



**Professional
Contractors and Consultants
Australia**

THE RESULTS TEST: DECIDING YOUR PSI STATUS WITH CERTAINTY



Information and advice for Professionals delivering business and IT services who may be affected by the Personal Services Income legislation

The Alienation of Personal Services Income (PSI) legislation was enacted on 1 July 2000 in response to recommendations set out in the Ralph Report. The legislation was intended to prevent individuals who generate income from their personal services from reducing their liability to taxation by diverting income through a company, partnership or trust, and to limit and clarify the work-related deductions available to the individual and the interposed entity. The ATO put in place Taxation Rulings which detailed a range of personal services business tests to determine how contractor status would be applied. Those who did not satisfy these tests would not be regarded as Personal Services Businesses (PSB's) and many of the business deductions formerly available will no longer be allowable.

While introduced as an anti-avoidance measure, Professionals Australia is of the view that the Alienation of Personal Service Income legislation has imposed both uncertainty and financial penalties on a significant number of genuine independent contractors and consultants.

One of the major problems with the legislation for professional consultants continues to be the 80/20 Rule which effectively limits the type and duration of contracts which genuine independent contractors and consultants can take on. The legislation presupposes a "normal" contract length of less than 12 months. However in many cases, this simply does not reflect the reality of commercial practice with many infrastructure projects and contract renewals meaning genuine contractors are often contracted to one client for a period longer than 12 months in the one financial year. The PSI legislation forces them to effectively reduce the number of hours provided to a client in order to diversify their client base and sources of income, or potentially lose the capacity to claim a range of legitimate deductions.

In the revised ATO Rulings, the Results Test was elevated as the first criteria against which contractor status was determined. In considering whether or not a taxpayer will satisfy the Results Test, the ATO considers the substance of the arrangement between client and principal giving rise to the income. A problem with the PSI measure is in its application by the ATO – tax office officials have interpreted commercial terms of engagement – which set out arrangements between contractor and client - very narrowly when assessing contractor status for the purposes of a Personal Services Business Determination. The fact that a client does not cover the professional's workers compensation, superannuation and professional indemnity insurance and the contractor has taken on these expenses is not seen as sufficient to indicate contractor status.

While we do not accept that it is acceptable in terms of policy or application to require independent contractors delivering business services to frame their contract documentation in a particular way, it is within this framework that we have aimed to highlight the issues members need to be aware of in drafting their contracts for service.

We strongly suggest that members read through this material and then seek individual advice from their Accountant or Taxation Professional where they have concerns about their status under the PSI legislation.

This Guide should be read in conjunction with:

- Professionals Australia's Guide to Writing Contracts for Service
- Professionals Australia's Standard Terms of Engagement
- Professionals Australia's PSI Solutions Guide, and
- A range of ATO Fact Sheets on PSI.

Members using the Contractor Hourly Rates information should ensure they refer to the Guide to Writing Contracts for Service and the Watchpoint Clauses chapter of this Guide if PSI is an issue. Charging an hourly rate can be regarded by the ATO that the contractor will be paid whether or not a particular result is achieved, is therefore not assuming commercial risk, and is therefore not deemed to be a PSB.

Acknowledgements

Professionals Australia thanks Graham Candy from Rigby Cooke Lawyers, Peter Van den Broek from Clayton Utz, and Ingmar Taylor from HB Higgins for their assistance in the preparation of this information.

Disclaimer

This information booklet describes the general tenor of the relevant legislation. It is not intended to be relied on as a substitute for professional advice in relation to actual facts and circumstances. No responsibility can be accepted by the authors for loss occasioned to any person doing anything or refraining from doing anything as a result of anything contained in it.

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PSI FAQ'S

What are the PSI Rules meant to do?

The rules were designed to improve the integrity of the tax system by addressing both:

- The capacity of individuals and interposed entities providing the 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.

The PSI Rules – who do they apply to?

The PSI rules apply both to individuals earning income from their own exertions and to companies, trusts, partnerships and other trading entities which earn income from the efforts of their individual employees or consultants.

What happens if the PSI measures apply (i) to entities and (ii) individuals?

- If an “entity” earns personal services income (as defined), that income will be attributed to the individual who does the work;
- The individual who does the work will have to pay income tax on the attributed income at personal rates; and
- The entity will not be able to claim many normal business deductions
- If an individual earns personal services income personally, rather than through an entity, that individual will not be able to claim many normal business deductions

Personal Services Income – what is it?

Section 84-5 (1) says:

“Your ordinary income or statutory income, or the ordinary income or statutory income of any other entity, is your personal services income if the income is mainly a reward for your personal efforts or skills (or would mainly be such a reward if it was your income)”.

Section 84-5 also says that:

- only individuals can have personal services income;
- the section applies whether the income is for doing work or for producing a result;
- the fact that the income is payable under a contract does not stop the income being mainly a reward for personal efforts or skills.

Section 84-10 says if the division applies to an individual, it does not mean that the individual is an employee. This means that an individual to whom PSI is attributed must account for it as non-salary income and that no other laws relating to employment will apply, simply because the individual is caught by the PSI system.

The Explanatory Memorandum gives the following examples of income from personal services:

- salary or wages;
- income of a professional person practising on his or her own account without professional assistance (for example a medical practitioner in a sole practice);
- income payable under a contract which is wholly or principally for the labour or services of a person;
- income derived by a professional sports person or entertainer from the exercise of his or her professional skills. This does not include income from endorsement by the person of a sponsor's products; and
- income derived by consultants, for example computer consultants or engineers from the exercise of personal expertise.

It says that the following is not personal services income:

- Income from the supply and use of assets (unless the supply is incidental to the task being undertaken); or
- Income from the sale of goods;

PSI – what do you do with it?

Once it is determined that income of an individual or an entity is PSI of an individual, then that income must be attributed to the individual that does the work as if it were remuneration personally received by that individual for that work. The individual must then bring it into account in calculating quarterly PAYG instalments and his or her tax return for the full financial year. If the income is earned by an entity, the entity is entitled to exclude that income from its assessable income for the same period.

The income retains its character even though it is attributed to an individual.

How does falling within the scope of the PSI measure limit deductions?

The PSI rules do more than just attribute personal services income to an individual. In keeping with the aim of putting persons that derive personal services income in the same position as employees, the legislation restricts the deductions that can be claimed by individuals and entities that have PSI income to those deductions that an employee could claim.

If an individual receives any PSI:

- home office costs are not deductible;
- payments to associates for work are not deductible unless it is “principal work”;
- deductions for superannuation paid for associates are excluded unless they do principal work;
- even if associates do principal work, only the compulsory superannuation contributions are deductible; and
- the only other deductions that can be claimed are those that an employee could claim.

For example, employees cannot, as a general rule, deduct expenses incurred in travelling to and from work. People earning PSI are no longer able to claim those expenses.

If an entity derives any PSI that is attributed to an individual that does the work:

- expenses for a motor vehicle cannot be deducted if it is used at any time for private purposes;
- if an individual to whom PSI income is attributed is provided with more than one car and private use is permitted, expenses (including fringe benefits expenses) can only be claimed for one of those cars;
- an entity can only claim a deduction for salary and wages paid to an individual that does the work if PAYG is remitted within 14 days; and
- payments to associates are not deductible unless the payments are made for work that forms part of the “principal work” from which the PSI is derived.

An individual or an entity can deduct the following expenses:

- costs of gaining work;
- insuring against loss of income or income earning capacity;
- public liability and professional indemnity insurance;
- engaging any entity that is not an associate to perform work;
- contributions to a superannuation fund for death benefits (for yourself and your dependants);
- workers compensation payments; and
- GST compliance costs.

A Personal Services Business – what is it?

The new rules do not apply to PSI earned through a “personal services business”. Normal tax rules apply to such income.

Division 87 in its original form imposed three primary tests, a secondary test and a number of tertiary tests to determine whether or not a taxpayer had a PSB, if less than 80% of the PSI was derived from one entity (or source) in any one year.

The three primary tests were:

- the “unrelated clients” test;
- the “employment” test; and
- the “business premises” test.

The amending act passed in 2001 made substantial changes in this area. Now, any taxpayer can either self-assess (under a selection of tests) as to whether the business is a PSB or ask the Commissioner to make a determination. Under the previous law, the Commissioner could only issue a determination if 80% or more of the PSI came from one source.

The range of tests now comprises the three existing tests (the unrelated clients test, the employment test and the business premises test) and a new test, the “results test”.

If 80% or more of the PSI comes from one source, the results test must be passed. Otherwise, the business is not a PSB and the PSI rules will apply.

If less than 80% of the PSI comes from one source, the business will be a PSB (and the PSI rules will not apply to that income) if the business can pass any one of the four tests.

To satisfy the results test,

- at least 75% of the income must be for producing a result;
- the entity or individual must supply the plant and equipment needed to perform the work to produce that result; and
- the entity or individual must be liable for the cost of rectifying any defect in the work

To satisfy the **unrelated clients test**, the business must obtain its income from two or more entities that are not associated with each other or the business and the business must be effectively offering its services to the public. The Commissioner has said that it is sufficient if those services are available to the public and are made known simply by word of mouth. However, this is not what the legislation says. For the test to be passed, the individual or entity must be making offers or invitations to the public at large, or a segment. This appears to require positive or active conduct by the individual or entity, not just passive reliance on the recommendations of others.

To satisfy the **employment test**, the business must employ some person other than the person to whom PSI would be attributable if the rules applied and that person must do at least 20% of the principal work of the business during the year or the business must have an apprentice for at least six months of the year.

To satisfy the **business premises test**, the premises occupied by the business must be:

- mainly used to conduct activities from which the PSI is gained;
- used exclusively by the individual or entity (in other words, not shared with anyone else);
- physically separate from any premises that the individual or entity (or an associate) uses for private purposes; and
- “apt for the purpose
- physically separate from any premises of an entity for whom the work is done or from an associate of that entity.

What are the consequences of passing or failing the tests?

Businesses that satisfy the PSB tests or obtain a determination from the Commissioner do not have to account for any income as PSI. Businesses that fail the tests and do not have a PSBD must bring their income to account as PSI income. This applies whether it is an individual or a separate entity that is conducting the business. In the case of an entity, the income must be attributed to the individual who earns it.

The consequences for an entity earning PSI are that:

- the entity will be treated as not having earned the PSI that has been attributed to the individual;
- the individual to whom the PSI is attributed will have to pay tax on it at individual rates; and
- deductions that can be claimed by the entity and the individual in connection with that income are limited in the manner indicated above.

The consequences for an individual who conducts his or her own business (for example, as a sole trader) is that the PSI will be taxed in the same way as ordinary income, but the deductions the individual can claim in deriving that income are limited.

How do I obtain a PSB Determination from the Commissioner?

The Commissioner’s discretion to issue a PSBD is still limited, even after the amending Bill was passed. The Commissioner must not issue such a determination, in the case of an individual, unless he is satisfied that:

- the results test, the employment test or the business premises test could have been satisfied by that individual; or
- but for unusual circumstances applying to the individual in that view, the individual could reasonably have been expected to have met at least one of the unrelated client’s test, the employment test or the business premise’s test.

The Act does not say what “unusual circumstances” means but the explanatory memorandum says that they will exist:

- where an individual, for a number of years has provided personal services to a range of different clients, decides to accept a long-term contract from one client; or
- where an individual is unable to satisfy the business premises test because he or she has only been deriving PSI from the premises for part of the relevant income year.

Similar restrictions apply if the Commissioner is asked to issue a PSBD to an entity.

It will be apparent from the above that it could be difficult for any taxpayer, whether an individual or an entity, to be able to satisfy those criteria. However, if a taxpayer is able to do so, the Commissioner will then consider whether or not to exercise his discretionary power to issue the determination.

However, in assessing whether or not to provide a PSBD, the Commissioner may have regard as to whether it is the custom or practice for the type of work to be performed by the individual in the particular way.

A PSBD can be issued with retrospective effect. The date of effect is important, because any PSI income that is earned before a determination is obtained will be subject to the PSI rules. Accordingly, it is crucial to ensure that all the contractors and people in a similar position that wish to take advantage of the “safe harbour” of PSBDs apply for them as soon as possible and specify 1 July 2000 as the operative date.

What if I work through an Agency?

The Treasurer announced on 29 June 2001, that agents whose income is derived predominantly from commission-based payments, will be treated as having received that income directly from the customers of the principal as if they had provided services directly to those customers, even though the payments may have been received from the principal. However, those amendments will only apply to agents who:

- receive less than 80% of their PSI from services provided to each customer;
- receive at least 75% of that income as commission or “results-based” payments, as opposed to retainers or salary-like payments;
- actively seek customers for their principal; and
- do not provide services from the premises of their principal (or an associate of the principal).

So, if I obtain work through an agency, is it possible for me to satisfy the Results Test?

A typical arrangement where an interposed entity could satisfy the results test is where the agency contracts with their client (end user) and assumes responsibility for completion of a particular result. Payment to the agency is conditional upon the completion of the result. Under the contract the agency assumes all risk and liability associated with the completion of the result including liability for damages arising from faulty work. The agency then sub-contracts with the interposed entity to complete that result and that interposed entity in turn assumes the same risks associated with its completion. The contract would generally stipulate the worker who is to do the work. Payment to the interposed entity is conditional upon the completion of the result and the individual contractor is then subcontracted to complete the work as required by the client of the agency.

What deductions are available to a personal services entity that relate to gaining or producing an individual’s personal services income (not conducting a personal services business)?

- the costs of obtaining work;
- expenditure related to obtaining workers compensation insurance;
- superannuation payments made for the benefit of the service provider;
- tax related expenses such as the cost of preparing tax returns;
- bank and other account keeping fees and charges;
- insuring against loss of income or income earning capacity;

- public liability and professional indemnity insurance;
- expenses incurred in engaging any entity that is not an associate to perform work;
- GST compliance costs;
- any cars used solely for business purposes;
- the cost of light and power used in a home office; and
- the cost of operating the entity’s bank account.

What deductions are NOT available to a personal services entity that relates to gaining or producing an individual’s personal services income (not conducting a personal services business)?

If you are an individual affected by the legislation you cannot claim a deduction against your personal services income for the following:

- rent, mortgage interest, rates or land tax for your home
- payments to an associate (for example, a spouse or child) for work that is not your principal work
- contributions to a superannuation fund for associates doing solely non-principal work. You can claim contributions for an associate doing principal work, but if they are doing less than 20% of the principal work, you can claim only up to the super guarantee amount

If you are a personal services entity affected by the legislation, you cannot claim a deduction against personal services income for the following:

- expenses or Fringe Benefits Tax for more than one car that you use partly or solely for private purposes;
- rent, mortgage interest, rates or land tax for the use of any part of a residence that belongs to the individual whose personal services income it is or any of their associates;
- payments to an associate (for example, a spouse or child) for work that is not principal work of the entity; or
- contributions to a superannuation fund for associates doing solely non-principal work. You can claim contributions for an associate doing principal work, but if they are doing less than 20% of the principal work you can claim only up to the super guarantee amount.

EXPERT REPORTS AND THE RESULTS TEST

In 2000, Professionals Australia on behalf of members requested clarification from the ATO on whether or not a report or series of reports produced by a professional in their capacity as a specialist expert would count as a result for the purposes of the PSI Results Test. The ATO provided members with the following interpretative advice.

Question asked

Would a professional engineer or scientist engaged as a consultant to produce a report or a series of reports, operating as either an individual or through an interposed entity, satisfy the Alienation of Personal Services Income Results Test?

Answer to question asked

A consultant who is engaged to produce a report, or a series of reports, could satisfy the results test. The terms of the contract under which the consultant is engaged will be the determining factor.

Reasons for decision

The Results Test

The results test provides that an individual or personal services entity meets the results test in an income year if in relation to at least 75% of the individual's personal services income:

- (a) the income is for producing a result; and
- (b) the individual is required to supply the plant and equipment, or tools of trade, needed to perform the work from which the individual produces the result; and
- (c) the individual is, or would be, liable for the cost of rectifying any defect in the work performed.'

Income for producing a result

To satisfy the first condition for the results test the personal services income must be for producing a result. The meaning of the phrase 'producing a result' means the performance of a service by one party for another where the first-mentioned party is free to employ his/her own means (ie., third party labour, plant and equipment etc) to achieve a contractually specified outcome. The essence of the contract has to be to achieve a result and not to do work.

The consideration often is a fixed sum on completion of the particular job as opposed to an amount paid by reference to hours worked.

The Explanatory Memorandum to the Alienation of Personal Services Income Act 2000 provides:

'The individual must actually be paid on the basis of achieving a result, rather than for example, for hours worked.' (paragraph 1.114)

Where there is a contract, regard should be had to its true essence and the circumstances surrounding the formation of the contract may be of assistance to determine the true character of the contract. Having regard to the true essence of the contract, the manner in which payment is structured will not of itself exclude genuine result based contracts. For example, there are results based contracts where the contract price is based on an estimate of the time and labour cost that is necessary to complete the task, or may even be calculated on that basis, subject to reasonable completion times.

In order to satisfy the first part of the results test it is necessary that not only is a result achieved but that the entitlement to receive income is dependent on that result. In a situation such as you have described where a consultant is engaged to produce a report or a series of reports the production of a report could constitute a result.

The relevant factor in determining whether the income is for producing a result will be the manner in which an entitlement to payment arises. If the consultant was entitled to payment only upon completion of the report then the first condition of the results test is satisfied. Where a contractor was entitled to be paid during the term of the contract on the basis of the work performed to that time then the first condition of the results test is not met, the income is not for a result but is for performing work.

Required to supply the plant and equipment, or tools of trade, needed to perform the work which produces the result

The second condition for the results test is that the individual or the personal services entity is required to supply the plant and equipment or tools of trade, needed to perform the work that produces the result.

Having regard to the custom and practice in relation to particular work there may be an expectation that a genuine independent contractor would be required to supply the plant and equipment or tools of trade necessary to perform the work. Where such an expectation exists, or where the contractual arrangements require the supply of necessary equipment or tools, such equipment or tools have to be supplied in order to meet the 'results test'.

This condition is to be considered on a substantive basis and minimal usage of the tools or equipment of others will not of itself disqualify the taxpayer. For example, the use of the service acquirer's pen or telephone by an electrician or even the temporary use of tools (where it is more convenient to do so because, for example, the electrician's tool kit is not readily available at a particular time) would not cause this condition to be failed. In relation to the work more generally, the common practice and requirement in such a case may be that the electrician would be expected to supply and would be required, as a practical matter, to supply the necessary tools for the job.

There are situations where, having regard to the custom and

practice of the work, or the practical circumstances and nature of the work, no plant or equipment or tools of trade are necessary to perform the work from which the individual or personal services entity produces the result. If no equipment or tools are needed the provision will always be met in these circumstances.

Whether a consultant satisfies the second condition for the results test will be determined according to the facts in each case. The condition will be satisfied where the consultant supplies all the tools and equipment (if any) which are necessary to perform the work which produces the result.

Liable for the cost of rectifying any defect in the work performed

The third condition for the results test requires that the individual or the personal services entity is or would be liable for the cost of rectifying any defect in the work performed.

The emphasis here is on 'liability for the cost' of rectifying faulty work. That is, the key underlying consideration is whether the individual or entity is exposed to commercial risk in terms of a liability to cover the cost of rectifying defective work. This is consistent with the focus on 'the chance of profit and the risk of loss' as a traditional indicator that a taxpayer is an independent contractor conducting their own business.

Paragraphs 87-18(1)(c) and 87-18(3)(c) of the ITAA 97 make it a requirement of the 'results test' that the individual or entity must meet the costs associated with rectifying the defect. It is only the cost of rectification of their defective work that must be met by the individual or entity. There is no requirement that the individual or entity actually perform the work which rectifies the defect so long as they pay for it. Nor does it matter whether the relevant exposure to a liability for the cost of defective work arises before or after payment by the service acquirer or delivery of the result.

The existence of a term in an agreement that the individual or personal services entity is liable for the cost of rectifying any defect in the work performed would support the conclusion that liability to make good any faulty workmanship exists, particularly where the individual or personal services entity and the service acquirer are dealing with each other at arm's length. However, the term in the agreement should not be merely 'window dressing', and regard may be had to all the circumstances of the case in determining whether the relevant liability really exists.

The phrase 'rectifying any defect' literally means to put right any fault or imperfection. Clearly, not all work of any individual or entity is capable of rectification if that phrase is given its narrow literal meaning. It is arguable on this narrow view that if the work is not capable of rectification then the 'results test' cannot be passed.

The Macquarie Dictionary definition of 'rectify' includes to 'remedy' which can mean 'legal redress or the legal means of enforcing a right or redressing a wrong'. Consequently, being liable to rectify the cost of any defect could be inclusive of a rectification achieved by the acquirer of the services pursuing a legal remedy for damages, in circumstances where the defect is incapable of physical repair.

A consultant would satisfy the rectification condition of the results test if they were to perform additional work to complete a job which was defective without an entitlement to any additional payment. Similarly a liability for damages resulting from defective work or a liability for the costs of having the job satisfactorily completed by a third party would satisfy this condition.

It must be noted that all three conditions of the results test must be met if a contractor is to satisfy the results test.



WATCHPOINT CLAUSES: DRAFTING YOUR TERMS OF ENGAGEMENT TO REFLECT THE FACT THAT YOU SATISFY THE RESULTS TEST

While the ATO will also consider the manner in which services are provided and remunerated, the terms of the contract under which a Consultant is engaged will be the major determining factor in whether or not an individual satisfies the Results Test. It is critical therefore that the contract is drafted in terms which explicitly set out the contractor arrangements where PSI might be an issue. The information which follows points out clauses which the ATO can potentially read as indicators of the character of a contract between a contractor and the acquirer of their business services.

The results test provides that an individual or personal services entity meets the results test in an income year if in relation to at least 75% of the personal services income:

- (a) the income is for producing a result; and
- (b) the individual is required to supply the plant and equipment, or tools of trade, needed to perform the work from which the individual produces the result; and
- (c) the individual is, or would be, liable for the cost of rectifying any defect in the work performed.

All three conditions must be met if a contractor is to satisfy the results test.

The first priority is to ensure that you have in place contract documentation which describes in detail the project result to be achieved by the contractor to the acquirer of those business services. A verbal agreement, or a quotation and email exchange accepting the quotation, may not be a sound or sufficient record of what is a complex business arrangement that should be appropriately documented. There is no doubt that in the case of problems arising with a project, the contracting parties will rely on the contract documentation for clarification of arrangements, so formalising these arrangements is essential to any independent contractor's standard business's risk management practice. The ATO will rely on the terms of engagement to determine PSB status.

To satisfy the results test, the essence of a contract has to be to achieve a result and not to do work, so in drafting terms of engagement, it is critical that professionals differentiate between payment for producing a result and payment for performing work (eg paid on hourly rate) in order to satisfy the first condition of the results test. Evaluating whether the individual is working for a result OR working to provide a service is the key area which will be considered by the ATO in assessing the character of the relationship between the contractor and client.

The terms of engagement should be drafted as follows:

The Contractor hereby agrees to achieve the following outcome [details of the outcome to be specified in sufficient detail so that the parties can determine whether the intention of the contract has been achieved] ("Services") by the following date [insert proposed date of completion] subject to any extension agreed in writing between the parties.

To satisfy the first condition of the results test, it is necessary that not only is a result achieved but that the entitlement to receive income is dependent on that result. Contracts for service should therefore specify that payment for service is contingent or conditional upon achievement of the result. That result can be a provision of expert advice in the form of a report (see ATO interpretative advice on Expert Reports and the Results Test), the conduct of a feasibility study whether or not the project goes ahead, or the achievement of specific milestones in a larger longer-term project. Terms such as "manage, coordinate, oversee, research, provide strategic input" are likely to be problematic in the context of the results test because they describe the work to be performed rather than the results to be achieved.

Payment by hourly rates or progressive periodic payments does not necessarily mean automatic failure of the results test but the clause should be drafted extremely carefully to ensure it reflects the fact that the contractor is bearing commercial risk - that is, the clause should state that the payment is conditional upon achievement or part achievement or progress toward achievement of a result and will be paid back if the final result is not achieved. Milestones, or results upon which the progress payments are to be paid, can be included as an attachment to the terms of engagement. Whether or not these payments would be paid back if the final result was not achieved would be seen by the ATO as significant in assessing the character of the relationship between the parties. The fact that repayment would be required should the result not be achieved should be specified in the terms of engagement.

This provision could be set out in the contract in the following terms:

The Contractor will provide the client with an invoice at the end of each week [or month if appropriate] indicating the progress made to achieving the performance of the Services and making a claim for a proportion of the contract sum based on the progress achieved.

The client will pay the Contractor the amount of the progress claim or such lesser amount as the client reasonably determines to reflect the progress to date within five days of the progress claim.

The Contractor agrees that this contract is for the obtaining of the result described above and unless that result is achieved, the Contractor will not be entitled to any of the contract sum and any amount of the contract sum that has been paid to date shall be refunded if the result is not achieved by completion.

To satisfy the second condition of the results test, the contract for service should specify a commitment to provide all tools and equipment necessary to achieve the result/s. ATO officials have confirmed that a laptop computer is generally accepted as a tool of trade. If you use a client's car, computer, phone, pen, etc., it is essential to satisfy this condition that they are incidental to the work and not necessary or required to complete the work. Temporary use of a client's tools/equipment where it is more convenient to do so or where it is custom and practice in the particular industry to do so will not of itself disqualify the individual or cause this condition to be failed where they are not required to complete the work.

The terms of engagement should read:

“The Contractor will supply all equipment and tools of trade necessary for the provision of the Services.”

If the client provides any tools and equipment necessary to completion of the result, the clause should be extended as follows:

“For convenience and in accordance with industry custom and practice, the client will provide [specify tools and equipment such as computer software and hardware, mobile phone, motor vehicle, measuring instruments, protective clothing, etc] to the Contractor. These items are incidental to the project rather than necessary.”

To satisfy the third condition of the results test, the contract for service should specify a commitment to liability for the cost of rectification. ATO officials confirmed that a contractor carrying own PI and PL insurance is important though not necessarily sufficient to satisfy this condition. Stated liability for the cost of rectification is sufficient – the contractor does not have to directly rectify the fault him/herself but the terms of engagement should specify liability for the cost of rectification. The key underlying consideration is whether the individual or entity is exposed to commercial risk in terms of a liability to cover the cost of rectifying defective work, consistent with the focus on “the chance of profit and the risk of loss” as a traditional indicator that an individual is an independent contractor conducting their own business.

A model clause would be:

“The Contractor will be liable for the cost of rectifying any defect in the work performed.”

This condition of the test would also be met by the following:

- the service acquirer pursuing a legal remedy for damages in circumstances where the defect is incapable of physical repair, or
- requirement for the consultant to perform additional work to complete a job which was defective without an entitlement to any additional payment.

Termination

The traditional criteria in relation to Termination set out in TR 2000/14 states: “An independent contractor is contracted to complete a set task. The payer may only terminate the contract without penalty where the worker has not fulfilled the conditions of the contract.”

Indications are that the ATO in evaluating the character of contracts is considering mutual termination clauses very narrowly by concluding that where a termination option for both the independent contractor and service acquirer are provided for within the terms of the contract, that the contractor may not be bearing full commercial risk of loss, and payment is for work performed up to the date of termination rather than for achievement of a result.

We reject the view that that a one month notice clause means that contractors are bearing ‘no risk’ - there is still the risk that the contractor will be without a client with only a month's pay to show for it. Nonetheless, contractors - particularly those working to only one client - who include a mutual notice period in their terms of engagement should be aware that a Termination clause providing for termination by either party may be regarded by the ATO as an indicator that the character of the relationship between the parties is not one of Consultant and Principal because the Consultant is receiving a payment regardless of whether or not they achieve a result.

NB: A Termination clause in the context of defaults made by either party is specifically outside the scope of factors considered in determining the character of the contract in the Ruling.

Rollover

Rollover clauses are similarly being interpreted by the ATO as an indicator that personal services income is not being paid to achieve a specified result or outcome but is for work performed.

Professionals Australia would therefore advise members for whom PSI is an issue to ensure they do not include a rollover clause in their contract for service.

Expenses

An expenses clause within the terms of a contract for service can similarly be used as an indicator that the character of a relationship between the parties is not that of Consultant and Principal. An independent contractor would normally incur their own expenses and these costs would be included in calculating the overall fee rather than being reimbursed for expenses, or paid disbursements, so we would suggest drafting the terms of engagement without a disbursements or expenses clause, but factoring these expenses into any hourly rate used to calculate the fee for the engagement.

DECIDING YOUR PSI STATUS WITH CERTAINTY: A CHECKLIST

You can use this checklist to self-assess against the results test. If your answers concord with those set out in the table, providing your terms of engagement reflect the reality and intent of the commercial relationship, you will satisfy the three conditions of the results test.

Where the word ‘indicator’ follows the question, the contractor will not necessarily fail the results test if the answer is other than that stated in this table. If the words ‘determining factor’ appear after the question, and if the answer is other than that set out in the checklist, it is very likely that you will not satisfy a condition of the results test and therefore the results test overall.

How the ATO assesses the character of the relationship between a contractor and acquirer of business services in relation to the results test

<i>Features of the terms of engagement and payment structure</i>	To be considered a contractor, answer should be:
Does the contract set out the result to be achieved rather than the scope of work or typical tasks to be performed?	Yes
Is payment based on specified outcomes or results set out under the contract? (determining factor)	Yes
Is payment conditional upon achieving these outcomes rather than for work performed? (determining factor)	Yes
Does the contract state that you have a high level of discretion and flexibility as to how the work is performed? (indicator)	Yes
Does the contract state that you have the right to subcontract the work? (indicator)	Yes
Does the contract state that you will provide all necessary tools and equipment required taking into account industry custom and practice and convenience? (determining factor)	Yes
Where the client provides tools and equipment, are they incidental rather than necessary to the achievement of the result or outcome taking into account industry custom and practice and convenience? (indicator)	Yes
Does the contract state that you are liable for the cost of rectifying any defects in the work performed? (determining factor)	Yes
Does the contract state that you will carry PI and PL insurance? (indicator)	Yes
If a daily/hourly rate or progress payments are specified in the contract, is payment tied to achievement of milestones or results set out within the terms of engagement and reimbursed if outcomes are not achieved? (indicator)	Yes
Does the contract contain provision for leave entitlements, expenses or any other disbursements or work-related outgoings? (indicator)	No
Can the contract be terminated without or with limited penalty? (determining factor)	No
Are you exposed to the commercial risk of making a loss under the performance of the contract?	Yes
Does the contract contain a mutual termination clause? (indicator)	No
If the contract is for a specified period, is there provision for the contract to be rolled over? (indicator)	No



**Professional
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THE RESULTS TEST: DECIDING YOUR PSI STATUS WITH CERTAINTY

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