

Thursday, 17 October 2024

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By email: SBPAGConsultation@ato.gov.au

Dear Sally

PCG 2024/D2 Personal Services Businesses & Part IVA of Income Tax Assessment Act 1936

Chartered Accountants Australia and New Zealand (CA ANZ) and the Institute of Public Accountants (IPA) appreciate the opportunity to comment upon draft Practical Compliance Guideline PCG 2024/D2 *Personal services businesses and Part IVA of the Income Tax Assessment Act 1936 (Draft PCG)*.

We welcome the ATO publishing guidance to assist taxpayers and tax practitioners determine when the ATO will consider the application of Part IVA of the *Income Tax Assessment Act 1936* (the general anti-avoidance provisions) to an alienation arrangement where personal services income (PSI) of an individual is derived through a personal services entity (PSE) that is conducting a personal services business (PSB).

The practical approach of the Draft PCG and the 13 examples provided are welcomed. However, we are concerned that the examples do not reflect the commercial reality of running a business.

The examples relating to the retention of income by companies is narrow

The examples suggest that the retention of income is only “low risk” when the purchase of a specific asset for a specific amount can be identified as needing to be made in the following year. The “low risk” examples in the Draft PCG all involve the PSE distributing all the profits to the individual or distributing all the profits after making a purchase of an asset. This suggests that to be considered low risk, a company cannot retain any profits. This is reinforced by the sixth high-risk indicator which states that the ‘mere fact that PSI is retained’ automatically triggers a higher-risk rating.

There needs to be a recognition of a wider range of circumstances when funds are appropriately retained, such as the retention of amounts to fund general working capital to cover the payment of invoices, a cash buffer to cover late customer payments or to fund unexpected emergencies e.g. urgent repairs to premises. For example, if the PSB typically incurs \$5,000 a month of overheads, it should be able to retain some profits to fund these costs in the next financial year, particularly if it anticipates it will not receive revenue in the short term. If the PSB only anticipates being paid for completing a contract in September, it should be able to retain \$15,000 of profits to fund its costs until it is able to receive its next payment. This is part of the cash flow management of any business, and it should not be the case that the PSB is expected to distribute the profits and immediately borrow them back.

That would be a more artificial and contrived means to fund future expenses than merely retaining profits to do so.

Example 9 suggests that investing retained profits in a passive investment such as a share portfolio will automatically trigger a higher-risk rating. It would be interesting to have an example where the passive investment was a modest and highly liquid investment such as a term deposit, cash holdings in high interest accounts, to determine whether it would be considered a low-risk arrangement by the ATO.

Timing of the profit calculation

Example 4 indicates that in the ATO's view, calculating profit and bonus figures prior to 30 June should be the norm and that undertaking the calculations after year end is only acceptable in one-off special circumstances. This does not reflect commercial reality.

It is often impractical to determine the profits of a company before year end and pay the entire amount as a bonus or dividend before 30 June. It is suggested that the draft guidance include a low-risk example which has a PSB finalising their accounts within a reasonable time after year-end.

Materiality

Example 8 suggests that, within the higher-risk category, a retained amount of \$380,000 or 95% of gross income (\$400,000) means that the ATO is more likely to have cause to apply compliance resources to the arrangement. On the other hand, should the PSE retain only \$20,000 or 5% of gross income, the ATO would be less likely to have cause to apply compliance resources.

While materiality is referred to paragraph 37 in context of an inefficient use of ATO resources we would appreciate greater clarity on the ATO's views in relation to materiality thresholds in terms of percentages and amounts. It would also be worthwhile clarifying whether business expenses should be considered in calculating materiality — this example uses gross income which is inconsistent with the message elsewhere that it is the net PSI which needs to be distributed to the individual.

A business owner will pay themselves last if financial viability of a business is at risk

Example 13 suggests that BLD should pay a bonus or salary to Tom equal to the net PSI made by BLD for the year. However, given BLD is in losses from its other operation, there could be a serious risk that paying a large amount to Tom could cause BLD difficulties paying its creditors and run the risk of insolvent trading. It is suggested that such commercial factors should be considered when determining whether the transaction is low or high risk.

Remuneration

In the low-risk examples 1 and 2, it is specifically noted that the employee who performs administrative services is paid in accordance with the relevant State award. In practice, many private businesses — large and small — may choose to (and can afford to) pay employees higher than award wages for genuine commercial reasons, perhaps to reward and retain a high performer or perhaps because it is particularly difficult to recruit someone with the right skills and availability in the local area. In the context of private businesses which are not subject to statutory caps on wages and salaries, taxpayers should not be left with the impression or at least uncertainty that their employees' wages should be 'capped' by a threshold which for employment law purposes is designed to be a floor. The PCG should confirm that paying an employee higher than award wages will not in itself trigger a higher-risk rating. We also note that awards do not apply in many industries. Accordingly, we suggest that the wording should be amended to simply reflect that the employees are being paid commercial, market value wages and salary.

Footnotes 27 and 31 explain that in most cases, a salary or other distribution that is commensurate with the duties and responsibilities of the individual will be the gross amount received by the PSE less allowable deductions. In other words, in most circumstances, any income splitting or income retention will be treated as higher risk. While we agree that Part IVA can apply, it appears to be too high a threshold to set that any alienation should automatically trigger a higher risk of review, when alienation of PSI derived through a PSB is generally legal and contemplated by the PSI provisions.

An additional example that could be incorporated in the PCG, is how would the 'definition' of remuneration that is substantially commensurate with the value of personal services of the individual work in a scenario where the PSE is a company, and a significant proportion of the shares are owned by someone who is not working in the business but provided much of the start-up capital. For example, perhaps a retired parent or relative had funds to invest in the business but does not derive much annual taxable income. They are rightfully due to receive their dividends as a return on their investment but they are on a lower tax rate than the service provider. The draft PCG would imply that this would not be a low-risk scenario. The service provider may then need to take out interest-bearing loans rather than accept capital contributions in exchange for shares.

Professional services and trades

All the examples relate to providers of professional services, with some references to administrative support. Professional service providers are not the only ones to provide services in this manner. It would be useful if there were examples that included taxpayers working in the trades, e.g. plumbers, electricians, especially if it included a scenario where there is also an apprentice.

If you would like to discuss any of the above, please contact CA ANZ Senior Tax Advocate, Karen Liew at Karen.Liew@charteredaccountantsanz.com.

Sincerely,

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