

Personal services income: An overview



It is not uncommon for professional people who provide services to set up a separate entity to run their business, be it a trust, partnership or incorporated company. The allure of course is the lower tax rate that these can secure, rather than at the top marginal tax rate that an individual would generally wear.

Running a business through such a structure can also lead to a wider range of deductions being available, depending on circumstances. So to stop taxpayers dodging their full share of tax, the tax law has in place a set of rules for income derived in this way, which the ATO has dubbed “personal services income”.

The personal services income regime taxes individual contractors on a similar basis as employees where income is derived mainly from the individual’s own skills, expertise or the provision of personal services. As mentioned, this also applies to companies, trusts and partnerships where income is generated primarily as a result of an individual’s personal efforts or skills.

The personal services income (PSI) rules restrict:

- the availability of tax deductions to affected individuals over and above deductions ordinarily available to

employees providing the same or similar services, and

- the “alienation” of PSI through an interposed entity to utilise lower tax rates by treating the relevant income as being earned by the individual from providing personal services. The individual is taxed on the attributed income at his or her marginal rates.

The provisions apply where the individual or interposed entity is deemed to be earning PSI. However, where the relevant individual or entity can meet one of a number of carve-out tests, the normal tax position of the taxpayer will be unaffected. That is, the PSI rules will have no adverse application (although ask us about “Part IVA”).

Those caught by the PSI rules are generally restricted in what can be claimed as a tax deduction. However, PAYG withholding obligations are imposed on any interposed entity that is subject to the rules.

Income derived mainly from the use of an asset may not be PSI. According to the ATO, income derived from the provision of personal services involving the use of some equipment may

nevertheless be PSI. Where the substance of an agreement is the provision by an individual of his or her personal efforts or the exercise of his or her skills, or the production of a result from those efforts or skills, income may be regarded as PSI.

Income that is derived mainly from the use of assets and equipment, or for the sale and supply of goods or for granting a right to use property is generally not PSI.

The ATO states that when determining whether income is mainly a reward for the personal efforts or skills of an individual or from a business structure, consideration should be given to the relative values of the efforts or skills of the individual and other inputs, such as the efforts of other workers, and the use of plant and equipment, intellectual or other property and goodwill.

Factors relevant to making this determination include:

- the nature of the activities being conducted that generate the income
- the extent to which the amounts paid under an agreement (whether directly to an individual or to an interposed entity) is primarily for the personal efforts or skills of a particular individual
- the extent to which the contract price has been calculated having regard to the costs to be borne by an individual or entity in providing assets to use in the performance of contractual obligations

- the market price of using any equipment, plant or tools as compared with the market price of hiring the relevant labour or skills for the same period
- the nature, size and significance of the assets used by the individual or entity in relation to the activity
- the value of the asset in relation to the total income generated under the agreement
- the uniqueness and degree to which an asset is specialised in the performance of a particular function
- the uniqueness, level of skill or degree of specialisation of an individual to provide the particular services contracted
- whether the payments made to an individual or an entity is for the transfer of the ownership or a right in respect of items produced by the individual or entity
- the existence of goodwill
- the existence of substantial income-producing assets
- the size of the business operation, and
- the contribution of other workers to the income-earning activities.

Some examples taken from ATO guidance on the matter are included in the panel below.

Examples

1. A taxpayer owns one semi trailer and he is the only person who drives it. The income derived from driving the truck is not PSI because it is mainly produced by the use of the truck and not mainly as a reward for the personal services of the taxpayer.
2. A taxpayer provides a computer programming service but she does all of the work involved in providing those services and uses the client's equipment and software to do the work. The income derived would be treated as PSI as it is a reward for her personal efforts or skills.
3. A taxpayer works as an accountant with a large accounting firm. None of the firm's ordinary or statutory income is PSI because it is produced mainly by the firm's structure and not mainly for his personal efforts or skills.

The ATO's PSI decision tool

To make things easier, and to help with your tax planning for the year ahead, the ATO has made available an online "decision tool" to assist you to work out whether you will or have earned PSI, and if the PSI rules will apply to that income. The tool however won't give an iron-clad result.

We can probably help you with a lot of the information required. To answer the questions in the PSI decision tool you may need:

- details of contracts or written agreements with your business's customers during the income year
- invoices from work performed during the income year

- records of payments to any employees or subcontractors.

After answering a series of questions, the tool will provide you with a report that gives you:

- guidance on whether your income is PSI and if the PSI rules apply to you
- a summary of the responses you have provided
- information about what your result means for your tax obligations.

We can discuss the outcomes with you to help you plan your tax affairs.

Important: Clients should not act solely on the basis of the material contained in Client Alert. Items herein are general comments only and do not constitute or convey advice per se. Also changes in legislation may occur quickly. We therefore recommend that our formal advice be sought before acting in any of the areas. Client Alert is issued as a helpful guide to clients and for their private information. Therefore, it should be regarded as confidential and not be made available to any person without our prior approval.