TR 2003/6 - Income tax: attribution of personal services income

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Taxation Ruling
Income tax: attribution of personal services income

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Preamble

The number, subject heading, ***What this Ruling is about*** *(including* ***Class of person/arrangement*** *section,* ***Date of effect****, and* ***Ruling*** *parts of this document are a 'public ruling' for the purposes of* ***Part IVAAA of the Taxation Administration Act 1953*** *and are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner of Taxation. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling deals with the alienation of personal services income measure (the alienation measure) contained in Part 2-42 of the *Income Tax Assessment Act 1997* ('ITAA 1997'), and explains:

- how the attribution of personal services income rules apply to a personal services entity that is not conducting a personal services business;
- how amounts distributed, from a personal services entity not conducting a personal services business that are, or are attributable to, attributed personal services income are not taxed twice;
- how the attribution of personal services income rules will not apply to interposed entity arrangements when the income derived by the head entity (that is the entity contracting with the services acquirer) is earned in the course of conducting a personal services business; and
- when an entity's income that is derived from a dealing or transaction with a personal services entity, other than by way of distribution, will be personal services income (and therefore potentially subject to the alienation measure).

Related Rulings

2. TR 2001/7: the meaning of personal services income.
TR 2001/8: what is a personal services business.

Class of persons/arrangement

3. This Ruling applies to those companies, partnerships or trusts whose ordinary or statutory income includes income that is mainly a reward for the personal efforts or skills of an individual (an individual's personal services income).

Background

4. The *New Business Tax System (Alienation of Personal Services Income) Act 2000* (Alienation of Personal Services Income Act) amended the ITAA 1997 by inserting new Part 2-42 into that Act and amended the *Taxation Administration Act 1953* ('TAA 1953') by inserting new Division 13 in Schedule 1 to that Act.

5. The alienation measure contained in Part 2-42 applies from the 2000-2001 income year. However, it does not apply until the 2002-2003 income year for those individuals or personal services entities who:

- were in the former prescribed payments system and were entitled to and had made a payee declaration to a payer;
- the payee declaration was in force as of 13 April 2000; and
- the Commissioner had received the payee declaration for the payee from the payer on or before 13 April 2000. [1]

6. The measure was introduced following the recommendations made in the report of the *Review of Business Taxation: A Tax System Redesigned* (commonly called the Ralph Report).[2] The relevant recommendations that relate to this measure are recommendations 7.2, 7.3 and 7.4. Those recommendations were aimed at improving the integrity and equity in the tax system. The recommendations arose out of concerns that:

[1] The Commissioner's declaration in relation to this deferral was published on 30 August 2000 in the Commonwealth of Australia Gazette No GN 34.

[2] See also Treasurer's Press Release No 74 of 11 November 1999.

- substantial erosion of the income tax base had occurred as a consequence of the alienation of personal services income through the use of interposed companies, partnerships and trusts; and
- there was a perception that individuals, as contractors, and interposed entities were claiming a greater range of deductions than those available to individuals who provided personal services as employees.[3]

7. The measure is intended to:

- limit and clarify the deductions available against personal services income at both the individual and interposed entity level; and
- ensure that, after allowing certain deductions to the interposed entity, any income remaining is attributed to the individual.[4]

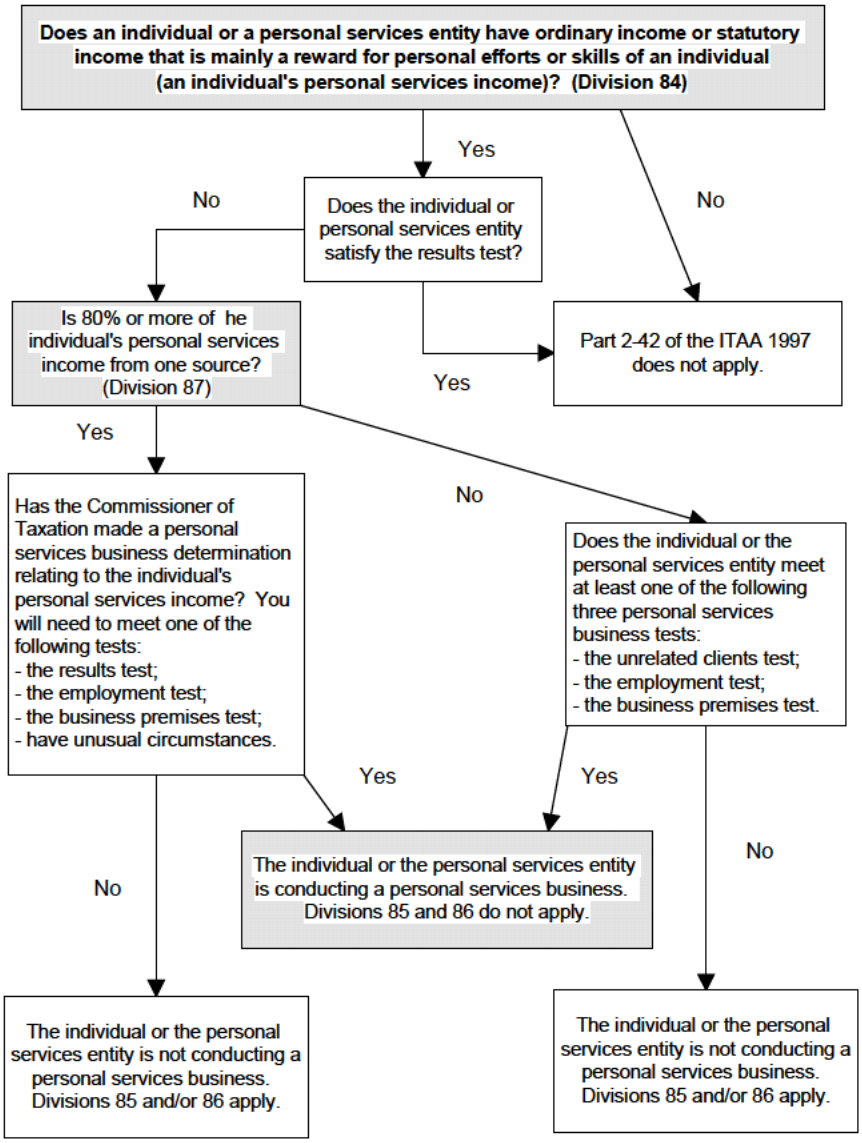
8. The application of Part 2-42 of the ITAA 1997 is predicated on the view that, contractually, income from personal services can be the income of any entity. However, subsection 84-5(2) of the ITAA 1997 ensures that for tax purposes, only an individual can have personal services income (as defined).

9. The application of Part 2-42 of the ITAA 1997 does not result in a change in the nature of contractual relationships between parties to an arrangement that involves the rendering of personal services. Individuals do not become employees of service acquirers as a consequence of the application of that Part. Nor does it affect an individual's or a personal services entity's entitlement to an Australian Business Number, or to be registered for the purposes of *A New Tax System (Goods and Services Tax) Act 1999* (GST Act).

10. Note also that the general anti-avoidance provisions of Part IVA of the *Income Tax Assessment Act 1936* ('ITAA 1936') may still apply to cases of alienation of personal services income that fall outside the alienation measure.[5]

[3] See also paragraphs 1.5-1.14 of the Explanatory Memorandum.
[4] Explanatory Memorandum at page 3.
[5] See Note to section 86-10.

11. The following flowchart explains how Part 2-42 applies.[6]



12. Note that you can apply for a Personal Services Business Determination (PSBD) from the Commissioner to confirm that you are not within the measure, or if you are not sure whether you are within the measure, or if you are subject to unusual circumstances. However, unless you are subject to unusual circumstances you cannot apply for a personal services business determination on the basis of the unrelated clients test. If you believe that the alienation measure

[6] See Treasurer's Press Release No.51 of 9 July 2001.

should not apply to you, you can request a PSBD from the Commissioner (see diagram above).

13. If:

(a) you have personal services income; and

(b) you or the personal services entity do not satisfy the 'results test'; and

(c) you or the personal services entity get 80% or more of the personal services income from one source,

you will be subject to the alienation measure, unless you have a PSBD.

Definitions

Personal services income

14. Personal services income is income which is mainly a reward for an individual's efforts or skills (or would mainly be such a reward if it had been derived by the individual) (subsection 84-5(1)).

Personal services entity (entity)

15. A personal services entity is a company, partnership or trust whose ordinary income or statutory income includes the personal services income of one or more individuals (see subsection 86-15(2)).

Service Acquirer

16. A service acquirer is the entity (or entities) that acquires the personal services of an individual, directly from the individual or through a personal services entity. The service acquirer is the client of an individual or personal services entity and is the source of the income of the individual or the personal services entity that constitutes an individual's personal services income.

Test individual

17. A test individual is the individual whose personal services income is included in a personal services entity's ordinary or statutory income, and to whom that income will be attributed under Division 86, unless one of the exceptions in that Division applies. A personal services entity may have more than one test individual. Part 2-42 applies on an individual by individual basis.

Associate

18. The word 'associate' has the same meaning as in section 318 of the ITAA 1936.[7]

19. For an individual an associate includes:

- a relative of the individual;
- a partner of the individual or a partnership in which the individual is a partner;
- if a partner of the individual is an individual, the spouse or child of that partner;
- a trustee of a trust estate under which the individual or an associate benefits; or
- a company under the control of the individual or associate.

20. For a company an associate includes:

- a partner of the company or a partnership in which the company is a partner;
- a trustee of a trust estate under which the company or associate benefits;
- another individual or associate who controls the company; or
- another company which is under the control of the company or the company's associate.

21. For a trustee an associate includes an entity or associate of the entity that benefits or is capable of benefiting under the trust.

22. For a partnership an associate includes each partner of the partnership or associate of the partner.

23. Section 87-35 specifically excludes the following from being associates of each other for the purposes of subsection 87-15(3) (the 80% rule) and paragraph 87-20(1)(a) (the unrelated clients test):

(i) Australian government agencies, which are:

- the Commonwealth, a State or a Territory; or
- an authority of the Commonwealth, a State or a Territory.

[7] 'Paragraphs 19 to 22 is not a comprehensive list of what entities are associates under section 318. An examination of section 318 is required for a full account of what entities are associates under this provision.'

(ii) Commonwealth government agencies within the meaning of the *Public Service Act 1999*.

(iii) Each part of an authority of a State or Territory that has, under a law of a State or Territory, a status corresponding to a Commonwealth government agency within the meaning of the *Public Service Act 1999*.

Distribution

24. In relation to a company, distribution refers to a dividend that is paid to a shareholder.

25. In relation to a trust estate, distribution refers to the share of the net income of the trust estate to which a beneficiary is presently entitled, or deemed to be presently entitled, or to an amount that is (or but for Division 86 would be) included in the assessable income of a beneficiary under section 99B of the ITAA 1936.

26. In relation to a partnership, distribution refers to the individual interest of a partner in the net income or net loss of the partnership.

Derives income

27. 'Derives income' includes 'has ordinary or statutory income'.

Ruling

Attributable income

28. If an entity ('the personal services entity') has income that constitutes personal services income of an individual ('the test individual'), the amount of the income after certain reductions (see section 86-20 and TR 2002/D5: deductions that relate to personal services income) is included in the assessable income of the test individual by sections 86-15 and 86-20. This amount is referred to as the net personal services income. The net personal services income is also excluded from the assessable and exempt income of the personal services entity by section 86-30.

29. In this ruling the inclusion of the net personal services income in the assessable income of the test individual, and its exclusion from the assessable or exempt income of the personal services entity, is called attribution. The amount of net personal services income included in the assessable income of the test individual in this way is called the attributed amount. The attributed amount cannot be less than nil.

30. Attribution will not occur where the personal services entity:

- has income from conducting a personal services business and the relevant income is from conducting that personal services business (subsection 86-15(3));
- pays the personal services income promptly to the test individual as salary or wages (subsection 86-15(4)); or
- is not assessable on the personal services income of the personal services entity under other provisions in the tax law (subsection 86-15(5)).

31. The attributed amount is included in the test individual's assessable income at the end of the year of income of the personal services entity. This means if the personal services entity has, say, a substituted accounting period ending on 31 December 200X, the attributed amount is included in the test individual's assessable income for the year ended 30 June 200X+1.

No double taxation

Companies

32. A personal services entity that is a company may still have accounting profits even if all of its profits are personal services income and the net personal services income has been attributed. The profits may be distributed by the personal services entity. If distributed to the test individual or to an associate of the test individual, to the extent that the distribution represents personal services income of the test individual that has been or will be attributed to the individual under subsection 86-15(1), the distribution will not be assessable or exempt income of the recipient (see subsection 86-35(1)).

33. The question of whether a dividend is a payment of an attributed amount for the purposes of subsection 86-35(1) is to be decided by reference to the account of profits debited by the company, and not by reference to the moneys with which the dividend is actually paid. In this regard *Ardmona Fruit Products Co-Operative Company Ltd v. Federal Commissioner of Taxation* (1952) 86 CLR 530 is to be distinguished. If a company keeps a separate account of profits that contains only attributed personal services income of a test individual, a dividend will be paid out of those profits to the extent that it is debited to that account. If a company does not keep a separate account of profits containing only attributed personal services income of test individuals, a dividend will be taken to be paid out of attributed personal services income of a test individual, in the proportion of profits consisting of such income compared to profits consisting of

other income. However, if the dividend is paid out of a special fund (e.g. an asset revaluation reserve) there should be no apportionment.

Trusts and partnerships

34. Subsection 86-35(2) applies to an entitlement of net income of a partnership or a trust estate. It is intended to ensure that to the extent that the test individual or an associate of the test individual is entitled to a share of net income of the personal services entity that is attributed personal services income, or attributable to such income, then it will not be assessable or exempt income of the partner or beneficiary entitled. Subsection 86-35(2) is unlikely to have any practical application. This is because as a result of section 86-30 (and the treatment of interposed entities explained below) an entitlement to net income of a partnership or trust estate will not include income that is attributed personal services income or income that is attributable to such income. Section 86-30 ensures that attributed personal services income is excluded from the personal services entity's assessable income and exempt income. Therefore attributed personal services income will not form part of the net income of the personal services entity and thus there can be no-one entitled to a share of that income.

35. Any amount distributed by a unit or fixed trust that represents personal services income attributed to the test individual under subsection 86-15(1) does not reduce the cost base of the trust interest under section 104-70. This is due to the operation of paragraph 104-71(1)(d).

Interposed entities

Head entity is a company

36. The following consequence arises if a company ('the head entity') derives income that is personal services income and the income is not derived in the course of conducting a personal services business. A distribution of or out of that income to a shareholder that is not an individual ('the interposed entity') will be excluded from the assessable and exempt income of the interposed entity, provided the shareholder is an associate of the test individual (subsection 86-35(1)).

37. In other words, subsection 86-35(1) ensures that a distribution will not be taxed again to the extent that the distribution is paid to an associate of the test individual and consists of income of the head entity that has been or will be attributed to the test individual under subsection 86-15(1).

38. In the case of a chain of interposed entities consisting of companies, provided that each interposed company is an associate of the test individual, each successive distribution of income representing the attributed amount will be excluded from the assessable and exempt income of the interposed entities under section 86-35.

39. In the case of a chain of interposed entities where the head entity is a company and an interposed entity is a trust estate or partnership (and also an associate of the test individual) and the interposed entity receives a distribution of, or attributable to, the attributed amount, subsection 86-35(1) will exclude the distribution from the assessable and exempt income of the partnership or trust estate. Thereafter each successive distribution of income by a partnership or trust estate representing the attributed amount to another partnership or trust estate will not be included in the assessable income of the recipient. This is regardless of whether the recipient is an associate (see paragraph 42). However, if a partner or beneficiary is a company, a distribution paid out of profits by that company representing the attributed amount to a non-associate of the test individual will not be excluded from assessable income or exempt income of the shareholder by reason of subsection 86-35(1).

40. In a case where a head entity that is a company makes a distribution to an interposed entity, which in turn makes a distribution, the question of the extent to which the distribution of the interposed entity is a payment of an amount that is attributable to the personal services income that was attributed income of the head entity is one of fact. In a practical sense it will be open for the interposed entity to make a distribution from a particular source provided its constitution or governing instrument so permits but, if it does not, any distribution it makes which is not out of a special account (e.g. an asset revaluation reserve or share capital) should be taken to consist proportionately of personal service income and other income.

41. The head entity may be a company that derives income that is personal services income in relation to the test individual from conducting a personal services business. If the entity makes a distribution out of that income to an interposed entity, the interposed entity will not be a personal services entity solely because of the dividend paid to it. This is because a dividend is not personal services income. Therefore subsection 86-15(1) will not apply. Note that Part IVA may apply where the head entity or the interposed entity pays a dividend to a shareholder other than the test individual: see paragraphs 101, 102 and 261 to 267 of TR 2001/8 Income Tax: what is a personal services business.

Head entity is a partnership or a trust estate

42. The following consequence applies if a personal services entity that is a partnership or trust estate ('the head entity') derives income that is personal services income and the income is not derived in the course of conducting a personal services business. A distribution of or out of that income to a partner or beneficiary that is an interposed entity will not be included in the assessable or exempt income of the interposed entity because under section 86-30 the amount is neither assessable nor exempt income, and thus not net income, of the head entity. Because it is not net income, each successive distribution of income representing an attributed amount in a chain of partnerships and trust estates will not be included in the assessable income of each successive partner or beneficiary. If the head entity distributes income that is, or represents, the attributed amount to an interposed entity that is a company, and that company in turn distributes to an interposed entity, the company is a head entity in relation to the second interposed entity and paragraphs 36 to 41 apply.

43. A personal services entity ('the head entity') may derive income that is personal services income in relation to the test individual from conducting a personal services business. If the entity distributes that income to an interposed entity then the interposed entity may be a personal services entity if the head entity is a partnership or a trust estate. This is because the distributed income may be personal services income (whether it actually is personal services income will depend on the facts of each case). However, by reason of subsection 86-15(3), subsection 86-15(1) will not apply. Note that Part IVA may apply where the head entity or the interposed entity being a partnership or trust makes a distribution to an entity other than the test individual: see paragraphs 101, 102 and 261 to 267 of TR 2001/8.

44. In the case of a chain of interposed entities, the foregoing paragraphs apply to each successive distribution of income representing the attributed amount.

Dealings between personal services entities

45. An entity ('the first entity') may derive income from a dealing or transaction with another entity ('the second entity') that is a personal services entity in relation to the test individual, other than by way of distribution of income from the second entity to the first entity. Whether the first entity is a personal services entity (in such a case) depends on whether the income is, in its hands, personal services income of the test individual. That is, it depends on whether the income of the first entity is mainly a reward for the personal efforts or skill of the test individual. For example, interest on a loan is not personal services income even if the loan moneys are used by the

second entity in gaining or producing personal services income. Nor would income from providing plant and equipment be personal services income.

46. If the income of the first entity was a payment that the second entity could not deduct by reason of subsection 85-20(1), the income will not be assessable or exempt income of the first entity by reason of subsection 85-20(3). Having regard to the enactment of subsection 85-20(3), the operation of subsection 86-35(1) is considered to be confined to the following:

- payments by personal services entities and associates that are distributions;
- payments made by personal services entities and associates that are not disallowed as deductions under subsection 85-20(1) but nevertheless are attributable to personal services income that has been included in the test individual's assessable income eg payments of salary or wages to the test individual made 14 days or more after the end of the PAYG period.

Date of effect

47. This Ruling first applies to the 2000-2001 income year and later income years. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanation

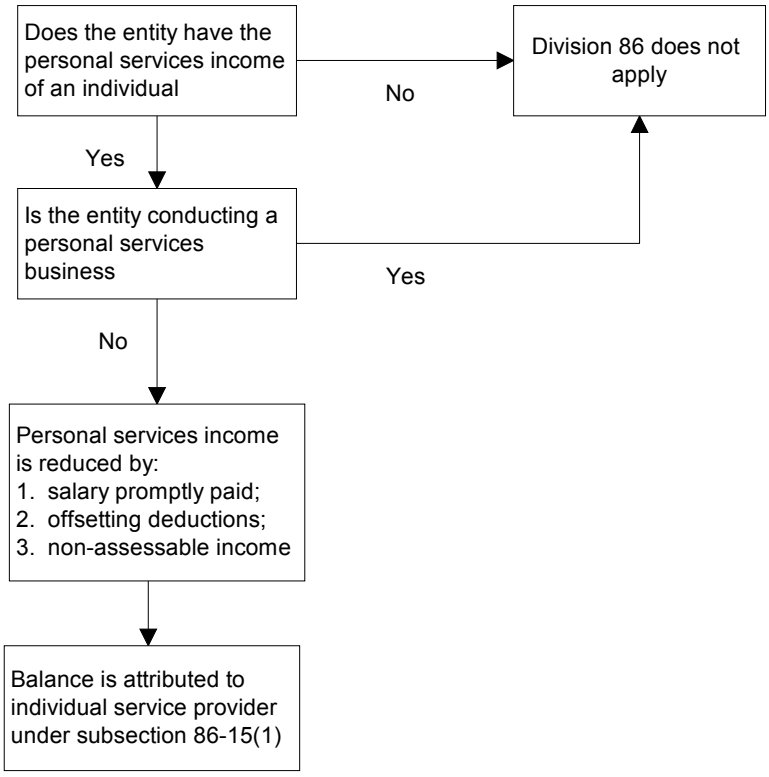
Attribution of income

48. Division 84 of Part 2-42 of the 1997 Act sets out the meaning of personal services income, and Division 86 contains the provisions that deal with the alienation of personal services income through the use of a personal services entity if that entity is not conducting a personal services business within the meaning of Division 87.[8]

[8] See TR 2001/8: what is a personal services business.

Attribution flowchart

49. The following flowchart outlines the process of attributing personal services income from the personal services entity to the individual.



Attribution of personal services income

50. Under subsection 86-15(1), an individual's assessable income includes that part of the ordinary or statutory income of a personal services entity that is the individual's personal services income.

51. There are three exclusions to the general attribution rule under section 86-15. These exclusions are where:

- The personal services income of the test individual is earned in the course of the personal services entity conducting a personal services business (subsection 86-15(3))[9].

[9] See TR 2000/8: what is a personal services business.

- The personal services income is promptly paid by the personal services entity to the test individual, as an employee, as salary or wages. Promptly in this context means that the salary or wages must be paid within 14 days after the end of the PAYG payment period in which that income became the ordinary or statutory income of the personal services entity (subsection 86-15(4)).
- The income is not assessable income of the personal services entity (subsection 86-15(5)).

52. For example if a personal services entity receives personal services income for a service, and GST is payable on the supply of that service, the GST component of the payment will not be included in the amount attributed to the test individual under subsection 86-15(1). This is because under section 17-5 of the ITAA 1997, the GST payable on a supply is neither assessable income nor exempt income of an entity.[10]

Reductions of the attributed amount

53. The amount to be attributed may also be reduced (but not below nil) by the amount of deductions to which the personal services entity is entitled that relate to the test individual's personal services income (subsection 86-20(1)).[11] In the case of a personal services entity that is a partnership, if the amount of the deductions exceeds the amount of the personal services income the partners may still be entitled to a deduction under subsection 92(2) of the ITAA 1936: see note 2 of section 86-20.

Apportionment of entity maintenance deductions

54. Where a personal services entity's ordinary or statutory income includes personal services income of more than one individual, section 86-25 requires any entity maintenance deductions of the entity to be apportioned between the individuals whose personal services income is included in the ordinary or statutory income of the personal services entity. The total of the entity maintenance

[10] Section 17-5 provides that an amount is not assessable income, and is not exempt income, to the extent that it includes an amount relating to GST payable on a taxable supply.

[11] The Government announced on 13 May 2003 that the law will be amended with effect from 1 July 2000, to allow a test individual a deduction in a year of income if the personal services entity has deductions that relate to the test individual's personal services income which exceed personal services income for that income year.

deductions is apportioned in proportion to the ratio of the amount of each individual's personal services income to the total amount of personal services income included in the entity's assessable income.

No double taxation

Personal services entity not taxed on the attributed amount

55. The amount attributed to the test individual under subsection 86-15(1) still remains income or profits of the personal services entity. In order to prevent double taxation of the personal services entity, section 86-30 provides that ordinary income or statutory income of a personal services entity is neither assessable income nor exempt income of the entity, to the extent that it is personal services income included in the income of an individual under subsection 86-15(1). Subsection 118-20(4) prevents this income being treated as a capital gain.

56. Because of the operation of section 86-20, only the net amount of personal services income of the entity is attributed to the individual under subsection 86-15(1). The net amount is also excluded from the assessable income of the personal services entity under section 86-30. The term 'to the extent that' in section 86-30 means that the assessable income of the personal service entity continues to include amounts of income that were sheltered from attribution under subsection 86-15(1) because there were allowable deductions taken into account under section 86-20. However, that assessable income will be offset, in calculating the personal services entity's taxable (or net) income, by the amount of the allowable deductions taken into account under section 86-20.

Distributions of, or out of, attributed amount not taxed again

57. A personal services entity that is a company may still have accounting profits, even if all of the personal services income has been attributed. The accounting profit could be distributed as a dividend. Consequently, the ordinary operation of the income tax law could result in a shareholder to whom the company's income is distributed being subjected to tax in respect of which the test individual has been or will be taxed.

58. In order to prevent double taxation of the test individual or his or her associates, subsection 86-35(1) operates to exclude attributed income from the assessable and exempt income of the test individual or his or her associates. It applies to both a distribution of the actual attributed income and to amounts that are attributable to such income; that is to say, amounts representing such income. This subsection will

usually apply to shareholders in respect of dividends paid by companies.

59. Subsection 86-35(1) applies to distributions from both the original personal services entity whose income was attributed ('the head entity'), and to distributions from interposed entities, provided the interposed entity is an associate of the test individual (usually also an associate of the head entity). Likewise it applies to distributions to persons other than the test individual, provided the person is an associate of the test individual.

60. Subsection 86-35(2) applies to partners and beneficiaries in respect of their share of the net income of a partnership or trust estate. The provision is intended to ensure that where a test individual or an associate of the test individual is entitled to a share of the net income of the personal services entity, to the extent that the share of the net income has been, or will be, attributed to the test individual under subsection 86-15(1), or is attributable to such income (that is to say represents that income), then that amount is neither assessable income nor exempt income of the entity receiving it nor of the entity entitled to receive it. The provision is unlikely to have any practical application. This is because section 86-30 ensures that attributed personal services is excluded from the ordinary or statutory income of the personal services entity. Accordingly attributed personal services income will not form part of the net income of a partnership or trust estate that is a personal services entity and there will be no net income to which subsection 86-35(2) could apply.

Determining whether a distribution of income is, or is attributable to, attributed personal services income

61. Where a personal services entity that is a company has both income that is personal services income of the test individual and income from other sources, and pays its shareholders a dividend, it will be necessary to determine whether, and to what extent, a distribution of income is, or is attributable to, attributed personal services income rather than the other income (or, in some cases, rather than capital). This is necessary so that the amount that is excluded from the assessable or exempt income of the recipient under section 86-35 can be calculated.

62. For personal service entities that are companies, the allocation of a distribution to attributed income and other income is done by having regard to the account debited with the distribution: the source of the actual money or property used to make the distribution is immaterial. Where a company appropriates profits by debiting an account of profits and distributing money in satisfaction of the dividend, the appropriation is binding between company and shareholder, and, subject to some exceptions, determinative of the

quality of the distribution for tax purposes in the hands of the taxpayer. The entitlement of the shareholder is to the sum of money that the company has decided to distribute. The shareholder is not entitled to the actual moneys or other assets of which profits consists, for these are the property of the company. The decision of the High Court in *Ardmona Fruit Products Co-Operative Company Ltd v. Federal Commissioner of Taxation* (1952) 86 CLR 530, a case on section 120 of the ITAA 1936, is to be distinguished. Section 120 gives a deduction where the assessable income of a year of income is distributed or applied in certain ways in that year of income. In that case the question of whether 'the assessable income' had been distributed among the shareholders was held to be a question of whether the actual moneys of which that income consisted had been distributed, rather than the account of profits debited. However, this decision turns on considerations unique to the statutory context of section 120.

63. As a practical matter, it is open for companies to determine the source of any distribution, whether of personal services income or other income. If no special provision is made for personal services income, and what is distributed is general profits (and not some special fund, such as the profits from revaluation of assets), then it would be appropriate to treat the amount distributed as consisting proportionately of both kinds of profits, personal services and other. For example, if half the profits of a company consists of attributed personal services income of a test individual and half consists of other income, half of a dividend paid to that individual, or his or her associates, will be excluded from the assessable and exempt income of that individual, or his or her associates, by subsection 86-35(1). When determining what proportion of a dividend is personal services income, the proportion would be determined by reference to profits comprising attributed personal services income for all years of income to profits comprising other income for all years of income.

64. As noted above, for personal services entities that are not companies it is 'for practical purposes' not necessary to make an allocation of distributions to attributed income and other income to avoid double taxation of partners and beneficiaries, or to apply subsection 86-35(2), since by reason of section 86-30 the net income of a partnership or trust estate will not include attributed income. Therefore, attributed income will not be included in the assessable income of a partner or beneficiary again by the operation of Divisions 5 or 6 of the ITAA 1936.

Interposed entities

65. Personal services income of an individual may be earned by an entity and subsequently passed through one or more other entities before being received by the individual actually performing the services for the service acquirer, or by his or her associate. In determining how the income should be treated as it passes from one entity to another, it is necessary to ascertain whether or not the income being passed to an entity still has the character of being mainly a reward for the personal efforts or skill of the test individual, that is, whether it is still personal services income.

66. It is important to distinguish between income that is personal services income, and income that merely represents, or is attributable to, such income; for the latter is not personal services income. An entity receiving a distribution will be a personal services entity by virtue of the distribution only if the distribution is itself personal services income. Subsection 86-15(1) will not apply to an entity unless it is a personal services entity. However section 86-35 will apply to income of an entity that is not a personal services entity (provided it is an associate of the test individual) even if its income has lost its character as personal services income, as long as it is still attributable to such income. Where it is no longer possible to attribute income to personal services income, section 86-35 will no longer apply. It is therefore necessary to characterise the income at every stage in the chain of entities to determine whether the entity has personal services income of the test individual, or income attributable to such income, included in its income.

67. Under subsection 86-35(1) a payment is not included in the ordinary or statutory income of either an individual or their associate to the extent that it is a payment of personal service income attributed to the individual under subsection 86-15(1). Consequently, any distribution through a chain of companies of an amount previously attributed under subsection 86-15(1) will not be attributed again as a result of being passed through the chain of companies, provided that each of the companies through which the amount is passed is an associate of the individual whose activities produced the personal services income (subsection 86-35(1)). The amount so passed on is not included in the ordinary or statutory income of each of the companies receiving it. A distribution from a partnership or a trust estate of an attributed amount or a distribution representing an attributed amount will not be included in the assessable income of the recipient because it is a non-assessable and exempt amount in the hands of the partnership or the trust estate and therefore not included in its net income.

Distributions to an interposed entity from a personal services entity conducting a personal services business

68. In some cases a personal services entity ('the head entity') will have personal services income that is derived from conducting a personal services business. Because it is conducting a personal services business, no amount will be attributed to the test individual under subsection 86-15(1): see subsection 86-15(3). The question arises, what happens when it distributes income to another entity ('the interposed entity'), if that entity is not conducting a personal services business? Section 86-35 will not apply to distributions of personal services income to the interposed entity because subsection 86-15(1) did not apply to the head entity: no personal services income will previously have been attributed.

Head entity is a company: distribution does not retain character as personal services income

69. If the head entity is a company, a dividend that it pays to the interposed entity will not be personal services income of the test individual therefore subsection 86-15(1) will not apply in respect of that distribution. The income of a company is not the income of a shareholder. When income is distributed by a company to a shareholder by way of dividend, a new item of income is created in the hands of the shareholder by the appropriation and detachment of profits; and it will have its own character in the hands of the shareholder. The dividend is a gain from property derived as a result of the right to dividends that is represented by the share. It is not a distribution of personal services income or a reward for the personal efforts or skill of the shareholder. Consequently, although a dividend paid out of profits consisting wholly or in part of personal services income may be income 'attributable' to personal services income for the purposes of section 86-35, it will not itself be personal services income in terms of subsection 84-5(1).

70. Under the alienation measure it was intended that the characterisation of personal services income be broader than it might otherwise be under the common law, ie an amount could be personal services income even though under the common law it would be otherwise characterised. However, the common law in this case provides the intended outcome. It ensures that the exemption from subsection 86-15(1) conferred on a company that is conducting a personal services business will not be reversed as soon as the company distributes personal services income to the interposed entity.

Head entity is a partnership or a trust estate: distribution may retain character as personal services income

71. If the head entity is a partnership, it is less clear whether the interest that each partner has in the assets and income of the partnership requires the conclusion that the entitlement of the partner to a share of the partnership profits containing personal services income is therefore an entitlement to personal services income. The entitlement that a partner has is to have an account of profits and to have their share paid to them after the partnership assets have been converted into money (by obtaining, if necessary, a winding up order). '(A partner's share) in the partnership consists of a right to a proportion of the surplus after the realisation of the partnership and the payment of the debts and liabilities of the partnership': see *Federal Commissioner of Taxation v. Everett* 80 ATC 4076 at 4079. This entitlement is an entitlement to be paid a sum of money regardless of the nature of the assets of the partnership which are to be converted into money. Also, the right to a surplus after assets are realised and debts paid is not the same as an entitlement to one of the elements from which the surplus is computed, i.e. personal services income.

72. In other words, the character of the rights of a partner may differ from the character of the rights of the partnership. Moreover, jurisprudentially the income of a partner derived under a contract of partnership is a gain flowing from property, that is, the partnership property: see *Everett*. Consequently, it is arguable that the character of the income of a partner is not determined by the character of the income of a partnership. If the partnership has substantial capital that has been provided by the partner, in at least these cases, depending on the facts, it would generally not be appropriate to characterise the income from the partnership as personal services income. However, in other cases one might conclude that the entitlement of a partner to partnership net profit is itself mainly a reward for the personal efforts or skill of the test individual, or would be if it were the test individual's income, and therefore personal services income.

73. If the head entity is a trust estate and the interposed entity is presently entitled to a share of the income of that trust estate consisting wholly or in part of personal services income, the statutory income of the interposed entity (usually arising under section 97 of the ITAA 1936) is personal services income. The entitlement of the beneficiary is to the very income of the trust that is personal services income: see *Baker v. Archer-Shee* [1927] AC 844 and *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598; 28 ALJ 117; 10 ATD 328. However, in the rare cases to which section 99B applies, the entitlement may only be to corpus attributable to the accumulation of such income and, in these cases, the statutory income

of the beneficiary would not generally constitute personal services income (although it would still be attributable to it).

Distributions of personal services income: no attribution when the head entity is conducting a personal services business

74. In cases where an entity has personal services income included in its ordinary or statutory income by reason of a distribution to it by the head entity, the interposed entity will be a personal services entity, and subsection 86-15(1) *prima facie* applies.

75. Subsection 86-15(3) provides, however, that subsection (1) does not apply if an amount of ordinary or statutory 'income that is personal services income of the test individual is income from the personal services entity conducting a personal services business'. The term 'from' governs 'personal services business', not 'personal services entity'. While the sub-section might, on a literal construction, be thought to apply only to the entity that is conducting the personal services business (because the section refers to 'the' entity), so to read the subsection would defeat its apparent intention, since the benefit of the exemption conferred would be reversed as soon as the entity made a distribution of personal services income to an interposed entity. Having regard to the scheme of Division 86, and the express indication in section 87-1 that the Division does not apply to personal services income that is income from conducting a personal services business, the Commissioner considers that subsection 86-15(3) covers 'income from a personal services business conducted by *a* personal services entity'.

76. Following this approach, if the head entity is a trust, and the trust is conducting a personal services business, a distribution of personal services income from the trust to a beneficiary will be, in the hands of the beneficiary, personal services income from an entity conducting a personal services business.

77. If the head entity is a partnership, and the partnership is conducting a business that is a personal services business, it will follow that the interposed entity is also conducting that personal services business. The business of a partnership is conducted by the partners as agents for each other and for the partnership. Therefore the personal services income of the partner is income from conducting a personal services business.

78. In summary, when a personal services entity that is conducting a personal services business distributes income to an interposed entity that is personal services income earned in the course of conducting that personal services business, subsection 86-15(1) will not apply to the interposed entity in relation to that personal service income.

Dealings between entities

79. Sometimes an entity ('the first entity') that is an associate of the test individual will derive income, being mainly a reward for the personal efforts or skill of the test individual, from a dealing or transaction with another entity ('the second entity'), also an associate of the test individual, that, for the second entity, is an allowable deduction from income of the second entity (because the payment is for principal work), which also happens to be personal services income of the same test individual. For example, a test individual may control two companies, one of which, the second entity, has contracted with a service acquirer to provide the services of the first entity, which in turn has contracted with the test individual to provide the services. In this case the gross income of the second entity is personal services income, as is the gross income of the first entity. Both entities will be personal service entities, and, unless they are conducting a personal services business, *prima facie* subsection 86-15(1) will apply to attribute the net personal services income of each. The net personal services income of the second entity, reduced by the deduction for the amount paid to the first entity, will be attributed to the test individual. In other words, the attributed income of the second entity will not include the amount paid to the first entity. (Note that if arm's length rates are used, then, unless the second entity is adding some commercial value to the first entity's services, the profit it retains for itself should be minimal.) Then the net personal services of the first entity, reduced by its own deductions, will be attributed. In these cases the income is not attributed income in the hands of the second entity, and therefore section 86-35 does not apply to the income of the first entity (though it may apply to the shareholders of the first entity). See example 5 for an illustration of how the alienation measure would apply to a case where there are dealings between two personal services entities.

80. Where the first entity derives income from a dealing or transaction with a personal services entity (that is, the second entity), otherwise than by way of distribution of income from the second entity, the circumstance that the second entity has personal services income that has been attributed to the test individual is irrelevant to the question of whether the income of the first entity is personal services income of the test individual. In these cases the second entity is to be treated as (potentially) the service acquirer in relation to the first entity, and the question is whether the first entity's income is mainly a reward for the personal efforts and skill of the test individual; whether the second entity in turn has its own dealings with another service acquirer is immaterial except insofar as it helps clarify what the income of the first entity is for.

81. It should be noted that if the first entity is providing, for example, capital equipment to the second entity, its income will not be personal services income (because it is a reward for the provision of equipment), and it will not be a personal services entity; therefore its income will not be attributed to the test individual. This will be true even if the second entity goes on to provide both equipment and personal services to a service acquirer, and its income, having regard to the relative importance of equipment and personal services, is personal services income of the second entity. Similarly, if the first entity lends money at interest to the second entity, and the second entity uses the money in gaining or producing personal services income, the interest income of the first entity will not be personal services income.

82. In many cases, income of the first entity derived from payments by the second entity will in any event be neither assessable nor exempt income of the first entity. This will be the case where the income is from a payment that is not deductible in the hands of the second entity by reason of section 85-20. That section denies a deduction for payments and amounts incurred in gaining or producing personal services income if the entities are associates of the test individual. (That is, unless the outgoing relates to engaging the first entity to perform work that is part of the principal work of the second entity: see TR 2002/D5.) An amount or payment that the second entity cannot deduct under that section is neither assessable nor exempt income of the first entity: subsection 85-20(3). Consequently, losses and outgoings incurred in gaining or producing income to which subsection 85-20(3) applies will not be deductible under section 8-1. For example, if the first entity has borrowed money at interest and on-lent it at interest to the second entity, which has in turn employed it in gaining or producing the personal services income of the test individual, the second entity cannot deduct the interest paid to the first entity, the interest so paid is not assessable income of the first entity, and therefore the interest which the first entity in turn pays to its lender is not an allowable deduction. Therefore it is inadvisable for interposed entities to borrow and on-lend to personal service entities.

83. A dividend to which section 86-35(1) applies is still a frankable dividend even though it is neither assessable income nor exempt income. However, if the distribution is not assessable, a rebate is not available to the taxpayer.

Examples

Example 1

84. Robyn is an environmental management expert who provides consulting services through her private company RedRobyn Pty Ltd. RedRobyn receives a payment of $33,000 for Robyn's personal services provided to a paper mill, which includes the GST payable on the services. The GST component of this payment is $3,000. Only the amount of $30,000, which is the amount of the payment less the GST component, will be attributed to Robyn under subsection 86-15(1) because subsection 86-15(5) excludes amounts that are neither assessable income nor exempt income of the entity from the attribution amount.

Example 2

85. Keith controls two private companies C Pty Ltd and PS Pty Ltd. There is a contract between PS Pty Ltd and Ultimate Acquirer which specifies that Keith will perform computer consultancy services for that company. The work is carried out on the premises of Ultimate Acquirer and Keith does not employ or engage anyone to assist him with his work. Ultimate Acquirer is the only client of PS Pty Ltd and the company does not have a personal services business determination.

86. As Keith is nominated in the contract to provide the services, the ordinary or statutory income derived by PS Pty Ltd as a result of the services performed by Keith is the personal services income of Keith. The income derived by the company can be characterised as a reward for Keith's personal effort and the application of his skill and knowledge in providing consulting services to Ultimate Acquirer.

87. As the income of PS Pty Ltd is personal services income of Keith, PS Pty Ltd must then determine whether the income is earned in the course of conducting a personal services business. In this scenario, the income is not taken to be from conducting a personal services business.

88. Accordingly, PS Pty Ltd will have to attribute the income (less any reductions pursuant to section 86-20) to Keith under subsection 86-15(1). If PS Pty Ltd pays any dividends to C Pty Ltd or to Keith out of the company's profit which has been attributed to Keith, it will not be assessable or exempt income in the hands of C Pty Ltd or Keith due to the application of subsection 86-35(1). Subsection 86-35(1) would apply because the dividends are paid to Keith and C Pty Ltd out of income that has been attributed to Keith. C Pty Ltd is an associate of Keith.

Example 3

89. The D&T partnership has two partners: Don and Tim. The partnership has been engaged by Efficient Workers to perform consulting services. Efficient Workers has agreed to pay the partnership $150,000 for the services provided in the income year ending 30 June 2004. Don performs all the work for Efficient Workers on behalf of the partnership. The partnership's ordinary and statutory income for the 2004 income year is $500,000 and the partnership's allowable deductions are $150,000.

90. The amount of $150,000 from Efficient Workers that is included in the partnership's ordinary or statutory income is Don's personal services income. It is a reward for the efforts and skills of Don. If the income is not earned in the course of conducting a personal services business, the income, reduced by any deductions allowable to D&T that relate to gaining or producing that income, will be attributed and included in Don's assessable income under subsection 86-15(1).

91. Assuming that the personal services income is not earned in the course of conducting a personal services business and there are $40,000 of allowable deductions that relate to gaining or producing that assessable income, $110,000 will be attributed to Don. Therefore, the partnership's assessable income will be $390,000 and the net income will be $240,000. Don and Tim will each be entitled to $120,000. Subsection 86-35(2) will not apply to either Don or Tim's entitlement given that the net income does not include the income attributed to the test individual.

Example 4

92. Assume the same facts as in Example 3 but Don and Tim are employed by a unit trust called D&T trust instead of a partnership. The trust conducts a business of providing consultancy services. Don's family trust and Tim's family trust each hold half of the units in the D&T trust. For the purposes of this example, assume Don's personal services income is earned in the course of conducting a personal services business. Subsection 86-15(1) will not apply and Don's personal services income will not be attributed to him.

93. At the end of the 2004 income year, Don's family trust is presently entitled to half of the net income of the D&T trust: $175,000 of which $110,000 is personal services income ($150,000 less personal services income deductions $40,000). Don's family trust has personal services income and is therefore a personal services entity. However, the income is from the conducting of a personal services business (for the purposes of section 86-15(3)). The personal services

income included in the net income of Don's family trust will not be attributed to Don under subsection 86-15(1) because of the operation of subsection 86-15(3). Note that Part IVA may apply where an entity makes a distribution to an entity other than the individual performing the services: see paragraphs 101, 102, 261 to 267 of TR 2001/8.

Example 5

94. Zany Computers Games has engaged PP Computer Services Pty Ltd to provide the services of PP2 Contractors Pty Ltd, which has in turn contracted with Peter to provide services in relation to developing new computer games. Neither PP Computer Services Pty Ltd nor PP2 Contractors Pty Ltd are conducting a personal services business.

95. In the relevant income year Zany Computer Games has agreed to pay $80,000 to PP Computer Services Pty Ltd for the services provided, while PP Computer Services Pty Ltd has agreed to pay PP2 Contractors Pty Ltd $70,000. In turn PP2 Contractors Pty Ltd has agreed to pay Peter a salary amounting to $50,000.

96. The amount of $80,000 paid to PP Computer Services Pty Ltd is the personal services income of Peter. Therefore the company is a personal services entity. Since PP Computer Services Pty Ltd is not conducting a personal services business, subsection 86-15(1) will apply. The amount attributed to Peter under subsection 86-15(1) will be $10,000. This is because subsection 86-20 provides that the gross amount of personal services income, i.e. $80,000, is reduced by $70,000 (a deduction to which the personal services entity is entitled for the performance of principal work that relates to gaining and producing personal services income).

97. The income of PP2 Contractors Pty Ltd, i.e. $70,000 is also Peter's personal services income. Given that the company is not conducting a personal services business, subsection 86-15(1) will apply and $20,000 will be attributed to Peter (assuming that the salary is paid to Peter promptly and subsection 86-15(4) applies). In the relevant income year, the total amount of $80,000 will be included in the assessable income of Peter.

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Related Rulings/Determinations:

TR 92/1; TR 92/20; TR 97/16; TR 2001/7; TR 2001/8; TR 2002/D5

Subject references:

- alienation of personal services income
- alienated personal services payment
- assessable income of personal services entity
- associate
- attributable income
- business premises
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- deduction entitlements of personal services entity
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- PSBD criteria
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- PSBD normal circumstances business premises test
- PSBD normal circumstances employment test
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- PSBD unusual circumstances business premises test
- PSBD unusual circumstances employment test
- PSBD unusual circumstances unrelated clients test
- service acquirer
- test individual
- tests for a personal services business

- unrelated clients test
- unusual circumstances

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- ITAA 1936 92(2)
- ITAA 1936 Div 6
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- ITAA 1997 118-20(4)
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- Public Service Act 1999
- New Business Tax System (Alienation of Personal Services Income) Act 2000

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- Federal Commissioner of Taxation v. Everett (1980) 143 CLR 440; 80 ATC 4076; (1980) 10 ATR 608
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