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Dear Sir/Madam,

Board of Taxation – Post-Implementation Review into the Alienation of Personal Services Income Rules

CPA Australia represents the diverse interests of more than 122,000 members in finance, accounting and business in over 100 countries throughout the world. Our mission is to make CPA Australia the global professional accountancy designation for strategic business leaders.

Against this background, we now provide this submission to the Board on the abovementioned topic.

We make the attached submission not only in respect of our members but also for the accounting profession generally and the broader public interest.

In essence, while we note that the current alienation of personal services income (APSI) rules have been successful to some extent, there appears to be scope for them to be improved to minimise their undue complexity and associated compliance costs while still being effective in addressing the concerns over excessive deduction claims and income splitting by some groups of taxpayers.

If you have any questions regarding the submission, please do not hesitate to contact me on ph. 03 9606 9771 or via email at garry.addison@cpaustralia.com.au.

Yours faithfully,

A handwritten signature in black ink that reads 'G. J. Addison'.

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Attachment

Submission to the Board of Taxation (BoT) Re Post-Implementation Review into the Alienation of Personal Services Income (PSI) Rules

The PSI rules in the income tax law can limit deductions available to individuals and can also attribute income derived by an interposed entity (eg. a company) back to the taxpayer. Personal services income is ordinary income derived mainly for the personal efforts or skills of an individual.

We note at the outset that the existing PSI rules have been successful to a certain extent in that they have effectively prevented employees (under so called 'Friday night – Monday morning arrangements') from seeking to obtain deductions generally only available to the self-employed and/or to split income from personal exertion among family members to reduce their overall tax liability. In other words, the PSI rules have been much more effective in curbing these practices than was the case when the ATO was confined to the use of litigation under the general anti-avoidance provisions in PartIVA of the Income Tax Assessment Act 1936.

It should also be borne in mind that the growth of 'contractors' in recent times does not appear to have been driven by tax considerations but instead appears to be more closely related to changes in the economy generally such as down-sizing and cost reductions by larger companies as employment costs have increased.

That said, however, the PSI rules appear to have been less successful in dealing with such practices by self-employed or professional persons (eg. accountant, architect, lawyer, etc) operating as a sole practitioner who derive personal services income and who are also subject to the PSI rules. The main problem in this area arises from the practical operation of the four personal services business (PSB) tests, namely:

- the results test
- the unrelated clients test
- the employment test, and
- the business premises test.

The main problem with these tests appear to be their complexity, particularly in respect to the 'results' test.

Problems re results test

Generally, if a person or the personal services (PSI) entity does not satisfy the 'results test' and that person or entity get 80% or more of their personal services income from one source, then they will be subject to the PSI rules. The 'results test' is only satisfied where the relevant person works to produce a result, and provides the tools and equipment necessary (if any) to produce a result, and is also liable for the cost of rectifying any defective work.

Current problems with this test include the following:

- the test is unfair to those contractors who are paid on a per hour basis as opposed to 'achieving a result' – this might be overcome by introducing a commercial 'at risk' test as an alternative/additional requirement (eg. a public practitioner who provides services to a single client and is paid on a per hour basis but is arguably 'at risk' as he/she may still be required to maintain professional indemnity insurance (PI) cover under the rules of the relevant professional body);
- there is also evidence that some contractors simply tick the 'results' box on the ATO form even though they may not in fact meet the criteria specified in the existing PSI rules (ie. an apparent compliance problem);
- the results test is the only test where taxpayers can self-assess in cases where they receive more than 80% of a test individual's PSI from one source, which in itself appears to create more risk especially given that this test is arguably the least understood one;
- we understand that those self-employed persons who fail to pass the 'results' test generally also fail the 'employment' and 'business premises' tests; and
- in this situation, the only way that such a person can qualify as a personal service business (PSB), and thus be exempt from the PSI rules, is to obtain a PSB determination from the ATO which is most unlikely in such a case.

In light of the above, we would argue that consideration be given to replacing the existing 'results test' with a more straightforward commercial risk test.

Unrelated clients test

Among other things, this test requires that services are provided by the taxpayer as a direct result of making offers or invitations (eg. by advertising) to the public at large or a section of the public. It is not entirely clear whether this test would be satisfied by 'word of mouth' referrals and the use of labour hire firms, employment agencies, etc is specifically excluded. There is a strong case, in our view, for this test to be amended to allow a wider range of solicitations to the public including 'word of mouth' referrals and the gaining of clients through labour hire firms, employment agencies, etc.

PSB Determinations

While these determinations do not appear to be granted easily (see above) and are arguably inconsistent with self-assessment, their availability at least allows the majority of potentially affected taxpayers to apply to the ATO for a PSB determination which can give them some certainty as to whether they are affected by the PSI provisions.

Compliance issues

In addition to the above, there is also a need to streamline the 'fix up' or changes necessary to enable taxpayers whose status varies during an income year to deal with the relevant compliance requirements.

In particular, there is a need to provide for an annual fix up where a personal service entity (PSE) has commenced but on looking back is not a PSB, or when a PSE that has been a PSB is found upon looking back to have failed the relevant PSI tests for the past year. This needs to be considered in light of the fact that the present 'quarter by quarter' fix-up requirements in the current law are simply unworkable.

Role of Part IVA

The main rationale for the current PSI rules is that they are easier to apply to PSI issues than the Part IVA provisions, notwithstanding the complexity and other problems associated with the current PSI rules. It is also relevant that the Part IVA provisions may still apply on a default basis to PSBs.

While the ATO has indicated that so-called 'vanilla' type arrangements such as 'mum and dad' partnerships would generally not attract Part IVA, uncertainty still remains for other business arrangements/structures and the ATO 'test case' program has now been disbanded without providing any further clarification of the law in this area. While we note that the ATO is currently reviewing its

earlier rulings in this area in consultation with an NTLG Alienation and Part IVA Working Group, this work has still not been completed.

The current PSI rules provide some clarity re deductions, PAYG obligations and attribution of PSI to test individuals, but they are arguably too complex and inflexible in many circumstances as outlined above. Problems also remain through the ongoing application of Part IVA to most PSB structures.

We understand that the removal of the application of Part IVA to PSBs would be generally welcomed by practitioners and affected taxpayers and it would be useful if such a change could be considered in the context of the current review.

Wider Tax Changes

It is of interest to note that changes to the personal income tax scale in recent years, particularly the increases in the upper marginal rate thresholds, have arguably reduced the incentives for income splitting. For example, the 38% or 37% marginal rate will now only apply to taxable incomes in excess of \$80,000 in 2009/10 and 2010/11 respectively while the top rate of 45% will only apply to taxable incomes in excess of \$180,000 in these years.

More systemic tax changes could fix the problem but the 'cure' could be worse than the 'disease', eg:

- flatter personal tax scale
- reduce/eliminate tax-free threshold (albeit probably not practicable unless replaced by an enhanced low income rebate arrangement which may entail similar problems), and/or
- introduction of a family taxation basis.

The above are all matters for the Henry Tax Review (HTR) with the possible exception of the first measure which appears to have been deferred pending an improvement in the Commonwealth's current fiscal position.

Other changes being considered by the HTR (such as a lower company tax rate, lower taxes on income from capital and reform of state taxes) would not appear to do much to ameliorate problems in the PSI area.

Other Jurisdictions

A recent review (S. Pennicott, Atax, UNSW) of the Australian PSI rules observed that there is nothing to suggest that corresponding rules adopted in other comparable OECD countries (USA, UK, Canada and NZ) are superior to those in Australia but that the overseas models do at least appear to be simpler than the current Australian rules. This suggests that the focus of the current review should be directed to some simplification of the current rules at least in the short-term.

Scope of current review

We note that the terms of reference for this BoT (post-implementation) review appear to preclude consideration of policy issues – ie. the focus of the review appears to be the identification of practical problems associated with the current rules as opposed to changes which are not consistent with the policy intent of the relevant provisions such as the ambit of Part IVA in the PSI area, particularly in respect to its current application to PSBs.

Nevertheless, as noted above, the earlier assumption by the Ralph Review that the major increase in sub-contractors in recent years has been mainly tax driven may not have been correct since such changes now appear to have been more closely associated with wider economic changes including the need to ensure that the Australian economy is more internationally competitive.

The difficulty here is that the application of Part IVA to PSBs remains problematic and compounds the complexities associated with the overall PSI regime. There is clearly a need for a less complex statutory mechanism to cover the whole PSI/PSB area.

One option might be to confine the application of the PSI rules to de facto employees where, as noted above, the PSI rules appear to have had some success while establishing a separate but simpler statutory regime for PSBs

Possible Statutory PSB Regime

While this might need to be the subject of a separate BoT review, some possible options could include (one or more) of the following:

- a separate regime based on the current ABN rules;
- post-income splitting/retention adjustments so that the PSI is attributed to the relevant individual;
- a revised PSI regime based on the existing NZ regime; and/or
- wider reforms arising from the Henry Review to reduce the incentives for income splitting/retention initiatives.

Option 1

The ABN option could involve the introduction of a subset of the ABN registration so that looking forward a PSE can be classed as a PSB by ticking the appropriate boxes. Such questions could include the following:

- did your business revenue come from two or more unrelated sources in the previous year?
- Do you have a contract that guarantees more than six months work, etc?

This could be an automated self-assessed test which, if passed, would qualify the taxpayer for an annual PSB certificate (subject to penalties in the case of false answers). Relevant tax (PAYG, SGC, etc) consequences would follow from this.

Option 2

- amend the existing PSI rules so where PSI is involved and a PSB test is passed then any PSI retained (in a company) or split is attributed to the test individual, and
- in relevant cases, prescribed business structure tests (based on existing case law such as number of employees, turnover, etc) could apply with borderline cases dealt with via an ATO determination.

Option 3

- existing PSI rules (or a modified version) to only apply where an individual's net PSI is greater than the threshold for, say, the 30% personal marginal tax rate.

Conclusions

CPA Australia believes that the existing complexity and associated compliance costs of the current PSI/PSB rules should be reduced while still retaining the basic objective or policy intent of these rules. Some options to achieve this are discussed above:

- replace the existing 'results' test with a simpler commercial risk test;
- vary the 'unrelated clients' test to clarify that invitations to the public go beyond strict advertising to also include 'word of mouth' referrals and use of employment agencies;
- deal with some existing compliance problems involved with the PSI rules via an annual 'fix-up' process; and

- introduction of a separate statutory PSB regime(see three potential options above) in lieu of the current application of the PART IVA general anti-avoidance rules in this area.

The above options could, of course, be affected by potential wider reforms arising from the Henry Tax Review.