

Alienation of Personal Services Income (APSI)

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Important

This booklet is simply a collection of Newsflash articles relevant to APSI. The articles are transferred from Newsflash into this booklet so it is best read from the back page forwards to ensure you are reading the latest article on the topic first. Note that the information contained in this booklet is not updated regularly so it is important that you seek professional advice before acting on it.

APSI When 80% of Income or MORE From One Source

You are considered to have received your income from the underlying customers rather than the principal that pays you if the following applies to you (refer section 87-40):

Principal and Agent Test

You receive income for a large number of clients but through one principal and you fit into all the following categories:

Where no one actual customer generates 80% or more of the agent's income.

At least 75% of the agent's income is from commission i.e. small or no retainer.

The agent actively seeks out the customers i.e. advertising.

The agent does not use the principal's premises except on arms length rental. Note this means you can never see a client on your principal's premises.

Examples of the type of people this will apply to include.

Doctors who receive all their income through Medicare but in relation to many patients

Financial Planners and Insurance Brokers who might receive all their income through AMP but have many clients

Network marketers and Party Plan sellers who might receive all their income from Tupperware but have many customers.

Franchisees who may supply many customers but are only paid by the franchiser.

Alienation of Personal Services Income (APSI) Test

The following only covers situations where 80% or more of the income is from one group of associates.

1	Are you providing personal services? i.e. the service is not just ancillary to the supply of goods or primarily provided from an income producing asset i.e. the contract specifies a particular asset must be used and without the asset the contract obligation could not be fulfilled. On this basis truck owner drivers and courier drivers providing a van or ute (but not a station wagon or sedan) are not providing personal services income? Refer TR 2001/8 for more detail for more detail.	No → Yes: Go to 2	You do not have to worry about the APSI (80/20 rule). Nor do you now have to worry about Part IVA
2	In at least 75% of the circumstances of the entity, is the contract to produce a result, supply plant and equipment or tools of trade (if it is normal in your industry to have tools) and liability for the cost of rectifying defective work or liability for damages remains with the sub contractor? APSI 87-18	Yes → No: Go to 3	You do not have to worry about the APSI (80/20 rule) but note comments below re Part IVA.
3	You are required to apply to the Commissioner for a determination that you are operating a personal services business. In your application to the Commissioner you will have to prove you satisfy one of the following tests. Do non associated entities, or individuals (or if in partnership other partners in that partnership) perform at least 20% of the market value of the work for that year? APSI 87-25 (2) or if not, for unusual circumstances?	Yes → No: Go to 4	You have avoided the APSI (80/20 Rule) but note comments at the end of this flow chart

4	Except for the unusual circumstances of this year would you have earned income from at least two unassociated to you or each other, sources due to your advertising, making offers to the public or word of mouth (APSI 87-20(1)(b))? Refer the above principal and agent test. If you satisfy this you can look beyond your principal to your customers for unrelated clients.	Yes → No: Go to 5	You have avoided the APSI (80/20 Rule) but note comments at the end of this flow chart re: part IVA.
5	Did you employ an apprentice for at least half of the year Refer APSI 87-25 (3).	Yes → No: Go to 6	You have avoided the APSI (80/20 Rule) but note comments at the end of this flow chart re: part IVA.
6	At all times during the year (or if not, for unusual circumstances) did the business exclusively maintain business premises (not necessarily the same premises all year) and were these premises used almost 100% to produce income for the contract in question? Refer APSI 87-30.	Yes: Go to 7 No: Go to 8	
7	Were these premises physically separate from any premises used by an associate or customer or an associates private residence of the entity for private purposes. In the Explanatory Memorandum using a shed in the back year of the home of the brother of the owner of the business was not considered to be physically separate. The draft ruling implies that a shop with residence above would be considered physically separate.	Yes → No: Go to 8	You have avoided the APSI (80/20 Rule) but note comments at the end of this flow chart re: part IVA.
8	Fail the test? The APSI legislation applies to you but you can apply to the Commissioner for a determination that you are operating a personal services business. Otherwise you will not be able to deduct expenses against the income in question unless one of the following applies: (1 or 2 below)		

1) The deduction would normally be available to you as an employee of the organization (refer APSI Act 85-10(1)). For example a claim for home to work travel will be permitted only if one of the following applies:

- (a) Bulky tools are carried as there is no safe storage at work (refer taxpack D1).
- (b) The travel is to an abnormal workplace (refer taxpack D1).
- (c) The home is the primary workplace, or work for the day began before leaving home (refer taxpack D1).
- (d) Work is actually performed on the way to work (refer taxpack D1).

Or

2) The deduction is in relation to one of the following:

- (a) Costs of gaining work i.e. Advertising, tendering & quoting.
- (b) Workers' Compensation, Public Liability, Professional Indemnity and Income Insurance.
- (c) Payments to others for participation in the business but not a payment to an associate unless it directly relates to the principal work of the business (85-20).
- (d) Superannuation contributions for self and other workers except for associates not performing work that directly relates to the principal work of the business. Note: if an Associate performs work that directly relates to the principal work of the business superannuation contributions can only be made up to the amount required by the Superannuation Guarantee unless that Associate performs more than 20% of the market value of the entity's principal work (refer APSI Act 86-75(2))
- (e) Costs associated with GST. This means you will not be able to claim rent, mortgage interest, rates or land tax for your or your associate's residence and payments to your spouse or associate for non principal work such as bookkeeping.

If you are operating as a company, trust or partnership you are also caught by the following additional requirements:

1. Deductions are only permitted for maintaining one car per owner who is involved in performing the principal work of the business unless the vehicle is used entirely for business purposes (refer APSI 86-70 (1) and APSI 86-70(2) & (3)).
2. Any profits remaining after allowable deductions are to be taxed in the hands of the main individual. But if losses remain they cannot be transferred into the individuals income tax return unless the business is operated as a partnership (refer APSI 86-20) and then subject to the new offset rules. Note the government announced in the 2003 budget that this would be changed but legislation has not yet come through.
3. When the business entity has both income from personal services i.e. amounts caught here and other income from other businesses including being in the business of personal services many expenses will need to be apportioned. A formula for this is provided at APSI Act 86-20 (2). Basically it requires you to claim any maintenance costs of the entity against the non personal services income first. APSI Act 86-25 provides for a pro rata of maintenance costs based on the ratio of income when the personal services income is from more than one individual.

Comments

Nothing has been done to override old rulings, case law and Part IVA on when income is deemed to be from business or personal exertion so passing the above test is not the end of the issue. But if you passed the PSI test above you can income split without fear of the old rulings, cases and Part IVA. Otherwise, if you didn't qualify before this legislation you won't qualify now.

The legislation has a provision to allow the ATO to examine each transaction of the business in isolation. This could mean applying the above test to each owner of the business separately and finding that the income they personally generate is Personal Services income and should be treated separately from the rest of the business. It is even wide enough to make non owners of the business taxable on all the income from one contract even though they will not and have no right to receive it. When enquiries were made of the ATO regarding this they took the attitude it was an unexpected result but nevertheless valid. At the moment they are not enforcing it.

APSI When LESS Than 80% of Income is From One Source

You are considered to have received your income from the underlying customers rather than the principal that pays you if the following applies to you (refer section 87-40):

Principal and Agent Test

You receive income for a large number of clients but through one principal and you fit into all the following categories:

Where no one actual customer generates 80% or more of the agent's income;

At least 75% of the agent's income is from commission i.e. small or no retainer;

The agent actively seeks out the customers i.e. advertising;

The agent does not use the principal's premises except on arms length rental. Note this means you can never see a client on your principal's premises.

Examples of the type of people this will apply to include:

- Doctors who receive all their income through Medicare but in relation to many patients;
- Financial Planners and Insurance Brokers who might receive all their income through AMP but have many clients;
- Network Marketers and Party Plan sellers who might receive all their income from Tupperware but have many customers;
- Franchisees who may supply many customers but are only paid by the franchiser.

Alienation of Personal Services Income (APSI) Test

The following only covers situations where less than 80% of the income is from one group of associates.

1	Are you providing personal services? i.e. the service is not just ancillary to the supply of goods or primarily provided from an income producing asset i.e. the contract specifies a particular asset must be used and without this asset the contract obligation could not be fulfilled. On this basis truck owner drivers and courier drivers providing a van or ute, (but not a station wagon or sedan) are not providing personal services income? Refer TR 2001/8 for more detail.	No → Yes: Go to 2	You do not have to worry about the APSI (80/20 rule). You can also income split without fear of the old rulings, cases & Part IVA
2	In at least 75% of the circumstances of the entity is the contract to produce a result (paragraph 114 of TR2001/8), supply plant and equipment or tools of trade (if normal for that industry), and liability for the cost of rectifying defective work or liability for damages remains with the sub contractor? APSI 87-18	Yes → No: Go to 3	You do not have to worry about (80/20 rule) but note comments below re Part IVA
3	During the year did you earn income from at least two unassociated, to you or each other, sources due to your advertising to the public (APSI 87-20)? Refer the above principal and agent test. If you satisfy this you can look beyond your principal to your customers for unrelated clients, but you must have acquired these clients by making offers or invitations to the public (87-20(1)(b)). For example advertising or word of mouth from other clients but not referrals from your principal.	Yes → No: Go to 4	You do not have to worry about (80/20 rule) but note comments below re Part IVA
4	Do non associated entities, or individuals (or if in partnership other partners in that partnership) perform at least 20% of the market value of the work for that year? APSI 87-25 (2) or if not, for unusual circumstances?	Yes → No: Go to 5	You have avoided the APSI (80/20 Rule) but note comments at the end of this flow chart re: part IVA.
5	Did you employ an apprentice for at least half of the year? Refer APSI 87-25 (3).	Yes → No: Go to 6	You have avoided the APSI (80/20 Rule) but note comments at the end of this flow chart re: part IVA.
6	At all times during the year (or if not, for unusual circumstances) did the business exclusively maintain business premises (not necessarily the same premises all year) and were these premises used almost 100% to produce income for the contract in question? Refer APSI 87-30.	Yes: Go to 7 No: Go to 8	
7	Were these premises physically separate from any premises used by an associate or customer or an associate's private residence of the entity for private purposes. In the Explanatory Memorandum using a shed in the back yard of the home of the brother of the owner of the business was not considered to be physically separate.	Yes → No: Go to 8	You have avoided the APSI (80/20 Rule) but note comments at the end of this flow chart re: part IVA.
8	Fail the test? The APSI legislation applies to you but you can apply to the Commissioner for a determination that you are operating a personal services business. Otherwise you will not be able to deduct expenses against the income in question unless one of the following applies:		

- 1) The deduction would normally be available to you as an employee of the organisation (refer APSI Act 85-10(1)). For example, a claim for home to work travel will be permitted only if one of the following applies:
- Bulky tools are carried as there is no safe storage at work (refer taxpack D1);
 - The travel is to an abnormal workplace (refer taxpack D1);
 - The home is the primary workplace, or work for the day began before leaving home (refer taxpack D1);
 - Work is actually performed on the way to work (refer taxpack D1).

Or

- 2) The deduction is in relation to one of the following:
- (a) Costs of gaining work i.e. Advertising, tendering & quoting;
 - (b) Workers' Compensation, Public Liability, Professional Indemnity and Income Insurance;
 - (c) Payments to others for participation in the business but not a payment to an associate unless it directly relates to the principal work of the business (85-20);
 - (d) Superannuation contributions for self and other workers except for associates not performing work that directly relates to the principal work of the business. Note if an associate performs work that directly relates to the principal work of the business, superannuation contributions can only be made up to the amount required by the Superannuation Guarantee unless that associate performs more than 20% of the market value of the entity's principal work (refer APSI Act 86-75(2));
 - (e) Costs associated with GST. This means you will not be able to claim rent, mortgage interest, rates or land tax for your or your associate's residence and payments to your spouse or associate for non principal work such as bookkeeping. If you are operating as a company, trust or partnership you are also caught by the following additional requirements:
 - 4. Deductions are only permitted for maintaining one car per owner who is involved in performing the principal work of the business unless the vehicle is used entirely for business purposes (refer APSI 86-70 (1) and APSI 86-70(2) & (3));
 - 5. Any profits remaining after allowable deductions are to be taxed in the hands of the main individual. But if losses remain they cannot be transferred into the individuals income tax return unless the business is operated as a partnership (refer APSI 86-20) and then subject to the new offset rules. Note the government announced in the 2003 budget that this would be changed but legislation has not yet come through.
 - 6. When the business entity has both income from personal services i.e. amounts caught here and other income from other businesses including being in the business of personal services, many expenses will need to be apportioned. A formula for this is provided at APSI Act 86-20 (2). Basically, it requires you to claim any maintenance costs of the entity against the non personal services income first. APSI Act 86-25 provides for a pro rata of maintenance costs based on the ratio of income when the personal services income is from more than one individual.

Comments

Nothing has been done to override old rulings, case law and Part IVA where income is deemed to be from business or personal exertion so passing the above test is not the end of the issue. If you didn't qualify before this legislation, you won't qualify now.

The legislation has a provision to allow the ATO to examine each transaction of the business in isolation. This could mean applying the above test to each owner of the business separately and finding that the income they personally generate is Personal Services Income and should be treated separately from the rest of the business. It is even wide enough to make non owners of the business taxable on all the income from one contract even though they will not and have no right to receive it. When enquiries were made of the ATO regarding this they took the attitude it was an unexpected result but nevertheless valid. At the moment they are not enforcing it.

Tax Minimisation Schemes Alert

This month the ATO web site has listed the following scheme which it is currently investigating.

Personal Services Partnership Arrangements

Apparently someone is promoting an arrangement where they will place you in a partnership with someone else. They then manage, for a fee, the arrangement so that you can avoid being caught by the Alienation of Personal Services Income Provisions (80/20 rule) and so be entitled to split the income from your personal services with your family.

The ATO are considering if the arrangement can be caught under Part IVA because the primary purpose of the arrangement is to avoid tax. They are also challenging the validity of the partnership and whether it really is the partnership providing the services. Providing the arranger knows what they are doing I don't think the partnership will be caught on any of the above. But the ATO is also looking to the APSI legislation to see if the scheme really does get around its provisions. This is where I think the ATO will succeed. Firstly, because

the APSI legislation allows the ATO to apply the rules to each contract the business has on an individual basis. Secondly, if there are only two people in the partnership the ATO could successfully argue that all the income is taxable in the hands of just one of them. Refer a previous Newsflash article on the matter which is now in our APSI booklet. This would put the partners in a far worse position than if they had not got involved in the scheme.

Partnerships with anyone are dangerous because you are joint and severally liable for each other. A partnership with a stranger is madness. I do not recommend using this arrangement to avoid the provisions of the APSI especially through an arranger as that will make the scheme more obvious to the ATO. But if you decide to do something similar with a friend do not use a bare partnership as your personal assets are at risk. Use a partnership of trust or a straight company or trust. Most people will still be caught by the APSI rules that allow the ATO to look at each contract within the business on an individual basis. Therefore before entering into anything like this you need to consult a professional tax adviser not a scheme arranger.

GST Upon the Purchase of a Business

The purchase of a business can be GST free if the following requirements are met.

- 1) The transfer of the business has some value
- 2) Both the buyer and seller are registered for GST
- 3) All things necessary to continue the operation of the business are transferred.
- 4) The seller carries on the business until the day of transfer.

GSTR 2002/5 goes into the detail of these requirements. In particular point 3 above is a problem (GSTR 2002/5 paras 58 to 70). For example to meet the requirements of transferring all that is necessary to run the business the lease on the business premises (if necessary for the continued operation of the business) must also be transferred. This requirement cannot be satisfied if the seller is behind in the rent and without a lease or does not pay rent (paying outgoings only does not meet the requirement of paying rent).

If the purchase of the business is subject to GST make sure the contract satisfies the tax invoice test on page 49 so you can claim the GST input credit back. Also make sure you are registered for GST on or before the date of the contract.

Whether the contract includes GST or is GST free is neither here nor there if you are registered for GST and if you receive a tax invoice, though it may cause an initial cash flow problem. If you end up paying GST you will be able to claim it back anyway. It is really for the seller to beware.

Changes to APSI 80/20 Rule

The government has been forced to make changes to the APSI legislation to correct some of the ridiculous problems the original legislation created for partnerships. For example the problem we pointed out in Newsflash 23, partnerships with only two partners had to distribute all of the profit to the partner who did more work than the other unless they did exactly 50% each. Taxation Laws Amended Bill No. 6 2001 provides a new employment test that takes into account the work of partners in the business as if they were employees. This widens the test at APSI 87-25 (2) to provide an exemption from the APSI provisions if another partner in the business performs 20% (based on price charged to the customer) of the work on a project.

This amendment also formalized the changes promises for entities that received their income from on principle but as a result of dealing with many clients i.e. commission.

As a result of the above the flow charts in our APSI Booklet have been updated so if you are relying on this information please e-mail us for an updated edition

Budget Report 2003

The following is a summary of the Income Tax parts of the budget report that would be relevant to our client base:

Low Income Rebate – has been increased from \$150 to \$235 and now it won't start to shade out until income exceeds \$21,600. There is no entitlement to the rebate when income exceeds \$27,475.

This means that if your income is under \$7,382 and you are a resident and not a minor you will not have to pay any income tax.

SATO- The Senior Australian Tax Offset will be increased so that single people over age pension age will not pay tax or Medicare if their income is under \$20,500. Couples who are both over age pension age will not have to pay any tax or Medicare if their combined income is under \$33,612. But note to achieve this both members of the couple must have exactly half of the \$33,612 in taxable income each. Any unevenness will result in the higher income earner losing part of his or her low income rebate and their spouse being unable to utilize all of their's.

APSI – Taxpayers caught by the Alienation of Personal Services Income rules will be entitled to offset any losses left in their interposed entities, against their personal income. This concession is back dated to 1st July, 2000 when the APSI legislation first took effect. An abnormality with FBT has also been removed retrospectively to 1st July, 2000.

Medicare- The threshold at which a low income earner has to pay no levy for the 2002/03 year is \$15,062 or individuals and \$25,417 for families stepped up by \$2,334 for each child. But note after this point it cuts in at 20 cents in the dollar.

Tax Thresholds – from the 1st July 2003 the resident income tax thresholds have increased (therefore tax decreases) as follows – note the rates do not include the Medicare levy:

0 to	6,000	No Tax Payable
6,001 to	21,600	17%
21,601 to	52,000	30%
52,001 to	62,500	42%
62,501	and over	47%

APSI (80/20 Rule) and the Building Industry

From 1st July, 2002 contractors who were registered for PPS before April 2000, became subject to the Alienation of Personal Services Income measures (80/20 rule) for the first time. As the 2003 tax returns will be the first returns for many subcontractors prepared on this basis the ATO has been issuing lots of warnings. A full flow chart of how the legislation works is available in our APSI Booklet. The following is just a guideline that should cover many subcontractors in the building industry.

The main sections that subcontractors use to avoid the APSI measures are:

87-65(5)&(6) (Repealed) In at least 75% of the circumstances the contract is to produce a result, the contractor supplies tools and equipment and is responsible for rectifying defective work or is liable for damages. This is called the results test. In its fact sheet on the results test the ATO have stated that "the results test is not met where the client is engaged to work or provide services as directed and is paid for the work or services (often on an hourly rate) rather than for a specified result or outcome produced by the work or services." As an example they use "a carpenter who is contracted to do fit out work on a building site and is allocated tasks or jobs on a daily or regular basis. He is paid on a regular basis (e.g. weekly), which is generally calculated on the number of hours that he works." An example the ATO uses of passing the results test is a carpenter who is "engaged to complete a specified job and payment is conditional upon completion of that job."

87-25(2) Other individuals or business entities perform at least 20% of the market value of the work for that year. Note this must actually be chargeable work not administration and it cannot be performed by an associated business i.e. another company owned by the same individual.

87-25(3) An apprentice was employed for at least half of the year.

87-20(1)(b) If 80% or more of your income is from one source you need to have another source of income that is not associated with the first and you acquired that source through advertising, word of mouth etc.

There are more provisions than those listed above, they are all listed in the booklet. If you are caught by the APSI measures you will not be able to claim deductions for home to work travel if you do not carry bulky tools. If you have more than one workplace during the day you will be able to claim all travel. You can also claim travel if you have regular workplace but had to work somewhere different that day. Rent, interest and rates associated with your residence are not claimable. Payments to your spouse for work that is not directly involved in earning the income (i.e. bookkeeping) are not deductible nor can you income split. You will only be allowed a deduction for one car other than a vehicle that is used solely in the business.

Claiming Company & Trust Losses in Your Personal Tax Return

The trick here is to find a way of failing the APSI test. It shouldn't be too hard seeing as the legislation was designed to catch you anyway.

Finally, something positive for taxpayers out of the APSI legislation. If your company or trust made a loss you will be permitted to offset the loss against your personal income if the loss is in regard to personal services income caught by the APSI legislation. This initiative was announced in the May 2003 budget. It effectively gives taxpayers caught by APSI an advantage over other taxpayers operating through a company or trust as other taxpayers' losses are quarantined until that company or trust makes a profit and satisfies other requirements. The new concession will be backdated to losses generated in the 2000/2001 financial years and all following years. Unfortunately, the legislation is not yet through parliament and it is now time to prepare these entities tax returns for the 2003 year. Tax returns can be amended for up to four years back from the date of their original assessment. Until this law passes through Parliament the amended returns can not be lodged and any 2003 tax returns prepared before the legislation is passed will not be able to take advantage of this concession. Accordingly, they will have to wait or be amended at a later date.

Nasty Sting for Legitimate Business Expenses

You may already be aware that if you are caught by the APSI rules you cannot claim a deduction for payments made to associates unless the work they perform directly relates to the principal work provided to customers or clients. An example of this is if I charged my brother for preparing the income tax return for his tutoring business he would not be able to claim the fee paid to me as a tax deduction, despite the size of my business. Naturally enough I don't charge him. Nevertheless, under GST legislation I am required to remit to the ATO the amount of GST that would have been applicable had I charged him! In an even further development of this double standard the ATO has taken the approach that the rules on payments to associates include payments for goods. Accordingly, if your spouse owns the business from which you purchase your business's stationery and your income is from personal services you cannot claim a deduction for that stationery. The following is an extract from the legislation validating the ATO's approach.

SECTION 85-20 Deductions for payments to associates etc.

85-20(1) You cannot deduct under this Act:

- (a) any payment you make to your associate; or
- (b) any amount you incur arising from an obligation you have to your associate; to the extent that the payment or amount relates to gaining or producing your personal services income.

85-20(2) Subsection (1) does not stop you deducting a payment or amount to the extent that it relates to engaging your associate to perform work that forms part of the principal work for which you gain or produce your personal services income.

85-20(3) An amount or payment that you cannot deduct because of this section is neither assessable income nor exempt income of your associate.

Makes you wonder if any of our highly paid politicians read the legislation before they vote on it, doesn't it.

Consultants Take Note

In *FC of T v Macarthur* 2003 the Federal Court ruled that Part IVA prevented a consultant from using a company to divert income (earned from provision of his own services) to his wife.

Macarthur resigned from the DMR in 1982 and worked overseas for 4 years. The company Macarthur and his wife set upon returning to Australia employed them both in the day to day conduct of the business of project management and consulting. The company had a contract in the Northern Territory for a short while then entered into a contract with the DMR. The contract was for an hourly rate and Macarthur was nominated as the consultant, the contract being for his expertise.

Macarthur claimed that if there was no company there would not be any income and that Part IVA relied on the argument that income was being diverted from one taxpayer to another. The court found that it was reasonable to conclude that without the company, Macarthur would have earned the money in his own right.

APSI (booklet available) governs these issues now but only in addition to case law. Most consultants try to argue that APSI does not apply to them because they are responsible for producing a result. This argument is difficult when you are paid an hourly rate. Nevertheless if you pass the APSI test you still need to consider whether you are caught by the above case.

Personal Services Income and Business Premises Test

Basically these rules determine whether you are just providing personal services or you run a personal services business. Only in the latter case are you entitled to split income with your family.

One of the ways income can qualify as having its source in a personal services business is if the business is run from separate premises to the owner's home. Until now it has been considered, by the ATO, that running a business from a shed on the same property as your home was not separate business premises. Dixon Consulting Pty. Ltd. V FCT (2006) AATA 186 has widened the scope of what is considered separate business premises so the shed may well now qualify.

In Dixon's case the business was operated from a two storey building that was structurally separate to Dixon's home but on the same piece of land. The court (AAT) found that this met the description of separate business premises. The AAT also stated that the premises do not have to be used "exclusively" in the business just "mainly". "Mainly" generally means something more than 50%.

This decision has since been overturned in a higher court.

Personal Services Income – Business Premises

To be able to distribute income from personal services to other family members you have to meet at least one of the conditions in a very strict set of rules. One of these conditions is that the business has its own premises. There are then a set of rules, all of which must be met for the premises to be considered business premises. Of particular concern for home based businesses is that the premises must be physically separate from any used for private purposes.

This has been tested in through the courts in Dixon Consulting P/L v FC of T. The Dixons had a two story garage structurally separate from their house that was used to house the company cars, some of their children's belongings downstairs and the company's office upstairs. There were signs that clearly showed the area to be a place of business though the drive way was shared with the home and clients used some of the shared yard.

The Federal court has just ruled that the AAT was incorrect in deciding that as long as the premises were mainly used for the business they passed the test. The Federal court then remitted the matter back to the AAT for the final ruling.

The AAT in its final decision emphasised that the following factors disqualified the premises from being physically separate from the home:

- 1) The two cars may have been company cars but there was some private use of them.
- 2) The storage of some items owned by the Dixon children.
- 3) There was insufficient physical separation from the home.

This seems to put an end to any argument that premises on the same piece of land as the family home can qualify as business premises for the purposes of the APSI legislation. The reference to private use of vehicles stored on the business premises and some private items really opens the flood gates for the ATO to attack any business premises. It maybe important to take that photo of your family off your desk straight away!

Alienation of Personal Services Income

The Results Test

At the end of 2007 IRG Technical Services Pty Ltd & Anor V DFC of T was a sharp reminder that there is more to the results test than being responsible to rectify mistakes. In this case a couple of engineers argued

that they passed the results test even though they worked as part of a team where their work had to be signed off as part of the payer's quality control. They contracted to the payer through their company and trust. If they could pass the results test the entities would be entitled to distribute their income to other members of their households who were in lower tax brackets.

The relevant section number is 87-18(3) which requires at least 75% of the entity's income to pass all of the following three tests:

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

The court found that they passed c) but not a) because they worked as part of a team and were paid an hourly rate. By simply finding that a) was not passed the court could rule but it also commented that b) was not passed either because while they had their own laptops and data base they were not required to bring them to work.

Audits

The ATO is now matching data to catch out people directing personal services income through other entities. It will be collecting data from labour hire firms, placement agencies and computer consultancies on payments they make to entities other than individuals together with the name of the individual who actually provides the services. The information will be cross matched with tax returns to easily detect those entities that are not redirecting all of their personal services income back to the individual who earned it.

If you are concerned about your circumstances our APSI booklet which is available under the free publications section of our web site has a flow chart you can use to see how these rules affect you.

Personal Services Income and 50% Investment Allowance

According to the ATO just having an ABN is not enough if you are an individual and your business's income is from your personal services.

Partnerships, trusts and companies that are in receipt of personal services income and do not pass the alienation of personal services income rules (commonly referred to as the 80/20 rule) will still qualify to claim the investment allowance. It is just the individuals that will miss out. For this reason it is important that an asset is purchased in the name of the partnership not one of the individual partners.

Our booklet on Alienation of Personal Services Income contains a flow chart on when you are caught by these rules. It is available under the free publications section.

In short if you are a sole trader and want to take advantage of the investment allowance it would be better to contact us first to make sure you qualify.

Personal Service Income That Passes the 80/20 Rule

In Newsflash 216 we discussed the considerations when choosing a business structure. This led to a brief discussion on the restrictions on splitting personal services income with your family. It was pointed out that even if you passed through all the alienation of personal income test, if the income is primarily generated by your labour you still have to pass the common law tests. In this edition we delve deeper.

In IT 2639 the ATO states that using a trust or company to split income with your family is a scheme with the dominant purpose of a tax benefit so it can use Part IVA to remove the tax benefit. The point being that income from your personal labour can never be taxed in someone else's hand unless it is generated in a personal services business where other people also provide labour to customers. One of the guidelines in IT 2639 is that there is at least as many employees whose services are being charged to clients as there is owners of the business. Administration staff do not count unless their services are being billed to clients.

IT 2639 looks firstly to see if the income is being generated primarily by personal services as opposed to the assets of the business. If it is not primarily an asset or sale of goods that generates the income then it is a head count to see whether chargeable employee staff exceed business owners. Paragraph 10 states:

If the practice company or trust has at least as many non-principal practitioners as principal practitioners,

then income is considered to be derived from the business structure (ie not personal exertion).

Practitioners are described in paragraph 11 as:

“Practitioners” include both full-time professional and non-professional staff whose function is to derive material fees from the practice. Part-time staff count proportionately. The term does not include administrative, clerical or support staff, for example, a nurse under the direction of a doctor or a legal secretary under the direction of a solicitor are not “practitioners” unless they earn material fees in their own right.

It seems that you can dissect the income of the business if there is some that is not directly earned from personal exertion. In paragraph 9 of IT2639 it recognises that the initial commissions earned by an insurance broker are income from personal services but the renewal commissions would not be caught. This would also no doubt be the same for trails received by finance brokers and financial planners.

IT professionals should also consider that if they write a program and then sell it the income of their business is not from personal exertion but from sale of goods.

Note that when the business is a partnership between individuals then all the partners are personally liable so the ATO accepts that they should all be entitled to the profits, even if the income is mainly generated by one partners labour. The catch is of course that a business does not provide any asset protection.

Refresher on APSI or 80/20 Rule

The Alienation of Personal Services Income (APSI) laws are intended to prevent contractors splitting income from personal exertion. Since its introduction several contractors have tested the APSI rules in the courts with no success. The legislation is very specific.

This is a brief summary, the full detail is available in our booklet

www.bantacs.com.au/booklets/Alienation_Of_Personal_Services_Income_Booklet.pdf

You can be caught by the APSI rules even if less than 80% of your income is from one source. The test really is whether you earned income from at least two unassociated to you or each other, sources, due to advertising, making offers to the public or word of mouth, you will not be caught by APSI. Here are the circumstances, at least one of which is necessary to avoid being caught by the APSI rules

- The invoice is primarily for the supply of goods, or equipment has a major part in providing the service such as a truck owner driver
- In at least 75% of the circumstances the contract is to produce a result, supply plant and equipment or tools of trade (if it is normal in your industry to have tools) and liability for the cost of rectifying defective work or liability for damages remains with the contractor
- Except for unusual circumstances, you would have earned income from at least two unassociated to you or each other, sources, due to advertising, making offers to the public or word of mouth
- You employed an apprentice for at least half the year
- Business premises were maintained at all times during the year (or if not, for unusual circumstances) which were used almost 100% to produce income for the contract in question? Note these premises need to be physically separate from any premises used by an associate or customer or your home. In the Explanatory Memorandum using a shed in the backyard of the home of the brother, of the owner of the business was not considered to be physically separate. The draft ruling implies that a shop with residence above would be considered physically separate
- non associates perform at least 20% of the market value of the work for that year or if not, only because of unusual circumstances.

If you are caught by the APSI rules you cannot claim a deduction for payments made to associates, unless the work they perform directly relates to the principal work provided to customers or clients. Section 85-20 makes it clear that it is any payment to an associate, it could be for the purchase of goods to use in your business.

The legislation states:

SECTION 85-20 Deductions for payments to associates etc.

85-20(1) You cannot deduct under this Act:

- (a) any payment you make to your associate; or

(b) any amount you incur arising from an obligation you have to your associate; to the extent that the payment or amount relates to gaining or producing your personal services income.

85-20(2) Subsection (1) does not stop you deducting a payment or amount to the extent that it relates to engaging your associate to perform work that forms part of the principal work for which you gain or produce your personal services income.

85-20(3) An amount or payment that you cannot deduct because of this section is neither assessable income nor exempt income of your associate.

Section 318 defines associate to include spouse, children, related business etc, but it also includes a relative of the natural person, so, if you buy your stationery from your cousin, then you cannot claim a tax deduction for it! In fact the definition of associate goes even wider than this with trusts, but to the extent that it is unlikely the court would enforce it in relation to section 85-20.

Nevertheless, it shows that our legislation is not well scrutinised before it is passed through parliament, and that Treasury has no hesitation it pushing through, catch all wording so taxpayers are left in a state of not being able to operate normally without fear of the ATO. In general the APSI rules are intended to prevent a contractor being entitled to any more tax deductions than an employee, so you may be able to argue that employees are entitled to a tax deduction for stationery purchased from their cousin. Nevertheless persuasive argument has very little chance of standing up against specific words in legislation.

Don't think that the ATO would not use its powers so unfairly. It does so all the time. Even when it doesn't get its own way it continues to use taxpayers' money to appeal through the courts while fining the taxpayer as much as possible so that eventually they can no longer afford to fight. And it just doesn't happen to the bad people. Back in the 80's they denied a minister of religion tax deductions for his car because he had not signed every entry in his log book. In court the judge said that there was no doubt the minister undertook the trips for work related purposes but the ATO had him on a technicality and the judge had to rule in accordance with the law, so the minister lost his case.

The ATO is getting just as carried away with Part IVA, using it to tell taxpayers when they can buy or sell shares without it being a scheme to create a capital loss. In TD2011/D8 they are requiring taxpayers to give first priority from their cash flow including wages to make the loan repayments on a rental property with no consideration that they may have other more pressing expenses such as food. Then there are their bullying tactics, look at what they did to Paul Hogan, wouldn't let him leave the country when he came back for his mother's funeral and then they had to drop their whole case against him as they had nothing of substance on him at all.

Why are they getting away with this? I'm sure people care about this but are just too busy. We really can't afford to let the ATO continue getting bolder. It is time they were reminded they are public servants not public nuisances. Please take the time to write to the newspapers, your local Federal member, the taxation ombudsman and the ATO complaints department. Maybe we can get accountability of the ATO as a Federal election issue next year.

Ask BAN TACS

For \$79.95 at Ask BAN TACS, <https://taxquestions.com.au/> you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. We will include ATO references to support our conclusion. There is also a notice board where some askbantac users have generously allowed their question and answer to be published. Lots of good real life information.

More Information

Please make sure you continue to keep your knowledge up to date by [subscribe to our Newsflash reminder](#). There are many other booklets available on our web site <https://www.bantacs.com.au/media-library/booklets/> in fact the whole web site is full of useful information so also have a look around under topics.

How to Make Sure Your Next Property Is a Good Investment

- Do you really know how much the property is going to cost you to hold?
- What name should the property be purchased in?
- Will this property fit your investment strategy and goals?
- What does the contract say about GST?
- How does the price compare with similar sales in the area?
- If it is negatively geared, how much capital growth is required before you breakeven?
- Do you know what records you need to keep and how?
- Are your financing arrangements maximising your tax deductions?
- What happens if interest rates rise?

.....and the list goes on!

To ensure you don't make a costly mistake with your next purchase make sure you see a BAN TACS Accountant before you sign



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