

# General anti-avoidance rules and how they may apply to a personal services business

This fact sheet contains information on how the general anti-avoidance rules in the tax law may apply to a personal services business conducted through a company, trust or partnership.

The information in this fact sheet is relevant to you if:

- you earn personal services income through your company, trust or partnership (that is, the income earned by the entity is mainly a result of your personal efforts or skills rather than being generated by income-producing assets or the business structure – for example, employees), and
- you are carrying on a personal services business and are therefore not affected by the alienation of personal services income legislation.

If you earn personal services income as a sole trader, then the information in this fact sheet is of less relevance to you because you are already taxed directly on that income.

### How do the general anti-avoidance rules apply to personal services businesses?

It is important to remember that a personal services business still earns personal services income and not business income for income tax purposes. Our views on how you should treat that income have been established for some time and have not changed in relation to arrangements that are not affected by the new alienation of personal services income legislation.<sup>1</sup> These views are set out in Taxation Rulings IT 2121, IT 2330 and IT 2503. Consequently, we would apply those views in appropriate cases.

The rulings rely on the general anti-avoidance provisions of the income tax law (Part IVA). The application of Part IVA to a particular case depends on all the relevant facts and circumstances. In particular, it only applies if there is a scheme that is entered into or carried out for a dominant purpose of obtaining a tax benefit. The conclusion about dominant purpose is required to be made on an objective analysis of the facts.

<sup>1</sup> See Taxation Ruling TR 2001/8 paragraph 102, reproduced at the end of the fact sheet, under *Extracts from relevant taxation rulings*.

The rulings can provide general guidance only and they need to be read against the background that the relevant purpose must be present if Part IVA is to apply to a particular case. If Part IVA does apply then the Commissioner may cancel any tax benefit you have received. A penalty of up to 50% of the tax avoided may also apply, although the law allows this penalty to be reduced in appropriate circumstances. If you have a reasonably arguable position the penalty will not exceed 25% of the tax avoided.

At the request of tax professional bodies, the principles set out in the rulings are summarised below. We consider that they apply equally to personal services businesses carrying on a trade and those carrying on a professional practice. For example, paragraph 17 of Taxation Ruling IT 2121 indicates that Part IVA may apply to fencing contractors, sports persons and entertainers. The *extracts from relevant rulings* section of this fact sheet will show you how the principles are articulated in the rulings.<sup>2</sup>

## General principles

- Arrangements where personal services income is alienated (for example, because your personal services are contracted through your company, trust or partnership) and taxed at a lower rate than if you had received the income yourself may attract Part IVA, particularly where your remuneration is less than commensurate with the value of your services. This means that the income may be assessed to you rather than to the entity. This will depend on your circumstances and each case must be decided on its own merits.
- If you split personal services income with an associated person, or with another entity associated with you, then Part IVA may apply to that arrangement. However, you can pay remuneration (for example, salary or wages) to an associate (or a service trust) for bona fide services related to the earning of your personal services income if that amount is reasonable for the services provided by them.<sup>3</sup> In supporting the claim it would be advisable to have details of the dollar value of the hourly rate of pay and the number of hours being paid (recorded by for example time sheets, diary records or the like) and of the duties involved and how they relate to the work being undertaken by the principal.
- In particular if you use a family trust or company to split personal services income with an associate (say a family member) and thereby reduce your income tax liability, then Part IVA may apply to that arrangement. For example, Part IVA may apply where a salary is paid to you as the principal worker by your trust or company and that salary is not commensurate with the value of your services<sup>4</sup>, and the remaining income is distributed to associates. In most cases, a salary commensurate

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<sup>2</sup> Note that rulings are only the Tax Office's view of the law and it may ultimately be a matter for the AAT or courts to determine whether the Commissioner's position is correct.

<sup>3</sup> See Taxation Ruling IT 2330 paragraph 13, reproduced at the end of the fact sheet, under *extracts from relevant taxation rulings*.

<sup>4</sup> For an example of this in the context of a business formerly owned by an individual and then transferred to a trust, see Taxation Ruling IT 2330 paragraph 29, reproduced at the end of this fact sheet, under *extracts from relevant taxation rulings*.

with your duties and responsibilities will be the gross amount received by your trust or company less allowable deductions (other than deductions associated with income splitting).

Even if you **have** to provide your services through an interposed entity in order to obtain the relevant service contract Part IVA may still apply if you use that entity to split your income or retain profits.

**What can I do to ensure the general anti-avoidance provisions do not apply?**

Notwithstanding these general principles, the application of Part IVA requires a conclusion in the particular case that the dominant purpose of the relevant arrangement was to obtain a tax benefit.

It is not therefore possible to give certainty as to the application of Part IVA in the absence of each factual situation being examined.

You can obtain certainty for your individual circumstances by applying for a private binding ruling. Alternatively taking the following steps will avoid the potential operation of Part IVA.

**If you are operating through a company**

If you operate through your company and there is no income splitting and no retention of profits in the company (for example, if the only advantage for income tax purposes is access to greater superannuation benefits) then Part IVA will not apply<sup>5</sup>.

If a bona fide attempt is made to break even, a relatively small amount of taxable income may be returned by the company provided that income is distributed to you by way of a franked dividend in the following year<sup>6</sup>.

**If you are operating through a trust**

If you operate through your trust with a corporate trustee the position is the same as for companies.<sup>7</sup>

You should receive income from the trust in relation to the personal services income that is commensurate with your duties and responsibilities, or be the sole beneficiary of the trust in relation to that income.<sup>8</sup>

**If you are operating through a partnership**

If you are in business and you conduct that business with your spouse through a genuine partnership then this will be accepted for income tax purposes.<sup>9</sup>

Where the partnership income results from the personal services of one or more of the partners (not from the services of employees or the use of income-producing assets) and where there is splitting of that personal services income which reduces the

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5 See Taxation Ruling IT 2330 paragraph 40 and Taxation Ruling IT 2503 paragraph 5, reproduced at the end of the fact sheet, under *Extracts from relevant taxation rulings*.

6 See Taxation Ruling IT 2503 paragraphs 10 and 11, reproduced at the end of the fact sheet, under *Extracts from relevant taxation rulings*.

7 See Taxation Ruling IT 2503 paragraph 34, reproduced at the end of the fact sheet, under *Extracts from relevant taxation rulings*.

8 See Taxation Ruling IT 2503 paragraph 34, reproduced at the end of the fact sheet, under *Extracts from relevant taxation rulings*.

9 See Taxation Ruling IT 2330 paragraph 13, reproduced at the end of the fact sheet, under *Extracts from relevant taxation rulings*.

amount of income tax which might otherwise be payable, then Part IVA may apply to this arrangement.<sup>10</sup>

**How will the Tax Office apply the views contained in this fact sheet?**

This fact sheet restates our views on when Part IVA may apply to personal services income cases.

We accept others may disagree with these views and that concepts of employment, business and entrepreneurship have progressed since the cases from which our views were formed were heard. We are looking to identify test cases to obtain further judicial guidance as to the correctness of our views. We are doing so in consultation with tax professional bodies.

While these views are being tested in the courts we will not be running a specific audit program in this area other than to support the test case program. However, cases arising from our ongoing audit operations will, as is currently the case, be progressed as necessary.

**Further information**

**What is personal services income?**

Personal services income is income that is mainly a reward for an individual's personal efforts or skills. The fact sheet *Alienation of personal services income – what is personal services income?* discusses personal services income in more detail and is available by phoning **13 24 78**. Further information is also available in Taxation Rulings IT 2639 and TR 2001/7.

**What is a personal services business?**

A personal services business is a company, trust, individual or partnership that derives personal services income but has passed one of the four personal services business tests set out in the alienation of personal services income legislation.

In determining the tax treatment of your personal services income your first step should be to see if the alienation of personal services income legislation applies to your circumstances. If it does then your personal services income will be treated as your income and you must include it in your individual tax return. However, the alienation of personal services income legislation will not apply to you if you pass one of the relevant tests, in which case you are considered to be conducting a personal services business.

For further information on what is a personal services business refer to Taxation Ruling TR 2001/8. Part IVA may still apply to entities conducting a personal services business if the dominant purpose of the relevant arrangement was to obtain a tax benefit.

<sup>10</sup> See Taxation Ruling IT 2330 paragraphs 33 and 38, reproduced at the end of the fact sheet, under *Extracts from relevant taxation rulings*.

## Extracts from relevant taxation rulings

### Taxation Ruling IT 2330

- *Paragraph 13:* '[A] taxpayer in business may employ family members in the business – provided the employment is bona fide and the wages reasonable'. Also in paragraph 13: 'A taxpayer in business may take his or her spouse into partnership in the conduct of the business and, provided a genuine partnership exists, it is accepted for income tax purposes.'
- *Paragraph 29:* 'As a general proposition the level of salary paid to the former proprietor [of a business transferred to a family company or trust] should be no less than commensurate with his or her continuing duties and responsibilities.'
- *Paragraph 33:* '[T]he use of family trusts and companies as a means of splitting income from the rendering of personal services and of reducing the amount of income tax which might otherwise have been payable ... would attract the operation of ... Part IVA'.
- *Paragraph 38:* '[P]artnership income will be treated as income from the rendering of personal services where it results from the personal services of the partners and not from the efforts of employees and/or income producing assets'.
- *Paragraph 40:* 'Where incorporation is explicable as an ordinary commercial or business step to take and does not result in any splitting of the income from personal services, and the incorporated business activity is conducted along normal business lines (see paragraph 13 [of Taxation Ruling IT 2330]), it will be acceptable for income tax purposes. The fact that the company may be able to obtain greater income tax concessions in providing superannuation benefits than would have been the case if the business had not been incorporated would not attract the operation of ... Part IVA.'

### Taxation Ruling IT 2503

- *Paragraph 5:* 'The incorporation of professional practices is accepted for income tax purposes where, inter alia, incorporation does nothing more in relation to income tax than reduce a professional's income by the amount of an appropriate superannuation cover.'
- *Paragraph 10:* 'The retention of profits in the practice company is generally not acceptable.'
- *Paragraph 11:* 'However, where a bona fide attempt has been made to break even but the practice company returns a relatively small taxable income because of the above or similar difficulties [eg. because it is not practicable for the company to ascertain its income and determine its allowable income tax deductions by 30 June], the company should distribute all its taxable income, to the professional person by way of franked dividend, in the following year.'

- *Paragraph 34:* 'Where a professional practitioner wishes to operate a practice through a trust structure no objection will be taken provided the trust structure achieves the same result for income tax purposes as the basis upon which incorporation of professional practices has been accepted. In particular, it should be ensured that the professional practitioner is the sole beneficiary of the trust.'

### **Taxation Ruling TR 2001/8**

- *Paragraph 102:* '... A Personal Services Business Determination accepts that an individual or entity is conducting a personal services business. This does not mean that Part IVA could not apply where the dominant purpose of an arrangement was the splitting of income.'

## **Disclaimer and guarantee**

The information in this publication is current at March 2003 and we have made every effort to ensure it is accurate. However, if something in the publication is wrong or misleading and you make a mistake as a result, you will not be charged a penalty. You may have to pay interest, depending on the circumstances of your case. You are protected under GST law if you have acted on any GST information in this publication. If you have relied on GST advice in this Tax Office publication and that advice has later changed, you will not have to pay any extra GST for the period up to the date of this change. Similarly, you will not have to pay any penalties or interest.

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