

TAX TALKS

Australia's Tax News Podcast - The Podcast for Australian Tax Professionals

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301 | PSI Rules

Do the PSI rules apply to you? The answer can cost or save you tax.

PSI Rules

The PSI rules are to prevent income splitting and additional tax deductions for personal services income.

In this episode Andrew Henshaw of [Velocity Legal](#) in Melbourne will discuss with you how and when the PSI rules apply and why. Andrew will also discuss the latest court cases around PSI as well as the new controversial PCG 2021/D2

Here is what we learned but please listen in as Andrew explains all this much better than we ever could.

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PSI Rules

The PSI rules are about income splitting and claiming tax deductions you wouldn't be able to claim as an employee.

One sentence summary:

"The PSI rules treat income derived for personal services performed by an individual as assessable income of that individual with tax deductions limited to those available to an employee."

PSE or PSB

PSE stands for personal services entity. A PSE is the entity deriving personal services income subject to the PSI rules. The entity can be an interposed entity like a company or trust. Or it can be yourself as a sole trader or a partnership.

PSB stands for personal services business. A PSB is an entity that derives personal services income but this income passed the PSI tests and hence the PSI rules don't apply. As for PSE, the entity can be a company or trust or yourself alone or in a partnership.

So a PSE falls under the PSI rules. A PSB doesn't. Hence the big question is when are you a PSE or PSB.

Relevance of PSI Rules

Not everybody has to worry about the PSI rules. They are only relevant if you earn personal services income and if you then want to do at least one of the following with that income:

- 1 – Park your income within a company, so you just take some of your income out through a wage or dividend, and then you leave the rest in the company or take it out as a Div 7A loan, taxed only at 25%.
- 2 – Distribute that income to others through a trust so that that income is taxed at lower tax rates
- 3 – Claim occupancy cost as a business expenses, so your rent or mortgage interest.
- 4 – Employ family members and other related parties who do no principal work.

When you want to do any of these four, then the PSI rules are highly relevant to you.

But if you don't – so you take all income out of the company as a wage or dividend, you don't use a trust, you don't claim occupancy cost and you don't employ family members – then the PSI rules don't really affect you.

Three Tests

The PSI rules can be confusing but let's try to simplify them with the following scenario.

Imagine you are in a prison and you try to get out. There are three locked doors and you need to get through one of them. Each door asks you a question. The 3rd door is particularly hard since it has two locks.

1st Door – Is less than 50% for your labour, skills or expertise?

2nd Door – Do you produce a result with your own tools and risk?

3rd Door – Lock 1: < 80% come from any one client? – Lock 2:

3rd Door – Lock 2: Employees, premises or unrelated clients?

Can you escape through one of these doors?

Door 1 – Less than 50% for your labour, skills or expertise?

The emphasis is on You. So not your employees' or contractors', but your own.

Yes – You have no PSI and the door opens.

No – You have PSI income and the door stays shut.

So you try the 2nd door.

Door 2 – Produce a result with your own tools at your risk?

This is also called the results test. If you don't need any tools, then you automatically meet the 'own tools' requirements per TR 2001/8. You only need to pass the results test for at least 75% of your work, so not 100%.

Yes – You run a PSB and the door opens.

No – You failed the results test and the door stays shut.

So you try the 3rd door.

Door 3 – Lock 1: Less than 80% come from one client?

Yes – You need the 2nd lock to open as well.

No – Try to get a PSB determination if you can open the 2nd lock.

You can apply to the ATO for a PSB determination if you think that you would pass the employment test or business premises test.

So you try the 2nd lock.

Door 3 – Lock 2: Employees, premises or unrelated clients?

This 2nd lock is a generous one. It gives you three chances.

Do you have employees, business premises OR unrelated clients?

An employee only counts if they do at least 20% of the principal work, so not just clerical or administrative work.

Business premises only count if they are separate from your private residence and you have exclusive use. So shared workspaces or home offices don't count.

Yes to any – The PSI rules don't apply. You run a PSB.

No – The PSI rules apply to you. You run a PSE.

So these are the PSI rules and you would think that finally things quietened down around PSI. But unfortunately they haven't.

Board of Taxation Review

In 2009 the Board of Taxation reviewed the PSI rules and found low levels of compliance. The PSI rules had been meant to reduce the Commissioner's reliance on Part IVA. But given that most tax payers declare to be PSBs, the Commissioner's reliance on Part IVA hasn't really changed.

In its review, the Board suggested a range of possible reform options:

- introduce a reporting obligation;
- extend the attribution rules to personal services businesses;
- clarify and simplify the deduction provisions;
- implement a test of "employee-like" manner to clarify who is affected by the rules; and/or
- introduce a deemed labour income approach.

Recent ATO Rulings

In response to this review, the ATO released TR 2021/D2 on 11 March 2021. TR 2021/D2 combines and modernises TR 2001/7 (meaning of PSI) and TR 2001/8 (what is a PSB).

Recent Cases

And then there also have been further court cases, which show that the PSI rules are far from being done and dusted.

Yalos

In the Yalos case a small number of companies engaged in offshore petroleum exploration and mining. The word of mouth offers to a 'section of the public' with very limited players was taken to be sufficient. The limited numbers of players were considered to be a section of public. The regular personal contact with companies to assess needs – opportunity to provide specialised services via word of mouth and personal recommendations – was held to be enough.

Cameron

Different to Yalos which operated in a highly specialised niche, in Cameron the taxpayer was a draftsman offering drafting services to a wide range of industries. However, Cameron only made personal offers to

individuals known to him, but not to the general public or a section of that. In other words, they were personal offers. The case is currently on appeal to the High Court.

Engineer Company

An engineering company in *Engineer Company v FCT [2008] AATA 934* obtained most of their work by responding to advertisements and making direct approaches to entities (i.e. cold calling). The court found that this did not satisfy the unrelated clients test.

The court suggested that to satisfy the unrelated clients test you need to advertise, for example through Google Adwords, SEO and website.

Dixon Consulting

In *Dixon Consulting Pty Ltd v FCT [2006] AATA 186* the taxpayer worked in an office above the garage. The cars in the garage were used for both private and business purposes. The court saw the absence of a bathroom and the shared driveway as not significant, but ruled against the taxpayer anyway and declared the consulting business to be a PSE.

On subsequent hearing *Re Dixon Consulting Pty Ltd v FCT [2007] AATA* the private use of the garage area was an issue. The court ruled that the business does not meet the premises test since the premises were on the main residence's land.

Fortunatow

In *Commissioner of Taxation v Fortunatow [2020] FCAFC 139 (17 August 2020)* Mr Fortunatow was a business analyst and a 100% shareholder, providing services to government departments, universities, banks and utilities. In 2012 and 2013 his company derived \$827k from eight different clients.

Five contracts were entered into through intermediary recruitment companies. The other three came from personal relationships. None of the engaged clients engaged Mr Fortunatow as a result of any advertising he did. So the court ruled that he failed the unrelated client test.

The Court said that the phrase "as a direct result" in s 87-20(1)(b) means that there must be

"a causal connection between the services provided and the offer or invitation to the public or a section of the public" and that the causal connection must be "direct".

This will "invariably involve an inquiry about what caused the client's decision to obtain the services". If the client's decision to obtain the services was "a direct result of the making of offers or invitations", then the unrelated clients test would be met.

If, however, an offer or invitation is only made to an intermediary and it plays no part in the client's decision to engage the relevant individual (or PSE), the offer or invitation does not directly result in the provision of the relevant services

Personal offers are not offers to the public in the meaning of ss 87-20(2). As a result, contracts through labour hire and similar do not qualify as offers to the public.

PCG 2021/D2

On 1 March 2021 the ATO issued PCG 2021/D2, which allows professional firms to assess their audit risk relating to PSI, using scoring tables and risk zones.

This new PCG is significantly different to its original version from 2014. The new PCG covers firms in accounting, architectural, engineering, financial services, legal and medical professions. It suggests a risk assessment based on scoring table and risk zones.

Two gateways in PCG 2021/D2

The PCG outlines a two step approach. Before you get to the scoring tables, you need to pass one of two gateways.

Gateway 1 – Commercially Driven

The arrangement between the interposed entity and the individual must be 'commercially driven'. It is crucial that the arrangement is appropriately documented.

Gateway 2 – No High-Risk Features

The arrangement must not contain 'high-risk features', for example multiple classes of shares or units held by non-equity holders.

If you get through one of these gateways, then you can use the scoring tables to assess your risk of an ATO audit of your PSI arrangements.

If you don't, then the PCG doesn't apply to you.

As a thumb rule, you are within the green zone if your overall tax rate is at least 35% or higher.

Joint Response to PCG 2021/D2

The Tax Institute, CPA, CAANZ, IPA and LCA submitted a joint response to PCG 2021/D2. And they criticised 4 points.

1 – No Legal Basis

There is no general principle stating that the income derived by a partnership, company or trust from the work of an individual can be regarded as the profit or income of that individual. To determine whether the PSI rules apply, it does not matter how involved such an individual may be in the activities from which the income is derived by the entity.

2 – Why this emphasis on specific professions?

It is unclear why the ATO compliance efforts would treat the income derived by an accounting or legal firm differently to a plumbing business or management consulting firm.

3 – Free to Pay

There is no general principle of taxation this PCG is based on. The owner of a business can decide whether to receive nothing, a little, a lot, or something in between and be taxed accordingly.

4 – No Consultation with Industry Bodies

The ATO did not consult with any of the five industry bodies, ie The Tax Institute, CPA, CAANZ, IPA and LCA.

Conclusion

So the PSI rules are not perfect and there are ongoing efforts to improve them. Just how to improve them, this is where minds differ.

MORE

[The History of PSI](#)

[Small Business Tax Concessions](#)

[Tax Deduct Your Home Loan](#)

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