent of the work?
    - 6.2. Is this because from Big Co's perspective they are seeking Kim's services and the income would still be Kim's PSI even if David was able to perform 100% of the job?
    - 6.3. How would this apply if the client requests a general service rather than seeking a particular individual?
        - 6.3.1. For example, if a member of the public requires an electrician to do some wiring and responds to a public advertisement rather than seeking out a particular individual, would the PSI be that of the individual who performed the job?
        - 6.3.2. If the job was delegated to a junior electrician could the fee still be the PSI of the senior electrician because they are the "principal" or have a supervisory role?

[1] All legislative references are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise indicated.

7. Paragraphs 29, 41 and 42 of the draft Ruling suggest that an amount of income will either be PSI or not (with no apportionment or dissection) if more than 50 per cent of the income was a reward from the personal efforts and skills of an individual. This suggests a binary approach where either the income is for personal efforts and skills or something else and one must consider what the income is mainly for.

    7.1. Would this be the case if the income was for three or more things (e.g. personal efforts, parts and something else like rent) or should the income streams be differentiated as in Example 3 instead?

    7.2. In this example, if you could allocate the income as being 40/30/30 per cent for these three things respectively, would the whole amount be PSI because the largest part of the income was for personal efforts or would the whole amount not be PSI because 40 per cent was for personal efforts and 60 per cent was for things other than personal efforts?

8. In relation to business structure, paragraph 38 of the draft Ruling defines 'Principal practitioners' as those who own or share in the ownership of the practice. There is no materiality here. An employed practitioner who is offered participation in an employee share scheme (very common in a lot of engineering firms we work with) may have an ownership interest of less than 1%, perhaps a few more (ESS scheme benefits apply up to 5%). Would every one of these employees therefore be considered principal practitioners notwithstanding the existence of goodwill, a large operation, income producing assets etc. We recognise this is just the "starting point" and a "rule of thumb" but one can imagine a case officer focussing too much on this rule of thumb and ignoring the other factors described in paragraph 36.

9. We question the view in paragraph 41 of the draft Ruling that considers one set of obligations and all the income derived from performing those obligations is either PSI in its entirety or not.

    9.1. There is no authority cited in these paragraphs of the Draft Ruling. In particular, there is no consideration of the cases of *Allsop* and *McLaurin*[2] which state that an entire amount of an undissected lump sum will not be ordinary income if there are a number of claims and the sum is paid to settle all claims, some of which are capital in nature.

    9.2. In Example 1, Andre is able to dissect the $250 invoice and attribute the amount to individual items. If one of the items were capital in nature, then one could dissect the item that is income in nature and treat it as ordinary income. Given that s 84-5 deals with individual items of ordinary or statutory income (i.e. it talks about "the" income being mainly a reward for personal efforts/skills), it is arguable that where one is able to dissect a receipt into two individual items of income then each can be treated separately as either PSI or not.

    9.3. This would still give work to do for the "mainly" test where the income cannot easily be dissected (e.g. the application of s 84-5 in Example 2 which requires one to consider whether the transportation fee is mainly for personal efforts or mainly for the use of the semi-trailer where the income would not normally be dissected into separate components for the individual's time and for the use of the equipment).

10. The commentary under "Determining whose personal services income it is" i.e. paragraphs 44 to 49 and example 12 needs further elaboration, particularly around the comment that the PSI generated under the contract is wholly attributable to the test individual, even if the PSE engages another individual to assist the test individual with principal work.

[2] McLaurin v Federal Commissioner of Taxation (1961) 104 CLR 381; Allsop v Federal Commissioner of Taxation (1965) 113 CLR 341.

10.1. Reading *The Engineering Company and Commissioner of Taxation [2008] AATA 934* cited in footnote 17 to paragraph 49 of TR 2021/D2, the Tribunal member provides his view of how to determine whose personal services income it is when different individuals perform the work for the PSE in paragraphs 18 -19:

"I have come to the view that, where it is possible to do so, each discrete amount of income that has been received from the entity's clients are the amounts of income that should be examined for the purposes of s 84-5(1). These amounts will generally be reflected in the invoices issued to the clients. Where the amount shown on a particular invoice is itself a total amount, and not capable of dissection into distinct components, the question that should be asked is whether the total amount is "mainly" a reward for an individual's personal efforts or skills. Where, on the other hand, the amount is capable of dissection, the question should be asked in relation to each distinct component of it. In summary, the "amounts" of income that are to be analysed in terms of s 84-5(1) are the amounts that have been identified by the personal services entity as the various amounts of ordinary income and statutory income that go to make up the entity's total income.

In the case of The Engineering Company, amounts invoiced to Client A that relate solely to work carried out by Mr Engineer form part of his personal services income. Amounts that are not capable of dissection, but that relate to work carried out by both Mr Engineer and Mr O, form part of Mr Engineer's personal services income only if the work invoiced is "mainly" – that is, to the extent of more than 50 per cent – a reward for his personal efforts or skills. Amounts that relate solely to Mr O's activities, of course, would not form part of Mr Engineer's personal services income."

10.2. In light of the Tribunal member's view, we recommend more commentary should be included after paragraph 48 to provide guidance on what to consider in the invoice and in determining the amount of income that should be examined for personal services income. What seems to be missing in the draft Ruling is commentary around where an amount shown on a particular invoice is itself a total amount, and not capable of dissection into distinct components, compared with where an amount shown on the invoice is capable of dissection.

11. In determining "whose PSI it is", paragraphs 44-48 and Examples 9 to 12 of the draft Ruling do not clearly state whether one is required to test each invoice under the one contract separately. It would be useful if there was an example in which two principals perform a contract which is billed periodically (e.g. monthly) during the course of the work (e.g. does each monthly invoice need to be analysed separately or does one look at the overall contract and determine who is the primary person performing the contract overall?)

12. Further clarification of the testing of a PSB "in relation to each individual" would be beneficial. Paragraph 51 of the draft Ruling states that a PSE is able to self-assess that they conduct a PSB "in respect of the test individual". Paragraph 59 suggests that a PSE self-assess the four PSB tests "in relation to each test individual". This indicates that a PSE may conduct a PSB in relation to some individuals who derive PSI through that entity, and not conduct a PSB for other individuals. This view should be made clear and elaborated upon in the ruling.

12.1. The exception to attribution in s 86-15(3) is where the amount of PSI is income "from the PSE conducting a PSB". Under s 87-15, a PSE conducts a PSB if the entity meets at least one of the four PSB tests. The wording of the four PSB tests suggests that either a PSE will meet the test for an income or it will not, rather than being able to meet the test "in relation to an individual" for a year and not meet it in relation to another individual.

12.2. On the other hand, s 87-15(1)(b) requires the PSE to have a PSB determination in force "relating to an individual whose PSI is included in the entity's income" and therefore suggests that a separate determination is required in respect of each such individual.

12.3. The ruling should clearly explain how the law applies on this issue and whether in fact, a PSE can meet one of the PSB tests in respect of some but not all individuals whose PSI is derived by the PSE.

12.4. For example, there may be three sole traders operating in the same field who derive PSI, two of which satisfy one of the PSB tests. If the sole traders entered into a partnership (via family trusts), but otherwise conducted the same activities as before, could this result in the partnership satisfying a PSB test such that no PSI is attributed to any of the partners?

13. Paragraphs 73 to 75 discuss the "producing a result" element of the results test. This is one of the main areas of confusion and misunderstanding in the PSI rules and we recommend the ruling provide more a detailed explanation.

13.1. For example, if a tradesperson is engaged to conduct repairs, they may charge a call-out fee and also invoice based on the time spent on the job. Even if the client is (from their perspective) paying the tradesperson to produce a result, the fee is calculated by reference to time spent on the job. Is this income for producing a result or merely an hourly rate?

14. In relation to paragraph 8 (specifically, producing a result), many labour intensive industries still use hourly or daily rates as the method of calculating the charge even though the delivery is of a specified output or result and we do not believe this has been adequately demonstrated in the ruling or in examples. There are also cases where businesses are engaged on fixed retainers, say monthly, that covers a range of services within the scope yet are still being engaged for producing specific results.

14.1. For instance, an accounting firm may be contracted to provide weekly reconciled accounts, fortnightly payrolls, monthly management reports, quarterly BAS lodgements and annual tax returns and financial statements. This is a clear set of deliverables, for which the accountant must provide all the tools and is responsible to rectify errors and bears professional indemnity risk. They also bear the economic risk of mispricing if the work takes significantly longer than anticipated but capture the positive upside when work can be delivered efficiently.

14.2. However, paragraph 74 would seem to indicate that completing identifiable tasks that form part of the work for a regular ongoing basis would not meet the results test.

15. We question the ATO's approach to referrals as discussed in paragraph 93. According to the ATO, if the clients you accept are through referrals, rather than from a public advertisement, it would not count towards unrelated clients from public offers. This seems contrary to a very typical way to attract clients in many service-based industries, particularly professional services.

16. Paragraph 144 suggests that a sole trader or PSE cannot rely on industry-wide circumstances and that the unusual circumstances must apply to the particular sole trader or PSE. We suggest that the ruling address or provide examples of whether the consequences of COVID-19 can be considered unusual circumstances, given how wide in reach they were and the impact on entire industries.

16.1. For example, if a PSE had business premises for which a lease expired sometime in 2020 and chose not to renew the lease or enter into a new lease over other premises until 2021 due to the principal/s of the PSE being forced to work from home, will this be an unusual circumstance for which a PSB determination can be given to the entity?

17. We are concerned that the paragraphs regarding Part IVA of ITAA 1936 and Example 40 are too hasty in concluding that Part IVA could apply.

    17.1. In particular, paragraph 51 states that "a likely conclusion would be that the dominant purpose of the arrangement is income splitting". The example does not address the tax benefit element of Part IVA and does not propose an alternate postulate. It should be made clear whether the establishment of the structure is a Part IVA scheme or if the annual resolutions by the trustee stand alone as a Part IVA scheme.

    17.2. If the dominant purpose of the establishment of the structure is not the purpose of obtaining a tax benefit (e.g. the structure may provide limited liability, asset protection, benefits for family members, etc), could the distributions alone be a scheme to which Part IVA applies? If so, how would this be distinguished from a different business conducted by a family trust which does not derive PSI (such as a retail business) even if there is a sole individual effectively running the entire business as their full-time occupation?

    17.3. Further, and in contrast to **PCG 2021/D2**, the conclusion in Example 40 would tend to suggest that Part IVA would apply even if JB returned 99% of the net income of the trust (which is PSI) in his own name (e.g. if only $450 of the $45,000 was distributed to JB's wife). As JB would have split some of the income that is a reward for his personal efforts and skill to someone else then the draft Ruling suggests that Part IVA could apply to include that 1 per cent in his assessable income. PCG 2021/D2 applies a risk framework and suggests that there is a low risk of the ATO seeking to devote compliance resources to the application of Part IVA if a certain proportion of net income is returned by the relevant individual professional practitioner (**IPP**) and a certain effective rate of tax is paid on that income.

    17.4. By taking the view that any level of income splitting is likely to result in Part IVA applying, this effectively suggests that the PSI rules have little work to do as Part IVA would effectively achieve attribution to the individual whose PSI is being derived even if that income is derived by a PSE that is conducting a PSB.

    17.5. In relation to paragraph 10, specifically Part IVA, it may be worth asking if the below market salary the primary indication that the "dominant purpose of the arrangement is income splitting"? If, for instance, in Example 40, he was remunerated $90,000 the trust would still have taxable income of $5,000 that would be distributed. It's also not clear that the $90,000 quoted value of JB's services is the value of him "doing work" or the value of the "result" of undertaking the work. Presumably the ATO intends for it to mean the former. We do not agree with the ATO using the isolated term "value" and would prefer the use of terms such as "market value" or "arm's length" remuneration. There are plenty of other areas of tax law that require consideration of these terms and are therefore better understood.

18. The position adopted by the Commissioner in Example 40 appears to be based upon the New Zealand general anti-avoidance rules case of ***Penny and Hooper v Commissioner of Inland Revenue [2011] NZSC 95*** and **Revenue Alert RA 21/01**.[3]

    18.1. The *Penny and Hooper* case involved a change in business structure by two orthopaedic surgeons (Penny and Hooper) who transferred their respective practices as sole traders to a new related

[3] New Zealand Inland Revenue, 2021. **New Zealand Revenue Alert RA 21/01 Diverting personal services income by structuring revenue earning activities through a related entity such as a trading trust or a company: the circumstances when Inland Revenue will consider this arrangement is tax avoidance.**

company owned by various family trusts. This change of structure allowed the profits of the business to be split amongst other family members instead of being fully taxable to the respective surgeon in their own name. The Supreme Court of New Zealand (being the highest court) held that section BG 1 of the *Income Tax Act 2007* applied to the arrangement as the use of this new structure went beyond parliamentary contemplation as the tax purpose was considered to be the overriding purpose driving the whole restructure. Consequently, the Commissioner was entitled to tax the taxpayers by reference to a 'commercially realistic salary' effectively negating the tax advantage achieved by the restructure.

18.2. New Zealand's **Revenue Alert RA 21/01** identifies concerns about arrangements involving taxpayers who effectively divert some or all of the income they earn (or could earn) from a business or activity of supplying personal services to a related entity where it has the effect of taking advantage of lower marginal income tax rates payable by that entity and/or by family members as beneficiaries or shareholders of that entity.

18.3. To provide interpretive certainty, we suggest that the Commissioner of Taxation should consider a test case to determine whether the Australian judiciary agrees that Part IVA would apply to such a case as illustrated by Example 40.

19. As a general comment on the PSI rules, we note they were developed in 1999 around the time of the Review of Business Taxation reforms. These rules may no longer reflect or accommodate modern business practices as many smaller businesses may now operate from non-exclusive premises such as shared office spaces or able to operate from home post-COVID and the roll-out of the NBN and 4G/5G infrastructure. Additionally, for the purpose of the unrelated clients test, the way in which advertising is done has changed from standard practice 20 years ago.

19.1. To this end, it may be worthwhile for the ATO to consider developing a practical compliance guideline (**PCG**) that addresses issues raised by the contemporary business environment and provides taxpayers and advisers with a methodology to self-assess their risk exposure to PSI issues.

19.2. We also suggest that the ATO review the **Personal services income tool** webpage and other PSI guidance material to make direct reference to seeking advice from tax agents and professional advisers given the complexity and potential misapplication of the rules by taxpayers.