PART IVA AND TAX REFORM

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Determining the extent to which the Australian general anti-avoidance tax provisions in Part IVA of the *Income Tax Assessment Act 1936* (ITAA36) apply to particular transactions is a perennial piece of work-in-progress for our tax professionals, tax administrators and the courts. The introduction of new legislation as a result of the tax reforms emanating from the Ralph Review provides yet another forum to test the application of Part IVA.

The personal services income (PSI) provisions (which are part of the tax reform measures) limit the availability of deductions against PSI where the person earning the income cannot satisfy the personal services business tests. A person or entity satisfying the relevant tests is no longer subject to PSI rules but still needs to consider the application of Part IVA to their particular situation.

This paper initially clarifies the concept of PSI and the types of entities that will be either within or outside the operation of the PSI rules. The paper then critically evaluates the likely application of Part IVA to PSI that is not subject to the PSI rules. This evaluation is completed by analysing the existing law in relation to Part IVA as well as any ruling and public pronouncements made by the Commissioner relevant to this matter. The paper concludes that certain types of entities generating PSI that are outside the PSI rules may be captured by the application of Part IVA.

1 Sections 177A to 177H of the *Income Tax Assessment Act 1936* (ITAA36).

2 On 21 September 1999 the federal government released the Ralph Review of Business Taxation Report entitled, *A Tax System Redesigned*. The Federal Government has subsequently introduced a substantial amount of legislation in line with the recommendations of that report.

3 Divisions 84 to 87 of the *Income Tax Assessment Act 1997* (ITAA97). These rules apply from 1 July 2000 with some transitional rules applying to 1 July 2002.

4 Section 86-10 of the ITAA97 states that taxpayers not covered by the PSI rules will need to consider the application of Part IVA.

5 The Commissioner of Taxation in Australia or the Australian Tax Office.
I INTRODUCTION

The general anti-avoidance rules in Part IVA\(^6\) apply to all transactions\(^7\) entered into\(^8\) that have the dominant\(^9\) purpose of generating a tax benefit\(^10\). It is recognised that where the conditions of Part IVA are not satisfied\(^11\) that the anti-avoidance rules will not apply. Where the rules apply any tax benefit derived from the scheme is cancelled\(^12\) and an amended assessment is issued\(^13\). Part IVA has been applied by the Commissioner of Taxation\(^14\) to many transactions with some success in relation to existing legislation\(^15\).

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\(^6\) Sections 177A to 177H of the ITAA36.

\(^7\) Generally Part IVA applies to schemes and a ‘scheme’ is defined in s 177A(1) to mean, unless the contrary appears: ‘(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and

(b) any scheme, plan, proposal, action, course of action or course of conduct;’

\(^8\) After 27 May 1981.

\(^9\) In its ordinary meaning, ‘dominant’ indicates that purpose which was the ruling, prevailing, or most influential purpose. *Spotless Services Ltd v FCT* 93 ATC 4397; 96 ATC 5201.

\(^10\) The primary examples of a tax benefit include a situation where:

- an amount is not included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or

- a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out.

\(^11\) For example *Mochkin v FC of T* 2002 ATC 4465; 2003 ATC 427; *Essenbourne Pty Ltd v FC of T* 2002 ATC 5201.

\(^12\) Section 177F provides that where a tax benefit has been obtained, or would but for this section be obtained, by a taxpayer in connection with a scheme to which Part IVA applies, the Commissioner may:

- in the case of a tax benefit that is referable to an amount not being included in the assessable income of the taxpayer of a year of income—determine that the whole or a part of that amount shall be included in the assessable income of the taxpayer of that year of income; or

- in the case of a tax benefit that is referable to a deduction or a part of a deduction being allowable to the taxpayer in relation to a year of income—determine that the whole or a part of the deduction or of the part of the deduction, as the case may be, shall not be allowable to the taxpayer in relation to that year of income’.

\(^13\) Section 177G(1) ITAA36 provides that:

Nothing in section 170 prevents the amendment of an assessment at any time before the expiration of 6 years after the date on which tax became due and payable under the assessment if the amendment is for the purposes of giving effect to subsection 177F(1).

\(^14\) In Australia or the Australian Tax Office.

\(^15\) Legislation that was in place at the time that Part IVA was enacted which was on 27 May 1981.
Fresh legislative measures being introduced as a result of the Ralph Review\textsuperscript{16} provide us with further opportunities to test the application of Part IVA. One example of this new legislation can be found in the PSI provisions\textsuperscript{17}. The objective of the PSI rules is to limit the entitlements of individuals or other entities to deductions relating to PSI derived directly or being alienated to other entities\textsuperscript{18}.

II OVERVIEW OF THE PERSONAL SERVICES INCOME (PSI) RULES

The PSI rules apply only where the income is personal services income. PSI is defined as:\textsuperscript{19}

Your ordinary income or statutory income, or the ordinary income or statutory income of any other entity, is your personal services income if the income is mainly a reward for your personal efforts or skills (or would mainly be such a reward if it was your income).

It is noted that only individuals can have PSI\textsuperscript{20} and can include income received for doing work or performing a result\textsuperscript{21}. Taxation Ruling TR 2001/7\textsuperscript{22} provides a very comprehensive discussion of what constitutes PSI and in paragraph 22 of the ruling it is stated:

The phrase “or would mainly be such a reward if it was your income” in subsection 84-5(1) ensures that the character of the income as being mainly a reward for an individual's personal efforts or skills is not altered in those circumstances where it is legally derived by another entity. The phrase requires a determination as to whether the income, if it was derived by an individual, would be mainly a reward for that individual's personal efforts or skills rather than being generated by the use of assets, the sale of goods, or by a business structure. If, as a practical matter, the income is mainly a reward for the individual's efforts or skills, then that amount or item of that entity's ordinary income or statutory income is an individual's personal services income.

The meaning of the word 'mainly' is generally understood to be a requirement that at least 50 per cent of the activity that generated the income was from personal exertion. While the concept of PSI is quite wide it does not include income that is mainly:\textsuperscript{23}

\textsuperscript{16} On 21 September 1999 the Federal Government released the Ralph Review of Business Taxation Report entitled, \textit{A Tax System Redesigned}. The federal government has subsequently introduced a substantial amount of legislation in line with the recommendations of that report.

\textsuperscript{17} Divisions 84 to 87 of the ITAA97. These rules apply from 1 July 2000 with some transitional rules applying to 1 July 2002.

\textsuperscript{18} Division 85 and 86 of the ITAA97.

\textsuperscript{19} Section 84-5 of the ITAA97.

\textsuperscript{20} Section 84-5(2) of the ITAA97.

\textsuperscript{21} Section 84-5(3) of the ITAA97.

\textsuperscript{22} Published on 31 August 2001.

\textsuperscript{23} Paragraph 29 TR 2001/7.
• from an entity supplying goods or granting a right to use property;
• generated by assets an entity holds; or
• generated by the business structure.

Also where the personal services that are provided are ancillary to:24

(a) the sale or supply of goods;
(b) the granting of a right to use property;
(c) the supply and use of assets that have a significant role in the generation of the income; or
(d) the generation of the income by the business structure.

The income so generated is not personal services income.

Depending on the circumstances, the question of whether the income will be derived mainly from personal exertion or whether it is ancillary to other activities will depend on the nature of the transactions. It will require a consideration of all the facts of the particular case keeping in mind that to be PSI at least 50 per cent of the income must be generated from personal exertion.25

Paragraph 45 of TR 2001/7 provides guidance in clarifying PSI, as follows:

To decide whether an entity's income is your personal services income, assume that it is your income, and ask yourself whether it would mainly be a reward for your personal efforts or skills. If the character of the income is mainly a reward for your personal efforts or skills and is not mainly from the use of assets, sale of goods, or a business structure, it will be personal services income within the meaning of subsection 84-5(1), although it may legally have been derived by the personal services entity.

III IMPACT OF THE PSI RULES APPLYING

There are two methods by which the PSI rules can apply depending on whether the income is derived by an individual directly26 or is alienated to a personal services entity27. Generally where the PSI is generated directly by an individual their deductions are limited to the amount of deductions available to employees. Accordingly expenses for home to work travel are not deductible as these would not be available to employees28. Some expenses that are specifically deductible include expenses of:29

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24 Paragraph 30 TR 2001/7.
25 Paragraph 31 TR 2001/7 outlines certain factors to be considered in determining if the income is personal services income.
26 Division 85 ITAA97.
27 Division 86 ITAA97.
28 See Lunney v FC of T (1958) 100 CLR 478.
• gaining work; or
• insuring against loss of your income or your income earning capacity; or
• insuring against liability arising from your acts or omissions in the course of earning income; or
• engaging an entity that is not your associate to perform work; or
• engaging your associate to perform work that forms part of the principal work for which you gain or produce your personal services income; or
• contributing to a fund in order to obtain superannuation benefits for yourself or for your dependants in the event of your death (but only to the extent of the Superannuation Guarantee amount where the contribution is for an associate\(^{30}\)); or
• meeting your obligations under a workers' compensation law to pay premiums, contributions or similar payments or to make payments to an employee in respect of compensable work-related trauma; or
• meeting your obligations, or exercising your rights, under the GST law.

Note that these rules do not apply where a person is carrying on a personal services business\(^{31}\) or where the income is derived in the capacity of an employee\(^{32}\).

Where the PSI is alienated to a personal services entity then Division 86\(^{33}\) deems the income so alienated as your income and limits the other entity’s entitlement to deductions to offset against the amount treated as your income\(^{34}\). The deductions available to the personal services entity are essentially those that would be available to the individual if they incurred them. Deductions available to the personal services entity include:

- Entity maintenance deductions\(^{35}\) which include tax related expenses\(^{36}\);
- Certain car\(^{37}\) expenses\(^{38}\);
- Superannuation\(^{39}\); and

\(^{29}\) Section 85-10(2) ITAA97.
\(^{30}\) Section 85-25(3) ITAA97.
\(^{31}\) Division 87 ITAA97 outlines what is a personal services business.
\(^{32}\) Section 85-30 and 85-35 ITAA97.
\(^{33}\) ITAA97.
\(^{34}\) Section 86-1 ITAA97.
\(^{35}\) Section 86-65 ITAA97.
\(^{36}\) Tax related expenses are deductible under s 25-5 ITAA97.
\(^{37}\) Section 86-70 ITAA97.
\(^{38}\) These expenses are limited to one car where there is private use of the car. Note a deduction is available for fringe benefits tax paid as well.
\(^{39}\) Section 86-75 ITAA97. Note that if the individual performs less than 20 per cent of the entity’s principal work and the individual is an associate of another individual whose personal services income is included in the entity’s ordinary income or statutory income the superannuation contributions are limited to the Superannuation Guarantee level (currently 9 per cent).
• Salary and wages paid promptly to the person who performs the personal services\textsuperscript{40}.

IV STAYING OUTSIDE THE PSI RULES

A taxpayer will be able to stay outside the PSI rules where the income is derived as part of a personal services business\textsuperscript{41}. There are four tests for determining your eligibility to be outside the PSI rules. Taxation Ruling TR 2001/8 at para 27 states:

You will not be within the alienation measure and can self-assess accordingly if you come within ONE of the following four situations:

• You satisfy the ‘results test’, that is:
  (a) You work to produce a result(s); and
  (b) You provide the tools and equipment necessary (if any) to produce the result(s); and
  (c) You are liable for the cost of rectifying any defective work.

OR

• None of your clients pay you 80\% or more of your personal services income in the year of income and you have two or more unrelated clients (who were obtained as a result of you making offers to the public at large or to a section of the public).

OR

• None of your clients pay you 80\% or more of your personal services income in the year of income and
  (d) You engage an individual(s) or an unrelated entity(ies) to perform 20\% or more (by market value) of the principal work (ie the work that generates the personal services income) or
  (e) You employ an apprentice for at least half the year.

OR

• None of your clients pay you 80\% or more of your personal services income in the year of income, and you exclusively use business premises that are physically separate from your home, or from the premises of the person for whom you are working.

In addition, if you cannot satisfy any of these four tests and 80 per cent or more of your personal services income comes from one source, you may be able to obtain a Personal Services Business Determination (PSBD) from the Commissioner to establish that you are conducting a personal services business. You can also apply for a PSBD if you are not sure whether you satisfy any of the tests. If the Commissioner is satisfied that you are entitled to a PSBD, you will not be subject to the alienation measure\textsuperscript{42}.

\textsuperscript{40} Section 86-80 ITAA97.

\textsuperscript{41} Division 87 ITAA97.

\textsuperscript{42} Paragraph 28 TR 2001/8.
V PART IVA RAISES ITS HEAD

For many taxpayers the exclusion from the PSI rules is a welcome relief but this is far from the end of the story as stated in para 32 of Taxation Ruling TR 2001/8:

Note that the general anti-avoidance provisions of Part IVA of the ITAA 1936 may still apply to cases of alienation of personal services income that fall outside the alienation measure: see section 86-1043 of the ITAA 1997.

The Commissioner has issued a fact sheet on the application of Part IVA to personal services business and in this fact sheet it is stated that:

It is important to remember that a personal services business still earns personal services income and not business income for income tax purposes. Our views on how you should treat that income have been established for some time and have not changed in relation to arrangements that are not affected by the new alienation of personal services income legislation. These views are set out in Taxation Rulings IT 2121, IT 2330 and IT 2503. Consequently, we would apply those views in appropriate cases.

This fact sheet restates the basic principles on which Part IVA will apply and in essence the Part applies if there is a scheme that is entered into or carried out for a dominant purpose of obtaining a tax benefit, and the conclusion about dominant purpose is required to be made on an objective analysis of the facts.

VI WHO ARE THE ATO TARGETS?

It would appear that where the income is derived from the use of business assets or from a business structure there will be no particular issues for taxpayers with the operation of Part IVA. The ATO targets are likely to be entities that satisfy one of the exceptions to the PSI rules. Examples are as follows:

- Professionals providing services to the public; and
- Tradespersons providing services to the public.

The targets will still be deriving income primarily from personal services rather than a business structure.

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43 Section 86-10 of the ITAA97 states that taxpayers not covered by the PSI rules will need to consider the application of Part IVA.

44 Fact sheet on the application of Part IVA, Commissioner of Taxation, General Anti-Avoidance Rules and how they May Apply to a Personal Services Business (September 2003).
VII WHAT IS A BUSINESS STRUCTURE?

As can be seen from the foregoing discussion, if the income is from a business structure (not mainly from personal exertion) then it will not be subject to immediate scrutiny by the Commissioner. Generally the income will be from a business structure where:

- There are a number of arm's length employees or others engaged to perform work;
- There is a presence of goodwill;
- The extent to which income-producing assets are used to derive the income;
- The nature of the activities carried out;
- The size of the operation and the extent to which the income is dependent upon a particular individual's own personal skills, efforts or expertise.

There have been a number of cases that have considered the existence of a business structure. In *Osborne v FC of T*\(^{45}\) a taxpayer who was a registered valuer commenced practice as a registered valuer working from home in 1980 and at the same time the business name and business was transferred into a family trust that was already in existence. In 1983 the valuation business was acquired by another family trust and in 1989 the taxpayer ceased valuation work. The primary issues before the court were whether s 260\(^{46}\) applied in respect of the 1983–84 year, and Part IVA applied in respect of the 1984–85 to 1988–89 years so that all of the valuation income was assessable to the taxpayer personally in those income years.

The AAT, at first instance held that both s 260 and Part IVA applied, however, the Federal Court subsequently held that while the taxpayer was the registered valuer that enabled the fees to be earned, the fees were actually earned as a result of the contractual arrangements made between the trustee and various clients and so s 260 did not apply. In addition the Court held that Part IVA did not apply because once it was concluded that the trustee derived the income, a subsequent change of trustee meant that the tax benefit was not obtained by the taxpayer but by the beneficiaries of the first trust.

\(^{45}\) 95 ATC 4323; (1995) 30 ATR 464.

\(^{46}\) ITAA36. Section 260 provides: ‘Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly:

(a) altering the incidence of any income tax;
(b) relieving any person from liability to pay any income tax or make any return;
(c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or
(d) preventing the operation of this Act in any respect,

be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.

This section does not apply to any contract, agreement or arrangement made or entered into after 27 May 1981.’
In coming to its conclusion in relation to s 260 the court stated:47

Whilst it may be said that the valuation fees were generated by the personal services of the applicant in the sense that it was his standing as a registered valuer that enabled the fees to be earned, they were earned as a result of contractual arrangements made between Bellatrix and various clients … The applicant at no time had any personal entitlement to any of the valuation fees paid to Bellatrix other than in accordance with the terms of the trust deed. Nor had the applicant at any antecedent time been employed as a valuer or conducted a business or practice whereby he had applied his professional skill as a valuer for the purpose of earning valuation fees. On the facts as found by the Tribunal the only “arrangement” the applicant made was, in his capacity as a director of Bellatrix, to contract on behalf of Bellatrix with various clients to provide valuations for reward. Neither Bellatrix nor trust no. 1 were set up for the purpose of “diverting” income derived from valuation fees. Both existed well before any such fees were derived. Bellatrix's income was already “diverted” to trust no. 1 well before any income was derived from valuation fees.

Furthermore the court indicated that s 260 was not satisfied:48

The respondent's case fails the test expressed by Gibbs CJ in Gulland49 namely that the arrangement will be within s 260 “if it alters the incidence of income tax in a case in which the taxpayer is in receipt of income”.

In relation to the application of Part IVA the court stated:50

Where a tax benefit has been obtained, or would but for s 177F be obtained, by a taxpayer in connection with a scheme, the Commissioner may, in the case of a tax benefit that is referable to an amount not being included in the assessable income of the taxpayer of a year of income, determine that the whole or part of that amount shall be included in the assessable income of the taxpayer for that year of income (s 177F(1)).

In holding that there was not tax benefit gained by the taxpayer the court stated:51

Once the position is established that the appellant was not, and had never been, liable to tax on the valuation income derived by Bellatrix as trustee for trust no 1 … If there was a scheme in connection with which a tax benefit was obtained, it was the beneficiaries of trust no 1 who obtained the tax benefit.

47 Olney J at para 4330.
48 Olney J at para 4331.
49 83 ATC 4352.
50 Olney J at para 4331.
51 Olney J at para 4332.
The case of *Rippon v FC of T* \(^{52}\) also considered whether the income derived was from personal exertion or from a business structure. In that case the taxpayer was an engineer who, following the collapse of his employer in 1976, went into business on his own as a project management consultant. He set up a unit trust and all of the units were held by the trustee of a discretionary family trust. The trustee of the unit trust conducted the consultancy business and engaged consultants on a sub-contract basis and obtained various professional engagements. Initially the taxpayer was employed by the company at a salary of $18,000 per annum, but this fell dramatically thereafter and bore no relation to the gross fees received by the company.

The Commissioner applied s 260 to strike down the corporate and trust structure so that the taxpayer was liable for tax as though the income were received in his own hands.

The Federal Court however held that s 260 did not apply despite the fact that there was a complex corporate structure because the structure could be explained by reference to the fact that it provided a convenient way to take in partners in the future. In addition, the business structure provided scope for future growth of the business and was an ordinary business and family dealing. The court held that the structure was not put in place to avoid tax.

The court did discuss the issue of reduced salary in later years as follows: \(^{53}\)

> Fourthly, the salary which the taxpayer received in the earlier years under review was fixed by reference to his previous experience as an employee. Such salary therefore reflected a proper commercial value of the personal service he was to render to the company ... The fact that much less salary was earned in 1980 to 1983 is explicable by the Kordiak problems. ... Absent the Kordiak problems, the reasonable inference is that the taxpayer's salary would have continued without substantial reduction. I do not see that the salary reduction which in fact took place assists the Commissioner's case.

The case of *Liedig v FC of T* \(^{54}\) is another example of where the Commissioner failed to convince the court that the relevant income was PSI. In this case the taxpayer was a registered land broker and the taxpayer's parents-in-law sold their land broking business to the taxpayer and his wife on the basis that it would be owned by them in equal shares. The taxpayer carried on the business for himself and his wife in his capacity as trustee. The Commissioner argued that the land broking business was operated by the taxpayer as a sole trader and the taxpayer's wife made no contribution to the running of the land broking business. Thus, the income was the taxpayer's personal exertion income which he could not divert to his wife.

\(^{52}\) *Rippon v FC of T* 92 ATC 4186; (1992) 23 ATR 209.

\(^{53}\) Ibid, Heerey J, at para 4191.

\(^{54}\) *Liedig v FC of T* 94 ATC 4269; (1994) 121 ALR 561; (1994) 28 ATR 141; (1994) 50 FCR 461.
On appeal to the Federal Court against this decision, the taxpayer sought to add to his grounds of objection by arguing that the tribunal should have granted an extension of the grounds of the taxpayer's objections on the basis that it was bound so to do on its own initiative. The court found that the contracts for work entered into by the taxpayer as trustee were, like service contracts with staff, the physical assets and goodwill, assets of the trust estate. Any income was derived as a result of those assets as much as through personal services.

In discussing the law in relation to PSI and the use of trusts, Hill J stated:

[Section] 260 applied and the more recent trilogy of cases in the High Court reported as *FC of T v Gulland; Watson v FC of T; Pincus v FC of T* 85 ATC 4765; (1985) 160 CLR 55 clearly indicated the application of s. 260 to the use of trusts to derive income which might ordinarily be described as “personal service or personal exertion income”. … There is no reason to doubt that Part IVA of the present Act, replacing s. 260 in respect of schemes entered into after 27 May 1981, would have the same result where, having regard to the various matters referred to in s. 177D of the Act, a conclusion would be reached that a person who entered into or carried out the scheme or any part of it did so for the purpose of enabling a taxpayer to obtain a tax benefit in connection with that scheme.

In holding that the income was derived from the assets of the trust Hill J stated:55

the Deputy President who recognised that there were some trust assets, including goodwill, and that income could be said to flow in part from those assets as well as the skill of Mr Liedig. But the problem is not even as simple as that. A land broker, like a solicitor, may, and probably does, enter into a contract with the client for the performance of work. Ordinarily moneys would not be payable under that contract unless and until the work contracted to be performed had been completed. Those contracts, like the service contracts with staff, the physical assets and goodwill, are all assets of the trust estate…

It can be deduced from the foregoing discussion that the distinction between personal exertion income earned by an individual in their own right and income earned from a business structure where the economic activity is essentially carried on by one person is a difficult task as noted in Hill J’s comments above.

A question that could be posed is whether the cases of Gulland, Watson and Pincus,56 if considered in the light of the current PSI provisions, would be captured by those rules to deem the income earned to be income of the individuals. It is clear that the taxpayers in those cases should be able to satisfy one of the four personal service business tests.57 Based on the facts in those cases it should be possible to satisfy the unrelated client


56 85 ATC 4765; (1985) 160 CLR 55.

57 Section 87-15(2) ITAA 97.
test,⁵⁸ the employment test⁵⁹ or the business premises test⁶⁰ and stay outside the PSI rules. However as pointed out by Hill J, Part IVA is very likely to strike down any tax benefit arising from the alienation of the relevant income.

VIII CURRENT APPROACH BY THE COMMISSIONER

In the fact sheet⁶¹ the ATO has indicated that the following types of arrangements are likely to require closer investigation for a potential application of Part IVA:

- Income is retained in the personal services entity and in addition splitting of income with other family members occurs.
- Husband and wife partnerships deriving income but where one of the partners does the dominant amount of the work but income is shared 50/50.
- Income paid to the principal in the entity where the income is not commensurate with the duties of that individual. An example of this would be where non-commercial salaries are paid to the principal.
- Excessive remuneration paid to a related party, eg spouse. The focus is on non-principal work. Remuneration includes superannuation contributions made – note the provisions governing super contributions are age based rather than salary based.
- Where a personal services business earns income from a few clients rather than from many clients.

In the fact sheet, the Commissioner is not prohibiting a taxpayer from operating through an entity structure. In fact he provides the following guidance:⁶²

\[\textit{Company:}\]

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⁵⁸ Section 87-15(2)(b) ITAA 97.
⁵⁹ Section 87-15(2)(c) ITAA 97.
⁶⁰ Section 87-15(2)(d) ITAA 97.
⁶¹ See above n 45.
⁶² Ibid.
If you operate through your company and there is no income splitting and no retention of profits in the company (for example, if the only advantage for income tax purposes is access to greater superannuation benefits) then Part IVA will not apply.

If a bona fide attempt is made to break even, a relatively small amount of taxable income may be returned by the company provided that income is distributed to you by way of a franked dividend in the following year.

**Trust:**
If you operate through your trust with a corporate trustee the position is the same as for companies.

You should receive income from the trust in relation to the personal services income that is commensurate with your duties and responsibilities, or be the sole beneficiary of the trust in relation to that income.
Partnership:
If you are in business and you conduct that business with your spouse through a genuine partnership then this will be accepted for income tax purposes.

Where the partnership income results from the personal services of one or more of the partners (not from the services of employees or the use of income-producing assets) and where there is splitting of that personal services income which reduces the amount of income tax which might otherwise be payable, then Part IVA may apply to this arrangement.

IX NON-COMMERCIAL REMUNERATION

A question could be asked as to whether the Commissioner can attack non-commercial remuneration. The primary issue here is if the Commissioner can, firstly, determine what a commercial remuneration is for a principal in a personal services entity, and, secondly, whether he or she can require an entity to pay that level of remuneration to the principal? Note that in the absence of the specific PSI rules discussed already there is no specific provision giving the Commissioner this power. Accordingly, it would appear that the Commissioner would be required to consider Part IVA. If the Commissioner can succeed with applying a non-commercial remuneration argument through the application of Part IVA this would substantially reduce the ability for income splitting.

The Commissioner has discussed commercial remuneration in Taxation Ruling IT 2330 as follows:63

the payment of a salary to the former proprietor considerably lower than the profits which he or she formerly derived from the business, accompanied by a corresponding diversion of income to family members, would require examination. There may be good and valid reasons for the particular level of salary, e.g. reduction in duties and responsibilities, contraction in business activities, payment that adequately enough compensates for the work that is done, participation by beneficiaries in the business activities, etc. As a general proposition the level of salary paid to the former proprietor should be no less than commensurate with his or her continuing duties and responsibilities.

Of course the Commissioner’s analysis here relies on there being a former business or former employment. If there are no precedent activities it may be more difficult for the Commissioner to determine a commercial salary.

In relation to remuneration paid to family members Taxation Ruling IT 2330 provides that:

a taxpayer in business may employ family members in the business - provided the employment is bona fide and the wages reasonable in amount, an income tax deduction is allowable for the wages.

63 Paragraph 29 of Taxation Ruling IT 2330.
On the subject of remuneration it would appear that, irrespective of whether the remuneration is to the principal or family members, the remuneration should be commensurate with the level of responsibilities in consideration of normal remuneration in the particular industry. Of course there will be many situations where it is not easy to determine exactly the correct commercial remuneration but it would certainly be possible to determine a range within which a person should be remunerated. If the actual remuneration were clearly outside that range then further investigation would be required.

Of course the Commissioner may take a more direct approach to determining commercial remuneration in a particular situation involving PSI. For example, rather than determine industry comparatives, the Commissioner may take the approach that if the primary income from the activity is derived from the services of one individual then all income reduced by allowable deductions should be the relevant remuneration amount. This may be seen as a harsh approach, and in many respects it is very similar to the outcome achieved when the PSI\textsuperscript{64} rules apply.

**X WHY PAY A LOW SALARY?**

It appears that the Commissioner’s initial reaction to the payment of a low level of salary is that there is a tax avoidance purpose. This may not always be the case as there can be other considerations, including:

- Profits may be retained to purchase business assets.
- Profits may be retained to retire debt incurred in acquiring the business.
- Profits may be retained to provide working capital for the business and retain a satisfactory level of liquidity.
- A low salary may be paid to reduce salary on-costs such as work cover, payroll tax and SGC.
- Retaining profits may assist in boosting the value of the business for future sales.

It would appear that the Commissioner considers that any retention of profits may give rise to a consideration of Part IVA. Taxation Ruling IT 2503 discusses this matter in relation to practice entities.\textsuperscript{65}

The retention of profits in the practice company is generally not acceptable. Where profits are retained, salary payments and, therefore, superannuation contributions will be reduced accordingly. Although at times the tax rates on the salary in the hands of the professional and the profits in the company may be the same, the purported main object of the incorporation, obtaining superannuation, will be frustrated. In effect, any retained profits will put in doubt the very basis on which the arrangements have been put forward and accepted, viz., the provision of superannuation benefits.

\textsuperscript{64} Divisions 84 to 87 ITAA97.

\textsuperscript{65} Taxation Ruling IT 2503 para 10.
This ruling does consider a situation where there are profits retained but provides that any retention should be merely temporary as follows:66

However, where a bona fide attempt has been made to break even but the practice company returns a relatively small taxable income because of the above or similar difficulties, the company should distribute all its taxable income, to the professional person by way of franked dividend, in the following year.

The ruling goes on to discuss the potential application of Part IVA where all profits are not distributed as follows:67

On the other hand, a practice company that makes little or no attempt to distribute the whole of its income to the professional person by way of salary prior to the end of its financial year, or retains income in the company, will not be taken to have made a bona fide attempt to comply with the guidelines. … In cases of this sort the income from the practice should be treated as that of the professional practitioner involved and reliance placed on Part IVA.

XI WHAT IF THE USE OF AN ENTITY IS FORCED UPON THE TAXPAYER?

In many cases taxpayers are required by service recipients to offer their services through an entity and accordingly it may be open to these taxpayers to argue that the use of the entity is not for a tax related purpose. The Commissioner in the fact sheet68 discussed this situation as follows:

Even if you have to provide your services through an interposed entity in order to obtain the relevant service contract Part IVA may still apply if you use that entity to split your income or retain profits.

In essence the Commissioner’s comments are suggesting that the mere fact of using an entity to provide services may be fine but you cannot seek to derive tax benefits from the use of the entity. This issue was discussed at length in Case W58.69 In that case the taxpayer was required to provide his services through a company in order to work as a consultant. He acquired a shelf company to act as his family company and, acting on professional advice, created a discretionary family trust the trustee of which was the family company. Consulting fees paid to the trustee company were retained to pay any debts or expenses of the family company, partly paid to the taxpayer as salary and partly distributed as trust income to members of the taxpayer's immediate family as beneficiaries under the family trust.

66 Ibid para 11.
67 Ibid para 12.
68 See above n 45.
69 Case W58 89 ATC 524.
The Commissioner, relying on s 177F, included in the taxpayer's assessable income part of the consultancy fees distributed by the family trust as trust income. The Commissioner contended that the whole arrangements entered into by the taxpayer constituted a ‘scheme’ for the purposes of Pt IVA, whereby surplus income of the family company was distributed to others, resulting in the taxpayer obtaining a tax benefit which should be cancelled.

The tribunal, in agreeing with the Commissioner’s argument, initially discussed the non-commercial nature of the salary paid to the taxpayer:70

I accept that the distribution occurred in the way set out in Exhibit 12 and I accept that the income received by the taxpayer bears no relationship to the services provided by him to the X Company through the TFC …

Clearly the payment of a non-commercial salary to the taxpayer influenced the tribunal in coming to the finding that Part IVA applied. The tribunal went on to discuss the requirement to form a company to undertake the income earning activity but was satisfied that there was no need to form a family trust in order to earn assessable income. The tribunal went on to discuss the entity structure as follows:71

The form of a corporate vehicle which employed the taxpayer and controlled the trust belies the real substance of that arrangement which essentially allowed the taxpayer to act in such a way as to attract to himself a lower incidence of personal income tax. The taxpayer, and his wife, were always in control of the income “coming in” and merely acted in such a way as to generate as small a liability to income tax as possible.

And further:72

I am satisfied, on the balance of probabilities, that having regard to the matters listed in sec. 177D para. (b) that the purpose of the taxpayer when he entered into and carried out the scheme was to obtain a tax benefit. It is not sufficient that this situation be described as a normal family arrangement. The ramifications of Pt IVA on a particular set of facts will always be judged on a case by case basis and no assistance will be gained from the establishment of broad categories such as “normal family arrangement”.

It is interesting to note that there is very little discussion in Case W58 about the question of whether the income earned by the taxpayer was business income or income from a business structure. This has been discussed earlier in this paper but the comments of the Commissioner in Taxation Ruling IT 212173 put the Commissioner’s position beyond doubt:

70 At para 532.
71 At para 536.
72 At para 537.
73 Taxation Ruling IT 2121, Income Tax: Family Companies and Trusts in relation to income from personal exertion.
Moreover, looking at the substance of these arrangements, the interposed entity is not itself carrying on a business. The income [from] which it purports to derive comes wholly, or almost wholly, from the work done by the taxpayer and that work is largely confined to work for the employing firm. In a practical sense, to say nothing else, the taxpayer works as an employee of the former employer.

The ruling goes on to further criticise these arrangements:74

In the view of this office all of these arrangements may be characterised as arrangements entered into primarily or principally or predominantly to avoid liability for income tax by means of the splitting of income. They are not explicable as ordinary business or family dealings. … The tax benefit arising out of arrangements entered into on or after 28 May 1981 will be removed through the application of Part IVA. … the practical result will be that the taxpayer doing the work will be liable to tax on the amount paid by the former employer to the interposed entity.

In situations where there is an interposed entity the Commissioner is more likely to apply Part IVA where upon the formation of the entity:75

(a) The taxpayer performs the same tasks as employees might ordinarily perform and generally works under the same physical conditions as other employees.
(b) The taxpayer attends throughout normal business hours the premises of the firm for which personal services are rendered through the interposed entity.
(c) The basis of payment of the income is akin to that normally paid for the personal services.
(d) In the performance of the duties the taxpayer is subject to a measure of control by the firm for which personal services are rendered.
(e) The firm has the right to dismiss the taxpayer.

The ambit of the Commissioner’s attack is clarified by the following comments:76

[Part IVA applies] to any arrangement for the splitting of income and consequent avoidance of liability for income tax where:
(a) the income involved is income arising from a taxpayer's personal exertions; and
(b) the arrangements operate solely in respect of that income.

The question of course is whether the Commissioner is aiming to extend the application of Part IVA to situations where income is not earned from personal exertion but from business assets. The following comments are relevant to set the scene:77

74 IT 2121 para 11.
75 IT 2121 para 15.
76 IT 2121 para 16.
77 IT 2121 para 18.
Taking up a point of contrast, in a true business situation, whether it be that of a sole trader or an individual professional practice, there will be many cases where arrangements are made to conduct the business or practice for the benefit of family members. The assets of the business, e.g. plant and machinery, trading stock, goodwill etc., will be transferred to a family company or trust and the business will be carried on thereafter for the benefit of family members.

However the Commissioner falls short of fully clarifying his position on the application of Part IVA to businesses as follows:

Whether or not the transfer of the income producing assets of a business to a trust and the subsequent conduct of the business for the benefit of family members is affected by section 260 or Part IVA can only be determined in the light of the circumstances of each case. Accordingly that matter is not addressed in this ruling. It should be remembered there is no inherent reason to deny that a business undertaking, be it carried on by an individual, partnership or company can be made the subject of a trust.

There is established authority on whether the transfer of business assets by means of sale or genuine gift to a family trust is an acceptable practice and not likely to be caught by Part IVA. The case of *Tupicoff v FC of T*78 discussed this matter as follows:79

The taxpayer further argues that the reasoning in Purcell's case (DFC of T v Purcell (1921) 29 CLR 464) demonstrates that sec. 260 cannot apply here. But that was a case of an out and out gift of a portion of certain property to members of the taxpayer's family under a declaration of trust. The beneficial interest in the property passed absolutely, and, despite the retention of wide powers of management, it was possible to characterise the transaction as no more than an “ordinary family dealing” (cf. Hollyock, supra, at ATC p 4205; CLR p 655). However, in the present case, there is no such absolute gift.

This analysis appears to provide some element of certainty that Part IVA will not apply where there is a transfer of property and income subsequently derived from that property can be distributed in accordance with the terms of a trust. Case W58 by contrast appears to provide guidance that Part IVA will apply where an interposed entity has been used to split personal service income.

The more recent case of *FC of T v MacArthur*80 provides a further example of the application of Part IVA in what was essentially a PSI case. In that case the taxpayer had previously been employed by the Department of Mains Roads (DMR) in Queensland as a civil engineer for ten years up to 1982. After his resignation he and his wife worked overseas until 1986. Upon returning to Australia in 1986 the taxpayer and his wife used a company to provide engineering services and to enable the taxpayer and his spouse to get access to superannuation.

78 *Tupicoff v FC of T* 84 ATC 4851.
79 Ibid para 4863.
80 *FC of T v MacArthur* 2003 ATC 4826.
In 1988 the company contracted to provide the services of the taxpayer to DMR and other parties. Many of the contracts specified an hourly rate and the taxpayer being nominated as the person to perform the actual work. The Commissioner considered that the income received by the company was the taxpayer's assessable income on the basis that the consulting services arrangement was a scheme to which Pt IVA applied.

The Federal Court, in agreeing with the Commissioner, considered that the arrangement was one to which Part IVA applied. It is noted that while the contracts were performed by the taxpayer for DMR his behaviour was very similar to the behaviour exhibited by an employee of DMR including such things as the completion of timesheets signed by the taxpayer and submitted by the company.

The court concluded that the taxpayer was legally not an employee of DMR even though he exhibited similar behaviour to an employee and the fact that the taxpayer was not an employee since 1982 clearly weighed in the favour of the taxpayer arguing that Part IVA did not apply because of the period of time since the earlier employment. The court addressed a broader question of whether the taxpayer would have received (or it was reasonable to expect that he would have received) assessable income in the absence of the scheme and stated it thus:81

In other words, the proper inquiry is as to what may have occurred had the scheme not been adopted and as to any amount which might, in those circumstances have been included in the taxpayer's assessable income. In the present case, the contracts with the Main Roads Department were identified as aspects of the scheme, but the relevant tax benefits need not have been tied to notional contracts that the taxpayer may have entered into with the Department. The Commissioner might well have postulated that the taxpayer would have continued to practise his profession in his own name, deriving income from retainers received from various unidentified entities, possibly, but not necessarily including the Main Roads Department.

The court in concluding that Part IVA may apply agreed that, in the absence of the scheme, the taxpayer would have received assessable income:82

There was every reason to expect that in the absence of the company, the taxpayer would have continued to practise his profession in his own name. It was quite possible that in so doing, he would have entered into contracts with the Department. The Tribunal's failure to deal with this possibility suggests to me that it misunderstood the appropriate question for consideration.

81 Ibid, Dowsett J at para 4834.
82 Ibid, para 4835.
XII ARE THERE SITUATIONS WHERE PART IVA WILL NOT APPLY?

You could be forgiven at this stage of this paper for perceiving the Commissioner as having the ‘whip hand’ in applying Part IVA to all transactions involving the alienation of PSI to an interposed entity. The case of FC of T v Mochkin provides evidence that where the other requirements of Part IVA are not satisfied the existence of a tax benefit from channelling income through an interposed entity will not be sufficient to strike down the arrangement.

In 1987 the taxpayer entered into a commission-sharing arrangement with a firm of stockbrokers who subsequently sued the taxpayer for losses that arose from defaults by the taxpayer’s clients. The stockbroking firm was successful in its claim for damages. At about the time of the court case for damages, the taxpayer commenced trading through a family trust (and subsequently through another family trust). The objective of the taxpayer was to limit his personal liability from the likelihood of being sued in the case of future client defaults.

The Commissioner argued, firstly, that the income derived by the family trusts should be included in the assessable income of the taxpayer, and, secondly, that the use of the trusts was a scheme to reduce the tax otherwise payable by the taxpayer. As with most schemes that require consideration there are commercial objectives as well as tax objectives. The question, of course, is whether the tax benefits merely come about as a result of affecting the scheme in a commercial manner, or whether steps in the scheme were added to enable the tax benefits to be achieved. This analysis must be completed in recognition of what the dominant purpose of the taxpayer is in affecting the trust structure. The Full Federal Court agreed with the Primary Judge as follows:

his Honour considered that the manner in which the scheme was entered into or carried out pointed to other purposes having actuated the Taxpayer. The most obvious was to immunise the Taxpayer personally, as well as the separate assets of himself and Daccar, from liability for client defaults or other debts or obligations of the business. Another purpose was to allow the business to build up goodwill, which could be detached from the Taxpayer's personality and continued participation in the business …

The Full Court in balancing the commercial and tax objectives observed:

It can readily be concluded that the Taxpayer had tax advantages in mind in choosing a discretionary tax structure as the means of carrying out the scheme. Doubtless, there were other ways in which he could have chosen to conduct the stockbroking business and to immunise himself from personal liability. … [T]he question is whether, in view of the matters identified in s 177D(b) it is reasonable to conclude that the Taxpayer's ruling, prevailing or most influential purpose in entering into or carrying out the scheme was to obtain the tax benefit identified by the Commissioner. In my respectful opinion, the primary Judge

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83 FC of T v Mochkin 2003 ATC 4272.
84 Ibid para 4283.
85 Ibid para 4290.
was correct in finding that a reasonable person would conclude that the tax advantages of the scheme were subsidiary to the commercial objectives. The Taxpayer has therefore established that a reasonable person would not conclude that he entered into or carried out the scheme for the dominant purpose of obtaining a tax benefit in connection therewith.

The foregoing analysis indicates that Part IVA will not apply where the normal requirements for its application are not satisfied. However it would appear that the avenues of defence against the application of Part IVA appear limited in relation to the determination of the existence of a tax benefit. The mere fact of operating through an entity and not paying all income to the person performing the personal services appears sufficient for the courts to find that there is a tax benefit present. The eight factors in s 177D that need to be considered in order to conclude that there exists a dominant tax purpose appear more difficult than the tax benefit test to apply in PSI cases.

The requirement to set up an entity to limit personal liability in the Mochkin Case appears in some respects similar to the need in Case W58 to set up a company in order to be able to provide personal services. As the tribunal in Case W58 concluded, the mere formation of a company was not enough in itself to be caught by Part IVA, it was the manner in which the company as corporate trustee split the income with family members that was the determining factor. The Commissioner endeavoured to argue this point in Mochkin as well:

The Commissioner attempted to meet this formidable difficulty by asserting that, even if a corporate entity had carried on the business, that entity would have paid or distributed to the Taxpayer the income that in fact was distributed to the beneficiaries through the No 2 Trust. However, this submission seems to assume, contrary to the primary Judge's findings, that the commission income was generated solely by the Taxpayer's own efforts and that the so-called Ledger team was (in Mr Maxwell's words) “largely ephemeral”.

It would appear that the Full Court is stating that the income derived by the trust was not really personal services income (as it was in Case W58) but was being generated from the services of a number of employees. As the income was not PSI then Part IVA was not applied as it was in Case W58. The Full Court did recognise, however, that the taxpayer should have been remunerated appropriately for his services:86

In view of the findings made by the primary Judge, it is difficult to see why, assuming the Ledger scheme had not been entered into or carried out, the net commission income derived by the hypothetical corporation substituted for Ledger, would have found its way to the Taxpayer. It might have been expected that some of that income would have come to the Taxpayer, in the form of a fair reward for the services he would have provided to the corporation. But the primary Judge was not asked to and did not make a finding as to what a fair salary might have been for the Taxpayer, if his salary was to reflect his contributions to Ledger or to a hypothetical corporation conducting the business.

86 Ibid para 4290.
As noted in this extract the Commissioner did not ask the court to make a determination as to what may be reasonable remuneration for the services of Mr Mochkin. If the Court did have to consider this matter the result may have been interesting but as the matter was not fully addressed we will have to wait until a further opportunity arises.\(^{87}\)

**XIII INCOME FROM A BUSINESS STRUCTURE IS FINE BUT…**

The analysis in this paper appears to indicate that if you earn income from a business structure Part IVA will not have immediate application, while income from personal exertion channelled through another entity will be captured. This raises the question of whether there are some types of activities more likely to be captured by Part IVA than others. Clearly where an economic activity earns income mainly from the sale of goods then this income will not be PSI and is thus less at risk from Part IVA where it is split with parties other than the taxpayer. This has the potential to create an inequity between different types of taxpayers. For example, taxpayers primarily providing personal services will be disadvantaged compared to taxpayers earning income from a business structure and the use or sale of assets. In addition, certain businesses in their early years may be more likely to derive PSI, whereas in later years the income may be mainly from the business structure or from the services of employees.

**XIV USE OF SERVICE TRUSTS: PSI AND PART IVA**

There may be an option to set up a service trust to provide administration services either directly to a personal service provider or indirectly to a personal services entity. The question of course is whether this is caught by Part IVA—in other words, assuming that the personal service provider is outside of the PSI rules, can the person use a service trust to provide administrative services and not be impacted by Part IVA? It would appear that the service trust would need to satisfy the normal Part IVA rules as they apply to it or otherwise any tax benefit may be struck down.

The use of service trusts has been very common since the case of *Phillips v FC of T*.\(^{88}\) The Commissioner appears to sanction the use of services trusts\(^{89}\) in his following comments:

> Given the view of the facts which the court adopted, that is, a re-arrangement of business affairs for commercial reasons and realistic charges not in excess of commercial rates, the decision to allow a deduction must be accepted as

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\(^{87}\) There were two issues in the Mochkin case that the Commissioner sought to apply Part IVA to. This paper discusses only one; the Commissioner was successful in applying Part IVA to the other transaction which essentially involved the taxpayer attempting to divert income that he had already derived to a family trust.

\(^{88}\) *Phillips v FC of T* 77 ATC 4169.

\(^{89}\) Taxation Ruling IT 276 para 4.
reasonable. Accordingly, the decision is not seen as requiring any alteration to existing policy concerning payments of this nature.

It would appear that, based on these comments, the use of a service trust is fine provided that the relevant charges are set at commercial levels. The following are some key issues in defending a service trust from attack by Part IVA:

- The dominant purpose for setting up the trust cannot be to obtain a tax benefit. It needs to be asset protection and the relief of the principals from the administrative burden of running the administration side of the business. To ensure that the argument of asset protection is defendable, then, as many assets as possible should be transferred out of the practice entity to the service trust.

- If the service trust is to provide services of added value to the practice entity then the service trust must deliver tangible managerial services—the employment of a professional manager is evidence of this.

- It would appear best that all non-professional staff should be employed by the service trust.

- Clearly principals of the practice entity should not be employed by the service trust. Non-principal professional staff should not be employed on a long-term basis by the service trust.

- All agreements between the service trust and the practice entity should be fully documented. Also, where such agreements exist, the actual practices of the entities should be in accordance with those agreements.

- The service arrangements should be reviewed regularly and necessary amendments undertaken.

- All fees charged should be commercially realistic including full documentation of how the fee was established.

- Avoid doubling up of charges by ensuring that if the labour component is already marked-up then services performed by those staff should not be marked-up.

- The issue of tax invoices, the payment of fees, and the collection of debts must be done on commercial terms. Apply wherever appropriate an ‘arm’s length’ principle in dealings.

- As the two entities are separate it is appropriate that each entity has its own set of accounts, own bank accounts; the principals of the practice entity do not treat the assets of the service trust as their assets.
XV CONCLUSION

This paper has analysed the potential operation of the general anti-avoidance provisions in Part IVA to income that is earned by personal service entities where one of the personal services business tests is satisfied and the PSI rules do not apply. The paper discusses the concept of PSI and distinguishes this income from income that is derived from a business structure. The paper concludes that it would appear that there is a considerable body of authority supporting the potential application of Part IVA to PSI derived by an entity where that income is not paid to the individual who is performing the services that generated that income.