TR 2002/D5 - Income tax: deductions that relate to personal services income

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Draft Taxation Ruling
Income tax: deductions that relate to personal services income

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Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

1. This Ruling explains the alienation of personal services income measure (the alienation measure) in Part 2-42 of the *Income Tax Assessment Act 1997* ('ITAA 1997').

2. This Ruling focuses on the key concepts that underpin the operation of Division 85 and Subdivision 86-B of Part 2-42 of ITAA 1997.

3. This Ruling incorporates the legislative amendments made to Pt 2-42 by the *Taxation Laws Amendment Act (No 6) 2001* (No 169 of 2001).This Act received Royal Assent on 1 October 2001.

Class of person/arrangement

4. This ruling applies to:

- those individuals whose ordinary income or statutory income includes income that is mainly a reward for their personal efforts or skills; and
- those companies, partnerships or trusts whose ordinary or statutory income includes income that is mainly a reward for the personal efforts or skills of an individual (an individual's personal services income).

Background

5. The *New Business Tax System (Alienation of Personal Services Income) Act 2000* (Alienation of Personal Services Income Act) amended the ITAA 1997 by inserting new Part 2-42 into that Act and

amended the *Taxation Administration Act 1953* (TAA 1953) by inserting new Division 13 in Schedule 1 to that Act.

6. The alienation measure contained in Part 2-42 applies from the 2000-2001 income year. However, it does not apply until the 2002-2003 income year for those individuals or personal services entities who were in the former prescribed payments system and were entitled to and had made a payee declaration to a payer where:

- the payee declaration was in force as of 13 April 2000; and
- the Commissioner had received the payee declaration for the payee from the payer on or before 13 April 2000.[1]

7. The measure was introduced following the recommendations made in the report of the *Review of Business Taxation: A Tax System Redesigned* (commonly called the Ralph Report)[2]. The relevant recommendations that relate to this measure are recommendations 7.2, 7.3 and 7.4. Those recommendations were aimed at improving the integrity and equity in the tax system. The recommendations arose out of concerns that substantial erosion of the income tax base had occurred as a consequence of the alienation of personal services income through the use of interposed companies, partnerships and trusts; and that there was a perception that individuals, as contractors, and interposed entities were able to claim a greater range of deductions than those available to individuals who provided personal services as employees.[3]

8. The measure is intended to:

- limit and clarify the deductions available against personal services income at both the individual and interposed entity level; and
- ensure that, after allowing deductions to the interposed entity, any income remaining is attributed to the individual.[4]

9. The application of Part 2-42 of the ITAA 1997 is predicated on the view that, contractually, income from personal services can be the income of any entity. However, subsection 84-5(2) of the ITAA 1997 ensures that for tax purposes, only an individual can have personal services income (as defined).

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[1] The Commissioner's declaration in relation to this deferral was published on 30 August 2000 in the Commonwealth of Australia Gazette No GN 34
[2] See also Treasurer's Press Release No.74 of 11 November 1999
[3] See also paragraphs 1.5 to 1.14 of the Explanatory Memorandum
[4] See Explanatory Memorandum at page 3

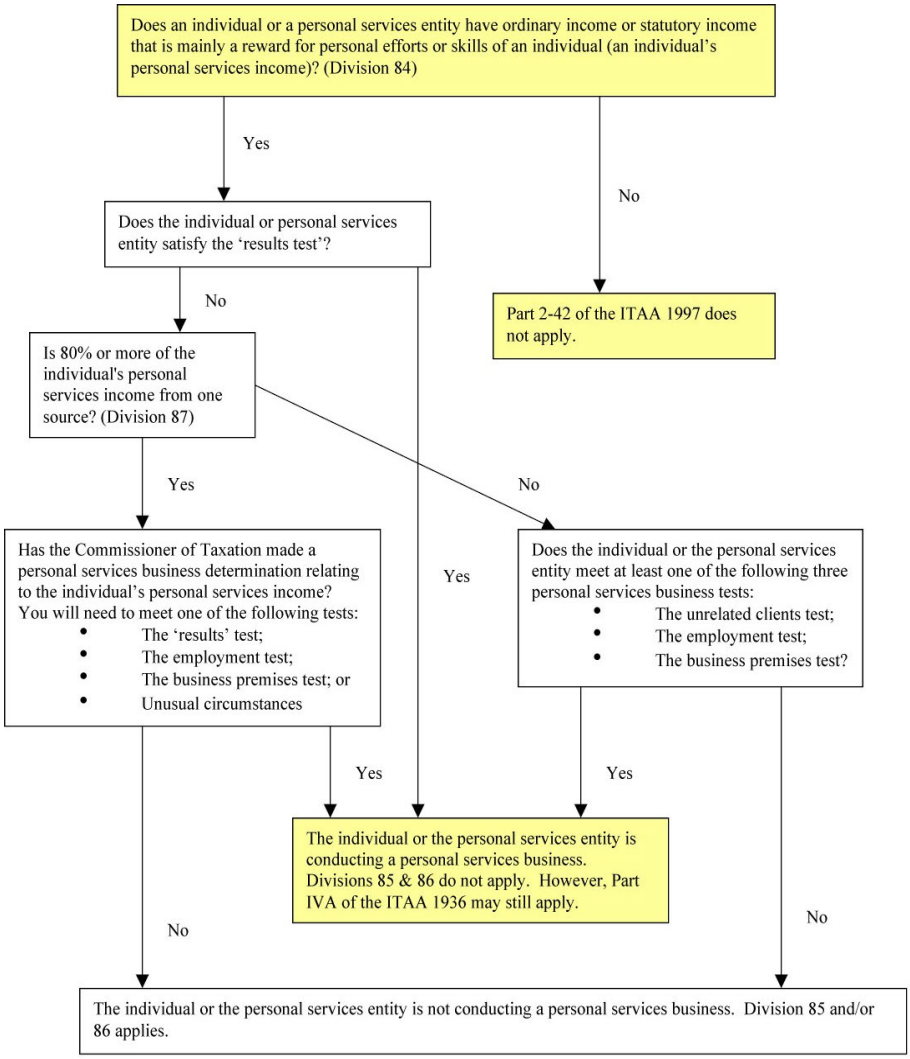
10. The application of Part 2-42 of the ITAA 1997 does not result in a change in the nature of contractual relationships between parties to an arrangement that involves the rendering of personal services. Individuals do not become employees of service acquirers as a consequence of the application of Part 2-42. Nor does the measure affect an individual's or a personal services entity's entitlement to an Australian Business Number, or to be registered for the purposes of *A New Tax System (Goods and Services Tax) Act 1999* (GST Act).

11. Note also that the general anti-avoidance provisions of Part IVA of the *Income Tax Assessment Act 1936* ('ITAA 1936') may still apply to cases of alienation and personal services income that fall outside the operation of the alienation measure.[5]

[5] See Note to section 86-10

12. The following flowchart explains how Part 2-42 applies.

Diagram showing the operation of the Alienation Measures[6]



13. Note that you can apply for a Personal Services Business Determination (PSBD) from the Commissioner to confirm that you are not within the measure, or if you are not sure whether you are within the measure, or if you are subject to unusual circumstances. However, unless you are subject to unusual circumstances you cannot apply for a personal services business determination on the basis of the unrelated clients test. If you believe that the alienation measure should not apply to you, you can request a PSBD from the Commissioner (see diagram above).

[6] See Treasurer's Press Release No.47 of 20 June 2001 and Treasurer's Press Release No.51 of 9 July 2001.

14. If:

(a) you have personal services income; and

(b) you or the personal services entity do not satisfy the 'results test'; and

(c) you or the personal services entity get 80% or more of the personal services income from one source,

you will be subject to the alienation measure, unless you have a PSBD.

Related Rulings

15. This Ruling should be read in conjunction with Taxation Ruling TR 2001/7 (concerning the meaning of personal services income) and Taxation Ruling TR 2001/8 (concerning what is a personal services business).

Definitions

Personal services entity (entity)

16. A personal services entity is a company, partnership or trust whose ordinary or statutory income includes the personal services income of one of more individuals (subsection 86-15(2)).

Personal services income

17. Personal services income is income which is mainly a reward for an individual's efforts and skills (or would mainly be such a reward) if it had been derived by the individual) (subsection 84-5(1)).

Salary or wages promptly paid

18. The phrase 'salary or wages promptly paid' refers to an amount paid before the end of the 14th day after the PAYG payment period during which the amount became ordinary or statutory income of the personal services entity.

PAYG payment period

19. The PAYG payment period:

- is each quarter for small withholders; or
- each month for medium and large withholders.

Service acquirer(s)

20. A service acquirer is the entity, or entities, that acquires the personal services of an individual directly from the individual or through a personal services entity. The service acquirer is the client of an individual or personal services entity and is the source of the income of the individual or the personal services entity that constitutes an individual's personal services income.

Associate

21. The word 'associate' has the same meaning as in section 318 of the ITAA 1936.

22. For an individual an associate includes:

- a relative of the individual;
- a partner of the individual or a partnership in which the individual is a partner;
- if a partner of the individual is an individual, the spouse or child of that partner;
- a trustee of a trust estate under which the individual or an associate benefits; and
- a company under the control of the individual or associate.

23. For a company an associate includes:

- a partner of the company or a partnership in which the company is a partner,
- a trustee of a trust estate under which the company or associate benefits,
- another individual or associate who controls the company; and
- another company which is under the control of the company or the company's associate.

24. For a trustee an associate includes an entity or associate of the entity that benefits or is capable of benefiting under the trust.

25. For a partnership an associate includes each partner of the partnership and associate of the partner.

26. Section 87-35 specifically excludes the following from being associates of each other for the purposes of subsection 87-15(3) (the 80% rule) and paragraph 87-20(1)(a) (the unrelated clients test):

(i) Australian government agencies which are:

- the Commonwealth, a State or a Territory; or
- an authority of the Commonwealth, a State or a Territory.

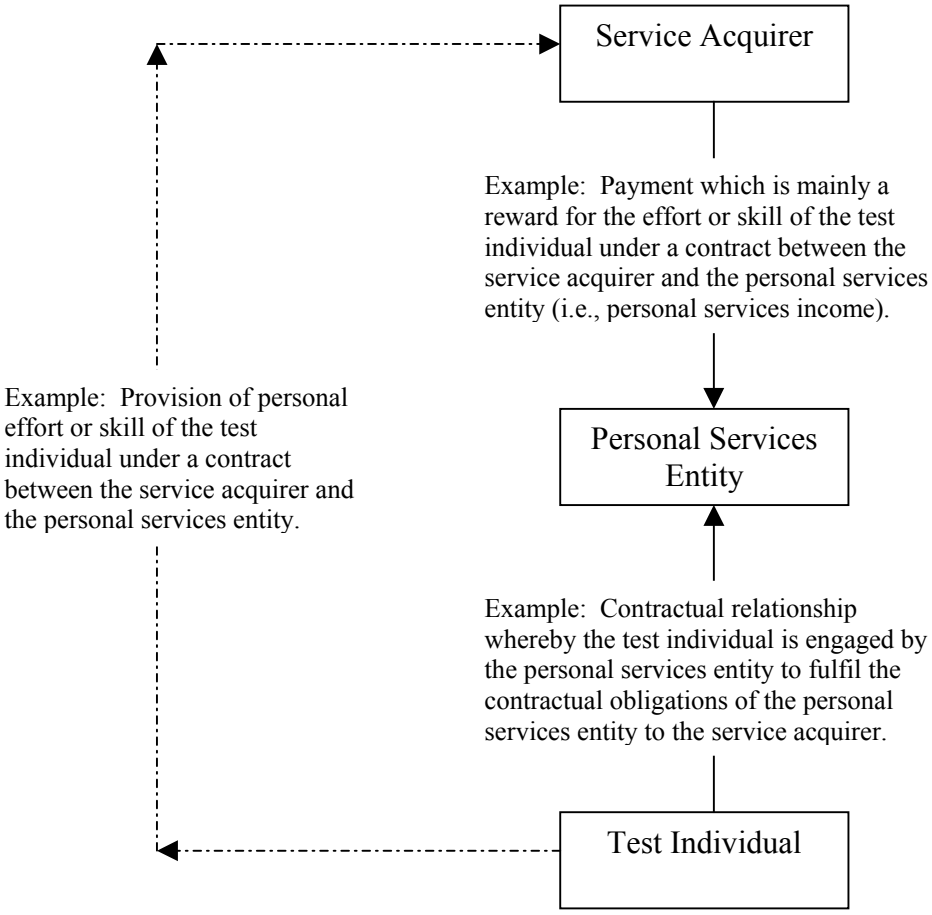
(ii) Commonwealth government agencies within the meaning of the *Public Service Act 1999*; and

(iii) Each part of an authority of a State or Territory that has under a law of a State or Territory a status corresponding to a Commonwealth government agency within the meaning of the *Public Service Act 1999*.

Test Individual

27. A test individual is the individual whose personal services income is included in a personal services entity's ordinary or statutory income, and to whom that income will be attributed under Division 86, unless one of the exceptions in that Division applies. A personal services entity may have more than one test individual. Part 2-42 applies on an individual by individual basis.

28. A diagrammatical representation of the above definition is as follows:



Ruling

When Division 85 (and this ruling) does not apply

29. Division 85 (and this ruling) does not apply to an individual or a personal services entity if:

- the individual or the personal services entity is taken to be conducting a personal services business under Division 87;
- the individual is an employee and therefore excluded under section 85-35 from the operation of the deduction rules contained in Division 85 (and the application of the general deduction rule in subsection 85-10(1)); or
- the individual is a member of an Australian legislature; a person who holds or performs duties of an

appointment, office or position under the Constitution or an Australian law; a member of the defence force; a member of the police force; or a member of a local governing body which has made a unanimous resolution to be treated an 'eligible local governing body'. Such persons are excluded from the operation of the deduction rules contained in Division 85 under section 85-35.

Deductions for individuals being non-employees relating to personal services income

General deduction rule

30. Subsection 85-10(1) denies a deduction for a loss or outgoing to the extent that:

- the loss or outgoing satisfies the requirements of paragraph 8-1(1)(b) *but not* paragraph 8-1(1)(a); and
- the loss or outgoing relates to the gaining or producing of that part of your assessable income that is your personal services income.

That is, subsection 85-10(1) applies to losses and outgoings that are only deductible under the second positive limb of section 8-1. This means that if a loss or outgoing satisfies, in whole or in part, the first limb of subsection 8-1 (paragraph 8-1(1)(a)), which is the limb applicable to employees, you can deduct the loss or outgoing to the extent that it satisfies the first limb (unless subsection 8-1(2) wholly or partly prevents you from deducting that amount).

Apart from paragraph 8-1(1)(b), no other provision of the Act, as at 31 December 2001, is affected by section by section 85-10, other than a provision dependent on the operation of paragraph 8-1(1)(b).

There are exceptions to the operation of subsection 85-10(1) in subsection 85-10(2). An amount satisfying one of the exceptions to the operation of section 85-10(1) in subsection 85-10(2) is not deductible just because it satisfies the exception. The amount must be deductible under section 8-1(1)(b). If it is deductible under section 8-1(1)(b) and satisfies an exception, subsection 85-10(2) will ensure that subsection 85-10(1) does not deny the deduction.

The specific rules that stop certain deductions

31. Sections 85-15 to 85-25 may deny a deduction even though an outgoing would otherwise be deductible under another provision of the Act (such as paragraph 8-1(1)(a)).

Deductions for rent, mortgage interest, rates or land tax

32. Section 85-15 denies a deduction for an amount of rent, mortgage interest, rates or land tax for some or all of an individual's (or an associates) residence to the extent that the amount relates to gaining or producing the individual's personal services income.

33. Section 85-15 does not apply to an amount of rent, mortgage interest, rates or land tax to the extent that it is paid in respect of the individual's business premises. Rent, mortgage interest, rates or land tax are not "for" a residence to the extent that they are for business premises. Taxation Ruling TR 2001/8 explains what is meant by the term "business premises".

34. 'Mortgage interest' means interest the payment of which is secured by a mortgage, whether or not over the residence of the individual. 'Mortgage' has its ordinary meaning and not the meaning provided by section 6 of the ITAA 1936. Mortgage interest is for a residence if it is for the use of money borrowed to acquire the residence, or expended in relation to the residence, or for the use of money representing such money.

35. Interest is mortgage interest even if the mortgage is not over the residence for which interest is incurred. Conversely, even if payment of interest *is* secured by a mortgage over the residence, section 85-15 does not apply if the interest so secured is incurred in gaining or producing assessable income other than personal services income.

36. Amounts of mortgage interest, rates, or land tax for a residence that are not deductible form part of the cost base of the residence for Capital Gains Tax (CGT) purposes. This reduces the amount of any capital gain upon disposal of the residence. However, the 'main residence exemption' may apply to the residence subject to the requirements of Part 3-1 of the ITAA 1997.

37. Section 85-15 does not prevent a deduction for amounts incurred by the individual for running expenses for using a room in the individual's home as a home office or study, for example amounts incurred for heating and lighting. Taxation Ruling TR 93/30 explains when such amounts are deductible.

Deductions for payments to associates

38. As a consequence of the operation of section 85-20, a payment or an amount incurred arising from an obligation to an associate will not be deductible to the individual to the extent the payment or amount relates to gaining or producing the individual's personal services income, unless the payment made or the amount incurred is in relation

to principal work. The meaning of 'principal work' is explained in TR 2001/8.

39. Subsection 85-20(3) prevents direct double taxation by providing that where a payment or amount is denied as a deduction under section 85-20, the payment or amount is neither assessable income nor exempt income of the associate.

40. The phrase 'any payment' in paragraph 85-20(1)(a) includes, amongst other items, remuneration such as a salary or commission, an allowance, a reimbursement of an expense, an amount for rent and an amount for interest on a loan.

41. Under paragraph 85-20(1)(b) an amount arises from an obligation if it results from a binding promise or the like that an individual made to an associate. However, it is not sufficient that something merely relates to or is connected to this obligation.

Deductions for superannuation for associates

42. The effect of section 85-25 is that any contribution to a superannuation fund or Retirement Savings Account (RSA) made by an individual on behalf of an associate will not be an allowable deduction to the extent that:

(a) the associate is engaged by the individual to perform work which relates to gaining or producing the individual's personal services income; and

(b) the work performed by the associate is not principal work.

43. The deduction is only denied to the extent the work relates to gaining or producing the individual's personal services income. Thus, if the work done by the associate is in relation to the earning of other income, entitlement to a deduction is not affected by section 85-25.

44. Where the work performed by the associate is principal work and a contribution is made in respect of that work, the deduction available is the lesser of:

(a) the amount contributed by the individual to the superannuation fund or RSA;

(b) the deduction limit set by section 82AAC of the ITAA 1936; and

(c) the deduction limit set by subsection 85-25(3).

45. The limit set by subsection 85-25(3) is the amount the individual would have to contribute in order to avoid an individual superannuation shortfall in respect of the employee. This amount is

calculated by reference to all the salary or wages[7] paid to the employee, as adjusted in accordance with subsection 85-25(4), rather than so much of the salary or wages as relates to the performance of principal work gaining or producing personal services income.

46. A contribution in respect of work producing assessable income other than the individual's personal services income is not affected by section 85-25 (see paragraphs 91 to 98).

47. Whether a contribution is in respect of principal work, non-principal work, or other work, is a matter open for the individual and associate to determine by the terms of any arrangement between them. If a single contribution is in respect of two or more kinds of work, section 85-25 requires an apportionment of the contribution according to the work done.

Personal services entities' entitlement to deductions relating to an individual's personal services income

48. Outgoings that:

- are incurred by a personal services entity (other than one conducting a personal services business);
- in gaining or producing its assessable income to the extent that it consists of an individual's personal service income; and
- are otherwise deductible under section 8-1 to that extent;

are allowable deductions to the entity except to the extent that such deductions are denied by sections 86-60 to 86-75.

49. At the end of the personal services entity's income year, section 86-15 operates to include the net personal services income in the assessable income of the individual whose work earned the personal services income.

50. Subsection 86-15(4) provides that personal services income is not attributed to the extent it is promptly paid to the test individual as salary or wages (salary and wages would nearly always be assessable income of the individual under section 6-1.). Generally, subsection 86-15(4) has no overall effect on taxable income. Salary or wages that are not promptly paid are attributed to the test individual under section 86-15(1). Section 86-35(1) stops the amount of salary or wages that is attributed being included in the assessable income of the test individual twice and paragraph 86-35(1)(d) denies the personal services entity a deduction for the payment of the salary or wages.

[7] within the meaning of the *Superannuation Guarantee (Administration) Act 1992*

General deduction rule for personal services entities

51. Section 86-60 contains the general deduction rule for personal services entities. Under that provision, for an outgoing to be deductible to the personal services entity, the outgoing must first be an allowable deduction under another provision in the Act, such as section 8-1, on the basis that the outgoing was incurred in the course of gaining and producing the personal services entity's income.

52. In addition, a deduction is only available to the entity if the individual would have been entitled to deduct that amount if the same outgoing had been incurred by the individual in the same circumstances as the personal services entity. '[T]he individual' referred to in paragraph 86-60(a) is the individual whose activities earn the personal services income.

53. Section 86-60 hypothesises that the circumstances giving rise to the entitlement to a deduction applied instead to the individual. The acts of the entity, and all the surrounding facts, that give rise to the entitlement to a deduction are treated as if they are the acts of the individual. Other circumstances are ignored. Only one circumstance is changed: the taxpayer is deemed to be the individual, not an entity.

54. Section 86-60 has the effect of applying provisions to the personal services entity *that would otherwise only disentitle individuals* to a deduction. Hence in determining whether a deduction would have been available to the individual regard must be had to the operation of Division 85 (discussed above). In principle, section 86-60 also prevents an entity from claiming deductions that are available only to companies, trusts or partnerships; such deductions, however, rarely relate to personal services income. Other than that it has little effect. Generally the individual would be viewed as incurring an expense in order to earn the relevant assessable income (i.e., the individual's personal services income) in the same way as the entity had.

Specific exceptions to the general deduction rules for personal services entities

Entity maintenance deductions

55. Section 86-65 ensures that entity maintenance deductions that might otherwise be thought to be denied under section 86-60, on the basis that an individual in the same circumstance could not have claimed such deductions, remain deductible to the personal services entity. Entity maintenance deductions are defined in section 86-65 and include expenditure such as bank fees, tax-related expenses, outgoings incurred in relation to preparation or lodgement of a

document prepared to comply with the *Corporations Act 2001*, and any fee or charge payable by the entity to an Australian government agency for any license etc that is granted under an Australian law.

56. Section 86-65 is generally declaratory in effect. However, subsection 86-65(3) is intended to prevent an entity from deducting any payment it makes to an associate of the personal services entity (not the test individual) for the preparation or lodgement of any document the entity is required to lodge under the *Corporations Act 2001*.

57. However, apart from the limitation in subsection 86-65(3) in respect of an expense covered by paragraph 86-65(2)(c), a personal services entity will be entitled to a deduction for payments made to an associate of the test individual for work that comes within the meaning of 'entity maintenance deduction', for example, the preparation of tax returns.

58. The personal services entity's deductions that do not relate to personal services income and are not entity maintenance deductions cannot reduce the amount of personal services income attributed to an individual under section 86-15. That is, deductions that relate to income other than personal services income that are not entity maintenance deductions cannot offset personal services income.

59. Where the income of a personal services entity includes the personal services income of two or more individuals, the entity maintenance deductions are apportioned between the two (see section 86-25). Example 9 shows how the entity maintenance deductions are apportioned amongst two or more test individuals.

Car expenses

60. A personal services entity is entitled to a deduction for car expenses in respect of one, or more, cars provided to the test individual where there is no personal use of those cars. It is arguable that section 86-60 by itself would achieve the same effect. Nevertheless, subsection 86-70(1) puts the issue beyond doubt.

61. Subsection 86-70(2) means that a personal services entity can potentially claim deductions for car expenses for one car for which there is private use. This is the case regardless of whether the car is provided to the test individual, or his or her associate. In the case of an associate the deduction is available notwithstanding that the deduction would otherwise be denied by subsection 85-20(1). Car expenses for a second car for which there is private use are not deductible, notwithstanding that all or part of the expense relates to gaining or producing personal services income.

62. If the entity provides more than one car that has private use, the entity must nominate the car for which it wants to claim the deductions (subsection 86-70(3)). Once the entity makes its choice of car for which it wants to claim deductions, that choice remains in force for as long as the entity holds that vehicle. This ensures that the entity cannot vary the cars for which it claims deductions and thereby obtain a greater amount of deductions.

Superannuation

63. Subsection 86-75(1) provides that section 86-60 does not prevent a personal services entity from deducting a contribution to a superannuation fund or RSA for the test individual. The subsection is merely declaratory except in those cases where the personal services entity is relying on subparagraphs (a)(i) and (a)(ii) and paragraph (b) of the definition of eligible employee in subsection 82AAA(1) of the ITAA 1936.

64. The interpretation of subsection 86-75(2) is not without difficulties. However, having regard to the overall context of the provisions and their intended purpose, the Commissioner considers the provision allows the personal services entity a deduction for superannuation contribution (subject to the limitations contained in Subdivision AA of Division 3 of Part III of the ITAA 1936) made in respect of an associate of the test individual, provided the superannuation contribution is in respect of work performed by the associate that is 20% or more (by market value) of the principal work of the entity. In such a case, the personal services entity would in any event satisfy the employment test and not be subject to Division 86.

65. In the case of work that is less than 20% by market value of the entity's principal work, including work that is entirely non-principal work, the deduction is capped at the amount necessary to avoid an individual superannuation shortfall. The cap is calculated by assuming for the purposes of section 19 of the *Superannuation Guarantee (Administration) Act 1992* that the associate's salary or wages is the amount which remains deductible after applying section 85-20 (section 85-20 is indirectly applied as a result of section 86-60.) The cap is therefore calculated by reference to the salary or wages attributable to the principal work performed by the associate plus any salary or wages paid to the associate for work performed in gaining or producing other income (ie., non-personal services income) of the entity.

Salary or wages to the individual

66. As previously stated, salary or wages promptly paid to the individual whose activities generate the personal services income are

deductible. Consequently, section 86-80 was inserted for the avoidance of doubt in cases where salary or wages are promptly paid.

Date of effect

67. This Ruling first applies to the 2000-2001 income year. The Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Deductions for individual non-employees relating to personal services income

68. The provisions of Part 2-42 are broadly directed at putting taxpayers who earn income in ways analogous to those of employees in the same tax position as employees. In effect, employee-like cases are treated as actual cases of employment. In some instances, however, employees and employee-like workers are not treated differently by the existing law. Nevertheless provisions have been inserted into the law that cover such cases, merely to remove any doubt. Section 85-10 is one such provision.

69. Section 85-10 ensures that in applying the general deduction provision, section 8-1, to individuals, the same criterion of deductibility is applied to the employed and the self-employed. There was a widespread, but largely erroneous, view that section 8-1 allows losses and outgoings incurred in gaining assessable income for the self-employed as deductions where, in exactly the same circumstances, an employee would not be allowed a deduction. However, generally it is only the different factual circumstances of the employed and the self-employed which result in different entitlements to deductions.

70. Section 8-1 is the only provision that allows deductions for amounts relating to the gaining or producing 'that part of your ordinary income or statutory income that is your personal services income'. The purpose of section 85-10 is to make it clear there is no legal difference in the entitlement of employees and individuals subject to the alienation measure to deductions for amounts incurred in gaining or producing personal services income. It does this by requiring an individual who derives personal services income otherwise than as an employee to treat the income as notionally from employment for the purposes of section 8-1.

71. Section 8-1 contains a paragraph applicable only to taxpayers who carry on business. The term business is defined to exclude occupation as an employee. Subsection 85-10(1) requires one to inquire whether an amount would be deductible if one derived income as an employee. In effect, subsection 85-10(1) denies the individual deductions that would only have been allowable under paragraph 8-1(1)(b). However, in a number of court decisions, it has been stated that the first limb of the general deduction provision is almost as wide as the second limb. In *FC of T v. Snowden and Willson Pty. Ltd. (1958*) 99 CLR 434 it was pointed out that the scope of the first limb is wide enough to cover most of the ground covered by the second limb:

> "No doubt the expression 'carrying on a business for the purpose of gaining or producing' lays down a test that is different from that implied by the words 'in gaining or producing'. But these latter words have a very wide operation and will cover almost all the ground occupied by the alternative."

72. Fullagar J supported such a view in *John Fairfax and Sons Ltd v. FCT* (1959) 101 CLR 30 when he said:

> "The two categories of section 51(1) are clearly not mutually exclusive and it has been said that 'in actual working' the addition of the second category 'can add but little to the operation of the leading words 'losses or outgoings to the extent to which they are incurred in gaining or producing assessable income'."

See Example 1 for an illustration of the operation of this provision.

Exceptions to subsection 85-10(1)

73. Subsection 85-10(2) provides exceptions to subsection 85-10(1). Because subsection (1) has little practical operation, neither does subsection (2). It was considered prudent to provide some exceptions to subsection (1), lest the provision was misinterpreted as having an effect beyond merely confirming that section 8-1 provides the same criterion for deductions by employees and non-employees alike.

74. An amount satisfying the description in one of the paragraphs of section 85-10(2) is not necessarily deductible. Whether an amount is deductible depends on whether it satisfies section 8-1, not subsection 85-10(2). For example, a cost of gaining work may be on capital account where it is the cost of winning a single contract that constitutes substantially the whole of the profit yielding subject of an enterprise.

75. Section 85-10 applies only to individuals. It is not considered that section 86-60 extends its operation to companies, trusts or

partnerships. (See below paragraphs 107 to 112). However, given that it is declaratory of the existing law, the question of its application to taxpayers other than individuals is not significant.

The specific rules that prevent certain deductions

76. The other sections of Division 85 affect the entitlement of individuals and, through the operation of section 86-60, other taxpayers, to deductions which would otherwise be allowable.

Deductions for a residence

77. The purpose of section 85-15 is to prevent an individual from obtaining a deduction for certain costs in respect of their residence, or the residence of an associate, to the extent that the entitlement to the deduction arises from gaining or producing the personal services income of the individual. The provision only applies directly to individuals, but has an indirect effect for companies, trusts and partnerships as a result of section 86-60 (see paragraph 114).

78. 'Residence' means one's dwelling place, usual abode, or home. In general, losses and outgoings in respect of a taxpayer's residence would not be incurred in gaining or producing the assessable income of the taxpayer: see *Handley, Forsyth v. Federal Commissioner of Taxation* 148 C.L.R. 182; 55 ALJR 345; 81 ATC 4165. However, there are exceptions: see *Swinford v. Federal Commissioner of Taxation* 84 ATC 4803; 15 ATR 1154 (section 85-15 reverses this decision). Losses and outgoings in respect of the residence of an associate might be deductible under section 8-1 either because they represent remuneration for the services of that associate rendered in the course of gaining or producing assessable income, being the personal services income of the individual (in which case there will usually be a taxable fringe benefit), or because the residence is owned or leased by the taxpayer and let or sublet to the associate for rent. The former but not the latter case is affected by section 85-15. In the latter case the losses or outgoings will be incurred in gaining or producing assessable income from rent, which is not personal services income.

79. The only losses and outgoings affected by section 85-15 are those in respect of rent, mortgage interest, rates or land tax. These terms are not defined in the ITAA 1997 and therefore have their ordinary meaning. The definitions of the ITAA 1936 do not apply: see subsection 6(1AA). In particular, the definition of mortgage in section 6 of the ITAA 1936 does not apply.

80. 'Rent' means the rent reserved under a lease, and does not include a premium for the grant of a lease. Mortgage interest means

interest secured by a mortgage properly so called, which includes a registered mortgage under Torrens Title, a common law mortgage, and an equitable mortgage (such as a second mortgage or a mortgage by the deposit of title deeds). It does not include a rent charge, an equitable charge, an equitable lien, or statutory encumbrances, charges, liens, or hypothecations.

81. Interest on an unsecured loan is also unaffected by section 85-15. The section applies if the mortgage interest is incurred in gaining or producing assessable income, being personal services income, 'for' the residence. (For the deductibility of interest see TR 2000/17 - Deductions for interest following the Steele and Brown decisions). An outgoing for interest is relevantly connected with the gaining or producing of the assessable income according to the purpose of the borrowing or other financial transaction and the use of the funds borrowed or raised. The nature of the assets mortgaged to secure payment of the interest is not relevant.

82. 'Rates' means the amount of an assessment on property for local purposes, and here refers to such a tax in respect of the residence or the land on which the residence is erected. 'Land tax' means a tax on the land on which the residence is erected.

83. Expenses for the lighting and heating of a residence, depreciation of plant in the residence, and like expenses are not affected by section 85-15. Such expenses, when incurred with the use of a home study in connection with the gaining or producing of assessable income, including personal services income, will generally be deductible.

Deductions for payments to associates

84. Section 85-20 deals with payments made to associates in the course of gaining or producing assessable income, being personal services income, where the payment is for non-principal work. Typically, such a payment will be by way of salary or wages for services rendered by the associate. However, the term payment would also include interest on a loan from an associate where the loan moneys were invested in a business from which personal services income is derived, or for the rent of business premises leased from an associate. (The indirect effect of section 85-20 on companies, trusts and partnerships because of section 86-60, is discussed below.) Most employees are not in a position to claim deductions under section 8-1 for payments to associates. The provision has the effect of placing both the self-employed and a personal services entity, who are otherwise entitled to a deduction for a payment to an associate (not the test individual), in the same position as the typical employee. The section applies even if an amount is reasonable for the purposes of section 26-35.

85. Paragraph 85-20(1)(a) provides that an individual cannot deduct any payment made to an associate to the extent the payment relates to gaining or producing the individual's personal services income.

86. As the term 'payment' is not defined in the ITAA 1997, it is to be given its ordinary meaning. The definition in the *Macquarie Dictionary* is broad and states it is 'that which is paid; compensation; recompense.' In addition the inclusion of the word 'any' before the word 'payment' indicates that the term should be read broadly.

87. Paragraph 85-20(1)(b) operates to deny a deduction when the deduction under section 8-1 is not for a payment as such, but for a liability to make an outgoing (or loss) which has been incurred. The provision also operates to deny a deduction for an amount that the individual incurs in respect of a party other than an associate which arises from an obligation to the associate to the extent that the payment relates to gaining or producing that individual's personal services income.

88. For paragraph 85-20(1)(b) to apply an amount must arise from an obligation an individual has to his or her associate. The *Macquarie Dictionary* defines an 'obligation' as a 'binding promise or the like'. The phrase 'arise from' is defined in the *Macquarie Dictionary*, to mean, 'to result or proceed [from]'. In addition, it is not sufficient that something merely relates to or is connected to an obligation. In *Hi-Fert Ltd & Anor v. Kiukiang Maritime Carriers Inc & Anor* (1998) 90 FCR 1 when the expression 'or relate to this agreement' was compared to the expression 'arising from this charter [contract]', Beaumont J stated that the latter phrase (FCR at 19): "does not include that wider expression but is limited to the expression 'arising from'" . Thus if the individual has borrowed money from an associate, the interest incurred by the individual may be said to arise from the obligation to repay principal and the promise to pay interest. Similarly, rent arises from the covenant to pay rent. The Commissioner considers that the provision extends to deductions in respect of the obligation itself, that is to say, where a person incurs a liability to make an outgoing of a particular amount, a deduction for the amount incurred arises from an obligation, namely, the liability.

89. Subsection 85-20(2) limits the application of the rule so that an individual can still deduct an amount to the extent that it relates to engaging an associate to perform the individual's principal work.

90. Subsection 85-20(3) provides that to the extent a payment or amount is denied as a deduction under section 85-20, the payment or amount is not assessable income or exempt income of the associate. This provision was inserted by *Taxation Laws Amendment Act (No 6) 2001* (enacted as No 169 of 2001) which received Royal Assent on 1 October 2001.

Deductions for superannuation for associates

91. Section 85-25 has the overall effect of limiting the deductions an individual is entitled to in respect of superannuation contributions made in respect of an associate of that individual.

92. A deduction for superannuation contributions in respect of associates arises under section 82AAC (and not section 8-1: see section 82AAR). An entitlement to a deduction arises when one makes a contribution in respect of an eligible employee, as defined in section 82AAA: it does not depend on a nexus to assessable income. Also, as explained below, the deduction is not proportionate to work done by, or salary or wages paid to, the employee.

93. Superannuation contributions are made by employers for employees as part of the remuneration for their work. Section 85-25 is attracted 'to the extent the associate's work … relates to gaining or producing … personal services income'. The Commissioner therefore considers that the section operates when the superannuation contribution is for work that relates to personal services income.

94. Thus to apply the section, one first works out for what work a contribution has been made to a superannuation fund or RSA. It is up to the taxpayer and the associate to decide for what work a contribution is to be made, but if the contribution is for all the work an associate does, the section requires an apportionment of the contribution based on the work done by the associate. (A memorandum of the agreement between the taxpayer and the associate recording the basis upon which the superannuation contributions are made would be sufficient evidence of the work in respect of which the contributions have been made).

95. If the associate engages in work that produces assessable income other than personal services income, and the contribution is in respect of that work, the whole contribution is deductible up to the deduction limit provided by subsection 82AAC(2A). In such cases section 85-25 is irrelevant. If the associate is engaged in producing assessable income that is personal services income, and if the superannuation contribution is solely for non-principal work of the associate, no deduction is allowable. However, if the contribution is solely for principal work of the associate, the deduction is allowable up to the cap provided by subsection 85-25(3), or the deduction limit under section 82AAC, whichever is less. If the contribution is for both, then an apportionment is required. The apportionment is to be done on the basis of the market value of each type of work done. See TR 2001/8 for an explanation of what is meant by the market value of principal work.

96. The cap or limit under subsection 85-25(3) is that amount necessary to avoid an individual superannuation shortfall in respect of the associate. (There is no requirement to make an apportionment of the shortfall amount where the associate performs work relating to personal services income and other income.) In calculating this amount, one notionally treats the salary or wages used in the calculation required by the *Superannuation Guarantee (Administration) Act 1992* (see subsection 19(2)) as the amount one is not prevented from deducting by sections 85-10 and 85-20. In other words, if one is prevented from deducting some or all of an amount by those sections, the salary or wages are reduced accordingly in making the shortfall calculation, so the cap is lower (subsection 85-25(4)).

97. This means, if wages are paid to an associate for non-principal work and they are deductible but for section 85-20, the wages would be disregarded, and the contribution necessary to avoid a shortfall reduced accordingly. Thus the extent of the allowable deduction is reduced. It is otherwise irrelevant whether salary or wages are deductible. If salary or wages are not deductible for some other reason than section 85-10 or section 85-20 (eg. because of the operation of section 26-35) they still count for the purposes of calculating the shortfall.

98. Note that subsection 85-25(4) does not relieve a taxpayer of his or her actual liability under the *Superannuation Guarantee (Administration) Act 1992* (SGAA). That Act requires contributions to be made to the required extent even if the salary or wages, or contribution, are not deductible. Also, this provision does not cause any taxable contribution to a superannuation fund to cease to be taxable.

Personal services entities' entitlement to deductions relating to an individual's personal services income

99. Division 86 of the ITAA 1997 contains rules which affect the entitlement of a personal services entity (that is, a company, trust or partnership deriving personal services income) to deductions. The primary object of the Division is to include the *net* assessable income of a personal services entity that is mainly a reward for the personal efforts or skill of the test individual (i.e., the personal services income of the test individual) in the individual's own assessable income, and to exclude it from the assessable income of the entity (see subsection 86-15(1) and section 86-30). Consequently, the net income is taxed at the individual's marginal rate of tax. This is part of a wider object of ensuring what is in effect disguised or quasi-employment income is taxed no more favourably than actual employment income. The Division does not affect a personal services entity's assessable income that is not personal services income, nor does it affect its entitlement

to deductions from assessable income that is not personal services income.

100. A personal services entity calculates its taxable income or net income in the usual way subject to certain provisions discussed below, but excludes from its assessable income, in accordance with section 86-30, that part of its assessable income included in the assessable income of the test individual under section 86-15. In determining the amount attributed to the test individual under section 86-15 regard must be had to the amount of any reduction arising from the operation of subsection 86-20(2). The attributed amount is the gross personal services income less the deductions to which the personal services entity is entitled for the year of income, that are deductions relating to personal services income. By way of exception, deductions defined as 'entity maintenance deductions' are deducted from gross personal services income only if they exceed the other assessable income of the entity.

101. The amount left after taking into account any reduction under section 86-20 is included in the test individual's own assessable income. It is included at the end of the personal services entity's year of income. The amount cannot be negative; that is, this provision will not permit a loss to be distributed. (However, if the entity is a partnership, a partnership loss may be deductible for the partners).

102. The result of this calculation is that the taxable income of the personal services entity includes that part of the gross personal services income equal to the deductions allowed against it. Where the deductions are in excess of the personal services income they remain available to be deducted against other assessable income of the personal services entity.

103. Section 86-30 excludes the amount included in the assessable income of the test individual from the assessable income and the exempt income of the personal services entity. This prevents direct double taxation of the personal service entity and, as a result of the exclusion of this amount from the exempt income, in the case of a trust or company, indirect double taxation through the reduction of carry-forward losses. In the case of a partnership it is the carry-forward losses of the partners that are preserved.

104. Section 86-35 prevents the double taxation of the test individual and his or her associates on account of a distribution or other payment to them of an amount that has been attributed to the test individual under section 86-15. For example, in the case of a company, the amount attributed would continue to form part of the company's distributable profits, and therefore be capable of distribution as a dividend. The income excluded under section 86-35 from the test individual's, and their associate's assessable income, is

also excluded from the assessable income of the entity under section 86-30.

105. Added to these provisions are the rules in Subdivision 86-B that affect the entitlement of the personal services entity to deductions. In certain cases these rules deny the entity a deduction to which it would otherwise be entitled. However, this does not affect the tax paid by the personal services entity. The effect of denying a deduction in relation to personal services income is to increase the net personal services income attributed to the individual. As the net personal services income is excluded from the entity's assessable income, the entity's taxable income or net income is unaffected.

106. An increase in the net personal services income included in the assessable income of the test individual will affect the tax of the test individual unless the disallowed deduction is in respect of an outgoing which is assessable income of the test individual (e.g., a second private use car which is leased by the personal services entity from the test individual). In that case, the increase in the assessable income consisting of attributed personal services income is matched by a decrease in other assessable income of the test individual. In other words, the practical effect of these provisions is confined to cases where the outgoing disallowed to the company is not matched by income excluded from the test individual's assessable income. The cases where the provisions have an actual effect on the tax of the test individual are mostly cases where an outgoing would otherwise be deductible to the personal services entity and assessable to an associate of the test individual. As section 86-35 generally has the effect of excluding the amount from the assessable income of the associate, the overall effect of these provisions is to transfer assessable income from the associate to the test individual.

General deduction rule for personal services entities

107. The central provision of Subdivision 86-B is section 86-60. Section 86-60 indirectly causes the personal services entity to be subject to provisions which would otherwise disentitle only the test individual to a deduction, had the test individual directly derived the personal services income (e.g., section 85-20).

108. In essence, section 86-60 notionally puts the test individual in the shoes of the personal services entity and asks whether that individual would be entitled to a deduction. Since, in the absence of section 86-60, the personal services entity would be entitled to a deduction, the test individual is *prima facie* also entitled to a deduction. However, there are provisions applicable only to individuals which might disentitle the individual to a deduction to which the individual would otherwise be entitled. The most important of these are sections 85-15, 85-20, and 85-25. If a provision

disentitling an individual to the whole or part of a deduction is applicable, the test individual would not get the whole deduction, or only part of the whole or part of the deduction. Where this is so, section 86-60 denies the personal services entity the deduction. In other words, it puts the entity in the same tax position as the individual, thereby furthering the objective of putting disguised or quasi-employment income in the same tax position as actual employment income.

More detailed explanation

109. Section 86-60 applies only to the extent that it relates to gaining or producing the test individual's personal services income. Under section 86-60, for an outgoing to be deductible to the personal services entity, the outgoing must first be an allowable deduction under another provision in the Act, such as section 8-1, on the basis that the outgoing was incurred in the course of gaining and producing the personal services entity's assessable income. Thus, section 86-60 applies to deductions relating to the gaining or producing of assessable income of the entity that is personal services income of the test individual.

110. Secondly, a deduction is only available to the entity if the individual would have been entitled to deduct that amount if the same outgoing had been incurred by the individual in the same circumstances as the personal services entity. '[T]he individual' referred to in paragraph 86-60(a) is the individual whose activities earn the personal services income.

111. Section 86-60 hypothesises that the circumstances giving rise to the entitlement to a deduction by the personal services entity apply instead to the individual. (It is important to note that this does not mean the individual's circumstances are applied to the entity.) It is only the circumstances giving rise to the entitlement of the entity to a deduction that are to be treated as applying instead to the individual. The acts of the entity that give rise to the entitlement to a deduction are treated as if they are the acts of the individual. Thus, if the personal services entity is carrying on a business, and that is a circumstance from which the entitlement to a deduction arises (as it usually is), the individual is treated as notionally carrying on that business. If incurring an outgoing is relevant to entitlement to a deduction, the individual is taken to have incurred an outgoing. If the character of the outgoing is relevant, as again it usually is, and the outgoing is not capital, private or domestic in character in the circumstances of the personal services entity, neither is it taken to be capital, private or domestic in character for the individual. Section 86-60 does not permit any change in the circumstances of entitlement

to a deduction, with the sole exception of the substitution of an individual taxpayer for the entity.

112. Consequently, section 86-60 will most commonly only prevent a deduction where it causes a disentitling provision applicable only to individuals to be applied to the relevant loss or outgoing. However, the section also potentially applies where the loss or outgoing is made deductible by a provision only applicable to a company, trust or partnership. (There are such provisions, but they are unlikely to apply in respect of personal services income, and therefore are not discussed further.)

Transactions between test individual and personal services entity

113. Section 86-60 does not have the effect of denying a deduction to the personal services entity in respect of a transaction between the entity and the test individual merely because it is with the test individual. Generally, where a company, for example, pays or incurs a liability to pay an amount to an individual and claims a deduction for it, the identity of the individual is not a circumstance relevant to the entitlement to the deduction. Thus if a company is entitled to a deduction for a payment for services rendered, it is nearly always irrelevant who rendered them. This means if a company is entitled to a deduction for wages paid to the test individual one is not required to suppose that the test individual is paying himself or herself a wage. Rather, one is required to assume that the test individual is paying a wage to an employee of his or her who renders the service that he or she in fact rendered. Besides, denying a deduction to the personal services entity in such a case would have no practical effect, since it merely results in the test individual deriving more personal services income and less wages with the same taxable income resulting.

The main disentitling provisions applicable to entities through section 86-60

114. Section 85-15 will apply to the personal services entity in a case where it would otherwise be entitled to a deduction for rent, mortgage interest, rates or land tax for the residence of the test individual and his or her associates on grounds related to the gaining or producing the personal services income (see paragraphs 77 to 83). Usually this would be on the basis that it was remuneration for the services rendered by the test individual or the associate (and therefore would usually be a taxable fringe benefit); note section 86-35 does not apply to fringe benefits.

115. Section 85-20 will apply to disallow a deduction for a payment, or a liability incurred to make a payment, to an associate of

the test individual for non-principal work[8]. In this case section 86-35 applies to exclude income resulting from that payment from the assessable income of the associate. The effect therefore is to transfer the income from the associate to the test individual (unless the remaining deductions which may reduce the personal services income are equal to or exceed the personal services income. – in such a case, there is no personal services income attributed to the test individual). Section 26-35 operates to disallow so much of a payment by the personal services entity to a relative of the test individual as the Commissioner does not consider reasonable. Having regard to section 85-20, which simply denies a deduction for non-principal work, section 26-35 operates to disallow excessive payments for principal work.

Wages

116. To the extent salary or wages are promptly paid to the test individual by a personal services entity in respect of personal services income the attribution amount under Division 86 is reduced. The payment of the salary, which is normally deductible to the entity and assessable to the individual, has the same effect. Under the provisions of Division 86, there are technically a number of different ways salary or wages can be treated. However, with the exception of section 86-40, none of these ways affects the taxable income of the test individual or the personal services entity.

117. Taxable income is also not affected if the salary or wages are *not* promptly paid, as the amount of salary and wages will be attributed to the test individual under section 86-15(1). The later payment of salary or wages is excluded from the test individual's assessable income because of section 86-35(1). The attributed amount is not assessable income of the personal services entity by virtue of section 86-30 and a deduction is denied for the payment of salary and wages under paragraph 86-35(1)(d). Subsection 86-15(4) provides that if salary or wages are promptly paid to the test individual in certain circumstances, Division 86 does not apply. With one exception this does not change the outcome, for the test individual and the personal services entity will have the same taxable income.

118. The one exception arises where subsection 86-40 deems salary or wages paid to a test individual in a particular income year to have been received by the individual in the preceding income year. Subsection 86-15(4) then operates to prevent the salary or wages from also being attributed to the taxpayer, under subsection 86-15(1), for that income tax year. This is on the proviso that the salary or wages

[8] What constitutes principal work is explained in TR 2001/8 – what is a personal services business

represents income derived by the personal service entity during the PAYG period ending 30 June of income tax year one (subsection 86-15(4)(b)). In these limited circumstances the personal services entity is not entitled to a deduction in the year in which the salary or wages are treated as received by the test individual. Subsection 86-40(2) expressly states that the provision does not alter the time at which the personal services entity is treated as having paid the salary or wages. An employer incurs salary or wages when there is a presently existing legal obligation to pay the amounts. The existence of such an obligation is a question of the proper interpretation of the relevant employment contract, having regard to the particular factual circumstance. As a general rule, the obligation would not come into existence until the end of the work period in respect of which the salary or wages are paid. Provided the relevant period of work finished after the end of the first year of income, a personal services entity would generally be entitled to a deduction for the salary or wages in the year in which the amount is paid.

119. Section 86-80 is effectively consequential on subsection 86-15(4) and like that section does not have a practical significance, since the same outcome would ensue with respect to the taxable income of the personal services entity and the test individual if it did not apply. Also, as discussed above, section 86-40 has only limited practical operation.

Attribution does not affect entitlement to a deduction

120. Section 86-85 makes it clear that if the personal services entity has income excluded from its assessable income as a result of section 86-30, the deductions to which the entity would be entitled under section 8-1 or section 42-15, after applying sections 86-60 to 86-75, are unaffected.

The exceptions to paragraph 86-60(a)

Entity maintenance deductions

121. Section 86-65 allows a personal services entity to deduct amounts that are entity maintenance deductions. The following table sets out the expenses that are defined in subsection 86-65(2) to be entity maintenance deductions:

Entity Maintenance Deduction	**Examples**
Fees or charges associated with an account with an ADI (but not including interest or interest like amounts)	Financial Institutions Duty Debits Tax General Account Keeping Fees
Tax-related expenses	Completion of Returns Compliance with an audit by the ATO
Preparation or lodgment of a document under the *Corporations Act 2001*	Annual Returns Financial Returns
Statutory Fees	Licence Renewals Registration Fees

Examples

Example 1: General entitlement to deductions

122. Melissa operates a computer consultancy and all of her income is personal services income from one firm. Melissa has a registered business name being, 'Melissa's Computing Services'. Melissa must pay an annual fee to maintain this business name. Subsection 85-10(1) does not prevent a deduction for such an expense, although the expense is not usually incurred by an employee. While subsection 85-10(1) prevents the application of paragraph 8-1(1)(b), the expense is deductible through the application of paragraph 8-1(1)(a), as it is incurred in the gaining or producing of assessable income.

123. Melissa also engages an accountant to complete the consultancy's profits and loss account for the year. The fee is deductible under paragraph 8-1(1)(a) and subsection 85-10(1) does not prevent the deduction for the fee for such work.

Example 2: Payments to associates

124. Sam is a consultant in sole practice. He has engaged his sister Sally to perform the administrative work of the practice and also some work in relation to the preparation of his major client's financial statements. The work for the major client involves the coding of income and expenses for the purposes of producing the general ledger. Sam is not conducting a personal services business. The market value of the administrative work is $20,000 and the market value of the

general ledger work is $30,000; these amounts accord with what Sam actually pays Sally. As Sally is Sam's associate, section 85-20 prevents Sam from claiming a deduction for the $20,000 paid to Sally for the administrative work and section 85-20(3) ensures Sally pays no tax on that same amount.

Example 3: Superannuation contributions

125. Jim derives both personal services income and other income. Jim is not conducting a personal services business. In the 2001 income year, Jim engages Jan to perform work which generates both personal services income of Jim and non-personal services income (other income). Jim contributes $5,000 to a superannuation fund in respect of Jan.

126. The market value of the salary attributable to the personal services income is $40,000 and the market value attributable to the other income is $20,000. Of the $40,000, $30,000 represents the market value of principal work, and $10,000 the market value of non-principal work.

127. The cap under subsection 85-25(3) is determined as follows:

Wages paid to Jan (PSI)	$40,000
Wages paid to Jan (other income)	$20,000
Less: reduction under subsection 85-25(4)	($10,000)
Notional Super Guarantee wages	$50,000
Notional Super Guarantee payable @ 8%	$4,000

Due to the operation of section 85-25, the deduction to which Jim is entitled under subsection 82AAC(2A) of the ITAA 1936 for superannuation support provided to Jan is $4,000.

128. Jim's actual liability under the SGAA to avoid a shortfall is $60,000 @ 8% which equals $4,800.

Example 4: Personal services entity's entitlement to deduction

129. Jack operates through a personal services entity Jim Pty Ltd which is not conducting a personal services business within the meaning of Division 87. Jim Pty Ltd buys pens and stationery and gives it to Jack to do work that generates the assessable income of Jim Pty Ltd which is the personal services income of Jack.

130. Section 86-60 places Jack in the shoes of Jim Pty Ltd and asks whether Jack would be entitled to a deduction had Jack purchased pens and stationary and given it to an employee for an identical purpose to that of Jim Pty Ltd. As Jack would be entitled to a

deduction under section 8-1 for such an outgoing, Jim Pty Ltd will not be denied a deduction for its outgoing under section 86-60.

Example 5: Personal services entity's entitlement to deduction

131. Pip Pty Ltd is a personal services entity whose ordinary or statutory income represents the personal services income of Paula. The personal services entity has engaged Paula's daughter Pam to perform non-principal work. Pip Pty Ltd is not conducting a personal services business within the meaning of Division 87 and is therefore subject to the operation of section 86-60. Section 86-60 places Paula in the shoes of Pip Pty Ltd and disallows a deduction if Paula could not claim a deduction in identical circumstances to Pip Pty Ltd. Section 85-20 would apply to Pam in such circumstances and would deny Pam a deduction. Therefore section 86-60 through the operation of section 85-20 denies Pip Pty Ltd a deduction for the wage paid to Pam. Pam is not assessable on her wage from Pip Pty Ltd due to the operation of section 86-35. The incidence of taxation is in effect merely transferred from Pam to Paula.

Example 6: Payment of salary and wages to a test individual

132. Mick is an IT contractor who operates through a company Mick Pty Ltd. Mick Pty Ltd commenced operations on 1 April 2002. The alienation measure applies to Mick. The company paid a salary to Mick of $20,000 on 15 July 2002 from its ordinary or statutory income for the year ended 30 June 2002, which represents the personal services income of Mick. As the salary is paid after the 14th day following the period in which the ordinary or statutory income is derived, the $20,000 is attributable to Mick as personal services income under section 86-15(1).

133. In terms of Mick Pty Ltd, the attributed amount is excluded from its assessable income of Mick Pty Ltd under section 86-30. Mick Pty Ltd cannot deduct that amount because of paragraph 86-35(1)(d).

Example 7: Car expenses

134. Craig, who is an engineer, and Karen, who is an architect, work though their entity CJ Pty Ltd. Craig and Karen do not work on the same contracts and as such each has personal services income. CJ Pty Ltd is not conducting a personal services business in relation to either Craig or Karen, so is subject to the alienation measure in respect of both individuals. CJ Pty Ltd provides one car to Craig and one car to Karen for private purposes. Although CJ Pty Ltd has two cars, subsection 86-70(2) allows one car of which there is private use, for each individual whose income is included in the ordinary or statutory

income of the entity. The amount of tax payable under the *Fringe Benefits Tax Assessment Act 1986* for the car fringe benefits provided to Craig and Karen will be allowable deductions to CJ Pty Ltd. The fringe benefits tax deductions will reduce the amount of personal services income that is included in Craig's and Karen's assessable income because they relate to gaining or producing Craig and Karen's personal services income.

Example 8: Entity maintenance deductions

135. Joanne is a computer consultant. She provides her consulting services through her personal services entity, Jo Pty Ltd. The company has contracted with B Pty Ltd for Joanne to provide consulting services for software development and network design maintenance. The income gained by Jo Pty Ltd for personal services is personal services income and will be attributed to Joanne and included in her assessable income.

136. The income and deductions of Jo Pty Ltd for the period 1 July 2000 to 30 June 2001 consist of:

Personal Services Income (PSI)	$100,000
Other Income	$4,000
Entity Maintenance Deductions	$5,000
Other Income Deductions	$500
PSI Deductions	$55,000

137. To determine the amount by which the personal services income should be reduced, the steps in the method statement at subsection 86-20(2) should be followed, that is:

> Step 1 - Work out the amount of any deductions (other than entity maintenance deductions) to which the entity is entitled that relate to the individual's personal services income.
>
> Step 2 - Work out the amount of the entity maintenance deductions to which the entity is entitled.
>
> Step 3 - Work out the entity's assessable income, disregarding the individual's personal services income or the personal services income of anyone else.
>
> Step 4 - Step 2 less step 3. That is, subtract from the entity maintenance deductions the non-personal services income first.
>
> Step 5 - If the amount under step 4 is greater than zero, the amount of the deduction against the personal services income is the sum of the amounts under steps 1 and 4.

Sept 6 - If the amount under step 4 is equal to or less than zero, the amount of the deduction against the personal services income is the amount under step 1.

Step 1	PSI Deductions	$55,000
Step 2	Entity Maintenance Deductions	$5,000
Step 3	Other Income	$4,000
Step 4	Entity Maintenance Deductions minus Other Income (step 2 minus step 3)	$1,000
Step 5	PSI is reduced by the sum of step 1 and step 4 ($55,000 + $1,000)	$56,000
Step 6	This step does not apply as the amount under step 4 is greater than zero.	

138. Under step 5, Joanne's personal services income will be reduced by $56,000. The amount attributed to Joanne is:

$100,000 – $56,000 = $44,000

139. Therefore, $44,000 is included in Joanne's assessable income under section 86-15.

140. The balance of the other income of the entity is reduced by the other income deductions:

$0 – $500 = ($500)

141. The personal services entity has a loss of $500. This loss is retained in the entity to be offset against future other (assessable) income that the entity earns.

Example 9: Entity maintenance deductions

142. Continuing Example 8: Carlo, who is a computer consultant, joins Joanne's company, which gains his personal services income. Jo Pty Ltd incurs entity maintenance expenses to the same extent in relation to both Carlo and Joanne and is entitled to a deduction for the amounts incurred. The income and deductions for the personal services entity consist of:

Total PSI of the entity	$200,000
PSI of Carlo	$100,000
Assessable Income of the Entity (Other Income)	$4,000
Entity Maintenance Deductions	$6,000

Other Income Deductions	$1,000
PSI Deductions (Carlo's only)	$55,000

143. To determine how much of the entity maintenance deductions Carlo can claim, steps 1 to 4 of the method statement in subsection 86-20(2) should be followed:

Step 1	PSI Deductions	$55,000
Step 2	Entity Maintenance Deductions	$6,000
Step 3	Assessable Income of the Entity (Other Income)	$4,000
Step 4	Entity Maintenance Deductions minus Other Income (step 2 minus step 3)	$2,000

144. The amount of $2,000 has to be apportioned between Carlo and Joanne using the formula in section 86-25:

$$\text{Original step 4 amount} \times \frac{\text{Your Personal Services Income}}{\text{Total Personal Services Income}}$$

$$\$2000 \times \frac{\$100,000}{\$200,000}$$

$$= \$1,000$$

145. Carlo can claim $1,000 for entity maintenance deductions.

146. To determine the total amount that Carlo's income is reduced by, the remaining steps in the method statement should be followed:

Step 5	As the amount in step 4 is greater than zero, the PSI is reduced by the sum of step 1 and the new amount worked out under section 86-20 ($55,000 + $1,000)	$56,000
Step 6	This step does not apply as the amount in step 4 is not greater than zero.	

147. Carlo's personal services income is reduced by the amount in step 5:

$$\$100,000 - \$56,000 = \$44,000$$

148. Therefore, $44,000 is attributed to Carlo and included in Carlo's assessable income under section 86-15.

Detailed contents list

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Your comments **150**

Your comments

150. We invite you to comment on this draft Taxation Ruling. We are allowing 6 weeks for comment before we finalise the Ruling. If you want your comments to be considered, please provide them to us within this period.

Comments by Date: **26 June 2002**

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Commissioner of Taxation
15 May 2002

Previous draft:

Not previously released in draft form

Related Rulings/Determinations:

TR 92/20; TR 93/30;TR 2000/17;
TR 2001/7; TR 2001/8

Subject references:

- accounting & record keeping
- alienation of personal services income
- associate
- associated persons
- complying superannuation funds
- contributions
- deductions and expenses
- depreciation
- deduction entitlements of personal services entity
- deductions for non-employees relating to personal services income
- employees
- employer superannuation
- entity maintenance deductions
- expense apportionment
- FBT car expenses
- home office expenses
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- partnership
- personal services entity
- personal services income
- personal services income expenses
- principal work
- producing assessable income
- retirement savings account
- service acquirer
- service personal services business
- service provider
- substantiation
- superannuation contributions
- superannuation guarantee shortfall
- tax related expenses
- test individual

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