

RESOLVING THE PERSONAL SERVICES INCOME DILEMMA IN AUSTRALIA: AN EVALUATION OF ALTERNATIVE ANTI-AVOIDANCE MEASURES

By Scott Pennicott*

Australian individuals have long used various means to split or alienate income from personal exertion among family members and thereby reduce their overall tax liability. Attempts to curb these practices initially involved litigation under the general anti-avoidance provision of Part IVA of the Income Tax Assessment Act 1936 (Cth), but with limited success and at substantial administrative cost and effort on the part of the Australian Taxation Office. In response, the specific anti-avoidance provisions of Part 2-42 of the Income Tax Assessment Act 1997 (Cth) were introduced from 1 July 2000. However, there are shortcomings in Part 2-42 that in practice still require the Commissioner of Taxation to resort to Part IVA in some instances. Further, Part 2-42 offers limited certainty to taxpayers making a self-assessment. This article examines the rationale behind the introduction of Part 2-42 and demonstrates its shortcomings in practice. A range of solutions is evaluated and a proposal made by which the personal services income dilemma can be resolved without having to undertake a major and radical overhaul of the Australian tax system.

* Scott Pennicott has undertaken this research as part of his postgraduate studies at the Australian School of Taxation, Faculty of Law, the University of New South Wales. The views expressed herein are the views of the author and not those of the Australian Taxation Office or any other party. The assistance of Dr Margaret McKerchar, Associate Professor of Taxation, the Australian School of Taxation, Faculty of Law, the University of New South Wales is gratefully acknowledged.

1. INTRODUCTION

Income splitting, where an individual splits their income from personal exertion among one or more family members, has been a method extensively used by individuals in Australia to reduce their tax liability. Its popularity is the product of having individuals as a ‘tax unit’ together with progressive tax rates.¹ Income splitting can be done by either using an entity (for example, a company) or by employing a family member and paying them a tax deductible salary (either via an entity or as an individual). In either event, the income is split between two or more people and advantage can be taken of lower marginal tax rates and the use of more than one tax-free threshold.² Remuneration can be at market rates, or inflated rates of payment may also be used to further reduce the overall level of tax payable.³

The practice of income splitting poses a threat to the government’s revenue⁴ and various attempts to curb it during the past 25 years have had mixed success. Initial attempts involved litigation under the general anti-avoidance provision of Part IVA of the *Income Tax Assessment Act 1936* (Cth) (‘the ITAA 1936’) and its predecessor, s 260. Following several cases, the Australian Taxation Office (‘the ATO’) issued four rulings in the mid-1980s in an effort to create greater certainty for taxpayers.⁵ However, applying

¹ R Vann, ‘Australia’s Policy on Entity Taxation’ (2001) 4 *Taxation in Australia (Red Series)* 3, 127.

² I Spry, *The Asprey Report and Income Splitting* (1975) 1; Commonwealth, *Reform of the Australian Tax System: Draft White Paper* (1985) 110 (‘the Draft White Paper’).

³ Draft White Paper, above n 2, 63. However, s 26-35 of the *Income Tax Assessment Act 1997* (Cth) counters this practice.

⁴ M Burton, ‘Start Making Sense: The Interaction of the PSI Rules and Pt IVA’ (2003) 15 *CCH Tax Week* 253, 259.

⁵ The rulings in question are *IT 2121*, *IT 2330*, *IT 2503* and *IT 2639*. These rulings resulted from the decisions in *Tupicoff v Federal Commissioner of Taxation* (1984)

RESOLVING THE PSI DILEMMA IN AUSTRALIA

Part IVA still had to be done on a case-by-case basis and proved to be a very labour intensive (and inefficient) exercise from the perspective of the ATO. The practice of income splitting continued unabated and worsened with the shift to using the services of contractors instead of employees. In response, new specific anti-avoidance rules were introduced from 1 July 2000. These rules are contained in Part 2-42 of the *Income Tax Assessment Act 1997* (Cth) ('the ITAA 1997') and are commonly referred to as the personal services income ('the PSI') regime. However, these provisions are not a complete code dealing with PSI, which means the Commissioner of Taxation ('the Commissioner') still has to resort to Part IVA in some instances.⁶

The purpose of this article is to evaluate the effectiveness of various alternatives in curbing the incidence of income splitting in Australia, and to propose possible solutions that do not require undertaking a major and radical overhaul of the Australian tax system. The balance of the article is presented in four sections. The

84 ATC 4851; *Federal Commissioner of Taxation v Gulland* (1985) 85 ATC 4352 ('Gulland'); *Watson v Federal Commissioner of Taxation* (1985) 85 ATC 4765; and *Pincus v Federal Commissioner of Taxation* (1985) 85 ATC 4765, which considered s 260 of the ITAA 1936. Part IVA cases include *Case W58* (1989) 89 ATC 524, where a computer salesman operating via a company and trust had pt IVA applied against his income splitting activities. It should be noted that he had been required to incorporate by his employer. In *Case X90* (1990) 90 ATC 6480 an arrangement involving a draftsman who formed a company and discretionary trust and contracted with his former employer for the provision of drafting services was successfully attacked under pt IVA. *Case Y13* (1991) 91 ATC 191 concerned an employee engineer who undertook part-time work via a discretionary trust which was used to split the engineer's income amongst family members. The arrangement was successfully struck down under pt IVA. Similarly, in *Case Y28* (1991) 91 ATC 296 an arrangement whereby a mechanical engineer sold his partnership business (with his wife) to a discretionary trust which was controlled by the former partners and was used to split income amongst family members was also struck down under pt IVA.

⁶ Burton, above n 4, 259.

first section presents the background to the introduction of Part 2-42. The second section examines the practical implications of applying Part 2-42 and Part IVA in practice, highlighting the problems that can be encountered. The third section evaluates various strategies for reform of the PSI regime, including practices from other jurisdictions, the use of service trusts and tax rate restructuring. The final section draws together the conclusions of the article and argues that, in the absence of a major and radical reform of the Australian tax system, the best solution possible would be to rewrite Part 2-42.

2. BACKGROUND

Historically, the Commissioner viewed income from personal exertion as being subject to personal income tax, notwithstanding any interposed entities through which the income was channelled.⁷ Under Part IVA (and its predecessor, s 260), the Commissioner was able to strike down income splitting and related arrangements where it could be shown that the main reason for the arrangement was to reduce tax. However, problems for the Commissioner arose where it could be shown that the main reason for switching from a sole trader position to a company (or trust with a corporate trustee) was to take advantage of limited liability.⁸

So called ‘Friday night, Monday morning’ arrangements, where an individual ceased employment and was re-engaged on a

⁷ F Buffini, ‘New Focus on an Old Issue’, *The Australian Financial Review* (Melbourne), 5 June 2003, 5. However, in *Federal Commissioner of Taxation v Everett* (1980) 10 ATR 608 (‘*Everett*’) the High Court allowed a partner to assign part of his interest in the partnership to his spouse and stated that a partner’s interest in the net income of a partnership derives from the partner’s interest in the partnership and not from the partner’s personal exertion. Consequently, the Commissioner accepts that assignments ‘on all fours’ with the *Everett* and *Gulland* decisions will not attract the application of s 260 or pt IVA.

⁸ M Newnham, ‘The Alienation of Personal Services Legislation Allows the Taxation Office to Have Your Cake and Eat It Too’, *The Australian Financial Review* (Melbourne), 26 November 2004, 6.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

consulting basis via an entity of which family members were 'employees', beneficiaries or shareholders (and the individual's income was split amongst them) were treated as void by the Commissioner, with several cases backing the Commissioner's view.⁹ However, many taxpayers continued to ignore the prohibition against income splitting.¹⁰

In 1999 the Review of Business Taxation¹¹ stated that in the previous 20 year period there had been a 320 percent increase in incorporated entities and a

significant and accelerating trend for employees to move out of a simple employment relationship to become unincorporated contractors or the owner-managers of interposed entities while not really changing the nature of the employer–employee relationship.¹²

This was described as 'the alienation of personal services income' and allowed individuals to split their income or access lower tax rates.¹³ Further, the use of an entity also provided opportunities for obtaining deductions which may not have been available to the individual as an employee, and for maximising tax deductible superannuation contributions made for the test individual's spouse.¹⁴ Additionally, there were identified non-taxation consequences such as individuals reducing their taxable income to the extent which allowed them to claim various government means-tested payments,

⁹ *Tupicoff v Federal Commissioner of Taxation* (1984) 84 ATC 4851; *Case W58* (1989) 89 ATC 524.

¹⁰ R Gottlieb, 'Income Splitting Headache', *The Weekend Australian* (Sydney), 15 March 2003, 8; Buffini, above n 7, 4.

¹¹ Review of Business Taxation Final Report, *A Tax System Redesigned: More Certain, Equitable and Durable* (1999) ('the Ralph Report').

¹² *Ibid* 48.

¹³ *Ibid*.

¹⁴ M Hine, 'Contractors in the New Environment' in Taxation Institute of Australia (ed), *14th National Convention Papers* (1999) 394, 398–9.

in addition to avoiding the Medicare levy surcharge, and child support obligations.¹⁵

The explanatory memorandum to Part 2-42 stated that the purpose of the alienation measures was as follows:

The rules are designed to improve the integrity of the tax system by addressing both the capacity of individuals and interposed entities providing the services of an individual to claim higher deductions than employees providing the same or similar services and the alienation of personal services income through an interposed entity.¹⁶

However, it should be noted that avoiding income tax is not always the main reason for individuals operating through entities. Quite often service acquirers have simply stipulated that the individual must contract through a company for 'industrial relations or economic reasons',¹⁷ for example, to avoid paying superannuation and workers compensation insurance. Other reasons for using an entity include distribution flexibility (for example, trusts), raising equity (for example, company share issues), succession planning, asset protection (for example, a beneficiary of a discretionary trust has no ownership interest which can be accessed by creditors) and limited liability (for example, for companies provided that unlimited guarantees are not required from the directors and the directors are not found to have engaged in insolvent trading).¹⁸

¹⁵ Explanatory Memorandum, New Business Tax System (Alienation of Personal Services Income) Bill 2000 (Cth) 6.

¹⁶ *Ibid* 3.

¹⁷ TAXability, *Alienation of Personal Services Income: An Essential Practice Guide* (2003) 1.

¹⁸ J Peterson, 'Formation of the trust' (Paper presented at a seminar for the Taxation Institute of Australia, 9 April 2002, 2-3); S Rodman, 'Choosing a Business Structure Post-Ralph: Choices and Matters for Consideration' (2001) 36 *Taxation in Australia* 4, 207-12; M Leibler, 'Trusts: Their Practical Usefulness' in Taxation Institute of Australia (ed), *Papers Presented at the Queensland State Convention* (1998) 359; J Middleton and G Johnson, 'My Client the Health Professional:

RESOLVING THE PSI DILEMMA IN AUSTRALIA

The Ralph Report proposed that income splitting could be curbed by taxing PSI ‘on the basis of economic substance rather than legal form’¹⁹ and estimated that the proposed measures would ‘raise up to \$530 million a year by 2004–05’ through the elimination of income splitting and denial of certain deductions²⁰ and that the PSI rules would raise \$2410 million over a four year period. Ralph’s proposal was to form the basis of Part 2-42 which was introduced effective from 1 July 2000. The proposed measures were intended to improve equity and efficiency in the Australian taxation system and protect the revenue.²¹

3. PART 2-42 AND PART IVA IN PRACTICE

Part 2-42 includes Divisions 84–87, with the meaning of personal services income contained in s 84-5 of the ITAA 1997. Under this section, only individuals can have personal services income and this is held to include the ordinary or statutory income of any other entity if the income is mainly a reward for the personal efforts or skill of the individual. Thus PSI includes income such as salary and wages,

Structuring Issues’ (Paper presented at a seminar at the UQ Business School for the Taxation Institute of Australia, 31 January 2005, 3–6).

¹⁹ Ralph Report, above n 11, 49.

²⁰ Ibid 722. There is some evidence in the information technology industry that pt 2-42 has reduced the use of companies to channel PSI through, with almost a third of one survey’s respondents stating they had abandoned using a company structure for their operations: P Yelland, ‘Former Free Agents Cry Foul’, *Sydney Morning Herald* (Sydney), 21 May 2002, 11. Taxation statistics for the 2000–01 year indicate that 6703 taxpayers had attributed PSI (income: \$131 million) and 37 550 taxpayers had net PSI (income: \$455 million). This total still only represented less than one percent of total income: Australian Taxation Office, *Taxation Statistics 2000–01* (2003) 17–18. The latest taxation statistics (for the 2002–03 income tax year) indicate that 6885 taxpayers had attributed PSI (income: \$147 million) and 58 910 taxpayers had net PSI (income: \$868 million): Australian Taxation Office, *Taxation Statistics 2002–03* (2005) 14.

²¹ Explanatory Memorandum, New Business Tax System (Alienation of Personal Services Income) Bill 2000 (Cth) 5-6.

income derived from contracts for a person's labour, professional sportspersons' and entertainers' income and professional persons' income (for example doctors, lawyers and accountants). It does not include income in relation to sale of goods, rights to use property, income from business structures, nor income derived from assets.²² Income *mainly* for the efforts and skills of an individual means that more than 50 percent of the income must have been a reward for the individual's efforts and skills.²³

Division 85 limits the entitlements of individuals to deductions relating to their PSI. Section 86-10 states that the intention of Division 86 is to prevent individuals from deferring their income tax liability in a year (for example, by retaining it in a company and paying a dividend or salary in a later year) or from reducing their income tax liability (for example by paying some of the income as a trust distribution or salary to a relative or some other person who did not generate the PSI).²⁴

²² R Woellner et al, *Australian Taxation Law 2005* (15th ed, 2005) 1562–3; P Rocher, 'Income Alienation' (Paper presented at a seminar for the Victorian Division of the Taxation Institute of Australia, 11 September 2003, 5); R Scales, 'Don't Get Trapped in the Labour Maze: Personal Services Income' (Paper presented at a seminar at the City West Function Centre West Perth for the Taxation Institute of Australia, 2 December 2004, 4).

²³ R Deutsch et al, *Australian Tax Handbook 2004* (2004) 94; *Taxation Ruling TR 2001/7* [25]. For example a plumber invoices two clients for two separate jobs. In the first job materials comprised 60 percent of the income for that job (with the remaining 40 percent being a reward for the plumber's labour). In the second job materials comprised 40 percent of the income received (with the plumber's labour comprising the remaining 60 percent of income received). The income received for the first job would not be PSI, whereas the income received for the second job would comprise PSI. See paras 27, 49, 52–56 and example 2 in paras 77–78 of *Taxation Ruling TR 2001/7*.

²⁴ Deutsch et al, above n 23, 96; Scales, above n 22, 7.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

PSI is subject to the provisions of Divisions 84–86 unless the individual (sole trader) or personal services entity²⁵ ('PSE') passes one of the four personal services business ('PSB') tests. Section 86-15(2) defines a PSE as being a 'company, partnership or trust whose ordinary or statutory income includes the personal services income of one or more individuals'.²⁶ Passing one of the PSB tests in relation to an individual's PSI means that PSI is not subject to the provisions of Part 2-42. Where PSI is subject to Part 2-42, it will be attributed to the test individual and taxed at the individual's marginal tax rate (and not at the entity's tax rate). Certain deductions against that income will be denied.

Where a PSE has more than one test individual (who is the person who generates the relevant PSI which is included in the PSE's income)²⁷ a PSB test must be specifically passed in relation to that test individual's PSI for the provisions of Part 2-42 not to apply to that PSI (see, eg, s 87-15 of the ITAA 1997).

3.1 Problems with Part 2-42: An Example

The practical application of these tests, and the difficulties that can arise, can be demonstrated by reference to the following typical scenario. Assume a computer programmer operates through a company. He performs all the principal work, namely computer programming, and his wife does the clerical work. The programmer's company has contracts with two major banks to perform computer programming work. One bank provides 65 percent of the company's income and the other bank provides the balance. Both contracts were obtained through a labour hire firm. The company invoices the banks each week based on the number of

²⁵ Sole traders are affected by the provisions in their own right and are subject to divs 85 and 87 of the ITAA 1997. This article mainly focuses on PSEs.

²⁶ Scales, above n 22, 7.

²⁷ *Taxation Ruling TR 2001/8* [19].

hours worked by the computer programmer. Under the contracts the company is paid a fixed sum per hour worked by the computer programmer. No equipment is required to be provided by the company and any defective work is rectified at the bank's expense. Each bank provides an office on its premises for the computer programmer to use. Some programming work is performed in a home office at the computer programmer's place of residence. The contract is for 12 months but can be 'rolled over' for a further term if the parties agree. The company is paid for any time spent rectifying problems with the programs.

The programmer is deriving PSI as he is providing his personal efforts and skills to derive the income, therefore the definition of PSI in s 84-5 is met.²⁸ An exception would be where the programmer produces an 'off the shelf' product and sells it to the public (or sells someone else's product): income derived from that product would not constitute PSI but the sale of an asset.²⁹ A clear distinction is made between intangible property created (or sold) by the programmer and programs developed for another entity where the service acquirer holds the rights to the program.³⁰

Does the company pass any of the PSB tests? There are four PSB tests, namely:

- the results test;
- the unrelated clients test;
- the employment test; and

²⁸ A Athanasiou, 'Personal Services Income: The Hidden Traps' (Paper presented at a seminar for the Taxation Institute of Australia Tasmanian Division, 20 August 2001, 78).

²⁹ As per *Taxation Ruling TR 2001/7* [110]–[113].

³⁰ Athanasiou, 'The Hidden Traps', above n 28, 79.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

- the business premises test.³¹

A taxpayer can only self-assess in relation to the unrelated clients test, the employment test and the business premises test if they receive less than 80 percent of their PSI from one source.³² Otherwise they must obtain a PSB determination from the Commissioner for Part 2-42 not to apply. The tests must be satisfied during the entire income tax year.³³

3.2 The Results Test

At least 75 percent of an individual's PSI (not including payments received in the capacity of an employee or office holder) must have been obtained under the conditions prescribed in paras (a) to (c) of s 87-18(3) of the ITAA 1997, namely:

- the PSI is for producing a result;
- the PSE is required to supply plant and equipment or tools required (if any) to perform the work; and
- the PSE would be liable for the cost of rectifying any defects in the work.³⁴

The results test is the only test where taxpayers can self-assess in cases where they receive more than 80 percent of a test individual's PSI from one source.³⁵ This in itself creates more risk especially given the fact that the results test is the least understood test.

³¹ TAXability, *Personal Services Income*, above n 17, 37; Rocher, above n 22, 5–6.

³² P McDonald, 'Independent Contractors and the New PSI Rules', *Taxpayers Australia* (24 September 2001) 105, 107.

³³ *Ibid.*

³⁴ TAXability, *Personal Services Income*, above n 17, 38–9; A Athanasiou, 'PSI: Looking Forward, Looking Back' (2002) 37 *Taxation in Australia* 2, 79–80; Rocher, above n 22, 5; G Mann, 'Indirect Taxes' (2001) 30 *Australian Tax Review* 219, 220.

³⁵ Mann, above n 34, 220.

In order to pass para (a), payments must actually be made upon achieving a result and must not be based on, for example, hours worked. The explanatory memorandum gives an example where a management consultant's contract requires the consultant to produce a report. If the consultant is paid according to hours worked, and not a fixed price on completion of the report, then this condition is failed.³⁶

In terms of the results test, the company does not pass the first requirement under s 87-18(1)(a) of the ITAA 1997 as the income is not paid upon achieving a result. The company receives the income on a weekly basis based upon the hours worked by the computer programmer. As per para 114 of *Taxation Ruling TR 2001/8* the payment must be upon achievement of a result and not merely for the performance of work (even if that work produces results). Paragraph 115 of *Taxation Ruling TR 2001/8* states that 'the consideration often is a fixed sum on completion of the particular job as opposed to an amount paid by reference to hours worked'. This was confirmed in *Dibarr Pty Ltd v Federal Commissioner of Taxation*³⁷ where the applicant was paid monthly in arrears based on services provided during the month (that is, payments were for hours worked). In addition, the taxpayer was reimbursed for expenses incurred, moved 'seamlessly from one project to another' and had an 'enduring and ongoing' arrangement with the service acquirer. The Administrative Appeals Tribunal ('the AAT') held that the contract was not for producing a result. A similar finding occurred in *Scimitar Systems Pty Ltd v Deputy Federal Commissioner of Taxation*³⁸ where contracts involved ongoing work and not payments for results. That

³⁶ Explanatory Memorandum, New Business Tax System (Alienation of Personal Services Income) Bill 2000 (Cth) 32.

³⁷ (2004) 57 ATR 1183.

³⁸ (2004) 56 ATR 1162.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

case also noted that results-based payments were not customary in the information technology industry.

If, however, the contracts were set out such that there were specific milestones and set sums were paid to the company upon achievement of specific milestones (and only then), then the first criterion of the results test would be met.³⁹ In addition, in situations where a contract is not fully completed, and the service provider is required to repay any money paid to date under the contract, then the payment can be said to have been for a result. Obviously, there would not be too many contracts that specify the latter as such a requirement would be too onerous and risky for the party performing the work. The contract does not require the company to provide equipment necessary to do the work therefore this part of the results test is satisfied.⁴⁰ The third part of the results test would not be passed as the company (and the test individual) are not liable for rectification of defects; payment is made for the hours spent doing so.

3.3 The Unrelated Clients Test

During the year in question the company must have derived PSI from 'providing services to two or more entities that are not associates of each other, and are not associates of the individual or the personal services entity'⁴¹ and the services must have been provided 'as a direct result of the ... personal services entity making offers or invitations ... to the public at large or to a section of the public'.⁴² This can include advertising or 'any form of solicitation to

³⁹ Athanasiou, 'The Hidden Traps', above n 28, 80.

⁴⁰ *Ibid.*

⁴¹ TAXability, *Personal Services Income*, above n 17, 43; A Smyth, 'Alienation of Personal Services Income' (2001) 35 *Taxation in Australia* 8, 443.

⁴² ITAA 1997 s 87-20(1). See also TAXability, *Personal Services Income*, above n 17, 43; Smyth, above n 41, 443.

the public or a section of the public'⁴³ but excludes clients obtained through labour hire firms, employment agencies and the like.⁴⁴

Does the company pass the unrelated clients test? If the services had been provided as a direct result of the company making offers or invitations to the public at large or to a section of the public (that is, the banks) via advertising or any form of solicitation and the contracts with the banks had not been obtained through a labour hire firm or an employment agency the test would have been passed. However, as the contracts were obtained via a labour hire firm, s 87-20(1)(b) precludes these clients from being counted for the purposes of the unrelated clients test. In addition, if a labour hire firm had not been used, but one of the banks was a subsidiary of the other, then the test would not be passed as the requirement of s 87-20(1)(a) of the ITAA 1997 that the clients not be related to each other would be violated.

3.4 The Employment Test

To meet this test, during the year the company must have engaged one or more entities to do work that constitutes at least 20 percent by market value of the company's principal work for that year.⁴⁵ This does not include the work performed by the test individual or non-individual associates of the company.⁴⁶ Principal work is defined as being that work which is required to be performed under the contract to generate the entity's (or individual's) income.⁴⁷

⁴³ *Taxation Ruling TR 2001/8* [50]–[51]; Smyth, above n 41, 443.

⁴⁴ ITAA 1997 s 87-20(2). See also TAXability, *Personal Services Income*, above n 17, 43; Smyth, above n 41, 443.

⁴⁵ ITAA 1997 s 87-25(2).

⁴⁶ TAXability, *Personal Services Income*, above n 17, 47; Smyth, above n 41, 443; Scales, above n 22, 9.

⁴⁷ Smyth, above n 41, 443; Scales, above n 22, 9.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

The test can also be met by the company having one or more apprentices for at least half the year.⁴⁸

Following the 2001 amendments, work performed by a partner in a partnership which assists in deriving PSI of another partner can be considered work performed by another entity engaged by the partnership.⁴⁹

As per s 87-25(2)(a)(i), any individual whose PSI is included in the PSE's ordinary or statutory income cannot be counted for the purposes of the employment test.

Does the company pass the employment test? The only employee of the company (other than the computer programmer) is the computer programmer's wife. She does not perform any principal work (computer programming) therefore the test under s 87-25(2) is not met.

3.5 The Business Premises Test

Section 87-30 states that a PSE will meet the requirements of the business premises test if at all times in the relevant year it maintains and uses business premises:

- at which the PSE mainly conducts activities which produce PSI;
- of which the PSE has exclusive use;
- which are physically separate from the test individual's (or their associate's) private residence; and

⁴⁸ ITAA 1997 s 87-25(3). See also TAXability, *Personal Services Income*, above n 17, 47; Smyth, above n 41, 443.

⁴⁹ Mann, above n 34, 220.

- which are physically separate from any service acquirer's premises.⁵⁰

The business premises need only be maintained for the times when the PSE is conducting business, for example if the business operates four days a week, the business premises need to be maintained for four days per week.⁵¹

Problems arise when the 'business premises' are on the same block of land as the test individual's residence and there is no physical separation of the two.⁵²

Another problem with the business premises test is the situation where there are joint lessees of the premises (neither is considered to have exclusive use) and situations where business premises are part of a larger building: there is the potential for the 'physically separate' criterion to be failed although various factors need to be considered, for example the extent to which the premises are 'incorporated functionally into the surrounding premises, including the extent to which facilities and staff are shared with occupants of adjoining or surrounding premises'.⁵³

Does the company pass the business premises test? This test cannot be met mainly because the requirements of s 87-30(c) and (d) have not been met. The offices provided by the banks are not physically separate from their premises and the home office is not physically separate from the computer programmer's residence.

⁵⁰ TAXability, *Personal Services Income*, above n 17, 48; Smyth, above n 41, 443; Scales, above n 22, 10.

⁵¹ Scales, above n 22, 10. See *Taxation Ruling TR 2001/8* [75].

⁵² Scales, above n 22, 10.

⁵³ TAXability, *Personal Services Income*, above n 17, 50. See *Taxation Ruling TR 2001/8* [80]–[83].

RESOLVING THE PSI DILEMMA IN AUSTRALIA

3.6 The '80 Percent Rule' and the Commissioner's Determinations

Except for the results test, a PSE cannot self-assess under the other three PSB tests where the PSE receives 80 percent or more of an individual's PSI from one source. In such cases, a PSB determination from the Commissioner must be held if Part 2-42 is not to apply.⁵⁴ If made, the determination allows the PSE to be 'treated as carrying on a personal services business'.⁵⁵

Section 87-65 states that the Commissioner must make a determination that a company (or other entity) is conducting a PSB (and therefore immune from the provisions of Part 2-42) if satisfied that:

The entity 'could reasonably be expected to meet one or more of'⁵⁶ the:

- results test;
- employment test;
- business premises test; or
- but for unusual circumstances, there is reasonable expectation that the company could be expected to meet one of the above tests or the unrelated clients test.⁵⁷

Unusual circumstances in relation to the unrelated clients test include circumstances in which the company does not provide services to sufficient numbers of clients (to meet that test):

- in the year of commencement of business and there is reasonable expectation the test will be met in later years; and

⁵⁴ ITAA 1997 s 87-15(3). See also TAXability, *Personal Services Income*, above n 17, 51.

⁵⁵ TAXability, *Personal Services Income*, above n 17, 54.

⁵⁶ J Dabner, 'PSI Rules Before the Tribunal' (2003) 11 *CCH Tax Week* 173, 174.

⁵⁷ *Ibid.*

- services are only provided to one client in the relative year but the test was met in prior years and there is reasonable expectation it will be met in later years.⁵⁸

Where the unrelated clients test is met, but 80 percent or more of the PSI came from one source because of unusual circumstances, the Commissioner may issue a PSB determination.⁵⁹ The Commissioner may also issue a PSB determination where the individual or PSE would have met the unrelated clients test but for unusual circumstances and 80 percent or more of the individual's or PSE's income came from one source due to unusual circumstances.⁶⁰ Previously the Commissioner could not issue PSB determinations in such cases.

For individuals the Commissioner must be satisfied (under s 87-60(3)(a)(i)) that the individual met or could reasonably be expected to meet the results test, employment test or the business premises test. Alternatively, the Commissioner must be satisfied (under s 87-60(3)(a)(ii)) that but for unusual circumstances, the individual in the year in question could have reasonably been expected to have passed one of the four PSB tests.⁶¹

As none of the four tests have been satisfied, the company can apply for a PSB determination from the Commissioner under s 87-65. However, given the facts, it is unlikely that such a determination will be issued unless it could be shown that unusual circumstances prevented the company from meeting one of the PSB tests as per s 87-65(3A)(a).

⁵⁸ ITAA 1997 s 87-65(4). See also *ibid*.

⁵⁹ ITAA 1997 s 87-65(5).

⁶⁰ ITAA 1997 s 87-65(6).

⁶¹ Scales, above n 22, 10.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

3.7 Complexity of Part 2-42

As illustrated in the above example, the PSB tests in Part 2-42 are complex, and the potential for Part IVA to apply (see next section) adds further complication. A good example of the complexity encountered in applying Part 2-42 can be seen in the *Metaskills Case*, which has been litigated through the appeals hierarchy in order to resolve Part 2-42 issues. The original case (decided on 22 November 2002) set aside the Commissioner's objection decision that the test individual and not the company had contracted with the service acquirer, which meant that the company could not pass any PSB tests in relation to the test individual's PSI and was also not entitled to a PSB determination.⁶² The AAT agreed that the company could not meet the results test and unrelated clients test because the company was not a contracting party. Curiously, the AAT did find that unusual circumstances prevented the taxpayer from meeting the business premises test. The Commissioner then appealed to the Federal Court, which found that it was not possible for unusual circumstances to apply to the company as it was not a PSE under s 86-15 (and therefore s 87-65 could not apply) and remitted the matter to the AAT.⁶³ The AAT then found that the test individual was the contracting party, therefore it was unnecessary to determine whether the Commissioner should have issued a PSB determination.⁶⁴ The AAT did, however, consider the PSB tests and found that the company would not have met a test in any event.

⁶² *Metaskills Pty Ltd v Federal Commissioner of Taxation* (2002) 51 ATR 1165.

⁶³ *Federal Commissioner of Taxation v Metaskills Pty Ltd* (2003) 130 FCR 248.

⁶⁴ *Metaskills Pty Ltd v Federal Commissioner of Taxation* (2005) 60 ATR 1055.

3.8 Application of Part IVA: Computer Programmer Example

However, even if a PSB test is passed (or a determination obtained from the Commissioner) resulting in Part 2-42 not applying to the computer programmer and his company, he still cannot split his income as Part IVA could be applied by the Commissioner.⁶⁵ That is, the individual will have gone through a long and complex assessment process which is unlikely to provide relief. Further, where the individual self-assesses as to having passed a PSB test, there is the risk of non-compliance. To address this risk, it is likely that many PSEs will apply for a PSB determination which complicates matters both for the taxpayer and for the Commissioner.⁶⁶ The Commissioner has noted that Part 2-42 'was intended to provide a specific legislative code to address the more straightforward cases'.⁶⁷ A major problem with Part 2-42, which was not initially well explained to the public, is that even where a company is conducting a PSB (or holds a PSB determination), income splitting and retention of PSI in a company are still not acceptable methods of treating an individual's PSI. Such treatment can be subject to attack by the Commissioner under the general anti-avoidance provision of Part IVA of the ITAA 1936. Part 2-42 even refers to this possibility itself by way of a note to s 86-10.⁶⁸ Other than reference to Part IVA, Part 2-42 does not mention tax avoidance, a fact of which many taxpayers are unaware.⁶⁹ However, the explanatory memorandum itself mentions Part IVA having the

⁶⁵ Athanasiou, 'The Hidden Traps', above n 28, 79; Newnham, above n 8, 3.

⁶⁶ M Fenton-Jones, 'Small Business: PSI Leniency Extended', *The Australian Financial Review* (Melbourne), 17 June 2003, 32.

⁶⁷ 'Tensions in Tax Administration' (2003) 11 *CCH Tax Week* 176, 176.

⁶⁸ H Rigney, 'Contractors' Tax Day of Reckoning Looms' (2002) 116 *Journal of Banking and Finance Services* 3, 56; Rocher, above n 22, 6.

⁶⁹ 'The PSI Trap', *InTax* (March 2001) 1, 20.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

potential to apply where Part 2-42 does not apply.⁷⁰ An example where Part IVA applies can be seen where a doctor has many patients and would meet the unrelated clients test and not be subject to Part 2-42 (many doctors would pass the business premises test also), however this does not mean the doctor could then split his or her income or retain profits in the company as Part IVA and previous rulings still apply, unless it can be shown that the income is derived through a business structure.⁷¹

Having to resort to Part IVA in such cases is inefficient for the Commissioner and labour intensive.⁷² It carries the risk that if the sole or dominant purpose is found to not be the obtaining of a tax benefit, the Commissioner will fail.⁷³

According to the explanatory memorandum that accompanied the introduction of Part IVA, the Part was intended to counter tax avoidance arrangements that are 'blatant, artificial or contrived'.⁷⁴ It was not intended to cover 'arrangements of a normal business or

⁷⁰ D Boccabella, 'PSI Rules and Pt IVA: Unlikely to Be an Exclusive Code' (2001) 38 *Weekly Tax Bulletin* 1235, 1235; TAXability, *Personal Services Income*, above n 17, 1–2.

⁷¹ L Hughson and A O'Bryan, 'PSI, Part IVA and *Mochkin's* Case: Paper, Rocks or Scissors?' (2003) 37 *Taxation in Australia* 11, 614; 'PSI Trap', above n 69, 1, 20; Middleton and Johnson, above n 18, 13–14; Athanasiou, 'The Hidden Traps', above n 28, 18. The rulings in question are *IT 2121*, *IT 2330*, *IT 2503* and *IT 2639*: 'PSI Hard Yards', *InTax* (June 2001) 1, 23. *Taxation Ruling IT2639* cites four major factors which determine whether income is PSI or derived from a business structure, namely the nature of the activities, the skill and judgement required, whether there are substantial income producing assets used, and the number of employees.

⁷² Explanatory Memorandum, New Business Tax System (Alienation of Personal Services Income) Bill 2000 (Cth) 64.

⁷³ A Carey, 'Personal Services Income Arrangement Falls Foul of Part IVA' (2001) 36 *Taxation in Australia* 2, 65. However, the decision in *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216 would appear to have strengthened the Commissioner's position.

⁷⁴ Explanatory Memorandum, Income Tax Laws Amendment Bill (No 2) 1981 (Cth) 2.

family kind'.⁷⁵ The Commissioner has recently confirmed this view, for example where a husband and wife operate a partnership where the husband produces the majority of the partnership's income. Where both partners are fully liable for the partnership's debts (as is usually the case) the Commissioner has stated that such an arrangement would not attract the application of Part IVA. This is because sharing profits and losses is a normal consequence of forming a partnership under the *Partnership Acts* and, having regard to the eight matters in Part IVA, it 'would not objectively be concluded that the dominant purpose of the partnership agreement was to obtain a tax benefit through the equal division of profits and losses'.⁷⁶ However, the Commissioner has stated that 'every case turns on its own facts' and Part IVA could apply in the following cases:

- where regulations or laws prohibit the use of a partnership;
- the contract with the partnership is in fact a 'disguised employment relationship'; or
- partnership losses are allocated in a different manner compared to profits 'having regard to the partners' respective tax positions'.⁷⁷

Kendall states that the application of specific anti-avoidance provisions (such as Part 2-42) is 'premised upon the arrangement being effective other than for the operation of that provision'.⁷⁸

⁷⁵ *Ibid.*

⁷⁶ Australian Taxation Office, *Part IVA: The General Anti-Avoidance Rule for Income Tax — Basic Principles about How and When It Applies* (2005) 4.

⁷⁷ Australian Taxation Office, *Refocus of the Income-Splitting Test Case Program* (2005) <<http://ato.gov.au/print.asp?doc=/content/67313.htm>> at 21 June 2006.

⁷⁸ K Kendall, 'The Structural Approach to Tax Avoidance in Australia' (2006) 9 *Taxation in Australia (Red Series)* 5, 296. Kendall goes on to state (see, eg, at 294) that where a specific anti-avoidance provision applies, pt IVA does not apply.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

Given the above, it would therefore appear that, in the absence of the application of any other measures (for example s 26-35 of the ITAA 1997) or any other unusual activity, some taxpayers who operate PSBs may be able to split income whilst others may be subject to Part IVA. *Federal Commissioner of Taxation v Cooke*⁷⁹ confirms that Part IVA still applies in situations where specific anti-avoidance provisions do not.⁸⁰

For example, the Commissioner has stated that Part IVA may still apply to profit retention in companies where its purpose is to defer or avoid tax.⁸¹ In addition to profit retention cases, the Commissioner considers the following cases to be potentially subject to Part IVA litigation:

- disguised employment cases, especially where a company or trust has tax losses;
- trusts being used to split PSI amongst beneficiaries who do not contribute to the derivation of income; or
- using more than one entity to split income when one entity would have been commercially acceptable.⁸²

As stated by Deutsch, there is no guarantee that Part IVA does not apply to any decision to use entities (that is, partnerships, trusts, service trusts or companies) to split PSI with family members as each case depends on the facts.⁸³ For example, it was held by the Full Federal Court in *Federal Commissioner of Taxation v Mochkin*⁸⁴ that

⁷⁹ (2004) 2004 ATC 4268.

⁸⁰ Kendall, above n 78, 296.

⁸¹ Australian Taxation Office, *Income-Splitting Test Case Program*, above n 77.

⁸² *Ibid.*

⁸³ R Deutsch, 'Today's Part IVA: A Report Card' (Paper presented at Crowne Plaza for the New South Wales Division of the Taxation Institute of Australia, 6 November 2004) 16.

⁸⁴ (2003) 127 FCR 185.

Mr Mochkin's income from stockbroking was not subject to Part IVA as the taxpayer had used a trust structure to limit his liability and protect his assets, and the taxpayer 'employed staff, and had offices and equipment'.⁸⁵

The case concerned income received by two trusts with corporate trustees. The taxpayer was using a business structure to provide 'genuine commercial services'.⁸⁶ Stockbroking services were provided by individuals other than Mr Mochkin (who also provided stockbroking services).⁸⁷ The structure was established for commercial considerations unrelated to taxation considerations.⁸⁸ In that case Part 2-42 did not apply as the years of income involved (1992-97) preceded the introduction of Part 2-42. The Commissioner's (Part IVA) argument that the taxpayer had been involved in income splitting was defeated as, although there was a tax benefit in operating through a company, the dominant purpose of the scheme was not tax avoidance but to limit the personal liability of Mr Mochkin arising from his business activities.⁸⁹ The tax benefits which accrued to Mr Mochkin were a subsidiary and not a dominant purpose.⁹⁰

Consequently, *Mochkin* confirms that where tax advantages are subordinate to other commercial reasons for channelling PSI through another entity, Part IVA will not operate to prevent income splitting.⁹¹ Further, the business structure concept is problematic in that there is uncertainty as to where the boundary between a business

⁸⁵ TAXability, *Part IVA Practice* (2003) 27.

⁸⁶ P Bobbin, 'Mochkin Appeal', *Asset* (1 October 2003) 72.

⁸⁷ D Barlin, 'Mochkin Arrives at the Emerald City' (2003) 38 *Taxation in Australia* 1, 10.

⁸⁸ Deutsch, above n 83, 14.

⁸⁹ N Orow and E Teo, 'Duties General Anti-Avoidance Rules: Lessons from Income Taxation' (2004) 7(2) *Journal of Australian Taxation* 251, 285.

⁹⁰ *Ibid.*

⁹¹ Barlin, above n 87, 13.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

structure and a ‘non-business structure’ lies⁹² and taxpayers are lacking certainty in a self-assessment environment.

Due to its nature, Part IVA is uncertain in its application as it relies on the Commissioner’s discretion to cancel, (or not) a tax benefit and the process detailed in s 177D(b) may be differently interpreted by ‘reasonable minds’.⁹³ As opposed to tax evasion, which by nature involves illegal acts, the line between tax avoidance and ‘legitimate tax minimisation’ is not clear.⁹⁴

Part IVA is also problematic for taxpayers as it can be difficult to obtain a private ruling in relation to it. This is due to one of the factors concerning determination of purpose (of entering into the scheme) being ‘the manner in which the scheme was entered into or carried out’.⁹⁵ The Full Federal Court has stated that:

Where the arrangement in respect of which a private ruling is sought has not yet been carried out, it is difficult to see how there could be adequate facts upon which to base a private ruling. Even where the scheme has been carried out, there may in many cases be difficulty in obtaining all relevant facts, particularly those relating to the manner in which the scheme was entered into or carried out.⁹⁶

The recent *Hart* case, whilst strengthening the Commissioner’s tax avoidance arsenal, makes creating tax effective transactions very risky indeed, as the Commissioner can ‘latch onto’ any aspect of a scheme and assess it to be an act of tax avoidance.⁹⁷ Conversely,

⁹² Middleton and Johnson, above n 18, 14.

⁹³ D Mossop, ‘Tax Avoidance Legislation and the Prospects for Part IVA’ (1997) 26 *Australian Tax Review* 70, 82; TAXability, *Part IVA*, above n 85, 3, 74.

⁹⁴ R Sackville, ‘Avoiding Tax Avoidance: The Primacy of Part IVA’ (2004) 39 *Taxation in Australia* 6, 295.

⁹⁵ ITAA 1936 s 177D(b)(i).

⁹⁶ *Bellinz Pty Ltd v Federal Commissioner of Taxation* (1998) 84 FCR 154, 170.

⁹⁷ P Donovan, ‘The Aftermath of Hart’s Case: A Case for Reform of Part IVA?’ (2004) 39 *Taxation in Australia* 5, 253.

taxpayers can ascertain their position in relation to Part 2-42 by obtaining a private ruling or applying for a PSB determination under subdiv 87-B of the ITAA 1997.

To clarify the rules relating to PSI, the Commissioner has funded a series of test cases involving Part IVA in PSI cases where Part 2-42 does not apply. Until these test cases are resolved there will remain uncertainty as to how the courts' view income splitting under the relevant circumstances, however there is doubt that the test cases will in fact resolve issues such as corporate profit retention.⁹⁸ The need for test cases, and reliance on Part IVA in some cases, brings the Commissioner back to the pre-Part 2-42 era where cases must be actioned on a case-by-case basis which is time consuming, inconsistent and goes against the intention of the recommendations of the Ralph Report.⁹⁹ Part IVA is the Commissioner's 'weapon of last resort'¹⁰⁰ and should not have to be relied on in the Commissioner's general day-to-day administration of PSI issues. It exists to protect the 'integrity of the operative provisions of the Acts' and to deal with those arrangements which have sidestepped these provisions.¹⁰¹

Allowing Part 2-42 to have PSB tests has facilitated the need to resort to Part IVA and Part IVA is not the solution to curbing income splitting. It is too cumbersome, uncertain, and should only be used in

⁹⁸ Burton, above n 4, 258.

⁹⁹ Ibid 254. In the Ralph Report it was stated, at page 290, that: 'Providing a legislative basis for dealing with people supplying personal services in an employee-like situation will address' the issues of inefficiency, labour intensity, inequitable treatment and risk to revenue.

¹⁰⁰ TAXability, *Part IVA*, above n 85, 3, 11; M Hayes and R Arkwright, 'Australia: Application of General Anti-Avoidance Rules Clarified' (2004) 31(7) *Tax Planning International Review* 12, 12; Deutsch, above n 83, 3.

¹⁰¹ M Carmody, *Corporate Governance and Its Role in Tax* (2005) Australian Taxation Office <<http://www.ato.gov.au/print.asp?doc=/content/56224.htm>> at 15 May 2005.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

‘extreme’ cases of tax avoidance. One of the purposes of Part 2-42 was to provide objective tests that, if failed, deemed the income to have been derived by the relevant individual and to provide a relatively simple means for the Commissioner to do this.¹⁰² Given that the intent of Part 2-42 was to reflect the outcome of the application of the Commissioner’s rulings (for example *IT 2639*)¹⁰³ and provide a similar outcome to the application of Part IVA (when dealing with income splitting), it is unfortunate that the designers of Part 2-42 stopped short and failed to cover situations where a PSB test is passed and PSI is being split via a PSE (or retained in a company).

Beharis sums up the effectiveness of Part 2-42 by stating that it ‘stands as a partially successful (or unsuccessful) first attempt at change [in relation to PSI]’.¹⁰⁴ One of Part 2-42’s strengths is that it now allows the majority of potentially affected taxpayers to apply to the Commissioner for a PSB determination, which gives taxpayers some certainty as to whether they are affected by Part 2-42. However, the same cannot be said for Part IVA.

The fact that Part 2-42 does not cover all situations involving PSI leads to the question as to whether it was necessary to create an incomplete layer of legislation, as the Commissioner was always able to rely on Part IVA (which he is currently doing with the test cases).¹⁰⁵ The main impact of Part 2-42 appears to be to clarify deductions available (for PSBs and non-PSBs) and Pay As You Go

¹⁰² Carey, above n 73, 65.

¹⁰³ Explanatory Memorandum, New Business Tax System (Alienation of Personal Services Income) Bill 2000 (Cth) 7.

¹⁰⁴ N Beharis, ‘Personal Services Income: The Gathering Storm’ (2003) 37(11) *Taxation in Australia* 585, 585.

¹⁰⁵ ‘Taxation Institute’s Response: Couriers Win the Battle but Not the War’, *Taxvine* (24 August 2001) 3; A McCleary, ‘Issues and Agendas’ (2002) 36 *Taxation in Australia* 7, 339.

(‘PAYG’) obligations,¹⁰⁶ and to attribute PSI to the test individual where no PSB test is met. Income splitting and retention of profits are still subject to Part IVA (where Part 2-42 does not apply). Other than the limitation of deductions and PAYG obligations, Part 2-42 has in many cases failed to address the problem of income splitting via entities (and profit retention in companies), unless the entities fail to pass a PSB test or cannot get a PSB determination, and has added further complications to the previous and still existing (Part IVA) regime.¹⁰⁷

The aims of Part 2-42 were to provide certainty for taxpayers and reduce compliance costs for business by providing a ‘more consistent and easily understood business tax system’.¹⁰⁸ However, Part 2-42 is commonly acknowledged as being complex, with some critics claiming it only obtains small income gains which can be obtained from simpler methods, and it is discriminatory in that it only targets services as opposed to income from production and sale of goods.¹⁰⁹ It has also been claimed that it works against recent economic reforms and economic gains obtained through recent ‘outsourcing and sub-contracting’ trends.¹¹⁰

There is also the argument that by allowing the Commissioner to determine what constitutes ‘principal work’ the economic principle of specialisation is violated.¹¹¹ Toohey quotes an example from the

¹⁰⁶ A Lampe, ‘The Contractor Factor’, *Sydney Morning Herald* (Sydney), 19 September 2001, 11; Explanatory Memorandum, New Business Tax System (Alienation of Personal Services Income) Bill 2000 (Cth) 10.

¹⁰⁷ Burton, above n 4, 255.

¹⁰⁸ Explanatory Memorandum, New Business Tax System (Alienation of Personal Services Income) Bill 2000 (Cth) 7, 65.

¹⁰⁹ B Toohey, ‘Poor Outcomes from Net Tax Laws’, *The Australian Financial Review* (Melbourne), 5 July 2001, 6.

¹¹⁰ *Ibid.*

¹¹¹ *Ibid.*

RESOLVING THE PSI DILEMMA IN AUSTRALIA

explanatory memorandum to Part 2-42¹¹² where a trainer is unable to claim a deduction for administration work done by another person (an associate). Consequently the trainer is penalised for concentrating on his or her specialisation. Conversely, where a large organisation (not subject to Part 2-42) employs a trainer, that trainer would be likely to receive administrative support the cost of which would be deductible by the large organisation. If this work were outsourced, the trainer would be financially penalised in the absence of compensatory remuneration by the large organisation.¹¹³

A major criticism of the recommendations of the Ralph Report is that the Committee considered the increase in sub-contracting as being 'mainly tax driven' when the trend was mainly caused by 'outsourcing and downsizing as a way of shifting costs from large corporations onto subcontractors'.¹¹⁴ In particular, major causes were the government and finance sectors cutting costs, and also desires to increase economy and efficiency in the construction, information technology and manufacturing industries.¹¹⁵

Whilst it has been assumed that many individuals have voluntarily left employment in order to become contractors (quite often via an interposed entity) in order to obtain tax advantages, this is not necessarily the case as many former employees were forced into these arrangements by their former employers. In addition, these former employees cease to have many benefits such as sick and holiday leave, employer-sponsored superannuation and regular income.¹¹⁶ It could therefore be argued that Part 2-42 provides a

¹¹² See Explanatory Memorandum, New Business Tax System (Alienation of Personal Services Income) Bill 2000 (Cth) 19–20 (examples 1.6 and 1.7).

¹¹³ Toohey, above n 109, 6. Note that where a non-associate is employed to perform non-principal work payments for this would normally be deductible as s 85-20 only denies payments to *associates* of the test individual for non-principal work.

¹¹⁴ *Ibid* 22.

¹¹⁵ Sceales, above n 22, 3.

¹¹⁶ Hine, above n 14, 399.

further penalty by eliminating one of the few advantages obtained from ceasing to be an employee. When applying Part IVA, could it be concluded (as per s 177D of the ITAA 1936) in such cases that the dominant purpose of such a scheme is to obtain a tax benefit (income splitting)? This further shows that if income splitting is considered undesirable we need a simple statutory mechanism to combat it: Part 2-42 and Part IVA are not good mechanisms in this area.

Finally, the lack of overall success of Part 2-42 can be seen in examining the taxation statistics, with less than one percent of total revenue collected by the Commissioner being from Part 2-42.¹¹⁷ In contrast, Ralph had estimated the measures would 'raise up to \$530 million a year by 2004–05' through the elimination of income splitting and denial of certain deductions and that the PSI rules would raise \$2410 million over a four year period.

4. ALTERNATIVE STRATEGIES

There is a need to consider alternative strategies for the curbing of income splitting. These include the treatment of PSI in other comparable jurisdictions including the United Kingdom ('the UK'), the United States ('the US'), Canada and New Zealand ('NZ'). Further, alternative strategies can include addressing the underlying causes of income splitting (including tax rates, tax-free thresholds, tax units, and industrial issues), eliminating the differentiation between non-PSI and PSI, and redesigning Part 2-42.

4.1 International Practices

Turning first to overseas jurisdictions, in the UK, PSI channelled through a company where an individual or their family control more than five percent of the ordinary share capital, or are entitled to receive more than five percent of the dividends, or the individual is

¹¹⁷ For more detail refer to n 20, above.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

entitled to receive or receives payments which could reasonably be considered to have been for services provided by the individual, is subject to rules which require PSI to be paid out to the individual deriving the income, either as Pay As You Earn ('PAYE') salary or as dividends. For partnerships the test is whether the individual or their family is entitled to 60 percent or more of the partnership's profits, or all or the majority of partnership income is received from one client or the partnership's profit sharing arrangements are designed to ensure the individual receives amounts based on payments received from clients for the individual's services.

The UK rules require consideration as to whether the individual would have been an employee, subject to tests which are similar to the Australian results test and unrelated clients test. PSI receipts for the year are totalled, five percent of this amount is deducted to cover company running costs, allowable expenses are deducted (basically expenses which the individual could have claimed had they incurred the expense), and PSI upon which PAYE tax paid was paid during the year, together with employer National Insurance contributions, is deducted. The remaining amount is the 'deemed payment' and if this amount is greater than zero, additional tax is payable.¹¹⁸ The UK rules were introduced in response to concern about Friday night–Monday morning arrangements (similar to Australia) and individuals in a field (for example doctors' secretaries) providing their services through companies.

In the US, a personal service corporation is defined as a company whose principal activity is performing personal services which are substantially performed by 'employee-owners'. Employee-owners are shareholders who own more than 10 percent 'of the fair market value of the corporation's outstanding stock on the last day of the

¹¹⁸ Inland Revenue, *Supplying Services through a Limited Company or Partnership*: (2001) 2–8.

testing period'.¹¹⁹ Principal activity in relation to personal services is defined as occurring where compensation costs for performing personal services is greater than 50 percent of total compensation costs.¹²⁰ Personal services are specifically defined as including personal services in the fields of 'health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting'.¹²¹ 'Substantial performance by employee-owners' occurs where more than 20 percent of the company's 'compensation costs for the performance of personal services are for services performed by employee-owners'.¹²²

US personal service corporations must normally use a calendar year accounting period.¹²³ A qualified personal service corporation (basically one in which 95 percent of its stock is owned by employees performing the services in the personal services fields identified above) is taxed at a flat rate of 35 percent compared with other corporations which are taxed on a progressive scale (between 15 percent and 35 percent).¹²⁴ A personal service corporation is not allowed to offset passive income against active income as can be done by other corporations.¹²⁵ In addition, where a personal service corporation is used to avoid or evade income tax the Internal Revenue Service can allocate income and expenses to employee-owners to prevent the tax evasion or avoidance.¹²⁶

¹¹⁹ Internal Revenue Service, *2004 Instructions for Forms 1120 and 1120-A* (2004) 10.

¹²⁰ *Ibid.*

¹²¹ *Ibid.*

¹²² *Ibid.*

¹²³ *Ibid.*

¹²⁴ *Ibid.* 21; M Lynch, 'When a Service is Not a Service' (2001) 191(3) *Journal of Accountancy* 81, 81–2.

¹²⁵ D Barney, 'Understanding the Appropriate Business Form' (1997) 42(10) *National Public Accountant* 9, 9–15.

¹²⁶ CCH, *2001 US Master Tax Guide* (2001) 426.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

Canadian tax law limits deductions available to companies which derive income from a ‘personal service business’. All deductions are denied except for:

- salary, wages, or other remuneration paid to an ‘incorporated employee’;
- selling and similar expenses that would have been deductible in computing employment income if the taxpayer had been employed and had been required by a contract of employment to pay them; and
- legal expenses incurred in collecting amounts owing for services rendered.¹²⁷

A Canadian personal service business is defined as one where the services of an ‘incorporated employee’ are provided to an entity in which it could reasonably be concluded that the ‘incorporated employee’ would be regarded as an officer or employee (that is, an employee as opposed to an independent contractor). The incorporated employee or a related person must own 10 percent of the issued shares of any class in the company at any time during the year.¹²⁸ Exceptions are where throughout the year the company employs more than five full-time employees or where a company receives the proceeds from an associated company.¹²⁹ Personal service businesses are ineligible for the small business deduction of 16 percent on the first C\$200 000 of active business income and are taxed at the highest corporate rate. The shareholders are also taxed upon distribution of the income, resulting in double taxation.¹³⁰

¹²⁷ CCH, *Canadian Master Tax Guide* (57th ed, 2002) 172–3.

¹²⁸ *Ibid* 730; *Income Tax Interpretation Bulletin IT-73R6* 5–6.

¹²⁹ CCH, *Canadian Master Tax Guide*, above n 127, 731; *Income Tax Interpretation Bulletin IT-73R6* 5–6.

¹³⁰ CCH, *Canadian Master Tax Guide*, above n 127, 726, 731; *Income Tax Interpretation Bulletin IT-73R6* 6.

In NZ, PSI received by a company is attributed to the individual who derived it, after allowable deductions (which include any remuneration paid to the individual and any fringe benefits: both the taxable value and the tax paid)¹³¹ are taken into account. The attributed amount is deducted from the entity's income for tax purposes.¹³² For attribution to apply all the following criteria must be met:

- 80 percent or more of the entity's PSI is from one source;
- 80 percent or more of the entity's PSI is derived from the individual or his or her relative;
- the entity's net income is greater than NZ\$60 000; and
- the business structure does not have substantial business assets (depreciable property costing more than NZ\$75 000 or at least 25 percent of the company's gross PSI for the year).¹³³

There are three exceptions, namely:

- both the entity and the person deriving the PSI are non-residents;
- the services provided are required to support a product supplied by the entity (the exception applies to the extent to which the services provided are required); or
- the net attributable PSI is NZ\$5000 or less.¹³⁴

There is nothing to suggest that any of the methods adopted by these four countries is superior to the Australian system of dealing

¹³¹ CCH, *2001 New Zealand Master Tax Guide* (2001) 1122.

¹³² *Ibid* 1121.

¹³³ *Ibid* 1122–3; D Fraser, 'Personal-Services Income-Attribution Rules Reminder' (2004) 83 *Chartered Accountants Journal* 3, 50.

¹³⁴ CCH, *2001 New Zealand Master Tax Guide*, above n 131, 1122; Fraser, above n 133, 50.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

with PSI. However, they do at least appear to be far simpler. For example, the New Zealand model simply uses income threshold tests to determine whether attribution will apply. This could be adapted for Australia, for example by having Part 2-42 (or its replacement) only apply where an individual's net PSI is more than the taxable income levels to which the tax rates greater than the company tax rate apply (see section on possible solutions).

While simplicity is desirable, curbing income splitting in Australia may be even more effective by dealing directly with its underlying causes, namely the disparity between tax rates for entities, having individuals as the tax unit, and the progressive nature of the tax scales (including the tax-free threshold).

4.2 Reduction in Current Tax Rates

Marginal tax rates can be changed directly, by changing the actual tax rates, or through more discreet means such as 'changing benefit withdrawal rates, tax offsets, etc'.¹³⁵

Tax rates have been a significant issue in Australia as indicated in a poll conducted in January 2004 where half the respondents indicated that the (then) top marginal rate applying for individuals at incomes of \$62 500 was excessive.¹³⁶

Prior to the 2004–05 budget amendments to the income tax scales, Australian workers earning slightly more than the average weekly wage had a marginal tax rate of 42 percent.¹³⁷ In 1959–60 the top marginal rate applied to income levels approximately 15 times

¹³⁵ P Apps, 'Family Taxation: An Unfair and Inefficient System' (Discussion Paper No 524, Centre for Economic Policy Research, The Australian National University, 2006) 3.

¹³⁶ A Norton, *Will You Still Vote for Me in the Morning? Why Politicians Aren't Rushing to Increase Taxes* (2004) 16.

¹³⁷ *Ibid* 16.

average earnings; by 1969–70 it had dropped to 9 times (\$32 000), in 1980 it was 3 times and in 2002–03 and 2003–04 it was 1.3 times, clearly indicating a large rise in the number of individuals at the top marginal tax rate.¹³⁸ If marginal tax rates had been indexed to cover inflation from 1969–70 the current threshold for the highest individual tax rate would apply to taxable incomes over \$268 647.¹³⁹ Taxpayers earning the top 25 percent of income pay 64.1 percent of all income tax received by the government.¹⁴⁰

Whilst there is a perception that Australia is a high taxing country, previous estimates by the Organisation for Economic Co-operation and Development ('OECD') of Australia's taxation expressed as a percentage of gross domestic product ('GDP'), place Australia amongst the lowest OECD countries (at a time when the tax rates were higher than they are today).¹⁴¹ Warren states that the Australian taxation levels (relative to GDP) compare with the OECD countries as follows:

- ignoring social security contributions, Australia has the 10th highest level of taxation;

¹³⁸ Department of Parliamentary Services, 'Taxpayers in the Top Tax Bracket', Research Note No 47 (29 March 2004) 1; P Saunders and B Maley, *Tax Reform to Make Work Pay* (2004) 3.

¹³⁹ Department of Parliamentary Services, above n 138, 1. Whilst the actual marginal tax rates during this period have fallen there have been changes to the company tax rates and the method of company taxation, for example imputation replacing the 'classical' system. Interestingly the Draft White Paper, above n 2, 63 stated that the 1985 top marginal rate would have applied to incomes of approximately \$400 000 if the tax scales had been aligned to the 1954–55 income level. In 1954–55 the top marginal rate applied to income levels about 18 times average yearly earnings: Draft White Paper, above n 2, 3.

¹⁴⁰ Norton, above n 136, 16; S Davidson, *Who Pays the Lion's Share of Personal Income Tax* (2004) 9.

¹⁴¹ P Apps, 'A Tax-Mix Change: Effects on Income Distribution, Labour Supply and Saving Behaviour' in J Head and R Krever (eds), *Taxation Towards 2000* (1997) 103.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

- including social security contributions (which Australia does not have but other countries have), Australia's level of taxation ranking drops to 25th; and
- including the Australian Superannuation Guarantee Charge brings Australia's ranking to 20th.¹⁴²

Notwithstanding these facts, the difference between the company tax rate and the top marginal individual tax rates means there is still some scope for reducing individual tax rates further.

However, such reductions in the marginal individual tax rates could necessitate either an increase in the company tax rate or indirect taxes (for example, GST, which, like any tax increase, would be politically unpopular), or both. The reasons for lowering the company tax rate in the first place were, among other things, to make the corporate tax rate 'internationally competitive' and to align it with the '30 per cent marginal tax rate applicable to most individual taxpayers',¹⁴³ so increasing it again may be counterproductive.

Part of the problem lies with the top individual marginal tax rate (now 46.5 percent) being much higher than the company rate (30 percent) which encourages income splitting and retaining earnings in companies for those whose marginal tax rate is greater than the company rate.¹⁴⁴ The Ralph Report recognised this and noted that the progressive individual tax rates encouraged income splitting.¹⁴⁵ This incentive would be greatly reduced if the tax rates were aligned. For example, recently there have been calls for the top individual marginal tax rate to be no more than 30 percent.¹⁴⁶ The

¹⁴² N Warren, *Tax: Facts, Fiction and Reform* (2004) 18.

¹⁴³ Ralph Report, above n 11, 425.

¹⁴⁴ Organisation for Economic Co-operation and Development, *Economic Survey of Australia 2004* (2005) 82.

¹⁴⁵ Ralph Report, above n 11, 289.

¹⁴⁶ Saunders and Maley, above n 138, 4.

Taxation Institute of Australia has noted that whilst the recent tax rate reductions have addressed the issue of bracket creep, in the long run the top individual marginal tax rate needs to be aligned with the company tax rate.¹⁴⁷

Recently, the chairman of the Board of Taxation has suggested an alignment between the top marginal individual tax rate and the company tax rate (through gradual reductions over the next three to five years) to eliminate the ‘arbitrage between the two rates’ which has caused the current legislative situation.¹⁴⁸

It has been stated that the government wishes to align the corporate tax rate with the top marginal individual rate, however there are doubts as to whether this would be fiscally achievable.¹⁴⁹ Whilst the marginal income tax rate has declined over the last 20 years, bracket creep has put many more taxpayers into the highest tax bracket.¹⁵⁰ Aligning tax rates would almost render Part 2-42 unnecessary, although it would not completely eliminate the incentive to income split amongst family members as taxpayers will still attempt to obtain the benefit of multiple tax-free thresholds and lower marginal rates.

Walker advances a proposition that reduction in tax rates can actually increase government revenue by positive incentive and growth effects.¹⁵¹ It has also been claimed that lower individual tax rates, together with a broad tax base, reduce the incentive for tax

¹⁴⁷ ‘Taxation Institute Says “Opportunities Grasped and Opportunities Lost”’, *Taxvine* (11 May 2005) 2.

¹⁴⁸ G Korporaal, ‘Call for Top Tax Rate of 30pc’, *The Australian* (Sydney), 20 July 2006, 3.

¹⁴⁹ Middleton and Johnson, above n 18, 15.

¹⁵⁰ Saunders and Maley, above n 138, 3.

¹⁵¹ G Walker, *The Tax Wilderness: How to Restore the Rule of Law* (2004) 15. In particular, Walker cites experiences in the US after 1981, Australian reduction in company taxes from 39 percent to 30 percent, and Russia after 2001.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

avoidance by using schemes.¹⁵² Walker cites the example of the US in 1981 where the top marginal tax rate was cut from 70 percent to 50 percent which resulted in increased revenue as funds were diverted from tax avoidance schemes into legitimate activity.¹⁵³ Similar results have been reported in other countries such as Singapore, Hong Kong, Austria, Japan and Britain.¹⁵⁴ Conversely, tax rate increases merely resulted in losses or lower than expected increases in revenue collections.¹⁵⁵

An alternative proposition would be to increase the company tax rate for private companies to the top individual marginal tax rate (or higher).¹⁵⁶ This would reduce the incentive to use companies as income splitting devices but would not be aligned with other countries' company tax rates (which was one of the Ralph Report's aims in reducing the company tax rate to 30 percent).¹⁵⁷

A partial solution could involve indexing the marginal tax thresholds, in order to reduce 'bracket creep'.¹⁵⁸ This would at least

¹⁵² G Larson, 'Getting Personal on Tax' (2004) 74(3) *Australian CPA* 8, 8.

¹⁵³ Walker, above n 151, 10.

¹⁵⁴ Ibid.

¹⁵⁵ Ibid.

¹⁵⁶ P Cowdroy, *The Asprey Report and Taxation of Companies* (1975) 9; Vann, above n 1, 127. Whilst international capital market considerations would preclude increasing the company tax rate for public companies, it is private companies which are predominantly used to split PSI. However, having separate tax rates for private and public companies could create tax avoidance opportunities.

¹⁵⁷ Cowdroy, above n 156, 9.

¹⁵⁸ However, a preferred method may be to introduce measures to alleviate the effects of effective marginal tax rates. Bracket creep is the situation where tax brackets are not indexed for inflation resulting in individuals paying a higher average rate of tax over time as their incomes increase. That is, at the same level of real income more tax is paid. See, eg, Buddelmeyer et al, *Bracket Creep, Effective Marginal Tax Rates and Alternative Tax Packages: A Report by the Melbourne Institute in Association with The Australian* (2004) 2–3, 13. Buddelmeyer et al state (at 3) that bracket creep does not include movement into higher tax brackets due to growth in real income.

provide some alleviation of the problem where inflation and other factors increase individuals' income (through negotiation etc) putting them in higher tax brackets (and encouraging income splitting). Between 2000–01 and 2003–04 inflation caused approximately 336 000 taxpayers to move into the two highest tax brackets.¹⁵⁹ The tax-free threshold in 1980 was \$4441. If this had been indexed the current tax-free threshold would be \$14 000.¹⁶⁰

Alternatively, there have been calls to abolish the tax-free threshold, which in itself encourages income splitting via trusts and other entities.¹⁶¹ The Draft White Paper noted that the tax-free threshold is 'a very expensive concession in terms of taxation revenue forgone since all taxpayers enjoy the threshold regardless of size of income'.¹⁶² It has been estimated that removal of the tax-free threshold would enable 90 percent of taxpayers to receive a reduction in their marginal tax rate of \$0.15 per dollar.¹⁶³ As an alternative to abolishing the tax-free threshold, perhaps it could be retained only for genuine low income earners. Problems would arise, however, in setting the level of income at which the threshold was phased out and would lead to manipulation of income in some cases to obtain the threshold. Problems would also arise in defining a 'genuine low income earner'.

¹⁵⁹ Ibid 4. Between the 2000 year and 2006 year it has been estimated that the government will receive an additional \$3.8 billion from bracket creep: *ibid* 13. Bracket creep's effects will be reduced (temporarily) following the recently announced tax cuts.

¹⁶⁰ Walker, above n 151, 9.

¹⁶¹ Draft White Paper, above n 2, 110.

¹⁶² *Ibid*.

¹⁶³ R Tanner, 'Care in Removing Tax Threshold', *The Australian Financial Review* (Melbourne), 1 November 2004, 67.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

4.3 What about Introducing a Flat Tax Rate?

Another option is to tax all forms of income at the same flat tax rate.¹⁶⁴ Russia replaced progressive rates with a 13 percent tax rate in 2001 (together with reduced deductions and a simplified system) and has since enjoyed greatly increased revenue collections from 9 percent to 16 percent of GDP.¹⁶⁵ It has been claimed that personal income tax revenue increased by 46 percent, however there is ‘no strong evidence that [the] tax reform itself caused the ... revenue boom’.¹⁶⁶ However, there is evidence that the level of tax compliance increased significantly, with an increase of approximately 16 percent in income declared by those affected by the tax reform.¹⁶⁷

Flat rate taxation would be inequitable and regressive¹⁶⁸ as those on lower incomes would effectively be paying a higher *rate* of tax. However, proponents of a flat tax rate argue that higher income earners should not be subjected to paying a ‘higher proportion of their income in taxation’ but should, however, pay more tax (overall) than low income earners.¹⁶⁹ They also argue that if a tax-free threshold is retained, a flat tax regime would retain some element of progressiveness, albeit on a smaller scale than the current tax.¹⁷⁰ For

¹⁶⁴ Buddelmeyer et al, above n 158, 12.

¹⁶⁵ Walker, above n 151, 10.

¹⁶⁶ A Ivanova, M Keen and A Klemm, *The Russian Flat Tax Reform* (2005) 40. When social security contributions are included, the actual tax cut is estimated at being only 2.5 percent. It has also been proposed that the increased income tax revenue was caused by real wage increases and not tax reforms: S Piper and C Murphy, *Flat Personal Income Taxes: Systems in Practice in Eastern European Economies* (2004) Commonwealth Treasury 46 <http://www.treasury.gov.au/documents/1042/PDF/04_Flat_taxes%20.pdf> at 20 June 2006.

¹⁶⁷ Ivanova, Keen and Klemm, above n 166, 40.

¹⁶⁸ A regressive tax is ‘a tax that takes a larger percentage of the income of low-income people than of high-income people’: InvestorWords, *Regressive Tax* <http://www.investorwords.com/4138/regressive_tax.html> at 12 May 2005.

¹⁶⁹ L Chipman, *The Very Idea of a Flat Tax* (2004) 4.

¹⁷⁰ *Ibid* 5–6.

example, assume a tax-free threshold of \$6000 and a flat tax rate of 30 percent on all income over this amount. A taxpayer earning \$7000 has an effective tax rate of 4 percent, whereas a taxpayer earning \$30 000 has an effective tax rate of 24 percent. Conversely, it has been argued that a flat tax rate (combined with an increased tax-free threshold) would result in a flat tax rate greater than 48.5 percent.¹⁷¹

Stated advantages of a flat tax rate include simplicity, transparency (changes in tax rates are more easily understood), and a reduced incentive to engage in tax schemes.¹⁷² It would also assist in achieving vertical equity.¹⁷³ Another argument in favour of a flat tax rate is that the so-called ‘rich’ are not required to pay higher prices for goods and services therefore why should they be discriminated in a similar manner in taxation?¹⁷⁴

Treasury state that whilst a flat tax can satisfy horizontal equity, it is far less likely to satisfy vertical equity considerations although some improvement can be obtained through a tax-free threshold or low income tax offset (which cause average tax rates to increase as income levels increase).¹⁷⁵ However, these concessions would have a negative impact on efficiency, which is otherwise met by a flat tax which is unlikely to affect people’s economic behaviour.¹⁷⁶

A flat tax should be simple, but there will be complications if equity considerations (for example tax offsets) are addressed.¹⁷⁷

However, Treasury also note that flat taxes were introduced in the Eastern European countries to address issues such as weak tax

¹⁷¹ R Tanner, ‘Voodoo Economics’, *The Australian Financial Review* (Melbourne), 15 November 2004, 60.

¹⁷² Chipman, above n 169, 4.

¹⁷³ *Ibid* 8.

¹⁷⁴ Davidson, above n 140, 5.

¹⁷⁵ Piper and Murphy, above n 166, 41.

¹⁷⁶ *Ibid*.

¹⁷⁷ *Ibid*.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

administrations, and simplicity (for example to cater for poorly educated populations who would have difficulty in understanding more complex tax obligations).¹⁷⁸ Unlike Australia, many countries which use flat rate taxation also levy social security contributions, often at relatively high rates (in some cases comprising the main tax burden) and also have higher rates of consumption taxation.¹⁷⁹ Therefore, Treasury conclude that high levels of consumption taxes and social security contributions (which form the bulk of the tax burden in many Eastern European countries) means the headline flat tax rate cannot be considered on its own.¹⁸⁰

4.4 Tax Units

In terms of tax units, one solution may be to have family unit income splitting as is the case in other jurisdictions and which occurs within family units.¹⁸¹ It has been suggested that wage earners (and by implication others who derive PSI) be able to split their income with their family members in much the same way as can an individual deriving income from assets or investments.¹⁸² Dwyer argues that many so-called income splitting arrangements in Australia are merely the result of people attempting to organise their affairs to reflect 'the economic reality of the income sharing that actually occurs within family units'.¹⁸³

In Canada the Carter Commission advocated family unit taxation as opposed to individual taxation.¹⁸⁴ Family unit taxation is used in the US.¹⁸⁵ As family incomes tend to be shared, the Irish

¹⁷⁸ Ibid 43.

¹⁷⁹ Ibid.

¹⁸⁰ Ibid 49–50.

¹⁸¹ T Dwyer, *The Taxation of Shared Family Incomes* (2004) 7.

¹⁸² Ibid.

¹⁸³ Ibid 9.

¹⁸⁴ Ibid.

¹⁸⁵ Ibid 3.

Commission on Taxation advocated 'income splitting between spouses'.¹⁸⁶ In NZ, its Task Force on Tax Reform recommended 'partial income splitting based on equivalence scales for married couples'.¹⁸⁷ Belgium has introduced income splitting for families and the UK provides some tax relief for single income families.¹⁸⁸ Between 1915 and 1976 the Australian taxation system provided for deductions to be made for dependants justified on the grounds that maintenance of dependants reduced a taxpayer's ability to pay.¹⁸⁹ Apps and Rees note the following problems with tax systems which are based on joint family income:

- The arrival of children in the family can cause inequity by moving the overall tax burden to 'low and middle wage families with both partners in work and away from families with much higher wages and in which only one member needs to work to earn the same joint market income'.¹⁹⁰
- Such systems apply higher effective tax rates on households who have a second income earner, especially the female partner.¹⁹¹
- Efficiency and equity are violated by redistribution of tax burdens from double income households to single income households.¹⁹²

Whilst there has been a move away from taxing the family unit, the introduction of measures such as the Family Tax Benefit, where the government provides family benefits which are income tested,

¹⁸⁶ Ibid.

¹⁸⁷ Ibid.

¹⁸⁸ Ibid.

¹⁸⁹ Ibid 4.

¹⁹⁰ P Apps and R Rees, 'The Household, Time Use and Tax Policy' (2004) 50(3) *CESifo Economic Studies* 479, 481, 498.

¹⁹¹ Ibid 481.

¹⁹² Ibid 495.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

has had a similar effect to taxation of joint family incomes.¹⁹³ Major differences in the Australian system are:

- it only applies to families who have children;
- families with two income earners and dependents under five years of age receive additional penalties; and
- working married mothers stand to lose approximately half their earnings due to taxes and reduction in family payments.¹⁹⁴

There are advantages and disadvantages of family unit taxation which are generally related to equity issues. The Australian government in 1985 retained individual taxation as it afforded equity amongst individuals, minimised choice distortions between engaging in paid employment and not doing so, and was consistent with promotion of independence for women and equal opportunity.¹⁹⁵ However, there are other alternatives to family unit taxation such as allowing income sharing up to a defined limit,¹⁹⁶ or allowing family unit taxation to be optional.¹⁹⁷

Recently, Apps found that the majority of families in Australia are effectively taxed on a joint income basis and have a marginal tax rate schedule that 'tends towards an inverted U-shaped profile' and is 'no longer progressive'.¹⁹⁸ As a result of bracket creep, combined with increases in 'joint and second income targeted family benefits', workers on low and average incomes have received an increased tax

¹⁹³ Ibid.

¹⁹⁴ P Apps and R Rees, 'Life Cycle Time Allocation and Saving in an Imperfect Capital Market' (Discussion Paper No 475, Centre for Economic Policy Research, The Australian National University, 2004) 17.

¹⁹⁵ Draft White Paper, above n 2, 62.

¹⁹⁶ Dwyer, above n 181, 8.

¹⁹⁷ Taxation Review Committee, *Full Report* (1975) 134 ('the Asprey Report').

¹⁹⁸ Apps, 'Family Taxation', above n 135, 2.

burden.¹⁹⁹ Apps cites an example of two households each earning \$70 000 per annum, one with both parents working (and paying for child care) and the other with one parent working and the other staying at home and providing child care. She states that the second family enjoys a much higher standard of living. Consequently, horizontal equity is violated as is the ‘progressivity of the overall system, due to the higher tax burdens on lower wage families’.²⁰⁰

The Taxation Institute of Australia (‘the TIA’) has recommended that Part 2-42 be amended to prevent Part IVA applying to PSBs in relation to family PSEs.²⁰¹ Prior to the federal election in 2004, the Australian Labor Party proposed to allow a working individual to include their dependent spouse’s tax-free threshold in their tax scales.²⁰² Using the family as a single ‘tax entity’ could largely eliminate the incentive to split PSI, particularly amongst family members, but there would still be problems with income derived via a company where income is retained and taxed at a lower company tax rate. Problems could also arise in relation to the definition of a ‘family unit’.

However, the introduction of family unit taxation in Australia would be replacing one form of income splitting with another and would represent a significant change in policy. With social policies currently being implemented via the taxation and the social security system, there would be difficulties in the implementation of family unit taxation. It would be necessary to radically overhaul both systems. Perhaps the simplest solution would be to allow income splitting for PSI in the same manner it is allowed for other forms of

¹⁹⁹ Ibid 8.

²⁰⁰ Ibid 10.

²⁰¹ Taxation Institute of Australia, *Discussion Topics for Meeting with Senator Helen Coonan Minister for Revenue and the Assistant Treasurer* (2003) 3.

²⁰² A Kohler, ‘Latham Gets Crafty with His Tax Break’, *Sydney Morning Herald* (Sydney), 8 September 2004, 24.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

income. However, the question arises as to whether such a broad range of income splitting should be extended to salary and wage earners.

Another alternative to family taxation may be to allow taxpayers (taxed as individuals) to make reasonable payments to spouses regardless of whether they are doing principal or non-principal work. Inflated payments (to split income) could be avoided by allowing payments to the extent they reflect amounts payable under an arm's length arrangement, for example by using award rates. There has been suggestion that acceptable payment amounts could be indexed to inflation.²⁰³

In relation to excessive payments made to associates of the test individual, an argument has been advanced that Part IVA is not required as this is specifically provided for in s 109 of the ITAA 1936.²⁰⁴ Rocher argues that where 'under or over valuation of payment for services rendered by a related party to an entity is of concern', s 26-35 of the ITAA 1997 could be amended to 'require that related parties be paid a "reasonable amount" for their services'.²⁰⁵ In relation to retained PSI, such amounts could simply be deemed to be a dividend²⁰⁶ and treated accordingly (perhaps in a similar manner to Division 7A in relation to shareholder loans). However, the tax law does not prescribe how much other parties should be paid, but rather the extent of that payment which can be claimed as a deduction for tax purposes. Therefore it remains for the Commissioner to apply s 26-35 in its current form.

²⁰³ M Fenton-Jones, 'PSI Decision Fails to Resolve Faulty Law', *The Australian Financial Review* (Melbourne), 10 July 2001, 6. By using award rates theoretically the inflation rate should be factored in when award rates change.

²⁰⁴ Rocher, above n 22, 8.

²⁰⁵ *Ibid* 9.

²⁰⁶ *Ibid* 10.

4.5 No Distinction between Non-PSI and PSI

Another option is to tax non-PSI and PSI in the same way. It is argued that the prohibition against retention of PSI in the business (for example, companies) makes it difficult to make provisions for capital expansion and the acquisition of new equipment financed by prior years' earnings.²⁰⁷

One way to remove this discrimination would be to prohibit (or penalise) all retained earnings in companies.²⁰⁸ However, this would be detrimental to 'capital formation and private sector earnings'.²⁰⁹ It would in effect return the company tax system to a similar footing that existed prior to the introduction of the imputation system.

From an equity viewpoint the argument has been raised that those who earn income from non-PSI sources (for example investments, assets) are usually able to split such income and effectively pay a lower tax rate. However, an individual deriving the same amount of income, but in the form of their own PSI, is unable to.²¹⁰ The Asprey Report noted that this results in horizontal inequity.²¹¹

4.6 Industrial Reform

In terms of industrial issues, the Ralph Report noted that there had been an escalating trend towards former employees incorporating and being treated as contractors when in reality their relationship with their former employer remained substantially one

²⁰⁷ Toohey, above n 109, 6.

²⁰⁸ Ibid.

²⁰⁹ Ibid.

²¹⁰ Burton, above n 4, 253–4. This was also recognised in the Draft White Paper, above n 2, 60–3 in 1985.

²¹¹ Asprey Report, above n 197, 131. Horizontal equity refers to taxpayers in similar situations being taxed similarly: Vann, above n 1, 120.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

of employer and employee. Perhaps a solution would be to legislate in this area to remove the existing levels of confusion and complexity.

4.7 Redesign Part 2-42

Barring a radical overhaul of our tax system (for example, introduction of flat tax rates, family unit taxation), or even a less radical overhaul (for example, indexation of tax brackets), the best solution may be to simply amend Part 2-42 so that where there is PSI involved, and a PSB test is passed, any PSI left in the company is attributed to the test individual (or, where income splitting occurs, adjustments are made so that the PSI is attributed to the relevant individual). However, this would in effect render a large portion of Part 2-42 in its existing form redundant. That is, there would be no need for PSB tests and perhaps direct attribution of PSI to the relevant individual in all cases would be preferable (or deeming of dividends to the relevant individual).

An exception, however, would be in cases where a business structure is involved which leads to the need to prescribe business structure tests. These could be based on existing case law (for example, number of employees, turnover etc), with industry-specific rules applying. For borderline cases, the Commissioner could be empowered to issue determinations stating a company is operating under a business structure. This would in effect replace the current PSB determination system as there would no longer be the existing PSB tests in place and all PSI channelled through companies (other than those conducting a business structure) would be attributed to the relevant individual.

This could be done in conjunction with indexing the marginal tax thresholds to further reduce the incentive to split income.

Alternatively, a system similar to the NZ system could be adopted where Part 2-42 (or a modified version of it) would only apply where an individual's net PSI is greater than the threshold where the 40 percent tax rate applies. This would simplify self-

assessment for many taxpayers. However there would still remain some incentive for taxpayers to split income to take advantage of the lower tax rates and multiple tax-free thresholds.

5. CONCLUSION

Income splitting (and retention of PSI in companies) via entities has been a problem for the Commissioner for very many years. Due to the escalating trend for individuals to become ‘incorporated contractors’ the problem has become more widespread. The Ralph Report recognised this and recommended introducing specific rules to overcome the PSI problem. However, the solution (Part 2-42) enacted by the government is complex and does not cover all cases of income splitting and profit retention. The Part fails to cover the situation where a PSB test is met and income splitting (or PSI retention) occurs. As a result, it forces the Commissioner to use Part IVA which was the situation which existed pre-Ralph. Part IVA is the Commissioner’s ‘weapon of last resort’ and it is ironic that Part 2-42 was introduced to overcome problems with using Part IVA in dealing with PSI issues²¹² yet must still be resorted to when a company passes a PSB test but is retaining income, splitting PSI or making excessive payments to associates of the test individual.

Major incentives for income splitting (and retention of PSI) include the difference between the company tax rate and the top individual marginal tax rate, and the progressive individual tax scales which encourage income splitting in order to obtain more than one tax-free threshold and multiple progressive tax scales. Although there has been a recent reduction in tax rates, these incentives still remain for high income earners. However, entities are not always chiefly used for income splitting purposes (for example companies may be used for limiting liability).

²¹² R Fisher, ‘Ralph Review: Reform by Name but not Nature?’ (2003) 7 *Taxation in Australia (Red Series)* 2, 65.

RESOLVING THE PSI DILEMMA IN AUSTRALIA

Possible solutions to income splitting include removal of the above incentives, for example, flat rate taxation, abolition of the tax-free threshold, aligning the company and individual tax scales, and family unit taxation. The latter would probably be the best solution, but would be difficult to implement considering the overlap between the tax system and the social security system.

Whilst numerous alternative treatments for PSI exist, in the absence of a major and radical overhaul of the tax system, the best solution would be to rewrite Part 2-42 to abolish the existing tests and simply attribute PSI to the relevant test individual, whilst allowing reasonable levels of deductions against PSI. Genuine business structures could be exempted, and in borderline cases, there could be provision for the Commissioner to grant determinations stating that a company is conducting a business structure and is exempt from both the PSI measures and Part IVA.

Whilst there is merit in the opposing argument that the tax system does not need additional ‘mini-Part IVAs’,²¹³ the provisions of Part 2-42 are complex and need to be replaced with specific anti-avoidance provisions which are simple to administer.²¹⁴ There is also the opposing argument that Australia relies more on general anti-avoidance rules (that is, Part IVA) than other Western countries.²¹⁵ In the absence of a radical overhaul of the Australian taxation system, the PSI rules need to have an anti-income splitting and profit retention mechanism similar in effect to Part IVA without the complexity, and labour-intensity, of the latter.

²¹³ See, eg, T Slater, ‘Imputation: Death by a Thousand Cuts’ in Taxation Institute of Australia (ed), *1998–99 Convention Papers* (1998) vol 1, 37.

²¹⁴ Rocher, above n 22, 10.

²¹⁵ Walker, above n 151, 3.