



**NTLG sub-forum governance report - Alienation and  
Part IVA Working Group**

**Income splitting and Part IVA Discussion Paper**

**Taxpayers Australia submission to the  
Australian Taxation Office**

# **1. Executive Summary**

*Our submission to the Australian Taxation Office (ATO) sets out our comments in relation to the application to Part IVA of the *Income Tax Assessment Act 1936* (Part IVA) to income splitting arrangements where:*

- the income is derived by or through an entity;*
- the income is mainly reward for the principal's personal efforts or skill; and*
- the income is not attributed under the alienation rules in Part 2-42 of the *Income Tax Assessment Act 1997* (ITAA97) (i.e. the personal services income rules).*

*Our comments are in light of the *Discussions Paper - National Tax Liaison Group Alienation and Part IVA Working Group Meeting 2 July 2009* (referred to herein as the "Discussion Paper").*

*In summary, Taxpayers Australia does not consider the application of Part IVA to be fair and equitable to the narrow group of small business taxpayers who may currently have such "income splitting arrangements" in place.*

*We do not believe such taxpayers should be discriminated when the practice of using an interposed entity (ie. a company or trust) to distribute income (whether investment or alternatively, personal exertion income) is commonly undertaken.*

*More importantly, from a policy perspective, the fact that Part IVA still has application, notwithstanding the introduction of Part 2-42, does not provide certainty to taxpayers.*

*If the Government considers "income splitting arrangements" from personal services to be unwarranted, then specific legislation should be introduced instead to counter the use of such arrangements.*

## **2. Specific comments**

### **2.1 Existing framework to tax Personal Services Income**

*The Personal Services Income (PSI) rules under Part 2-42 ITAA97 were specifically enacted to deal with the alienation of personal services income where the services of an individual are provided through an interposed entity (such as a company or trust) rather than directly by the individual.*

*When alienation occurs, income may be retained in the entity and either taxed at the lower rate available to the entity and/or diverted to associates, allowing a lower rate of tax to be paid on that income.*

*In particular, we wish to draw your attention to the Explanatory Memorandum (EM) to the *New Business Tax System (Alienation of Personal Services Income) Bill 2000* which led to Part 2-42 ITAA97 being enacted.*

*Most notably, the PSI rules were introduced by Government with the following intentions:*

***Why is there a need for specific rules to deal with issues relating to personal services income?***

*1.11 The current deduction rules have not stopped a growing perception that interposed entities and individual contractors affected by this measure are entitled to deductions which are not available to employees working in similar circumstances.*

*1.12 Apart from the existing general anti-avoidance provisions of Part IVA of the ITAA 1936, there are no specific rules to address the adverse revenue implications which can result when alienation occurs. The courts have held that Part IVA can be used to counter alienation practices. Applying Part IVA has to be on a case by case basis which is labour intensive and an inefficient use of ATO resources.*

*1.13 The rules proposed, in so far as they apply to alienation practices, should produce a similar outcome as that obtained from the application of Part IVA. They also reflect the outcome which should result if taxpayers comply with the Commissioner's rulings which explain how personal services income should be treated for tax purposes. Introducing specific rules in the law which outline the tax consequences for certain personal services income*

***will provide certainty for those taxpayers affected, and address any potential alienation of that income.***

***1.14 The new arrangements will not impinge on any commercial or contractual obligations between parties affected by the measures and will not impact on genuine business undertakings. Nor will the measures treat the individual as a common law employee for taxation or any other purpose. The arrangements will achieve a consistent taxation treatment for personal services income irrespective of the structures in place to receive that income.***

***[emphasis added]***

As acknowledged at para. 26 of the Discussion Paper, Part IVA continues to apply (as outlined in s86-10 ITAA97), notwithstanding that there are specific PSI rules in place to deal with the alienation of income.

### **Taxpayers Australia comment**

***We acknowledge that Part IVA continues to remain a “catch-all” provision for schemes where the present PSI rules do not attribute income to the principal and such schemes were undertaken with the dominant purpose of obtaining a tax benefit.***

***However, as the EM states, the PSI rules were specifically introduced as a framework to provide taxpayers with certainty and to address issues in relation to alienation of such income.***

***For Part IVA ITAA97 to continue to extensively apply where Part 2-42 ITAA97 is in place to deal with the alienation of PSI suggests that there are inherent flaws in the drafting and application of the PSI legislation.***

***Further, the fact that income splitting arrangements, as outlined in the Discussion Paper, are being considered under Part IVA goes against the initial intentions of the PSI provisions to provide guidance and certainty to affected taxpayers and to make efficient use of ATO resources.***

***From a policy perspective, we consider that if there was any intention to address the income splitting arrangements contemplated, the framework taxing PSI income would have been expanded at the time to include such arrangements (as opposed to relying on applying Part IVA). This will then provide certainty to taxpayers who are considered to be affected.***

## **2.2 Income splitting arrangements**

*Para. 15 of the Discussions Paper states that one of the features which will point to the existence of a dominant purpose to obtain a tax benefit, and therefore, Part IVA applying, is where:*

- the principal is paid a salary from a company which is not commensurate with the value of services provided by the principal; and*
- where amounts are distributed by the interposed entity to their associates (such as the principal's spouse, dependents, etc) who are on lower tax rates or to tax advantaged entities including those with tax losses.*

### **Taxpayers Australia comment**

*Ordinarily, the distribution by an interposed entity (such as a trust or company) to their relevant beneficiaries or shareholders is a common practice to reduce the income tax payable by the beneficiary.*

*In particular, where the entity is a discretionary trust, having regards to the terms of the trust deed, the trustee has the discretion to make distributions to the beneficiaries identified in that deed.*

*In principle, there does not appear to be any notable difference between distributions made to beneficiaries or shareholders from an interposed entity which was set-up to derive income from personal exertion and that which has been established for investment purposes.*

*In our view, there should not be any discrimination between those two types of arrangements, as they are considered to be common practices.*

*In any case, there are existing tax laws in place to ensure that taxpayers are penalised if distributions from an interposed entity are made to certain beneficiaries/shareholders.*

*More specifically, if a distribution is made by a discretionary trust, the Family Trust Election rules are in place to ensure that distributions are made within the family group, otherwise family trust distributions tax will apply at the rate of 46.5%. Similarly, penal rates apply where the distributions are made to minors.*

*Alternatively, if the distribution is made by a company to its beneficial shareholders, there are currently dividend and franking credit streaming rules to prevent others from benefiting.*

## **2.3 Income from personal services and goodwill**

The Discussion Paper considers arrangements where the income derived by the principal constitutes “personal services income” (PSI). That is, income derived mainly from the result of the efforts and skills of the principal.

In particular, we wish to draw your attention to *TR 2007/1 - Income Tax: the meaning of personal services income* (at para. 30-31) which considers the factors in determining whether income derived by the principal is PSI:

- 30. Where personal services are provided that are ancillary to:*
- (a) the sale or supply of goods;*
  - (b) the granting of a right to use property;*
  - (c) the supply and use of assets that have a significant role in the generation of the income; or*
  - (d) the generation of the income by the business structure,*

*the income so generated is not personal services income.*

*31. The determination of whether income is mainly a reward for the personal efforts or skills of an individual or is income generated from the circumstances outlined in paragraph 30(a) to (d) above, requires the exercise of practical judgment as to whether the value contributed by the efforts or skills of the individual exceeds the value of the other inputs, such as the efforts of other workers, and the use of plant and equipment or machinery, or intellectual or other property or goodwill. In making that judgement, regard may be had to factors including:*

- the nature of the activities being conducted that generate the income;*
- the extent to which the amounts paid or payable or particular amounts paid or payable by a service acquirer to an individual or a personal services entity under an agreement 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 a personal services entity in providing and using assets or plant and equipment in the performance of the obligations of the individual or the personal services entity to the service acquirer;*

- *the market price of using any equipment, plant or tools in comparison with the market price of hiring the relevant labour or skills for the same period;*
- *the nature, size and significance of the plant and equipment or other assets that are used by the individual or the personal services entity in relation to the income-producing activity;*
- *the value of the asset in relation to the total income generated in the performance of obligations under an 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 for by the service acquirer;*
- *whether the contractual payments made to an individual or a personal services entity is for the transfer of the ownership or a right in respect of an item that is produced by the individual or personal services 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.*

***[emphasis added]***

Therefore, the existence of any goodwill in a business tends to point to the fact that income derived by the interposed entity may not be PSI under Division 86.

### **Taxpayers Australia comment**

Goodwill is succinctly defined In FC of T v Murry 98 ATC 4584, at para. 68:

*For legal purposes, goodwill is the attractive force that brings in custom and adds to the value of the business. It may be site, personality, service, price or habit that obtains custom....*

**In addition, in placing a value on goodwill, the following was acknowledged at para. 60:**

***...The value of the goodwill, if it existed, might be assessed in a number of ways. However, the value of the goodwill of a taxi business, like the value of the goodwill of a money lending business, a mobile vending business, or a one person professional practice or trade is likely to be small.***

**Generally, most sole practitioner businesses would ordinarily have some form of goodwill (albeit this may be small). Arguably, the longer the business is in operation the more likely that there is transferable goodwill.**

**On this basis, in a majority of circumstances, income derived by sole principals by way of interposed entities are unlikely to be defined as “personal services income” under TR 2007/1.**

**For example, an IT services business which has a principal providing their services should not be deriving PSI on the basis that over time goodwill would be generated.**

**Therefore, to the extent that the Commissioner of Taxation considers Part IVA to apply to such income splitting arrangements for personal services income derived by a principal, there would be a narrow band of taxpayers which may fit within this category.**

**We envisage this to include sole practitioner businesses which do not have a repeat customer base. An example is a specialist medical practitioner (such a dermatologist) or radiologist’s practice. However, in most cases, there is a commercial need for the principal to have interposed entity structure in place, such as asset protection purposes (refer to comments below).**

**In this regard, Taxpayers Australia is of the opinion that it would not be fair and equitable to tax this narrow band of small business taxpayers any differently to their larger counterparts.**

## **2.4 Remuneration commensurate with services**

*Para. 15 of the Discussions Paper states that one of the features which will point to the existence of a dominant purpose to obtain a tax benefit, and therefore, Part IVA applying, is where the principal is paid a salary from a company which is not commensurate with the value of services provided by the principal.*

*The Discussion Paper also acknowledges at para. 10 that arm's length remuneration to an associate or a service trust for bona fide services related to the earning of the PSI will not attract the application of Part IVA.*

### **Taxpayers Australia comment**

*One of the objects of the PSI rules is to ensure that income derived from personal exertion would be taxed in the hands of the principal as an individual taxpayer (as opposed to an interposed entity).*

*The above comments suggest that where the principal and/or their associates are not being remunerated on an arm's length basis, then Part IVA should apply to impose an arm's length value on the services. There is no requirement under Division 86 (or any other provision under Tax law) which requires an arm's length valuation of salary and wage income.*

*If the intention is to tax the employees on income from their personal exertion, then imposing income tax on the arm's length value of the principal's salary would be the more straight-forward approach compared to applying Part IVA.*

*Whist this approach is conceptually simpler, we concede that this would be difficult to achieve in practice because the value of the services provided by the employee would vary from business to business.*

Arguably, the best approach would be to align personal income tax rates with other business entities. Obviously, this would be a policy matter to be considered by Government. If there is an intention to pursue such policy objectives, this will remove the need to "tweak at the edges" the rules in relation to PSI.

## **2.5 Use of retained profits where a company structure used**

*At para. 13 of the Discussion Paper, Part IVA is considered to apply where the distribution to the principal by the interposed entity is less than the PSI derived by that entity, unless specific circumstances justify that difference.*

*In particular, one of these circumstances is that the amounts retained are required to be commercially driven (and only the principal benefits from the accretion to those assets). We envisage the retention of profits for capital investment in the business would be one of the commercial reasons contemplated.*

### **Taxpayers Australia comment**

*The question of whether profits should be retained or reinvested by the company varies between businesses.*

*In Ropibon Tin NL v FC of T (1949) 78 CLR 4; ATD 431, it was held that:*

*... it is not for the Court or the Commissioner to say how much a taxpayer ought to be spending in obtaining his income, but only how much he has spent.*

*In this regard, unless the intentions of the principal are clearly demonstrated, we acknowledge that it would be difficult for the Courts and the Commissioner to apply Part IVA by examining the retained profits of a company and determining the extent in which the profits should be retained or distributed.*

*The intention and use of those retained earnings whether for future capital investments or for day to day running expenses is best left to the management of the company.*

## **2.6 Retained profits not for the benefit of principal**

*At para. 15 of the Discussion Paper states that an indicator of a dominant purpose to obtain a tax benefit is where profits are retained in the company purportedly on commercial grounds but the principal has little opportunity to benefit from the continued success of the business in the future.*

*An example is where a principal holds a minority interest in a company or is merely a beneficiary of a trust.*

*In addition, at para 10 of the Discussion Paper, it is accepted that if the principal is conducting a business with their spouse through a genuine partnership, then such an arrangement will be accepted for income tax purposes, and does not attract Part IVA.*

*We understand that such arrangements contemplated by the Commissioner involves a husband and wife conducting business partnership together, with the sharing of profits and losses as prescribed under the Partnership Act, notwithstanding that one partner performs the majority of the work.*

*However, the arrangement exposes each partner to the full liability of debts of the partnership.*

### **Taxpayers Australia comment**

*As previously noted, we contend that the above arrangement does not differ to an arrangement whereby the principal, as settlor for a trust, contributes an asset to a trust for the benefit of other beneficiaries.*

*For tax purposes, there should not be any distinction between the income derived from an asset contributed by the principal compared with income derived by the personal exertion in that same entity. We do not see any reason why the beneficiaries cannot benefit from the personal exertion of the principal.*

*This is no different to a genuine husband and wife business partnership, where the other partner is benefiting from the personal exertion of the principal.*

*For example, if husband and wife each have a 50% interest in a company instead of a joint interest in a partnership, income derived in the company is likely to be PSI of the principal and taxed that person's hands.*

*In this regard, there appears to be inconsistent tax treatment between partnerships and companies and trusts.*

## **2.7 Retained profits available for private benefit of principal or their associates**

*Para. 15 of the Discussions Paper states that one of the features which will point to the existence of a dominant purpose to obtain a tax benefit, and therefore, Part IVA applying, is where:*

- the principal is paid a salary from a company which is not commensurate with the value of services provided by the principal; and*
- the profits are retained by the company purported on commercial grounds but are effectively available for the private benefit of the principal and/or their associates.*

### **Taxpayers Australia comment**

*We acknowledge that there are currently provisions under income tax law which deal with scenarios where retained profits in a private company are being put to use for the principal's private benefit.*

*In particular, Division 7A of the Income Tax Assessment Act 1936 (Division 7A) is in place to ensure that payments, loans or debt forgiveness made by a private company to its shareholders (or their associates) are treated as deemed dividends and assessed in the hands of the recipient.*

*In addition, we note that in the recent 2009-10 Budget, Division 7A was extended to payments by way of license or right to use real property, such as cars, boats and real estate.*

*In any case, to the extent that the shareholder is an employee of the company - the provision of any benefits to those employees and/or their associates for private use would be subject to fringe benefits tax (as these provisions override any Division 7A application).*

*Whilst the above comments relate to company structures, where the interposed entity is a trust, any available profits of the trust would ordinarily be distributed to beneficiaries presently entitled to the net income of the trust in the relevant income year. To the extent that there are retained profits to which no beneficiary is presently entitled, then such income would be taxed in the hands of the trustee at the top marginal tax rate.*

*Therefore, in summary, any available profits in the company put to use for the private benefit of the principal (or their associates) would be subject to some form of tax and should not be subject to Part IVA.*

## **2.8 Use of structure for commercial purposes**

*Para. 15 of the Discussion Paper acknowledges that a dominant purpose to obtain a tax benefit does not exist if the entity structure is adopted for a clearly demonstrable commercial purpose, it achieves that commercial purpose, and it achieves it no more than that commercial purpose.*

*At para. 79, the Discussion Paper refers to FC of T v Mochkin 2003 ATC 4272, accepting that the principal in that case, the taxpayer adopted the structure to protect against personal liability.*

### ***Taxpayers Australia comment***

*In most instances, where the principal undertakes a business using a structure such as a company, the motivation to undertake such a structure would generally be commercially driven in any case.*

*The use of a company or a trust by a principal for asset protection purposes (eg. to protect the family home from creditors) should be a reasonable commercial reason for establishing the business in that particular manner.*

### **3. Concluding comments**

*By relying on the application of Part IVA as a general anti-avoidance provision to “income splitting arrangements”, we consider that this does not provide any certainty to taxpayers.*

*If the Tax Office believes that the Division 86 rules which govern the operation of arrangements involving PSI are inadequate, there should be a legislative solution pursued rather than the application of Part IVA.*