The Institute of Chartered Accountants in Australia

29 July 2009

Mr Keith James
PSI Working Group Chair
Board of Taxation
The Treasury
Langton Crescent
CANBERRA ACT 2600

Dear Mr James

Post-Implementation Review into the Alienation of Personal Services Income Rules

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to make this submission to the Board of Taxation's post-implementation review into the alienation of personal services income rules (the APSI rules).

By way of background, it is useful to point out that the Institute represents more than 62,000 Chartered Accountants in Australia, and that its members work in diverse roles across commerce and industry, academia, government, and public practice throughout Australia and in 140 countries around the world. Owing to the diversity of its membership, the Institute considers itself to be well positioned to make a valuable contribution to the issues being examined in this Board of Taxation review.

We understand that the Board of Taxation (the Board) and the Government have determined that the scope of this review is to examine whether or not the APSI rules, introduced in July 2000, are considered by taxpayers and their advisors to be delivering the government's original policy objectives. The Board has also asked those making submissions to identify whether any improvements can be made to the operation of the rules.

Specifically, the Board's letter of invitation dated 16 June 2009 states that it is seeking to identify the extent to which the APSI rules:

- give effect to the government's policy intent, with compliance and administration costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure;
- is expressed in a clear, simple, comprehensible and workable manner;
- avoids unintended consequences of a substantive nature;
- takes account of actual taxpayer circumstances and commercial practices;
- is consistent with other tax legislation; and
- provides certainty.

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Overall remarks

The Institute understands the clear underlying policy objectives surrounding the introduction of the APSI rules in July 2000, which followed recommendations made by the Ralph Review of Business Taxation in 1999. At that time, the practice of 'income splitting' and tax deferral was evidentially shown to pose an increasing threat to the revenue and the existing mechanism by which the Commissioner of Taxation was able to challenge such arrangements relied substantially on the use of the general anti-avoidance rules in Part IVA of the Income Tax Assessment Act 1936 (and prior to that, section 260).

The Ralph Review of Business Taxation in 1999 identified that there was 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'.[1] This practice was sometimes referred to as 'Friday night, Monday morning' arrangements. The Review identified that there had been a 320 percent increase in the use of such arrangements over the preceding 20 year period.

The introduction of the new APSI rules from July 2000 constitutes a specific – albeit incomplete – anti-avoidance code primarily dealing with the practice of 'income splitting' and tax deferral.

It is important to note that the use of a personal services entity (PSE) structure is not always motivated by a desire to engage in 'income splitting' and/or tax deferral. In some cases, it is legally necessary for individuals to carry-out their duties through a legal structure in order to satisfy certain contractual, legal and/or occupational health and safety obligations. The impact of the APSI rules on the use of PSEs for non-tax motivated purposes such as these should not be overlooked by the Board in carrying-out this review.

Whilst the Institute is supportive of the underlying policy objectives of the APSI rules, the current regime which applies under Part 2-42 of the Income Tax Assessment Act 1997 is considered by many of our members to be overly complex and therefore in some ways, ineffective, in achieving all of the government's original policy objectives in this area.

These high levels of complexity result in significant compliance costs for taxpayers and their advisors in seeking to self-assess the application of the APSI rules. When viewed in the context of the micro-businesses who are typically exposed to the APSI rules, the significant compliance costs present a disproportionately significant burden falling on those taxpayers and their advisors in complying with the APSI rules.

It is interesting to note that the Regulation Impact Statement that accompanied the Explanatory Memorandum to the New Business Tax System (Alienation of Personal Services Income) Bill 2000 foreshadowed that "small up-front costs" would be incurred by taxpayers in familiarising themselves with the new law, and that "overall, the measure in this Bill is expected to reduce compliance costs for businesses".[2]

In conducting this review, the Board should determine whether the government's policy objectives could be better served by undertaking a more thorough process of re-examining the underlying policy and the best vehicle through which to deliver that policy with a view to determining whether a re-write of Part 2-42 is warranted in the future. The Institute's view is that simplification of the APSI rules is necessary in the future in order to better achieve the government's policy objectives and improve overall taxpayer awareness and compliance in this area.

The Explanatory Memorandum states that the overarching policy objective of the APSI rules is to:

> "… Improve the integrity of the tax system by addressing both of 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".[3]

[1] Review of Business Taxation: A Tax System Redesigned, Report July 1999, page 48
[2] Paragraphs 2.13 and 2.14 of Chapter 2 of the Explanatory Memorandum to the New Business Tax System (Alienation of Personal Services Income) Bill 2000
[3] Page 3 of the Explanatory Memorandum

In the sections below, the Institute makes note of some practical difficulties encountered by our members in seeking to apply the APSI rules to individual taxpayer circumstances. These practical issues address some of the Board's review objectives around what appear to be unintended consequences, as well as identifying whether or not the APSI rules appropriately take account of the commercial circumstances of taxpayers.

Part IVA is still an issue for the Commissioner and taxpayers

One of the principal reasons for the introduction of the APSI rules was that the Commissioner of Taxation was finding it increasingly difficult to apply the Part IVA general anti-avoidance rules to each incidence of 'income splitting' and tax deferral which involved an alienation of personal services income. The introduction of the APSI rules in Part 2-42 was intended to alleviate the problems encountered by the Commissioner and provide a mechanism for taxpayers to self-assess their own situation to determine whether they would be viewed as deriving personal services income which should be attributed to the test individual. Where a test individual is deemed to be deriving personal services income and therefore attributed such income, the individual would be taxed at their normal marginal tax rate. Furthermore, certain deductions against that assessable income will be denied when contrasted against the deductions which may have been available to the individual had that income been derived through a PSE structure.

Notwithstanding that an individual may pass one or more of the four personal services business (PSB) tests contained in Division 87, it may still be the case that the individual's arrangements could be challenged through the application of the general anti-avoidance rules in Part IVA. Is such a situation, the individual will find themselves in a position where they have been through a long and complex process of determining whether or not they derive personal services income through a personal services business, only to still be left with an exposure to further uncertainty and complexity through the potential application of Part IVA on the basis that the arrangement is viewed by the Commissioner as one that involves a sole or dominant purpose of obtaining a tax benefit. The explanatory memorandum to the APSI Bill identifies this potential risk.

In the Institute's view, the potential application of Part IVA is not a consideration or risk factor that is well understood by all tax advisors involved in advising their clients about the impact of the APSI rules. There is anecdotal evidence that some tax advisors consider that Part IVA does not have a role to play once a taxpayer has satisfied one or more of the PSB tests in Division 87. In contrast, there are other tax advisors who are unsure about the potential application of Part IVA and who therefore adopt an overly cautious approach to advising their clients in this area.

This uncertainty and complexity presents a significant challenge for taxpayers and their advisors. The compliance burden which results is considered to be overly burdensome and disproportionate when considered in the context of the level of awareness and tax sophistication of taxpayers who are most impacted by Part 2-42; As the Board will be aware, such taxpayers often do not have the resources or capacity to seek complex professional advice from a tax advisor who is appropriately skilled and experienced in the application of both Part 2-42 and Part IVA.

Denial of certain deductions under Division 85

As the Board will be aware, Division 85 of the APSI rules can apply to deny or limit certain deductions in respect of personal services income incurred by taxpayers.

Whilst the rationale for such limitations under Division 85 is understood, the Institute has received representations from some of its members that the operation of these rules [specifically sections 85-10(2)(d) and (e)] can result in a seemingly anomalous outcome whereby certain costs incurred in respect of essential functions such as bookkeeping are denied when paid to an associate (such as a spouse). The equivalent costs would however be deductible if they were paid to a third party.

In such situations, it would appear to be artificial to deny the taxpayer a deduction for such costs incurred if paid to an associate. It may be appropriate therefore to re-consider the application of Division 85 and whether appropriate amendments could be made to ensure that tax deductions are available where legitimate costs

[incurred on an arm's length basis] are incurred in deriving assessable personal services income, even where that work is not considered to be part of the 'principal work' from which the individual derives that income.

Mismatch between accounting and attributed income tax rules

Where the APSI rules operate to attribute certain income to an individual rather than a PSB carried on through a PSE, the practical challenges that can result from the 'mismatch' between accounting and tax classification can be both significant and complex.

The mismatch arises as a result of the deemed attribution that takes place for tax purposes under Part 2-42, whereas for accounting and financial reporting purposes, such an attribution does not take place. For some time, a solution to this mismatch has not been able to be identified. In some cases, taxpayers will not be aware of the potential accounting and tax mismatch that can arise in this situation.

There are potential risks associated with retaining attributed PSI in the retained earnings of a company, as that account may be viewed as being available to creditors in the event of winding-up and liquidation. Similarly, there are potentially adverse commercial consequences and additional costs that can arise from the actual payment as salaries and wages of all attributed PSI; for example, payroll tax and superannuation obligations may arise in respect of the payment of such salaries and wages.

Whilst the Institute acknowledges it is not the role of the taxation laws to prescribe the processes or rules that ought to apply for accounting or financial reporting purposes, this issue has been identified for the Board in the interests of better understanding some of the practical compliance challenges and complexities that can be faced by taxpayers who are exposed to the rules under Part 2-42.

Potential improvements to the APSI regime

As the Board will be aware, the Australia's Future Tax System Review (the AFTS Review) is examining, amongst other things, whether a family unit taxation model could be adopted in Australia. If the AFTS Review does recommend such an approach in the future, then the relevance of the APSI rules could diminish along with any incentive that may currently exist to engage in the practice of 'income splitting' or tax deferral. However, the incentive to retain income in a corporate structure may not necessarily diminish as a result of any move towards family unit taxation.

Until the outcome of the AFTS Review is known, other options to improve the APSI rules available to the Board to consider include:

1. Allow arm's-length payments to spouses and associated parties where the payment is incurred for the purpose of deriving assessable income and can be regarded as being commercially in-line with the level and skill of the actual work being undertaken. Under such an arrangement, section 26-35 of the ITAA1997 could be used by the Commissioner as a substitute to Part IVA in determining the extent to which a PSE is entitled to deduct amounts paid to the related party;

2. It is our understanding that New Zealand adopts PSI rules which only apply where the test individual's net PSI is greater than the threshold at which the 40 percent tax rate applies. A similar model could be adopted here where the APSI rules only operate where the test individual's net PSI exceeds a certain marginal tax rate (perhaps 30 percent). Although this would still leave some incentives for individuals to split their income to take advantage of multiple tax-free thresholds, it would remove some of the current complexities that can arise for certain taxpayers.

Conclusion

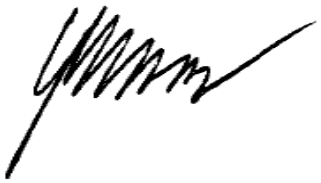
It is apparent to the Institute that Part 2-42 does not adequately address all of the government's original policy objectives which existed at the time of introduction of the APSI rules in July 2000. The overly complex structure of the APSI rules, and the unintended outcomes that can sometimes result from their application, means that the Commissioner is still left in a position where the application of Part IVA needs to be considered and tested. This is largely the situation that existed before the Ralph Review of Business Taxation and the subsequent introduction of Part 2-42.

Additionally, anecdotal evidence suggests that there is a general lack of awareness present amongst certain taxpayers and their advisors as to the precise application of the Part 2-42 rules. Given the complex nature of the rules and the impact of those rules on small taxpayers; this lack of awareness is explainable.

The Institute's view is that further work should be undertaken in the future to simplify the existing rules whilst still delivering the government's key policy objectives. Ultimately, simplified APSI rules should provide a definitive code that taxpayers and their advisors are able to readily understand and apply in the context of Australia's self assessment regime without needing to resort to complex and costly tax advice and PSB determinations by the Commissioner.

The Institute would be pleased to continue to work with government and the Board in this area where the opportunity exists. If you would like to discuss any aspect of this submission further, please do not hesitate to contact me on 02 9290 5623.

Yours sincerely



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