



**Professional
Contractors and Consultants
Australia**

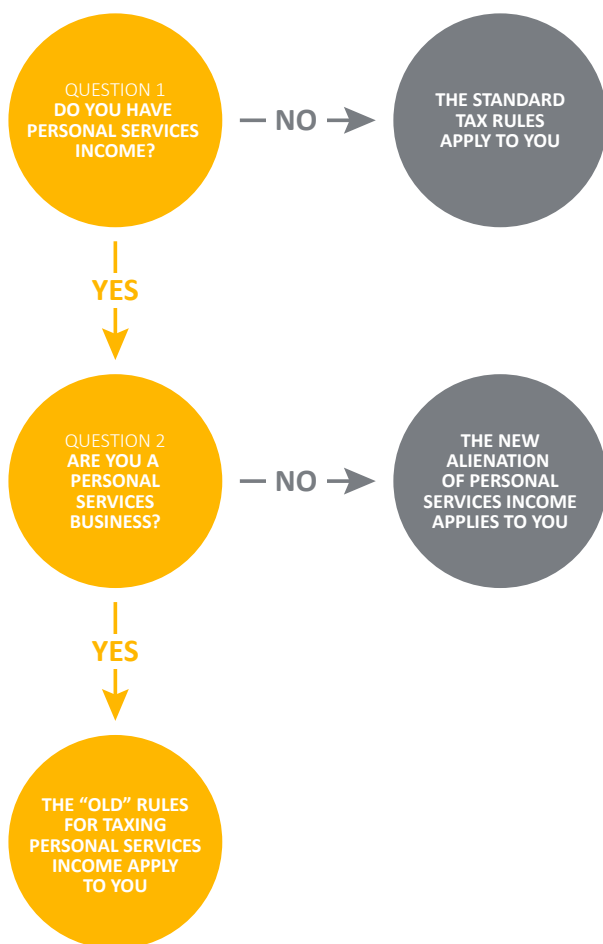
PSI TRICKS, TRAPS AND OPPORTUNITIES

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Personal services income (PSI) is a significant tax issue for contractors and the results test is a pivotal part of the process of determining how PSI is taxed. It is the test most contractors will rely on to be classified as a Personal Services Business (PSB).

Yet for such an important set of rules, it is surprising how misunderstood the application and implications are.

In considering any aspect of the personal services income rules, it is worth revisiting how the overall concepts fit together. The following diagram provides a basic summary:



The first question is critical – do you have personal services income? If your income is not personal services income, you don't need to worry about these provisions at all.

The second question only applies if you have personal services income – are you a personal services business? Whilst this test refers to a 'business', a PSB in fact has little to do with whether or not you are a business. A PSB is purely a legislative concept that creates an exception to the Alienation of Personal Services Income provisions. If you are a PSB, you don't need to apply the PSI rules.



¹The tests apply to any individual or entity that is in receipt of personal services income, however for simplicity in this article, I will simply use the term 'contractors' to refer to this group.

What are the 'old' rules?

The 'old' rules for taxing PSI are found in case law and various rulings published by the ATO. The basic principle is familiar – income that relates to a particular individual is taxable to that individual and cannot be alienated – but the specifics of how this is applied can be quite subjective.

An entity that is receiving PSI and is a PSB cannot retain that income. The income needs to be distributed by year end to the individual that performed the services to earn the income. The ATO will accept a small amount of income being left in the entity, but only if this income is distributed soon after year end. The rules are similar to the attribution rules in the alienation of PSI legislation, although the legislation is a lot more prescriptive in its method.

An entity that is receiving PSI and is a PSB can deduct 'reasonable' expenses against the PSI. What is reasonable and what is not has been subject to numerous court cases. The Alienation of Personal Services Income legislation tried to overcome this uncertainty by providing a list of the deductions that could be claimed. Rather than resolve the issue, this list created an incentive for contractors to classify themselves as a PSB and so not be subject to these restrictions on deductions. Deductions for certain travel expenses, home office expenses and payments to associates are effectively prohibited by the legislation.

Tip: Understand the difference between how a PSB and a non-PSB are taxed.

Whilst claims for travel expenses and home office expenses have not been tested in any detail before the courts, payments to associates has been the subject of a number of recent cases. When assessing whether a payment to an associate is reasonable, you should:

- specifically identify the work-related functions performed by your associate;
- find an independent market rate of remuneration for these services; and
- compare the remuneration package you are proposing – salary, superannuation and benefits – to the market rate.

If you are paying over the market rate, then the excess is likely to be viewed by the ATO as unreasonable and the deduction disallowed.

Tip: Ensure any payments to associates can be justified as reasonable.

If only for the increased flexibility, most contractors prefer to be treated as PSBs and be subject to these old rules.

When will a contractor have income that is not PSI?

Whilst most contractors want to be classed as PSBs, the greatest tax benefits can be obtained by going back a step and reconsidering whether your income is in fact PSI after all. If your income is not PSI, then you can retain it in an entity or distribute it to associates.

The ATO has available a publication which specifically deals with the distinction between income from personal services compared with income from a business structure. It is available at <https://www.ato.gov.au/Business/Personal-services-income/In-detail/Applying-PSI/Income-from-a-business-structure/>.

The ATO recognises that many contractors undertake their affairs in a business-like manner; however they draw a distinction between the concept of a business for tax purposes and a business-like activity that derives PSI.

The sorts of factors which are relevant for making the distinction include:

- the number of arm's length employees or others engaged by your business to perform work and the efforts of those employees;
- the extent to which the income depends on your own personal skills, efforts or expertise;
- the extent to which income-producing assets such as plant and equipment or machinery or intellectual or other property are used to derive the income;
- the presence of goodwill (other than personal goodwill);
- the nature of the activities carried out; and
- the size of the operation.

The greater the number of employees, the more substantial the income-producing assets, the larger the operations, the less the activities are dependent on one key individual, the more likely the income will be income from a business structure and not PSI.

It is worth every contractor reviewing their overall activities to determine if the income derived from those activities constitutes income from a business structure.

Even if you cannot demonstrate that all your income is derived from a business structure, it is still worthwhile to consider if a particular stream of income, or a particular contract, can be classified as not being PSI.

Opportunity: Review your income to see if any can be classified as not being PSI.

The results test

If you have PSI, then the PSB tests become relevant. The first test is the results test and this is the one that most independent contractors will apply. The results test requires that in relation to at least 75% of your PSI for the income year:

- the income is for producing a result; and
- you are required to supply the plant and equipment, or tools of trade, needed to perform the work from which you produce the result; and
- you are, or would be, liable for the cost of rectifying any defect in the work performed.

There are some obvious pitfalls to be aware of with this test. Firstly, it is measured on a year by year basis. Where your customers change from year to year, this can mean you would pass the test one year and fail the next. Most contractors will also use the cash basis to determine what income is taxable in any particular year (i.e. you are only taxable on your income once it is actually paid to you). Therefore, receipt of an amount of income in one year rather than the next could affect whether you meet the 75% requirement.

Trap: The results test needs to be applied on a year-by-year basis.

The 75% threshold is also only measured in respect of PSI – non-PSI income received by the contractor, whether it is investment income or income from a business structure (refer above) is not relevant.

The results test criteria extend beyond being contracted to produce a result. It also requires that you provide the tools of trade necessary to undertake the work, and that you are liable for rectifying defects in your work. You need to meet all three criteria to pass the test.

Trap: You need to meet all three criteria in respect of at least 75% of your PSI for the year to pass the results test.

The results test is an attempt to reflect in the legislation the concept of 'entrepreneurial risk'. The Alienation of Personal Services Income legislation was only intended to apply to contractors whose situation was akin to that of an employee. Where a contractor bears entrepreneurial risk, they are beyond the scope of what the legislation was intended to apply to. This is important to remember. If you are setting up your contracts so that you pass the results test, you should compare the tax benefits you might obtain against any potential increase in the commercial risks that you are facing. For many contractors, the benefits will not justify the risks.

Tip: Compare the benefits of being a PSB against the potential costs of structuring your contracts to meet the results test.

The PSI rules create additional complexities in the tax affairs of contractors. Having up-to-date financial information will help you manage your affairs, but being fully informed on how the PSI rules apply to you is vital. The Professionals Australia Contractors and Consultants website and the ATO website contain detailed information on the PSI rules and should be your first stops in finding out how your situation is affected.



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