

Personal services income for companies, partnerships and trusts



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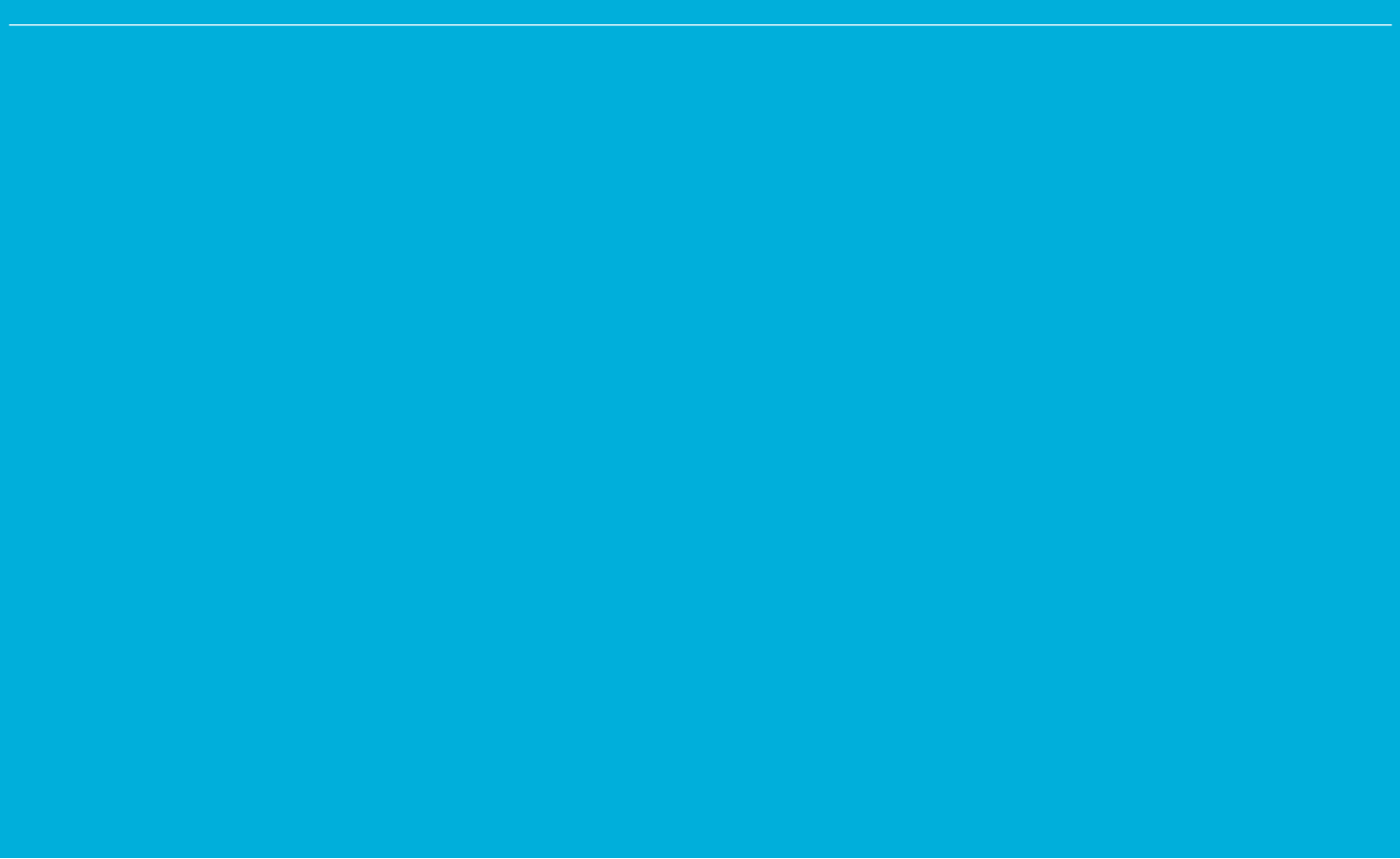
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WHAT PERSONAL SERVICES INCOME IS



WORKING OUT IF THE INCOME YOUR BUSINESS RECEIVES IS PERSONAL SERVICES INCOME (PSI)

Many consultants and contractors operate their business through a company, partnership or trust. In many cases, the income received for the work they do may be classified as PSI.

! If you are an employee only earning salary and wages (that is, working for an employer and **not** under an Australian business number), do not read any further. This information does not apply to you.

When we say 'you', 'your' or 'your business' we are referring to the company, partnership or trust you earn your income through.

! If you are a sole trader refer to *Personal services income fro sole traders* (NAT 72511).

To know if your business is receiving PSI, you will need to look at the income (or reward) from each contract you complete, and work out what percentage of the payment is for:

- the skills, knowledge, expertise or efforts of those who performed the services – that is, the labour component
- the materials supplied and/or tools and equipment used to complete the job.

If you work out that:

- **more than 50%** of the income you received is for the skills, knowledge, expertise or efforts of the individuals who performed the services, then the income for that contract is PSI
- **50% or less** of the income received is for the skills, knowledge, expertise or efforts of the individuals who performed the services, then the income for that contract is not PSI.

Your business income can be a mixture of PSI and other income. So, it is important to look at the income you received from each separate contract to work out whether it is PSI. The terms and conditions of the contract as well as invoices and written agreements (which show the arrangement you have for the work) are important in working out whether the income is PSI or not.

! Even if the income received from the contract is in the name of your business, you still need to work out whether this income is classified as PSI.

If more than one individual provides services through your business, you will need to work out the amount of PSI that belongs to each individual.

EXAMPLE: Working out if income is classified as PSI

Mark is a qualified plumber who operates through his company, Mark's Plumbing Services Ltd. He is the only plumber in the business and owns the company.


In a week, two customers call Mark's Plumbing Services Ltd and request plumbing work to be completed. Mark completes both contracts on behalf of the company. The company will be paid for the work completed.

Contract completed	Work done	What Mark charged	Is the income PSI?
Contract 1	<ul style="list-style-type: none"> ■ Fixed blocked toilet ■ Repaired several leaking taps 	Total amount of \$250: <ul style="list-style-type: none"> ■ \$225 labour (90%) ■ \$25 materials (10%) 	Yes, the \$250 is PSI as more than 50% of the income received is for Mark's skills and knowledge.
Contract 2	<ul style="list-style-type: none"> ■ Installs a bathroom vanity 	Total amount of \$800: <ul style="list-style-type: none"> ■ \$160 labour (20%) ■ \$640 materials (80%) 	No, the \$800 isn't PSI as 50% or less of the income received is for Mark's skills and knowledge.

INCOME THAT IS PSI

You can receive PSI by performing services in any industry or occupation. This includes income:

- of a professional practising on their own account without assistance – for example, a medical practitioner in a sole practice
- payable under a contract where the labour or services of a person make up more than 50% of the value, for example, contractors in the building, IT and transport industry
- of a professional sports person or entertainer from the exercise of their professional skills (this does not include income from endorsements)
- of consultants, for example, computer consultants or engineers from the exercise of personal expertise
- of a commission agent who contracts with a supplier to sell goods on their behalf.

 This is not a complete list. To decide whether an amount of income is PSI, ask whether the majority (more than 50%) of the income you received relates to the skills, knowledge, expertise or efforts of the individuals who performed the services.

EXAMPLE

Louise is a management consultant who operates through her company Louie Pty Ltd.

Louie Pty Ltd was recently successful in obtaining a contract to provide management consulting services. Louise, on behalf of Louie Pty Ltd, completes this contract and uses computer equipment and office stationery in providing the services. Louie Pty Ltd is paid \$10,000 for the successful completion of the contract.

This \$10,000 is PSI as the majority of the income was generated by Louise's skills, knowledge, expertise and efforts. The use of computer equipment and office stationery are a minor part of the services that generated the income.

EXAMPLE

Bill and Ben are management consultants who operate through a company, Bill and Ben Pty Ltd. In an income year, Bill and Ben work on separate contracts. Neither consultant works on the other's contract.

Bill completes a contract for Green Pty Ltd which generates \$40,000. This \$40,000 is Bill's PSI as the majority of the income was generated by Bill's skills, knowledge, expertise and efforts.

Ben completes a contract for Red Pty Ltd which generates \$60,000. This \$60,000 is Ben's PSI as the majority of the income was generated by Ben's skills, knowledge, expertise and efforts.

INCOME THAT IS NOT PSI

The following income is not PSI as 50% or less of the income is for the skills, knowledge, expertise or efforts of the individuals who performed the services.

1 INCOME FROM THE SALE OR SUPPLY OF GOODS

Income from selling or supplying goods, such as retailing, wholesaling or manufacturing, is generally not PSI as the majority of the income is for the sale or supply of finished goods.

EXAMPLE

Alan builds reproduction furniture for his company Alan's Furniture Pty Ltd. This furniture is sold through his friend's shop.

The income Alan's Furniture receives from selling the furniture in the shop is considered income from the sale of goods and not PSI because the buyers are paying for the furniture – that is, the finished goods. These buyers did not contract Alan's Furniture to build the furniture.

Supplying materials that are a minor part of the services provided is not regarded as the sale or supply of goods. Examples of this include the use of:

- art supplies by a graphic designer in doing design work for a client
- nails and glue by a carpenter in carrying out repairs on behalf of a building company
- paint by a painter in carrying out work for a painting company
- wiring by an electrician when installing wiring into a building, and
- paints, canvas and other consumables by an artist painting a commissioned portrait.

2 INCOME GENERATED BY AN INCOME-PRODUCING ASSET

If your business' income is mainly generated by income-producing assets, such as a bulldozer or printing press, rather than the skills, knowledge, expertise or efforts of the individuals who performed the services, the income is not PSI. This applies even if some personal efforts or skills are involved in operating the asset.

It is more likely that the income is being generated by the asset rather than by the individual's efforts or skills and therefore is not PSI where the asset is:

- large-scale or high value
- essential to performing the work, and
- is specified in the contract.

In such cases, using the asset will represent substantially more than 50% of the contract price and the services of the person operating their equipment will be substantially less than 50% of the contract price.

EXAMPLE

Ian's company, Ian Pty Ltd, has a contract to supply an excavator to level uneven surfaces. The income mainly comes from the supply and use of the income-producing equipment – the excavator. The income is not Ian's PSI.

3 INCOME FROM GRANTING A RIGHT TO USE PROPERTY

Income from granting a right to use property, such as copyright to a computer program or book, is generally not PSI as the majority of the income is generated from the right to use the property.

EXAMPLE

Joy, on behalf of her company Joy Pty Ltd, writes a book on the pay as you go (PAYG) system. Joy Pty Ltd sells the copyright to the book to a publishing house for \$20,000 plus a royalty of 40 cents a book.

Income from the sale of the copyright is not PSI. Rather, Joy Pty Ltd is being paid for transferring the rights to the book to the publishing house.

However, if an organisation contracted Joy Pty Ltd to write a book (where Joy wrote the book on behalf of the company) and the book became the organisation's asset, this income would be Joy's PSI. In this case, the organisation is paying for Joy's skills, knowledge, expertise and efforts in writing the book.

4 INCOME GENERATED BY A BUSINESS STRUCTURE

Income from a business structure, such as a large national professional firm, is generally not PSI as most of the income is generated by the significant assets, many employees or contractors, sizable operations or goodwill of the business structure; not the skills, knowledge, expertise or efforts of the individuals who performed the services.

EXAMPLE

Matt is a partner in a large accounting partnership of 20 partners and 200 employees. Matt's partnership income flows from his interest in the partnership.

None of the firm's income is Matt's PSI, because his income is generated from the partnership's goodwill, assets and the work of the other partners and employees of the firm. Therefore, the partnership income is not mainly a reward for Matt's skills, knowledge and expertise.

Whether your income is generated mainly by a business structure can depend on the extent to which the income is generated, not by the skills, knowledge, expertise or efforts of the individuals who performed the services but by:

- significant business assets – such as plant and equipment, or intellectual or other property used to earn the income
- employees and other contractors at 'arm's length' (not associated with the individual who generates the PSI) performing a significant portion of the work
- business goodwill, and
- the size of your business operations.

➤ For more information, refer to *Alienation of personal services income: income from personal services compared with income from a business structure* (NAT 10974).

DOES YOUR BUSINESS RECEIVE PSI?

YES, YOUR BUSINESS DOES RECEIVE PSI

If your business receives PSI, then certain rules (known as the PSI rules) may apply where:

- your business cannot claim certain deductions against the PSI.
- the PSI (less relevant deductions) your business received will need to be attributed (treated as belonging) to each individual who performed the services – that is, the profits can't be retained in the business
- your business needs to meet certain tax return obligations
- your business may have additional pay as you go (PAYG) withholding obligations.

➤ For more information about whether the PSI rules apply, refer to *Working out if the PSI rules apply*, on page 12.

NO, YOUR BUSINESS DOESN'T RECEIVE PSI

If your business doesn't receive PSI, then you do not have to read any further. There are no changes to your tax obligations.

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WORKING OUT IF THE PSI RULES APPLY

02

OVERVIEW

The PSI rules only apply to PSI. As a business can receive PSI and non-PSI, it is important to work out if the income your business receives is PSI.

! If you are not sure whether the income your business receives PSI, see *What is personal services income?*, on page 5.

For the PSI your business received, you need to work out if the PSI rules apply to this income.

If the **PSI rules apply**:

- your business cannot claim certain deductions against the PSI.
- the PSI (less relevant deductions) your business received will need to be attributed (treated as belonging) to each individual who performed the services – that is, the profits can't be retained in the business
- your business needs to meet certain tax return obligations
- your business may have additional pay as you go (PAYG) withholding obligations.

If the **PSI rules don't apply**, the only change in your business' tax obligations is there will be certain tax return reporting obligations for the PSI you received.

HOW TO WORK OUT IF THE PSI RULES APPLY

To work out if the PSI rules apply, your business needs to work through a series of tests:

- **results test** – use this test first to work out if you've received the income after achieving a specific result or outcome

! If you do not pass the results test, you need to apply an additional rule, called **the 80% rule**, to work out if 80% or more of your income comes from one client.

- **unrelated clients test** – use this test to work out if you have received the income from two or more clients who are not connected or related
- **employment test** – use this test to work out if others were employed or contracted to help complete the work that generates the PSI
- **business premises test** – use this test to work out if the location and usage of your business premises meet certain criteria.

The step-by-step flowchart shows how to work out if the PSI rules apply to the PSI your business receives.

Step-by-step flowchart showing how to work out if the PSI rules apply

Step 1: The results test

Do you pass the results test?

YES



Outcome
PSI rules do not apply

UNSURE OR UNUSUAL
CIRCUMSTANCES



What to do
If you are unsure **or** have unusual circumstances that stop you from passing one of the tests, apply for a **determination** and we'll tell you whether the PSI rules apply.

NO

Step 2: The 80% rule

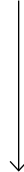
Does 80% or more of your PSI come from one client **or** if you are a qualifying agent, is 80% or more of your PSI from one of your principal's clients?

YES



What to do
Apply for a **determination**
If you don't the **PSI rules apply**

NO



Step 3: The other tests

Do you pass **one** or more of the following tests?

- Unrelated clients test
- Employment test
- Business premises test

YES



Outcome
PSI rules do not apply

UNSURE OR UNUSUAL
CIRCUMSTANCES



What to do
If you are unsure **or** have unusual circumstances that stop you from passing one of the tests, apply for a **determination** and we'll tell you whether the PSI rules apply.

NO



Outcome
PSI rules apply

STEP 1: THE RESULTS TEST

To work out if the PSI rules apply, work through the results test first. Your business will pass the results test in the income year if you can answer 'yes' to all three of the following questions for at least 75% of the PSI.

- Under your contract or arrangement, will your business only receive payment when the work has been completed, that is, after producing the contracted result?
- Does your business need to provide the equipment or tools necessary to do the work?
- Do you have to rectify defects in the work, or is your business liable for the cost of rectifying defects?

! If more than one individual is generating the PSI, your business will need to apply the results test to each individual separately.

EXAMPLE

Kim and Sara, two management consultants, operate through a company. They provide services to the public under separate contracts. Neither consultant works on the other's contracts.

As each consultant is providing exclusive services under separate contracts, each test must be applied separately to each consultant to work out if the PSI rules apply.

If Kim passes the results test, this does not mean Sara automatically passes it. Sara's circumstances need to be applied to the results test to work out if the PSI rules apply.

Step-by-step flowchart showing how to work out if the PSI rules apply

Step 1: The results test

Do you pass the results test?

YES



Outcome
PSI rules do not apply

UNSURE OR UNUSUAL
CIRCUMSTANCES



What to do
If you are unsure **or** have unusual circumstances that stop you from passing one of the tests, apply for a **determination** and we'll tell you whether the PSI rules apply.

NO

Step 2: The 80% rule

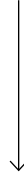
Does 80% or more of your PSI come from one client **or** if you are a qualifying agent, is 80% or more of your PSI from one of your principal's clients?

YES



What to do
Apply for a **determination**
If you don't the **PSI rules apply**

NO



Step 3: The other tests

Do you pass **one** or more of the following tests?

- Unrelated clients test
- Employment test
- Business premises test

YES



Outcome
PSI rules do not apply

UNSURE OR UNUSUAL
CIRCUMSTANCES



What to do
If you are unsure **or** have unusual circumstances that stop you from passing one of the tests, apply for a **determination** and we'll tell you whether the PSI rules apply.

NO



Outcome
PSI rules apply

Question 1: Under your contract or arrangement, will your business only receive payment when the work has been completed, that is, after producing the contracted result?

For you to answer 'yes' to this question, the contract needs to say that your business must produce an outcome before being paid. This may include progressive payments paid on achieving specified outcomes.


A contract to produce a result is usually flexible about how the task is done, for example, you are free to engage people and hire plant; and payment is usually made on a negotiated price rather than an hourly rate.

Indicators that the contract is not to achieve a specified result or outcome include:

- your business is contracted to provide services with no outcome specified
- the contract lists a scope of work only (indicating the typical tasks to be undertaken)
- the outcome to be delivered is not specified, or can't be specified, at the start of the contract.

Indicators that the income is not paid to achieve a specified result or outcome include:

- payment is made on a basis other than to meet the result or outcome specified in the contract
- the contract is rolled over and your business continues to be paid
- you end the contract before producing the specified result and you are entitled to payment for the services performed up until the time you ended it, or
- your payer ends the contract before the contract expires and you are entitled to be paid for the services performed up until the time it ended.

 If you are paid on an hourly basis or daily rate for the services provided, it is unlikely your business will pass the first condition of the results test as this payment would generally not be linked to producing a specific result or outcome.

EXAMPLE

A government department enters a contract with Consultant Co for the provision of services by a named individual. The individual is required to develop a product for the department's IT system to the functional specifications nominated by the department. The contract specifies a daily rate of payment to Consultant Co for developing the product, with payments to be made on a weekly basis.

This contract does not pass the first condition of the results test as payments are for work done during the week and not upon completion of a specified result.

EXAMPLE

Supermarket Pty Ltd enters into a contract with Scanning Prices Pty Ltd (the contractor) for the provision of services by a named individual. The contract is to coordinate and manage the installation of pricing scanners. The contract does not set out specific outcomes but lists typical tasks, including:

- overseeing and scheduling the installation
- identifying and resolving day-to-day issues
- preparing and undertaking staff training
- attending meetings at the direction of the Pricing Manager
- writing reports as requested by the Pricing Manager, and
- other services as required by the Pricing Manager.

The contractor is required to report to the Pricing Manager on a regular basis. In the initial phase of the project they are required to be available five days a week and this will be reviewed by the Pricing Manager.

Payment arrangements

The contract specifies a daily rate for the contractor's services. The contractor submits a weekly invoice to the Pricing Manager. The worksheet shows what activities the contractor undertook during that week for each store.

Termination clause

The contract can be ended for any reason by either party giving three weeks notice. Supermarket can end the contract without notice where the contractor is guilty of misconduct or unsatisfactory performance. In either case, the contractor is entitled to an invoice and to be paid for the services provided up until the end date.

Where the contract is ended for any reason before the contract period ends, Supermarket only has to pay the contractor for services provided up to the end date.

The contract does not pass the first condition of the results test

The contract does not specify an outcome the contractor must produce. It only describes the types of tasks that the contractor will be required to undertake. The contractor can be directed by the Pricing Manager to do any tasks in relation to coordinating and managing the installation of pricing scanners, and the payment arrangements are not based on the contractor achieving an outcome – the contractor is being paid for the time worked rather than for achieving a result.

EXAMPLE

A&B Plumbing Partnership contracts with a local authority to provide services by an individual, Joseph Plumber, for two years. The local authority owns and maintains a large number of properties requiring regular maintenance. The contract is for providing plumbing maintenance services for these properties.

The partnership:

- receives a daily work direction that describes the location and work to be done for the day
- is paid fortnightly on the basis of an hourly labour rate, and
- does not have to fix defects at its own expense or to indemnify the local authority for the cost of fixing such defects.

Termination clause

The contract can be ended for any reason by either party giving four weeks notice. The local authority can end the contract without notice where the contractor is guilty of misconduct or unsatisfactory performance. In either case, the contractor is entitled to issue an invoice and to be paid for the services they provided up until the end date.

If the contract is ended, for any reason, before the contract period ends, the local authority only has to pay the contractor for services provided up to the end date.

The contract does not pass the first condition of the results test because:

- the contractor is not engaged to complete a specific job
- payment is not made on the condition that the job is completed, and
- the partnership is paid for the service or work rather than the result produced by those services or that work.

Question 2: Does your business need to provide the equipment or tools necessary to do the work?

To answer 'yes' to this question, you would need to supply the equipment or tools needed to complete the contracted work.

Your business passes the second condition of the results test if:

- your client supplies only minor tools or equipment items, for example, an electrician using a client's telephone or pen
- you do not need plant and equipment or tools of trade to perform the work, or
- your client provides plant and equipment you do not actually need to perform the work, for example, if a carpenter uses onsite scaffolding provided by the client to access their work area, the carpenter can still pass this condition as the scaffolding is not needed to perform the carpentry work.

EXAMPLE

Clarissa is a software developer who operates through her company, Clarissa's Software Design Pty Ltd.

Clarissa's Software Design Ltd recently obtained a contract to develop a software package for a new recruitment company, New Recruitment Pty Ltd.

Clarissa, on behalf of the company, designs the software from her home office using her company's computer and equipment.

Occasionally, Clarissa goes to the office of New Recruitment Pty Ltd's and uses their computer to access their IT system. Using New Recruitment Pty Ltd's computer to access their IT system is incidental to the development of the software product and does not stop Clarissa's Software Design Ltd from passing the second condition of the results test.

If Clarissa could only complete the contract by accessing New Recruitment Pty Ltd's equipment and/or mainframe, Clarissa's Software Design Ltd would pass this condition if there is:


- no clause in the contract requiring Clarissa's Software Design Pty Ltd to provide these assets and equipment
- no expectation for Clarissa's Software Design Pty Ltd to do so, having regard to the custom and practice in that industry.

Question 3: Do you have to rectify defects in the work, or is your business liable for the cost of rectifying defects?

This condition may be passed if a contract says:

- your business must pay for fixing any defect in your work
- you must have insurance, such as professional indemnity insurance.

However, clauses like these do not mean you definitely pass this condition. You must take all your circumstances into account.

 If your business can invoice your payer for the hours you spend in fixing any defects in your work, your business does not pass this condition.

Your business may either fix the defects or pay someone else to fix it at anytime during or after the contract. Where physically fixing it is not possible, this condition would be satisfied by a contract where:

- your client can claim for damages for your faulty or negligent performance, and
- your business must pay any amount of damages related to the faulty or defective work.

EXAMPLE

Dave's Timber Services fells trees and delivers the logs to a saw mill. Under their agreement, the saw mill can recover damages for any logs that don't meet their standards by retaining money from future payments. While Dave can't fix any sub-standard logs he has delivered, he still risks not being paid. Therefore, Dave's Timber Services passes the third condition of the results test.

WHERE SOME CONTRACTS PASS THE RESULTS TEST AND SOME DO NOT

! In situations where some contracts pass the results test and some do not, you need to pass the results test for at least 75% of the PSI. If more than one individual is generating the PSI, your business will need to work out if each individual passes the results test for at least 75% of their PSI.

EXAMPLE

Sue Pty Ltd receives Sue's PSI. Ninety per cent of the PSI comes from one source and 10% comes from another source. The 10% contract passes the results test, but the 90% contract does not. Sue Pty Ltd does not pass the results test in relation to Sue's PSI as less than 75% of the PSI comes from results-based contracts.

DOES YOUR BUSINESS PASS THE RESULTS TEST?

Yes, your business passes

If your business answered 'yes' to all three questions in the results test, your business passes this test and the PSI rules don't apply to the PSI.

When the PSI rules don't apply, this means:

- the only change to your tax obligations is you will have some tax return reporting obligations for the PSI received, and
- you need to consider the anti-avoidance rules if you have entered into an arrangement where the main purpose is to obtain a tax benefit, for example income splitting.

! You do not have to read the following information on the 80% rule or the other tests.

> For more information about your tax return obligations and anti-avoidance rules, see When the PSI rules don't apply, on page 53.

Not sure if your business passes

Apply to us for a determination if:

- you are unsure whether you pass the results test, or
- your business had unusual circumstances that stopped it from passing this test.

We'll apply your circumstances to the relevant tests and let you know if the PSI rules apply or not. This is a free service.

Unusual circumstances for the results test could be where your business has passed the results test each year for several years as all contracts completed were results-based. However your business has just accepted a 12 month contract which is not results-based (your business is paid for hourly work which is not linked to you achieving specific results) and it will be the only contract you complete in the income year. After this contract finishes, your business expects to have results-based contracts each year.

> For more information, refer to *Personal services business determination application* (NAT 72465).

! A determination is a notice from us stating the PSI rules don't apply.

No, your business doesn't pass

If you didn't answer 'yes' to all three questions in the results test, your business hasn't passed this test.

The next step for your business is to work through **the 80% rule**.

STEP 2: THE 80% RULE

If your business has not passed the results test the next step is to work through the 80% rule.

Step-by-step flowchart showing how to work out if the PSI rules apply

Step 1: The results test

Do you pass the results test?

YES



Outcome
PSI rules do not apply

UNSURE OR UNUSUAL
CIRCUMSTANCES



What to do
If you are unsure **or** have unusual circumstances that stop you from passing one of the tests, apply for a **determination** and we'll tell you whether the PSI rules apply.

NO

Step 2: The 80% rule

Does 80% or more of your PSI come from one client **or** if you are a qualifying agent, is 80% or more of your PSI from one of your principal's clients?

YES



What to do
Apply for a **determination** if you don't the **PSI rules apply**

NO



Step 3: The other tests

Do you pass **one** or more of the following tests?

- Unrelated clients test
- Employment test
- Business premises test

YES



Outcome
PSI rules do not apply

UNSURE OR UNUSUAL
CIRCUMSTANCES



What to do
If you are unsure **or** have unusual circumstances that stop you from passing one of the tests, apply for a **determination** and we'll tell you whether the PSI rules apply.

NO



Outcome
PSI rules apply

For the 80% rule you need to work out whether 80% or more of the PSI comes from one client (and their associates) in an income year.

❗ If more than one individual is generating the PSI, your business will need to work out whether each individual has 80% or more of their PSI from one client (and their associates).

A client's associate includes the client's:

- relatives
- partner in a partnership and their spouses or children
- trustee of a trust they or an associate benefit from
- company which is under their control or their associate's control
- beneficiary or their associates, if the client is a trustee.

For a company, the individual or associate controlling the company is also an associate.

❗ If you receive PSI from one client and an associate of this client (eg a company and a subsidiary of that company), you need to treat this PSI as if it comes from one client (that is, one source).

EXAMPLE: 80% or more of the PSI coming from one client

Sasha is an IT consultant who works through her company IT Consultant Pty Ltd. The income IT Consultant Pty Ltd receives is PSI as most of the income is a reward for Sasha's knowledge, skill and expertise.

In an income year Sasha – on behalf of IT Consultant Pty Ltd – designs software for two different clients which generates \$100,000. The first client is charged \$90,000 and the second client is charged \$10,000 for Sasha's work.

IT Consultant Pty Ltd received more than 80% of its PSI from one client as the first client provided 90% of the business' PSI.

EXAMPLE: Each client providing less than 80% of the PSI

Xavier is an engineer who works through his company Xavier's Engineering Services Pty Ltd. The income Xavier's Engineering Services Pty Ltd is PSI as most of the income is a reward for Xavier's knowledge, skill and expertise.

In an income year Xavier – on behalf of Xavier's Engineering Services Pty Ltd – completes three contracts which generate \$100,000. For Xavier's work, the company charges:

- ABC Pty Ltd \$25,000
- ABC telecommunications Pty Ltd (a subsidiary company of ABC Pty Ltd) \$35,000
- XYZ Pty Ltd (a company not related to either ABC Pty Ltd or ABC telecommunications Pty Ltd) \$40,000.

The \$25,000 from the first contact and the \$35,000 from the second contract (totalling \$60,000) are considered to come from one client as ABC telecommunications Pty Ltd is an associate of ABC Pty Ltd.

Each of Xavier's Engineering Services Pty Ltd clients provided less than 80% of the PSI as ABC Pty Ltd and ABC telecommunications Pty Ltd (considered one client) provided 60% of the PSI and the other client provided 40% of the PSI.

❗ If your business works as a commission agent there are special rules that affect your business in relation to the 80% rule. Refer to *Personal services income for financial planners* (NAT 9802).

IS 80% OR MORE OF YOUR BUSINESS' PSI FROM ONE CLIENT?

Yes, 80% or more of your business' PSI comes from one client

If 80% or more of your business' PSI comes from one client, your business will need to apply for a determination from us to work out if the PSI rules apply or not. To do this, complete the *Personal services business determination application and instructions* (NAT 72465). After we receive your completed application, we will write to you and tell you whether the PSI rules do or don't apply to you.

⚠ If you don't apply to us for a determination, the PSI rules will automatically apply.

No, each of your clients provided less than 80% of your business' PSI

If each of your clients provided less than 80% of your business' PSI then your business can use **the other tests** (unrelated clients test, employment test and business premises test) to work out if the PSI rules apply.

STEP 3: THE OTHER TESTS

If each of your clients provided less than 80% your business' PSI, the next step is to work out if your business passes one of the following tests:

- **unrelated clients test** – use this test to work out if you've received the income from two or more clients who are not connected or related
- **employment test** – use this test to work out if others are employed or contracted to help complete the work which generates your PSI
- **business premises test** – use this test to work out if the location and usage of your business premises meet certain criteria.

If your business passes one of these tests, the PSI rules do not apply to the PSI you received.

⚠ Your business can apply these tests in any order, for example if you think your business is more likely to pass the employment test, your business should look at this test next.

Step-by-step flowchart showing how to work out if the PSI rules apply

Step 1: The results test

Do you pass the results test?

YES



Outcome
PSI rules do not apply

UNSURE OR UNUSUAL
CIRCUMSTANCES



What to do
If you are unsure **or** have unusual circumstances that stop you from passing one of the tests, apply for a **determination** and we'll tell you whether the PSI rules apply.

NO

Step 2: The 80% rule

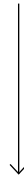
Does 80% or more of your PSI come from one client **or** if you are a qualifying agent, is 80% or more of your PSI from one of your principal's clients?

YES



What to do
Apply for a **determination**
If you don't the **PSI rules apply**

NO



Step 3: The other tests

Do you pass **one** or more of the following tests?

- Unrelated clients test
- Employment test
- Business premises test

YES



Outcome
PSI rules do not apply

UNSURE OR UNUSUAL
CIRCUMSTANCES



What to do
If you are unsure **or** have unusual circumstances that stop you from passing one of the tests, apply for a **determination** and we'll tell you whether the PSI rules apply.

NO



Outcome
PSI rules apply

UNRELATED CLIENTS TEST

⚠ If more than one individual is generating the PSI, your business will need to apply the unrelated clients test to each individual separately.

Your business will pass the unrelated clients test in an income year if you answer yes to both of the following questions.

Question 1: Does your business receive PSI from two or more unrelated clients?

Unrelated clients are clients who are not associates of each other. This means they are not related or controlled by the same individuals, business or entities. To work out if you pass this test, only count clients who are not related.

Question 2: Does your business provide services as a direct result of making offers or invitations (such as advertising) to the public?

This means there must be a definite connection between the offer to the public and the engagement for the work. Making offers to the public includes advertising in a newspaper or business directory, maintaining a website, and word-of-mouth referrals.

Your business is not treated as having made offers or invitations to the public merely by being available to provide the services through a labour hire firm or similar organisation.

EXAMPLE

Raji operates a computer programming company and she has two major clients. One of Raji's clients provides 65% of her company's income (the programmer's PSI) and the other client provides the balance. Raji's company obtained both contracts with her clients through a labour hire firm.

As the contracts were obtained via a labour hire firm, these clients cannot be counted for the purposes of the unrelated clients test.

If Raji's company had obtained her clients as a direct result of advertising to the public (and not through a labour hire firm), she would have passed this part of the unrelated clients test.

EXAMPLE

Michael's company Mickey Pty Ltd was engaged by Z Pty Ltd three years ago to provide Michael's consulting services for 18 months. He was previously an employee of Z Pty Ltd and Mickey Pty Ltd obtained this contract because of Michael's past relationship.

In July 2013, Mickey Pty Ltd entered into another contract with Z Pty Ltd. Mickey Pty Ltd also has a contract with ABC Pty Ltd that he obtained via advertising. Neither company provides Mickey Pty Ltd with 80% or more of Michael's PSI.

Mickey Pty Ltd does not pass the unrelated clients test as the contract with Z Pty Ltd is not taken to have resulted from making direct offers or invitations to the public. This is because Mickey Pty Ltd did not obtain the original contract three years ago as a direct result of making offers or invitations to the public.

DOES YOUR BUSINESS PASS THE UNRELATED CLIENTS TEST?

Yes, your business passes

If you answered 'yes' to both the questions in the unrelated clients test, your business passes this test and the PSI rules do not apply to the PSI.

When the PSI rules don't apply, this means:

- the only change to your tax obligations is your business will have some tax return reporting obligations for the PSI received, and
- your business needs to consider the anti-avoidance rules if it has entered into an arrangement where the main purpose is to obtain a tax benefit, for example income splitting.

➤ For more information about your tax return obligations and anti-avoidance rules, see *When the PSI rules don't apply*, on page 53.

Not sure if your business passes

For the unrelated clients test, by law we can only provide a determination where unusual circumstances have stopped you from passing this test and/or the 80% rule. If you are unsure whether you pass the unrelated clients test and less than 80% of your income comes from each of your clients, we recommend you apply for a private ruling.

➤ For more information refer to *Private ruling application (not for tax professionals)* (NAT 13742).

Apply to us for a determination if your business had unusual circumstances that stopped it from passing the unrelated clients test.

We'll apply your circumstances to the relevant tests and let you know if the PSI rules apply or not. This is a free service.

⚠ Unusual circumstances for the unrelated clients test could be where your business has provided services to two or more different clients each year for several years. However your business has just accepted a 12-month contact with one client (the only contract that the business will complete in the income year), thus PSI is no longer received from two or more unrelated clients. After this contract finishes, your business expects to return to having two or more clients each year.

➤ For more information, refer to *Personal services business determination application* (NAT 72465).

No, your business doesn't pass

If you didn't answer 'yes' to both of the questions in the unrelated clients test, your business does not pass this test.

You can work out if the PSI rules apply to your business by using either of the two other tests:

- the employment test, or
- the business premises test.

If your business passes one of these tests, the PSI rules don't apply.

THE EMPLOYMENT TEST

⚠ If more than one individual is generating the PSI, your business will need to apply the employment test to each individual separately.

Your business will pass the employment test in an income year if you answer 'yes' to one of the following questions.

- Does your business get employees, partners (in a partnership) or other contractors to perform at least 20% (by market value) of the principal work?
- Does your business have one or more apprentices for at least half of the income year?

Question 1: Does your business get employees, partners (in a partnership) or other contractors to perform at least 20% (by market value) of the principal work?

Principal work is the work your business must perform under contract and for which the business is paid. It does not include support work such as bookkeeping. It can be described as work that is central to meeting the obligations under agreements between your business and the acquirer of the services.

Your business can count principal work a family member or partner does.

Your business can't count principal work done by:

- a business (company, partnership or trust) associated with you
- yourself as an employee of your business
- the individuals who have PSI.

It is possible that a partner in a partnership is performing principal work that is helping to generate another partner's PSI. In these cases, the work that a partner performs is taken to be work that the partnership engages another business to perform.

The important factor in the employment test is the market value of the principal work performed by a business or other businesses you engaged. Generally, the market value of the principal work performed is the amount paid by the business to the employee or the sub-contractor. If your business is not dealing at arm's length with the other business or businesses you engage, it is the amount your clients would pay for the same work in the general marketplace for that industry.

EXAMPLE

Julie and Greg work through their company J & G Deliveries Pty Ltd. Their company has a contract with Australia Post to sort and deliver mail in the metropolitan area. Greg and Julie collect and sort the mail together but only Greg delivers it.

The value of the work performed by Julie amounts to 25% of the principal work under the contract. J & G Deliveries Pty Ltd passes the employment test as Julie does more than 20% of the principal work at market value.

Question 2: Does your business have one or more apprentices for at least half the income year?

An apprentice is a person who works for another for a fixed period of time with obligations to learn a trade, business or skill. This includes government or industry group training schemes. Research and other assistants do not qualify.

An apprentice need not be apprenticed to the contractor. A series of apprentices supplied by the Group Apprentice Scheme to work for the contractor as part of their trade training meets the requirement.

Apprentices may work for you for broken periods throughout the income year, as long as the total periods add up to at least six months.

However, your business does not pass this condition of the employment test if, for example, you had two apprentices concurrently for the first three months of the income year.

DOES YOUR BUSINESS PASS THE EMPLOYMENT TEST?

Yes, your business passes

If you answered 'yes' to either of the questions in the employment test, your business passes this test and the PSI rules do not apply to the PSI.

When the PSI rules don't apply, this means:

- the only change to your tax obligations is your business will have some tax return reporting obligations for the PSI you received, and
- your business needs to consider the anti-avoidance rules if it has entered into an arrangement where the main purpose is to obtain a tax benefit, for example income splitting.

➤ For more information about your tax return obligations and anti-avoidance rules, see *When the PSI rules don't apply*, on page 53.

Not sure if your business passes

Apply to us for a determination if:

- you are unsure whether you pass the employment test, or
- your business had unusual circumstances that stopped it from passing this test.

We'll apply your circumstances to the relevant tests and let you know if the PSI rules apply or not. This is a free service.

⚠ Unusual circumstances for the employment test could be where your business has passed this test for several years as other contractors have provided more than 20% of the principal work. However, in an income year your business goes through a restructure and, as a result, contractors only perform 15% of the principal work (so you do not pass the employment test). After this income year, you expect the restructure to be finalised and contractors to provide more than 20% of the principal work again.

➤ For more information refer to *Personal services business determination application* (NAT 72465).

No, your business doesn't pass

If you didn't answer 'yes' to either question in the employment test, your business does not pass this test.

You can work out if the PSI rules apply to your business by using either of the two other tests:

- **the unrelated clients test, or**
- **the business premises test.**

If your business passes one of these tests, the PSI rules don't apply.

BUSINESS PREMISES TEST

! If more than one individual is generating the PSI, your business will need to apply the business premises test to each individual separately.

Your business will pass the business premises test in an income year if you answer 'yes' to all parts of the following question.

At all times in the income year were the business premises:

- owned or leased by your business
- used for personal services work more than 50% of the time
- used exclusively by your business and the individuals who generated the PSI
- physically separate from the residence of the individuals who generated the PSI and associates' residences, and
- physically separate from the business addresses of clients and their associates?

! The phrase 'at all times in the year of income' means on every day during the income year in which your business generates the PSI.

Two common scenarios that don't pass the business premises test are:

- a home office, as this not considered physically separate from your residence
- an office jointly leased with another person/business, as neither lessee has exclusive use of the premises.

EXAMPLE

Dennis works through his company Dennis Company Pty Ltd. The income the company receives is PSI as most of the income is a reward for Dennis' knowledge, skills and expertise.

Throughout the income year, Dennis Company Pty Ltd rents a small office in a commercial complex from which Dennis conducts work that generates PSI. The office is not shared. The company has exclusive use of the office and it is physically separate from the client's premises (and the client's associates' premises) and Dennis' private residence.

The requirements of the business premises test are met.

What if your business begins trading during the year?

Where your business begins to trade during the income year, you still pass the business premises test if you maintain and use business premises for that entire portion of the income year during which you conduct your activities.

EXAMPLE

John does management and consultancy work through his company John's Management and Consultancy Services Pty Ltd. His company started trading on 1 February, so in the income year, he has only traded for five months.

For these five months John did the management and consultancy work from an office building he rented.

John's Management and Consultancy Services Pty Ltd passes the business premises test as he maintained and used business premises for the portion of time that the business was trading in the income year.

Who can your business share the premises with?

Your business must have exclusive use of the premises. However, you may share the premises with parties who work for your business. For example if your business has three people who perform the work for your business, these three people could work from your business premises and it would still be considered exclusive use. However, if you share or jointly lease premises with another person/business that isn't performing work for your business, then this is not exclusive use.

The business premises must be separate from any premises the person who provides the personal services uses for private purposes or any of the person's associates. This means that business premises within private premises generally will not be considered to be physically separate. The term 'associate' includes a business in which you have an interest or control, or a relative.

The premises must also be physically separate from premises of our clients (or their associates).

Some of the factors to take into account in deciding whether the premises are 'physically separate' are whether:

- the business premises are detached from other building structures on the land
- the business premises have separate external access for you and your clients, and
- there is a permanent barrier preventing internal access between the business premises and the remaining premises.

Does it matter where the work is performed?

Yes. You must use the premises mainly for the work that generates your PSI. It is not enough to merely own or lease the premises and conduct activities that are unrelated to your personal services work at the premises.

What if you change premises during the year?

The premises do not need to be the same premises throughout the year. This means that you can change premises during the year as long as, at all times during the income year, your business has premises meeting the requirements of the business premises test.

DOES YOUR BUSINESS PASS THE BUSINESS PREMISES TEST?

Yes, your business passes

If you answered 'yes' to all parts of the question in the business premises test, your business passes this test and the PSI rules do not apply to the PSI.

When the PSI rules don't apply, this means:

- the only change to your tax obligations is your business will have some tax return reporting obligations for the PSI you received, and
- you need to consider the anti-avoidance rules if your business has entered into an arrangement where the main purpose is to obtain a tax benefit (eg income splitting).

➤ For more information about your tax return obligations and anti-avoidance rules see *When the PSI rules don't apply* in this product, on page 53.

Not sure if your business passes

Apply to us for a determination if:

- you are unsure whether you pass the business premises test, or
- your business had unusual circumstances that stopped it from passing this test.

We'll apply your circumstances to the relevant tests and let you know if the PSI rules apply or not. This is a free service.

⚠ Unusual circumstances for the business premises test could be where your business has passed this test for several years. However, in an income year, the office building where your business is located undergoes a major renovation and you need to move your premises temporarily until the renovations have been completed. For this period of time your business operates from a room in your house (thus not passing the condition 'physically separate from your residence'). As this is a temporary situation that has caused your business to not pass the business premises test, you should apply for a determination.

➤ For more information, refer to *Personal services business determination application* (NAT 72645).

No, your business doesn't pass

If you didn't answer 'yes' to all parts of the question in the business premises test, your business doesn't pass this test.

You can work out if the PSI rules apply to your business by using either of the two other tests:

- **the unrelated clients test**, or
- **the employment test**.

If your business passes one of these tests, the PSI rules don't apply.

IF YOUR BUSINESS DOESN'T PASS ANY OF THE TESTS – THE PSI RULES APPLY

If you have worked through the tests and your business doesn't pass any of them, the PSI rules apply. This means:

- your business won't be able to claim certain deductions against the PSI including rent, mortgage interest, rates, land tax, payments to associates and superannuation for associates – refer to Deductions when the PSI rules apply, on page 36.
- the PSI your business received will need to be attributed (treated as belonging to) the people who performed the services (that is, the profits can't be retained in the business)
- your business will need to meet certain tax return reporting obligations
- your business may have additional pay as you go (PAYG) withholding reporting obligations.

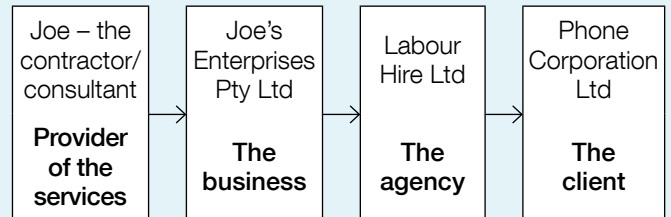
➤ For more information about your business' PSI obligations, see When the PSI rules apply, on page 36.

WHERE WORK IS OBTAINED THROUGH AN AGENCY

Businesses (usually contractors and consultants) who work through an agency (for example, a labour hire firm) may be affected by the PSI rules. This section explains how the PSI rules affect your business if you use an agency to obtain work.

⚠ You only need to read this section if your business obtains work through an agency.

EXAMPLE: A contractor or consultant, working through a business that obtains work through an agency



Joe creates a company called Joe's Enterprises Pty Ltd.

His company contracts with Labour Hire Ltd who offers Joe's services to their clients. Joe is required to perform work for and at the direction of the agency's clients. Labour Hire Ltd provides Joe's services to Phone Corporation Ltd as a consultant.

Phone Corporation Ltd pays Labour Hire Ltd for Joe's services.

Joe's Enterprises Pty Ltd receives 100% of its income from Labour Hire Ltd.

IMPACTS OF PSI RULES WHERE WORK IS OBTAINED THROUGH AN AGENCY

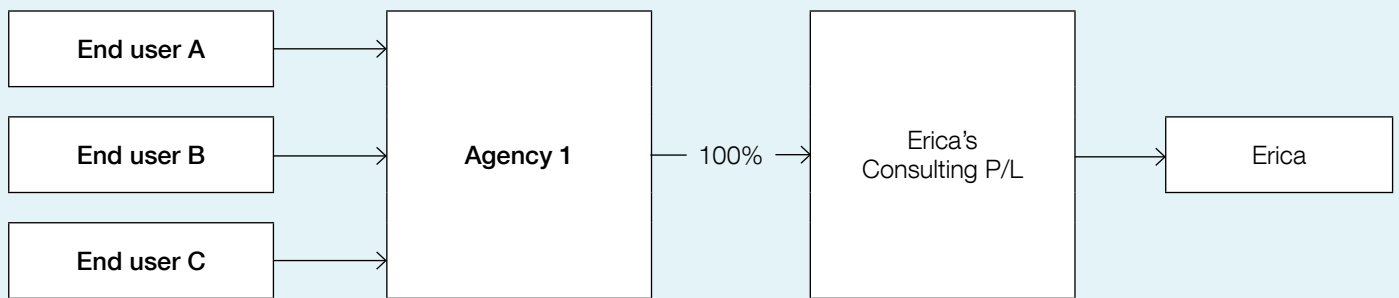
The results test

Erica, Alan and Simon are consultants. Each provides their skills through their own private company. The private company is an interposed business – that is, it stands between the individual contractor or consultant and the agency. The PSI of Erica, Alan and Simon comes through this arrangement.

EXAMPLE: Erica – one agency, three end users

Erica's company, Erica's Consulting Pty Ltd, contracts with Agency 1 for the provision of Erica's services. Erica is required to perform work for and at the direction of the agency's clients. Agency 1 has three contracts that Erica works on. Erica's company receives 100% of its income from Agency 1.

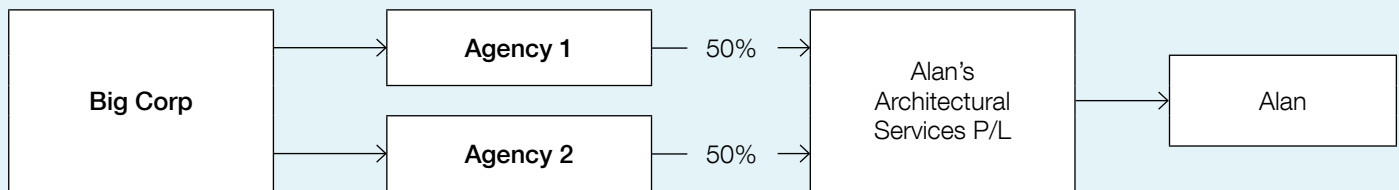
Income flow:



EXAMPLE: Alan – two agencies, one end user

Alan's company, Alan's Architectural Services Pty Ltd, contracts with two agencies, Agency 1 and Agency 2, for the provision of Alan's services. Under both contracts, Alan is required to perform work for and at the direction of the agencies' clients. Agency 1 and Agency 2 provide Alan's services to the same end user, Big Corp. Alan's company receives 50% of its income from Agency 1 and 50% from Agency 2.

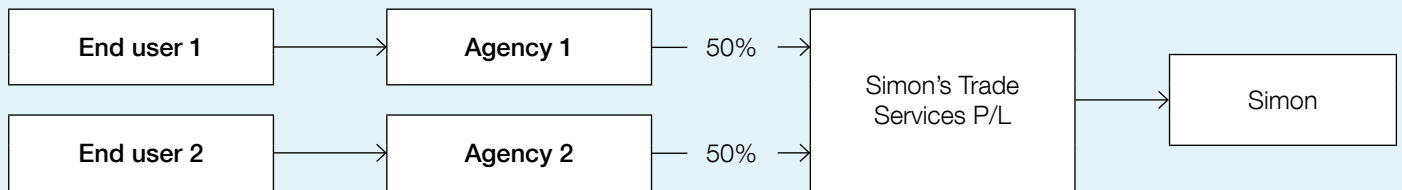
Income flow:



EXAMPLE: Simon – two agencies, two end users

Simon's company, Simon's Trade Services Pty Ltd, contracts with Agency 1 and Agency 2 for the provision of Simon's services. Under both contracts, Simon is required to perform work for and at the direction of the agencies' clients. Each agency has a different end user. Simon's company receives 50% of its income from Agency 1 and 50% from Agency 2.

Income flow:



In these examples, Erica, Alan and Simon are not employed by the agencies. In addition, their companies are contracting to provide Erica's, Alan's and Simon's services to the agencies. That is, they are not contracting to complete a specific result or outcome for those agencies. They are merely contracting to provide labour. Therefore the PSI is not generated to produce a result so the businesses do not pass the results test.

Therefore, the PSI rules apply to Erica's, Alan's and Simon's PSI unless they pass one of the other tests.

Successfully applying the results test

In the previous examples, Erica's, Alan's and Simon's businesses do not pass the results test. However, in other circumstances, they could pass the results test. A typical example would be if the agency contracts with their client (end user) and assumes responsibility for completion of a particular result. Payment to the agency depends on the completion of the result.

The agency assumes all risk and liability associated with the completion of the result including liability for damages arising from faulty work. The agency then subcontracts with the business to complete that result and the business in turn assumes the same risks associated with its completion. The contract would generally stipulate which worker is to do the work. Payment to the business depends on the completion of the result and the individual contractor is then subcontracted to complete the work.

80% RULE

In the examples above, the agency has made the payments to the companies. The source of the PSI received by the contractors' private companies is the agency, not the end users.

This affects the application of further tests.

Erica's Consulting Pty Ltd receives 100% of the PSI from one source – the agency.

Her business cannot self-assess for any of the other tests. The PSI law applies in the relevant income year unless we grant her business a determination.

Alan's Architectural Services Pty Ltd and Simon's Trade Services Pty Ltd receive 50% of their PSI from each agency. Less than 80% of their PSI comes from each source, so Alan and Simon will need to work through the remaining tests.

The unrelated clients test

Since they offer their services through an agency, they are not offering services to the public. This means Alan's Architectural Services Pty Ltd and Simon's Trade Services Pty Ltd do not pass the unrelated clients test.

Alan's and Simon's businesses need to work through the employment and business premises test to see if the PSI rules apply.

Applying for a determination

Alan and Simon can ask us for a determination if they:

- are uncertain whether they pass, or
- have unusual circumstances which stop them from passing a test.

TWO SERVICE PROVIDERS OPERATING THROUGH ONE PRIVATE COMPANY

Sometimes there is more than one service provider in the business and in these cases, the income earned by each provider need to be considered when deciding if the PSI rules apply.

In most cases, the PSI rules are applied to the income each provider earns and cannot be looked at as earned by the business.

EXAMPLE

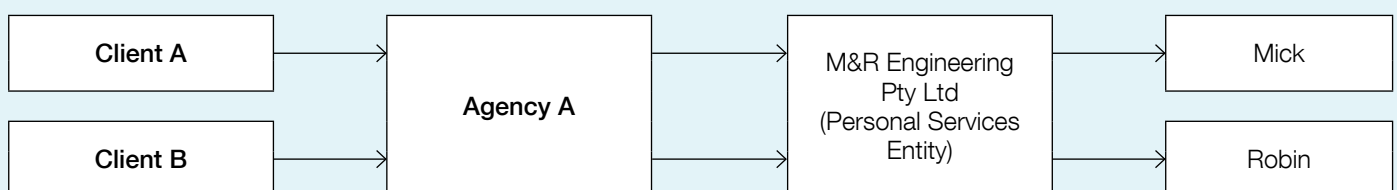
Mick and Robin are engineers who create a company, M&R Engineering Pty Ltd, to provide their services. M&R Engineering Pty Ltd contracts with Agency A. Mick and Robin are each required to perform work for and at the direction of the agency's clients.

- Agency A provides:
- Mick's services to Client A
 - Robin's services to Client B.

Both engineers work independently of each other.

The tests must be applied separately to the PSI of each individual contractor (Mick and Robin) whose income is received by M&R Engineering Pty Ltd.

Income flow:



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Additional PAYG withholding obligations	44

WHEN THE PSI RULES APPLY

03

OVERVIEW

The PSI rules apply if you have worked through the tests and your business doesn't pass any of them, or you don't hold a personal services business determination from us.

➤ If you haven't worked through the tests yet, see Working out if the PSI rules apply, on page 11.

⚠ If you are unsure or had unusual circumstances that stopped you from passing one of the tests, apply for a determination. Refer to *Personal services business determination application and instructions* (NAT 72465).

When the PSI rules apply:

- your business won't be able to claim certain deductions against the PSI – see Deductions when the PSI rules apply, opposite.
- the PSI your business received will need to be attributed (treated as belonging) to each individual who performed the services, and the individual will need to declare the income in their individual tax return – see Attributing PSI on page XX.
- you will need to meet certain tax return obligations – see Tax return obligations when the PSI rules apply on page XX.
- your business may have additional pay as you go (PAYG) withholding reporting obligations – see Additional PAYG withholding obligations on page 44.

⚠ It is important to note that when the PSI rules apply there is no change in:

- the nature of the contractual relationships between you and your clients or customers. For example, you do not become an employee of the ultimate service acquirer
- your entitlement to an ABN or registration for goods and services tax (GST).

DEDUCTIONS WHEN THE PSI RULES APPLY

When the PSI rules apply there will be:

- deductions your business can't claim against the PSI
- deductions your business can claim against the PSI.

The PSI rules only apply to income that is PSI. You can still claim expenses against other income and normal tax rules apply. If you receive both PSI and other income then you may need to allocate your expenses between each category of income.

DEDUCTIONS YOUR BUSINESS CAN'T CLAIM AGAINST THE PSI

The deductions your business can't claim against the PSI received include the following.

Rent, mortgage interest, rates and land tax

You can't deduct rent, mortgage interest, rates and land tax for an individual's (or their associate's) residence, where those expenses relate to that individual's PSI. This also means you cannot deduct these expenses when the business premises are at the individual's home.

EXAMPLE

Sarah has recently set up a business called Sarah's Financial Services, where Sarah provides financial advice and completes tax-related forms eg business activity statements and tax returns. Sarah operates this business from one of the rooms in her house.

All of the income generated is PSI as most of the income relates to Sarah's skills, knowledge and expertise. Sarah has also worked out the PSI rules apply. Since the PSI rules apply, Sarah cannot claim rent, mortgage interest, rates or land tax relating to her residence against the PSI generated.

PAYMENTS TO ASSOCIATES FOR SUPPORT WORK (NON-PRINCIPAL WORK)

Your business can't deduct payments you make to an associate (eg spouse, child or other relative, or a related entity or business) for performing non-principal work for the business.

Principal work is the work required to be done under the contract and generates the PSI.

Non-principal work is incidental or subsidiary work that is not central to meeting the obligations under the contract (that is, not the main work for which the business gets paid). Examples of non-principal work include bookkeeping for the business, issuing invoices, secretarial duties and running the home office.

Payments to associates include:

- remuneration such as a salary or commission
- an allowance
- reimbursing an expense
- rent
- interest on a loan.

Therefore, your business:

- can't claim payments to an associate for bookkeeping for the business, issuing invoices, secretarial duties, running the home office or any other non-principal work
- can claim
 - reasonable amounts you paid to an associate for principal work
 - salary or wages for an arm's-length employee (not an associate).

EXAMPLE

Rodri provides marketing consultancy services through his company Rodri Co Pty Ltd. Its sole income is Rodri's PSI.

Work Rodri's wife Jenna does falls into two categories:

- inputting daily sales data into spreadsheets Rodri uses to prepare recommendations and reports, and
- issuing invoices, banking receipts and administering the home office.

As the data entry work is the first stage in the work required to fulfil the obligations under the contract, it forms part of the principal work and is therefore principal work.

However, issuing invoices, banking and administering the home office, is not principal work. Rodri can't deduct the wages paid to Jenna for issuing invoices, banking and administering the home office.

SUPER CONTRIBUTIONS FOR ASSOCIATES WHO DO SUPPORT WORK (NON-PRINCIPAL WORK)

Your business can't deduct super contributions for an associate (eg spouse, child or other relative), who does non principal work such as bookkeeping for the business, issuing invoices, secretarial duties and running the home office.

EXAMPLE

Wendy is an editor who does editing and proofing work through her company Wendy's Editing Services Pty Ltd. Wendy has little spare time and decides to get her brother, Jack, to do the bookwork and issue invoices for work completed.

Jack's salary is \$10,000 a year and Wendy's Editing Services Pty Ltd contributes \$900 to a super fund for Jack.

As Jack is an associate (he is Wendy's brother) and he performs non-principal work (bookwork and issuing invoices are not the main work clients pay for), Wendy's Editing Services Pty Ltd cannot claim a deduction for the \$900 super contribution.

However, your business can deduct super contributions for an associate, relating to principal work they do. You can only deduct the superannuation guarantee (SG) amount your business has to contribute for the associate. The SG amount is based only on the salary or wages you paid the associate for principal PSI-related work (and not non PSI-related work such as bookkeeping for the business).

The superannuation guarantee limit does not apply where you operate through a company, partnership or trust and the associate does 20% or more (by market value) of your business' principal work. However, in that situation your business passes the employment test and may not be subject to the PSI rules anyway.

The PSI rules do not affect the deduction of super contributions for:

- an associate that relate to work they do for your business from which your business gets income other than PSI
- yourself.

⚠ The term 'super contributions' in this section refers to contributions you make to a super fund or retirement savings account (RSA). Deductions for super contributions are subject to other tax rules.

➡ For information on other tax rules applying to super, refer to www.ato.gov.au/super

EXAMPLE

David is an engineer who works through his company David Co Pty Ltd. In the 2008–09 income year most of the income is PSI as it is mainly for David's knowledge, skills and expertise.

The company hires Mary (an associate of David's) to perform principal work. Mary completes 5% of the principal work (by market value) and is paid salary of \$5,000. The company contributed \$2,500 to a super fund for Mary.

David Co Pty Ltd is not entitled to claim a deduction for the full amount it contributed to the super fund for Mary. The deduction that David Co Pty Ltd is entitled to is capped at the amount it would have had to contribute in order to avoid an individual superannuation guarantee shortfall for Mary. For the 2008–09 income year that amount was \$450 (9% of \$5,000).

However, if Mary performed 20% or more (by market value) of the principal work, David Co Pty Ltd could claim the entire \$2,500 as a deduction.

Car expenses for more than one motor vehicle

Companies and trusts can normally claim all their motor vehicle expenses, although private use of their vehicles is generally subject to FBT.

The PSI rules add a special rule for businesses. If your personal services are contracted through a company, partnership or trust that is subject to the PSI rules, it is only allowed to claim expenses for one car used for private purposes. If your business has more than one car in private use at the same time, you must choose the one to claim deductions for. This choice remains in effect for as long as your business has that car.

A car is a motor vehicle designed to carry a load of less than one tonne and fewer than nine passengers, but not including a motorcycle.

➤ For more information about motor vehicle deductions and FBT, refer to *Tax basics for small business* (NAT 1908).

General deduction rule

As well as the specific deductions listed above that can't be claimed (or the amount that can be claimed but is limited), there is an additional rule, called the general deduction rule, that only allows businesses to claim the same deductions that the individual who generated the PSI could have claimed in the same situation.

For your business to be entitled to a deduction under the general deduction rule the expense must:

- be an allowable deduction under tax law; and
- relate to gaining or producing the individual's PSI.

DEDUCTIONS YOUR BUSINESS CAN CLAIM AGAINST THE PSI

Your business can claim the following deductions against the PSI you received, if your business incurred the expenses to generate this income:

- gaining work – for example advertising, tendering and quoting for work
- registration and licensing fees
- insuring against loss of income, earning capacity or liability for acts or omissions in the course of earning income
- meeting obligations under GST
- salary or wages paid to the individuals who performed the services – the principal worker
- salary or wages for an arm's length employee (not an associate)
- reasonable amounts paid to an associate for principal work
- complying with workers' compensation law
- super contributions for the individual or an arm's length employee (not an associate)
- running expenses for a home office – for example, heating and lighting (but not rent, mortgage interest, rates or land taxes)
- depreciation of income-producing assets
- entity maintenance deductions which include:
 - fees or charges associated with a bank, credit union or other financial institution account (but not including interest or interest-like amounts)
 - tax-related expenses (eg preparing and lodging tax returns and activity statements)
 - any expense incurred for preparing or lodging a document under Corporations Law, except where the payment is made to an associate, and
 - statutory fees.

In particular, your business can only claim a deduction for an expense paid or incurred in gaining or producing assessable income. The expense cannot be a capital, domestic or private expense.

This is not a complete list of what your business can claim because what businesses do, and how they do it, varies.

⚠ Where the PSI has been generated by more than one individual, the deductions relating to that PSI need to be apportioned between these individuals.

RECORDS YOUR BUSINESS NEEDS TO KEEP FOR DEDUCTIONS

You must keep the documents that support your claims for deductions for five years from the date you incur the expense. You will need to show whether the expense relates to PSI or other income.

WHAT HAPPENS IF AN EXPENSE IS NON-DEDUCTIBLE?

If an expense is non-deductible, it means your business cannot claim a deduction for the expense against its income. It also means that the expense can't be used to reduce PSI attributed to the individual who performed the services.

To prevent double taxation, where a payment to an associate (a salary payment, for example) is non-deductible under the PSI rules, the amount received by the associate is not included in their assessable income.

EXAMPLE

Julie, through her company Julie Co Pty Ltd, pays a salary to Frank to do the bookwork and run the home office (that is, non-principal work). Julie Co Pty Ltd is not entitled to claim a deduction for the salary it pays to Frank because he was not performing principal work.

As Julie Co Pty Ltd is not allowed to claim a deduction for the salary paid to Frank, the salary Frank receives is not included in his income tax return as assessable income. Any PAYG withholding tax Julie Co Pty Ltd pays on Frank's behalf can be credited to Julie when she completes her individual tax return.

⚠ When an expense is non-deductible it also can't reduce the PSI treated as belonging to (attributed) to the individual who performed the services and which is included in their individual tax return.

FRINGE BENEFITS TAX ON NON-DEDUCTIBLE EXPENSES

If you have to pay fringe benefits tax (FBT) on an expense that is non-deductible under the PSI rules, the taxable value of the fringe benefit is reduced by the non-deductible amount.

This prevents double taxation – where an expense is taxable under the FBT system and non-deductible under the income tax system.

ATTRIBUTING PSI

When the PSI rules apply, your business needs to attribute or treat any PSI generated, but not promptly paid as salary or wages, as belonging to each individual who performed the services. This means that:

- your business cannot retain the profits from the PSI within the business
- each individual who performed the services needs to declare the income in their individual tax returns and pay the relevant amount of tax on this income.

HOW DOES YOUR BUSINESS ATTRIBUTE THE PSI?

There is a series of steps your business needs to take to attribute the PSI. There is a slightly different process depending on the number of individuals generating the PSI.

Attributing the PSI when only one individual generated the income

Step 1: Identify the amount of PSI received in an income year where one individual generated the income (do not include non-PSI income).

Step 2: Subtract any salary or wages that your business has promptly paid to the individual who performed the services.

Promptly paid means paying an amount before the end of the 14th day after the relevant PAYG payment period from the date when the PSI was generated. For example, if your business lodges activity statements quarterly and PSI was generated in the January to March quarter; promptly paid would be if the salary or wages were paid to the individual who performed the services by 14 April (14 days after the end of the first quarter, 31 March).

Step 3: Reduce entity maintenance deductions from other income first and then subtract any remaining amount from the PSI.

If your business has PSI and non-PSI, your business needs to deduct the entity maintenance deductions from the business' other income (non-PSI) first, before subtracting any remaining amount from the PSI.

For example, if your business incurs \$4,000 in entity maintenance deductions, this \$4,000 would need to be offset against non-PSI (such as interest or rent income) first before any remaining amount is subtracted from the PSI. If your business had \$3,000 in interest income (non-PSI), the \$4,000 would be offset against this \$3,000 interest income first, which would leave \$1,000 to be deducted from PSI.

Step 4: Subtract any other allowable deductions from the PSI received.

If you work out the expense your business incurred is an allowable deduction (including payments to associates for principal work), subtract this amount from the PSI you received.

Step 5: Work out if there is net PSI (or net PSI loss).

If there is net PSI

If, after subtracting all amounts from the PSI you received, there is a positive amount left, then the individual has net PSI. This amount will need to be allocated and treated as belonging to the individual who performed the services.

The business gives the individual a PAYG payment summary and the individual then needs to declare this amount on their individual tax return and pay the relevant amount of tax on this income.

Companies include the net PSI amount as a reconciliation item, under 'Other income not included in assessable income' in the company's tax return. The company does not include the amount that has been allocated to the individual in the company's tax return, avoiding double taxation.

Partnerships and trusts include the net PSI amount as a reconciliation item, under 'Income reconciliation adjustments' in the relevant tax return.

➤ For more information, refer to *Personal services income schedule* (NAT 3421).

If there is a net PSI loss

If, after subtracting all amounts from the PSI you received, there is a negative amount, then there is a net PSI loss. This net PSI loss must be transferred to the individual to use as a deduction. The business cannot use this loss.

The individual can claim this loss as a deduction against any other income in their tax return. If the individual does not have enough other income in their tax return in that year to offset the loss, the individual may carry this loss forward under the carried forward loss rules.

Companies include the net PSI loss amount as a reconciliation item, under 'Non-deductible expenses'.

Partnerships and trusts include the net PSI loss amount as a reconciliation item, under 'Expense reconciliation adjustments' in the relevant return.

➤ For more information, refer to *Personal services income schedule* (NAT 3421).

EXAMPLE: Attributing the PSI where one individual generated the PSI

Sandi is an architect, who works through her company Sandi's Architecture Services Pty Ltd. Sandi completes two contracts on behalf of Sandi's Architecture Services Pty Ltd which generates \$40,000.

This \$40,000 is PSI and the company has also worked out that the PSI rules apply. In addition to the PSI, the company earned \$2,000 in interest income.

Sandi's Architecture Services Pty Ltd:

- promptly paid \$30,000 to Sandi as salary or wages
- incurred \$20,000 in allowable deductions (none of these were entity maintenance deductions)
- incurred \$5,000 in entity maintenance deductions.

The attributed amount is worked out as follows:

- \$40,000 PSI is received by the company
- \$30,000 salary or wages promptly paid to Sandi
- \$3,000 entity maintenance deductions remaining after offsetting them against the other income first (the \$5,000 entity maintenance deductions is offset against the \$2,000 interest income first leaving 3,000)
- \$20,000 allowable deductions (all PSI related)
- **\$13,000 (net PSI loss)**

The income position of Sandi's Architecture Services Pty Ltd would be as follows:

PSI	\$40,000
PSI deductions	\$50,000 (\$30,000 promptly paid salary or wages plus \$20,000 PSI deductions)
Other income	2,000
Entity maintenance deductions	\$5,000
Net PSI loss claimed by Sandi	\$13,000
The company has net taxable income of	\$0 (\$2,000 other income less entity maintenance deductions allocated – \$2,000)

Sandi's Architecture Services Pty Ltd will need to:

- advise Sandi of her \$13,000 net PSI loss (the company cannot use this loss)
- report this \$13,000 net PSI loss as a reconciliation item, under 'Non-deductible expenses' in the company tax return.

Reporting the \$13,000 as a reconciliation item does not mean the company can claim a loss for this amount; it is simply a reporting method that shows a loss has been allocated to Sandi.

In her individual tax return Sandi would declare:

- \$13,000 net PSI loss and offset this against other income
- \$30,000 salary or wages.

Attributing the PSI when two or more individuals generated the income

Step 1: Identify the amount of PSI received in an income year where two or more individuals generated the income (do not include non-PSI income).

Your business needs to work out the amount of PSI that belongs to each individual who performed the services (the individuals' PSI).

Step 2: Subtract any salary or wages that your business has promptly paid to the individuals who performed the services.

For each individual's PSI, your business needs to subtract any salary or wages that has been promptly paid to this individual.

Promptly paid means paying an amount before the end of the 14th day after the relevant PAYG payment period from the date when the PSI was generated. For example if your business lodges activity statements quarterly and PSI was generated in the January to March quarter, promptly paid would be if the salary or wages were paid to the individual who performed the services by 14 April (14 days after the end of the first quarter, 31 March).

Step 3: Deduct entity maintenance deductions from other income first and then subtract any remaining amount from the PSI

If your business has PSI and non-PSI, your business needs to offset the entity maintenance deductions from the business' other income first, before subtracting any remaining amount from the PSI.

For example, if a business incurs \$4,000 in entity maintenance deductions, this \$4,000 would need to be offset against non-PSI income (such as interest or rent income) first before any remaining amount is subtracted from the PSI. If the business had \$3,000 in interest income (non-PSI income), the \$4,000 would be offset against this interest income first, which would leave \$1,000 (\$3,000 of the \$4,000 has been offset against the interest income).

When two or more individuals generate the PSI, your business needs to apportion the excess entity maintenance deductions between the individuals using the following formula:

$$\frac{\text{Excess entity maintenance deductions}}{\text{Total PSI}} \times \text{individual's PSI}$$

If, in an income year, the business had \$50,000 PSI (\$20,000 belonging to individual A and \$30,000 belonging to individual B), \$1,000 excess entity maintenance deductions would be allocated as follows:

Individual A	Individual B
$\frac{\$1,000 \times \$20,000}{\$50,000}$	$\frac{\$1,000 \times \$30,000}{\$50,000}$
= \$400 entity maintenance deductions	= \$600 entity maintenance deductions

Step 4: Subtract any other allowable deductions from the PSI received.

Your business needs to work out the allowable deductions relating to each individual's PSI. The allowable deductions that relate to each individual should be subtracted from that respective individual's PSI.

Step 5: Work out if there is net PSI (or net PSI loss).

If there is net PSI

If, after subtracting all amounts from the PSI received, there is a positive amount left (that is, net PSI), this amount will need to be allocated to the individual who performed the services. The individual will then need to declare this amount on their individual tax return and pay the relevant amount of tax on this income.

Companies include the net PSI gain amount as a reconciliation item (as 'Other income not included in assessable income') in the company's tax return. The company does not include the amount that has been allocated to the individual in the company's tax return (this avoids double taxation).

Partnerships and trusts include the net PSI amount as a reconciliation item, under 'Income reconciliation adjustments' in the relevant tax return.

➤ For more information, refer to *Personal services income schedule* (NAT 3421).

If there is a net PSI loss

If, after subtracting all amounts from the PSI received, there is a negative amount (that is, a net PSI loss) then the net PSI loss must be transferred to the individual to use as a deduction. The business cannot use this loss against any other business income or carry forward the loss.

The individual can claim the loss as a deduction against any other type of income in their tax return. If the individual does not have enough other income in their tax return in that year to offset the loss, the individual may carry this loss forward under the carried forward loss rules. Companies include the net PSI loss amount as a reconciliation item, under 'Non-deductible expenses'.

Partnerships and trusts include the net PSI loss amount as a reconciliation item, under 'Expense reconciliation adjustments' in the relevant return.

➤ For more information, refer to *Personal services income schedule* (NAT 3421).

EXAMPLE: Attributing the PSI where two individuals generated the PSI

Joe and Jim are engineers who work through their company Joe and Jim's Engineering Services Pty Ltd. Joe and Jim complete a contract on behalf of Joe and Jim's Engineering Services which generates \$100,000. Joe completes 60% of the work and Jim completes 40%.

This \$100,000 is PSI as most of the income was generated for Joe and Jim's knowledge, skills and expertise. The company has worked out that the PSI rules apply.

Joe and Jim's Engineering Services Pty Ltd:

- promptly paid \$30,000 to Joe as salary or wages
- incurred \$20,000 in allowable deductions (none of these were entity maintenance deductions) where 55% of the deductions relate to Joe's PSI and 45% relate to Jim's PSI.

Thus the attributed amount is worked out as follows:

Attributed amount calculation for **Joe**

\$60,000 PSI (60% of \$100,000 total PSI)	–	\$30,000 salary or wages promptly paid to Joe	–	\$11,000 deductions (55% of \$20,000 total deductions)	=	\$19,000 net PSI for Joe
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Attributed amount calculation for **Jim**

\$40,000 PSI (40% of \$100,000 total PSI)	–	\$9,000 deductions (45% of \$20,000 deductions)	=	\$31,000 net PSI for Jim
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Joe and Jim's Engineering Services Pty Ltd will need to:

- attribute \$19,000 to Joe and \$31,000 to Jim
- report this \$50,000 as a reconciliation item, under 'Other income not included in assessable income' in the company tax return.

Reporting the \$50,000 as a reconciliation item does not mean the company pays tax on this income; it is simply a reporting method that shows income has been allocated to Joe and Jim and the company's taxable income is reduced accordingly.

Joe would declare the \$19,000 attributed income and \$30,000 salary or wages on his individual tax return and pay the relevant amount of tax on this income.

Jim would declare the \$31,000 attributed income on his individual tax return and pay the relevant amount of tax on this income.

EXAMPLE

A company derives PSI from the efforts of a director. Part of the PSI has been promptly paid to the director as salary or wages. The company's profit and loss statement discloses:

Income (all the director's PSI)		\$100,000
Less Expenses		
Salary (director)	\$30,000	
Other (all deductible)	\$30,000	\$60,000
Net profit		\$40,000

As all of the expenses are deductible, the net profit is attributed to the director. The director includes in their income tax return the director's fees of \$30,000 and attributed PSI of \$40,000.

To avoid double taxation, the company's assessable income is reduced to \$60,000, as company income – to the extent that it is attributed – is neither the company's assessable nor exempt income. As a result, the taxable income of the company is nil.

If the company pays the \$40,000 to the director as dividends, it is not included in the director's assessable income a second time as dividends.

TAX RETURN OBLIGATIONS WHEN THE PSI RULES APPLY

Both your business and each individual who performed the services have tax return obligations for the PSI received.

Your business will need to complete several questions on the:

- company, partnership or trust tax return
- *Personal services income schedule* (NAT 3421).

Each individual who performed the services will need to declare the PSI attributed to them and any relevant PAYG withholding credit at question 9 'Attributed Personal services income' in the individual tax return.

➤ For detailed information about completing tax returns and schedules, refer to *Personal services income – completing your tax return* (NAT 8526).

ADDITIONAL PAYG WITHHOLDING OBLIGATIONS

When the PSI rules apply, your business will have additional PAYG obligations for the amount attributed (treated as belonging) to each individual who performed the services.

The additional PAYG withholding obligation ensures:

- an amount of withholding has been reported and paid to us for the attributed income (the income treated as belonging to the individual who performed the services)
- each individual who performed the services receives a PAYG withholding credit for their individual tax return.

Normal PAYG withholding applies to the PSI you received that is promptly paid out to the individual as salary or wages.

⚠ If your business has a net PSI loss for an income year, there are no additional PAYG withholding obligations as no income has been attributed.

Companies and trusts

If your business operates as a company or trust, you have:

- normal PAYG withholding obligations for salary or wages promptly paid to each individual who performed the services
- additional PAYG withholding obligations for amounts attributed to each individual who performed the services for PSI which has not been promptly paid as salary or wages.

Partnerships

If your business operates as a partnership:

- you have additional PAYG withholding obligations for amounts attributed to the partner who performed the services
- normal PAYG withholding on salary or wages does not apply because partnerships can't pay salary or wages to partners.

These additional PAYG withholding obligations will continue for the attributed income until your circumstances change and the PSI rules no longer apply.

For example, if your business worked out last income year that the PSI rules applied, then your business would have additional PAYG withholding obligations for the attributed income in the current financial year unless:

- all PSI is promptly paid out as salary or wages and appropriate PAYG amounts are withheld from the payments
- you worked out the PSI rules didn't apply, or
- you received a determination from us stating the PSI rules didn't apply.

For a new business (that is, one that has not previously received PSI), the additional obligation arises where your business must attribute income in the current income year.

⚠ If the business does not expect to pass the results test and more than 80% of its income comes from one client:

- the PSI rules are considered to apply to the business for the purposes of this withholding
- the business will have additional PAYG withholding obligations to meet.

WHAT'S REQUIRED WHEN THERE ARE ADDITIONAL PAYG WITHHOLDING REQUIREMENTS?

When your business has additional PAYG withholding obligations, it must:

- register for PAYG withholding, if the business is not already registered
- work out the amount of PAYG withholding for the attributed income
- report and pay the additional PAYG withholding amounts through its activity statement
- give each individual who performed the services an annual PAYG payment summary, and
- send us an annual report showing additional PAYG withholding.

⚠ Each individual who performed the services reports the relevant PAYG withholding credit on their individual tax return.

EXAMPLE

Claire is a computer programmer who operates through her company Claire's Computer Programming Services Pty Ltd. In the first quarter (1 July to 30 September), Claire (on behalf of the company) completed three contracts which generated \$100,000 PSI. The company did not earn any other income.

The company has worked out the PSI rules apply to the PSI and the company is registered for PAYG withholding.

For the \$100,000 PSI, Claire's Computer Programming Services Pty Ltd has:

- promptly paid \$30,000 to Claire as salary or wages
- incurred \$10,000 in allowable deductions (other than entity maintenance deductions)
- attributed \$60,000 (\$100,000 – \$30,000 – \$10,000) to Claire, as she was the individual who performed the services.

Claire's Computer Programming Services would have:

- additional PAYG withholding obligations for the \$60,000 attributed to Claire
- normal PAYG withholding obligations for the \$30,000 salary or wages promptly paid to Claire
- to give Claire PAYG payment summaries for the salary or wages and for the attributed PSI at the end of the financial year.

For the additional PAYG obligations, Claire's Computer Programming Services must:

- work out the amount of PAYG withholding for the income attributed to Claire
- report and pay the additional PAYG withholding amounts through the company's activity statement for the first quarter
- give Claire an annual PAYG payment summary at the end of the financial year, and
- send us an annual report showing additional PAYG withholding at the end of the financial year.


Claire would report the PAYG withholding credit on her individual tax return.

HOW TO WORK OUT THE ADDITIONAL PAYG WITHHOLDING AMOUNT YOUR BUSINESS HAS TO REPORT AND PAY

Your business needs to work out the amount of additional PAYG withholding for each business activity statement (BAS).

Most small businesses report and pay additional PAYG withholding quarterly, with the quarters ending on:

- 30 September
- 31 December
- 31 March
- 30 June.

 For more information, refer to *Essential information about PAYG withholding* (NAT 5195).

WORKING OUT THE AMOUNT OF ADDITIONAL PAYG WITHHOLDING FOR EACH PAYMENT PERIOD

Your business works out the additional PAYG withholding for the attributed income only. Salary or wages promptly paid to the individual who performed the services is done separately.


It can sometimes be difficult for businesses to accurately work out the attributed income amount each time their BAS is due. So, we have introduced simplified ways to work out the attributed income amount for additional PAYG withholding you must report and pay.

Instead of working out the additional PAYG withholding on the actual amount attributed to each individual who performed the services, under the simplified methods your business can work out the additional PAYG withholding based on:

- 70% of the gross PSI received in the PAYG payment period (70% of PSI received method)
- a percentage of the net PSI from the previous income year (percentage based on the previous income year method).

If your business would prefer to work out the actual amount of PSI it will attribute for the BAS period and base the additional PAYG withholding on this actual attributed income amount, your business can still use this method. We refer to this method as the legislative approach method.

The legislative approach method allows you to more closely match your PAYG withholding obligations with your current PSI and expenses. However, you may be penalised if your calculations are incorrect.

 If you correctly use either of the two other simplified methods, you are not penalised.

Step 1: Select a method and work out the attributed income for the additional PAYG withholding

Select a method to work out the attributed income using one of the following three methods:

- 70% of PSI received method
- percentage based on the previous income year method
- legislative approach method.

Next, work out the attributed income amount which the additional PAYG withholding will be based on.


Step 2: Work out how much to withhold on the attributed amount

After you've worked out the attributed income amount from step 1, you'll need to work out the additional withholding amount to report and pay. You work out this withholding amount using the individual withholding rates. You can do this using either the:

- PAYG withholding tax tables, or
- Tax Withheld Calculator.

If you use the PAYG withholding tables, use the:

- table with the correct frequency of payment (this is generally quarterly for small businesses)
- correct column in the tables.

 For more information visit our website at www.ato.gov.au – For Businesses – Business home page – What you can do – Rates, calculators & tools.

METHOD ONE: 70% OF INCOME

The simplest method is to report and pay PAYG withholding on 70% of gross PSI (excluding GST) received by your business for the PAYG payment period.

EXAMPLE

Kieran and Jackie are directors of Smith Pty Ltd, which reports GST and PAYG quarterly. Smith Pty Ltd provides Kieran's services as a computer consultant to a bank.

For the period 1 July 2008 to 30 September 2008, Smith Pty Ltd received income of \$16,000 (excluding GST) as payment for Kieran's services – this is Kieran's PSI. Smith Pty Ltd has paid Kieran \$9,000 salary for the work he did for the bank. Smith Pty Ltd withheld \$1,222 from his salary.

Under method one, the amount subject to PAYG withholding for the period is 70% of \$16,000 = \$11,200.

PAYG withholding applies to the salary or wages amount of \$9,000 and additional PAYG withholding applies to the attributed income amount (\$11,200 – \$9,000 = \$2,200). Kieran has provided a tax file number declaration and has claimed the tax-free threshold. Using the tax withheld calculator (quarterly), the amount of PAYG withholding payable is \$1,963. This is made up of the:

- tax withheld from the salary paid to Kieran of \$1,222
- PAYG withholding on the attributed income of \$741.

That is, the \$741 is the total PAYG withholding applicable to all the PSI – \$1,963 – less the \$1,222 Smith Pty Ltd already withheld from the salary paid to Kieran.

METHOD TWO: NET PSI PERCENTAGE FROM PREVIOUS YEAR INCOME

Under this method, you report and pay PAYG withholding on:

net PSI percentage from the previous year	×	gross PSI (excluding GST) received for the current period	
The net PSI percentage equals:		Deductions that reduced PSI for the previous income year	100
individuals gross PSI (excluding GST) for the previous income year	–		
<hr/>			
business' gross PSI (excluding GST) for the previous year	×		1

Using the same example as in method 1	For the period 1 July – 30 Sept (\$)	For the previous income year (for the net PSI percentage method) (\$)
Income (excluding GST) received by Smith Pty Ltd as payment for Kieran's services – this is Kieran's PSI	16,000	60,000
Investment income received by Smith Pty Ltd	2,500	10,000
Salary paid to Kieran by Smith Pty Ltd for the work he did for the bank	9,000	35,000
Tax withheld from the salary paid to Kieran	1,222	
Salary paid to Jackie by Smith Pty Ltd for paying the company's bills and answering telephone calls	3,000	10,000
Other expenses incurred by Smith Pty Ltd to generate the income paid for Kieran's services	4,000	20,000
Entity maintenance expenses	1,000	3,000

Jackie is Kieran's sister. Smith Pty Ltd can't deduct the wages it paid to Jackie in its tax return because she is an associate and her work is not principal work.

Also, as the entity maintenance expenses of \$3,000 are first offset against the other income (that is, investment income) of \$10,000, the entity maintenance expenses are not included in the deductions that reduce PSI.

The PSI percentage from the previous year is:

$$\frac{\$60,000 - \$20,000}{\$60,000} \times \frac{100}{1} = 67\%$$

The amount subject to PAYG withholding for the period equals the net PSI percentage from the previous income year, multiplied by your PSI:

$$67\% \times \$16,000 = \$10,720$$

PAYG withholding applies to the salary or wages amount of \$9,000 and additional PAYG withholding applies to the attributed income amount (\$10,720 – \$9,000 = \$1,720). Using the tax withheld calculator (quarterly) the amount of PAYG withholding payable on \$10,720 is \$1,794.

This amount is made up of:

- tax withheld from the salary paid to Kieran of \$1,222
- the PAYG withholding on the attributed income of \$572.

That is, the \$572 represents the total PAYG withholding applicable to all the PSI, \$1,794 less the \$1,222 Smith Pty Ltd already withheld from the salary paid.

➤ For more information, refer to Law Administration Practice Statement PS LA 2003/6 Administrative arrangements for the calculation of Alienated Personal Services Payments withholding amounts. To view this practice statement, visit our website at www.law.ato.gov.au

METHOD THREE: LEGISLATIVE APPROACH

Under the legislative approach method, you can work out the attributed income amount for each PAYG payment period as follows:

	PSI (less GST) received by the business	
less	wages or salary paid to the individual within 14 days of the end of each PAYG period	
less	deductions (excluding entity maintenance deductions) you are entitled to claim in relation to the PSI.	

Before entity maintenance deductions can reduce the amount, you must first offset them against any income of the business that is not PSI.

For the final PAYG payment period in an income year, you can further reduce this amount by the amount (if any) that entity maintenance deductions exceed other income for the year.

Using the same example as in method 1.

Following on from the example above, the attributed income amount is:

				\$
	PSI Smith Pty Ltd received		16,000	
less	salary or wages paid to Kieran	9,000		
less	deductions excluding entity maintenance deductions	4,000	13,000	
	Attributed income		3,000	

Add the PSI attributed to Kieran to the salary Smith Pty Ltd paid him (\$9,000 + \$3,000 = \$12,000). Applying the PAYG withholding tax tables (quarterly) the amount of tax Smith Pty Ltd must withhold from \$12,000 is \$2,444.

The amount withheld from Kieran's salary was \$1,495.

The attributed PSI withholding amount is:
\$2,444 – \$1,495 = \$949.

Smith Pty Ltd must report and pay an amount of \$2,444 to us in its activity statement. This amount is made up of:

- tax withheld from the salary paid to Kieran of \$1,495
- the PAYG withholding on the attributed income of \$949.

Because Smith Pty Ltd received income other than PSI and incurred entity maintenance deductions, it will need to consider whether it has any entity maintenance deductions not applied during the year that can be deducted in the last PAYG period of the year.

HOW TO REPORT AND PAY THE ADDITIONAL PAYG ON YOUR BAS

Once you have registered your business for PAYG withholding we will send you an activity statement showing when the withholding payment is due. At the end of each PAYG period, your business reports PAYG withholding amounts on the activity statement at the following labels:

- W1** Salary or wages paid within 14 days after the end of the period, and/or any attributed income amount.
- W2** The amount withheld from the amount at W1.

EXAMPLE

Carrie and Jamie are partners in a partnership trading as Chic Deco. Chic Deco provides Carrie's services as an interior designer. Chic Deco does not have any employees but is registered to report quarterly for PAYG withholding. Jamie helps to administer the partnership.

Chic Deco chooses to work out its PAYG withholding obligations using 70% of the partnership's PSI.

During the period 1 July 2008 to 30 September 2008, Chic Deco received PSI (exclusive of GST) of \$28,000.

Chic Deco attributes \$19,600 (70% of \$28,000) to Carrie.

Chic Deco then works out the amount to pay using the PAYG withholding tax tables (quarterly), which is \$4,914.

Chic Deco has no other activity statement obligations.

Chic Deco has not made any other withholding payments during the quarter so it reports the amount of \$19,600 at W1, and the amount of \$4,914 at W2 on its quarterly activity statement. Chic Deco then lodges the activity statement and pays the \$4,914 owing to us.

HOW DOES PAYG WITHHOLDING AFFECT YOUR BUSINESS' INCOME TAX RETURN?

You can claim the salary or wages you paid as a deduction in your business' income tax return. The attributed amount, however, is not a deduction – instead you exclude this from your business' assessable income.

⚠ Your business can't claim a deduction in its income tax return for the amount of tax it paid as additional PAYG withholding. Amounts of tax your business pays under this obligation are credited to each individual who performed the services and had income attributed to them in their individual income tax returns.

After the end of each income year, your business must:

- give a payment summary to each individual the income was attributed to, and
- complete an annual PAYG withholding report and send it to us.

PAYMENT SUMMARIES

Your business is required to give a payment summary to each individual the income was attributed to by 14 July following the end of the income year. Each individual receives credits in their individual tax returns for the amounts that your business withheld.

➤ You will need to include any:

- salary or wages you promptly paid to individuals and amounts you withheld from those payments in the form *PAYG payment summary – individual non business* (NAT 0046)
- income you attributed to each individual who performed the services and amounts you withheld from that income in the form *PAYG payment summary – personal services attributed income* (NAT 3446).

COMPLETING AN ANNUAL REPORT

By 14 August each year, your business has to report its PAYG withholding information for the year to us. You can report either electronically or on paper.

➤ For more information, refer to *PAYG withholding for small business* (NAT 8075).

⚠ For tax agents, an extension of time to lodge the report may be available – for example, to the date of lodgment of the business' tax return. Tax agents need to check our current lodgment program to check whether an extension of time applies.

PAYMENT OF SALARY OR WAGES TO AN INDIVIDUAL IN THE FOLLOWING INCOME YEAR

If your business makes payments of salary or wages to you between 1 and 14 July (after the end of the income year) and is affected by the PSI rules then, for the purpose of the PSI rules, the payments are treated as having been received on 30 June of the previous income year.

These payments must be included in your:

- business' activity statement covering the month of July
- payment summary for the previous income year, and
- business' annual PAYG report for the previous year.

FAILURE TO WITHHOLD

Where your business has already lodged some of its activity statements and has not been withholding as required, you need to correct this mistake by lodging a revised activity statement. You can't simply correct the withholding understatement on a future activity statement.

EXAMPLE

Betty is a management consultant who contracts her personal services through her private company, Betty Pty Ltd. As a small withholder, the business reports and pays PAYG withholding quarterly.

The PSI rules applied to the business from 1 July 2008 but Betty did not realise the business had additional PAYG withholding obligations until early December 2008. Betty had already lodged the business' September 2008 activity statement without reporting its additional PAYG withholding obligations.

Betty Pty Ltd must lodge a revised activity statement for the business for the September 2008 quarter to correct the withholding understatement. Betty Pty Ltd can't correct the mistake in a later activity statement in 2008–09.

HOW DO YOU WORK OUT HOW MUCH TO WITHHOLD WHEN COMPLETING A REVISED ACTIVITY STATEMENT?

Your business must use the legislative method to work out the amount to withhold when revising an activity statement.

You can't use the simplified methods (that is, the 70% of income method and the net PSI percentage from the previous year) for a PAYG payment period that has ended. However, for later PAYG payment periods you can choose to use one of these methods.

PENALTIES

If your business does not report and pay an amount to us for attributed PSI, penalties and the general interest charge (GIC) may apply.

If a business correctly uses a method other than the legislative method to work out its PAYG withholding obligations and there is a shortfall on the amount that should have been paid, we will remit the penalty on any shortfall that arises as a result of using that method.

➤ For more information, refer to *Law Administration Practice Statement PS LA 2003/6*.

EXAMPLE

A partner in a partnership paid PAYG instalments because the partnership was not aware of its obligation to pay additional PAYG withholding.

In this case, the partnership is penalised because it has failed to pay additional PAYG withholding amount as required. The penalty is equal to the additional PAYG withholding amounts that the partnership should have paid to us.

However we may reduce the penalty amount. When deciding on any reduction, we will consider the business' conduct both at and leading up to the time that the failure to pay the additional PAYG withholding amounts occurred.

Any PAYG instalments paid by the partners may also be considered. Any reductions in penalty are considered case by case.

➤ For more information about remission of the GIC visit our website at www.ato.gov.au and search for 'ATO Receivables Policy'.

ACCOUNTING FOR PAYMENTS TO ASSOCIATES FOR NON-PRINCIPAL WORK

Your business can't claim a deduction for salary or wages paid to an associate employee for performing non-principal work. The salary or wages are not included in the associate's assessable income. Instead, these amounts are included in the attributed income of each individual who performed the services generating the PSI.

However, you can include amounts in the attributed PSI payment summary of the person generating the PSI as payments of attributed PAYG withholding amounts if:

- your business withheld amounts from salary or wages paid to an associate for non-principal work, and
- you have not yet issued the payment summaries for the service provider and the associate.

The associate must not receive a payment summary for salary or wages paid out of the attributed PSI.

If you have already issued payment summaries to the service provider and to the associate, then either:

- your business can issue a letter to each of them amending the payment summary with a copy for them to send to us when lodging their tax returns, or
- the associate can lodge their income tax return showing no income in the form of salary or wages from your business but claiming the amount of tax withheld – they must include additional information with their tax return explaining their circumstances.

PARTNERSHIPS AND PAYG INSTALMENTS

If your business is a partnership, you can work out instalment income where a partner pays instalments each period by using the 'instalment income × instalment rate' option.

The partner's share of the instalment income is based on the partnership's instalment income for the period.

The partnership's instalment income excludes amounts attributed to the individual under the PSI rules.

The amount of PSI attributed is reduced (but not below nil) by the amount of certain deductions the partnership is entitled to. Therefore, some amounts of PSI will be included in the partnership's instalment income, even in those cases where the partnership net income is reduced to nil because of the attribution process. In such cases the partners should consider varying their instalment rate.

VOLUNTARY AGREEMENTS

Where your business has additional PAYG withholding obligations, your business can't enter into a voluntary agreement to withhold.

 For more information refer to *Law Administration Practice Statement PS LA 2003/6*.

WHEN THE PSI
RULES DON'T APPLY

04

The PSI rules don't apply if you pass one of the tests, or hold a determination from us.

The only change to your tax obligations is you need to complete:

- specific questions on your business' tax return (that is, company, partnership or trust tax return) for the PSI your business received
- several questions in the *Personal services income schedule* (NAT 3421).

⚠ There are no other changes to your tax obligations, for example:

- there are no changes to the deductions your business can claim
- there are no additional pay as you go (PAYG) withholding obligations
- the PSI doesn't need to be attributed (treated as belonging) to each individual who performed the services – the profits from PSI can be retained within the business.

➤ For more information about what tax return and schedule items your business needs to complete, refer to *Personal services income – completing your tax return* (NAT 8526).

ARRANGEMENTS THAT MAINLY AVOID TAX

⊖ Although the PSI rules don't apply, if you have entered into an arrangement where the main purpose is to obtain a tax benefit, the anti-avoidance rules may apply to your PSI that restricts these activities.

What we consider to be an arrangement where the main purpose is to obtain a tax benefit depends on the individual circumstances of each case.

Two examples of obtaining a tax benefit where the anti-avoidance rules apply is where:

- your personal services are contracted through your business (company, partnership or trust) and taxed at a lower rate than if you had received the income yourself, particularly where your remuneration is less than the value of your services
- you split PSI with an associate, particularly through use of a family trust or company – an associate can be a person or business.

Even if you have to provide your personal services through your business to get a contract, the general anti-avoidance law may still apply if you use that business to split your income or retain profits.

If the PSI rules don't apply, you do not break the general anti-avoidance law if you pay an associate, for example your spouse, a reasonable amount for work they actually do, even if it is non-principal work.

➤ For more information, refer to *General anti-avoidance rules and how they may apply to a personal services business* (NAT 8028).

PERSONAL
SERVICES INCOME
TERMS EXPLAINED

05

80% rule

This rule looks at whether you receive 80% or more of your PSI from one client (and their associates). Do not look at the 80% rule unless you do not pass the results test. You use it to work out if you can use the other tests. This rule may also be called the '80% threshold rule'.

Alienation of personal services income (PSI)

See PSI rules.

Arm's length

People who are not connected and therefore cannot influence or control each other are said to be at arm's length. The term does not apply to transactions between associates.

Associate

Is broadly defined and includes:

- your relatives – see relative.
- if you are in a partnership, the partnership, your partners and their spouses or children
- the trustee of a trust under which you or an associate benefit
- a company under your control or that of an associate
- for a company, also the individual or associate controlling the company
- for a trustee, also a beneficiary or their associate.

Attributed personal services income

When the PSI rules apply, the business must attribute (treat as belonging) the income to the individuals who performed the services. Attributed personal services income is the net amount of income that has been treated as belonging to these individuals.

Business premises test

This test looks at where your business premises are and how you use them and is used to work out if the PSI rules apply.

Employment test

This test looks at whether others were employed or contracted to help with completing principal work and is used to work out if the PSI rules apply.

Business

This term has a broad meaning in income tax law, but in this guide it means a company, partnership or trust.

Determination

See *personal services business determination*.

Entity maintenance deductions

Includes:

- bank and other account keeping fees and charges (not interest)
- tax-related expenses (eg preparing and lodging tax returns)
- expenses relating to the Corporations Act documents – for example ASIC fees
- statutory fees
- registration and licensing fees.

General anti-avoidance law

General legislation in Part IVA of the *Income Tax Assessment Act 1936* that applies to any scheme or arrangement whose main purpose is to obtain a tax benefit. We can issue a tax assessment that cancels the tax benefit.

Net personal services income

The personal services income amount remaining after subtracting from the gross personal services income:

- non-assessable components (for example GST)
- salary and wages promptly paid to the individual
- allowable deductions
- entity maintenance deductions.

Net personal services income loss

This is the excess of personal services deductions over personal services income. When the PSI rules apply, this net personal services income loss needs to be allocated to the individuals who performed the services. It cannot be used by the business.



For more information, refer to *Personal services income schedule* (NAT 3421).

Not a personal services business

See *PSI rules apply*.

Pay as you go (PAYG)

Is a comprehensive system for collecting income tax and other liabilities. Under PAYG, employers pay tax withheld from employees' wages, and personal services entities pay withholding tax on attributed personal services income when they lodge their activity statement.

PAYG payment period

Is:

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

Personal services business (PSB)

See *PSI rules don't apply*.

Personal services business determination

This is a notice from us stating the PSI rules don't apply.

Personal services business (PSB) tests

See *The tests*.

Personal services entity

A company, partnership or trust whose income includes the personal services income of one or more individuals. When we mean 'personal services entity' we generally say 'business'.

Personal services income (PSI)

Is income that is mainly (more than 50%) a reward for the skills, knowledge, expertise or efforts of the individuals who performed the services.

Principal work

Means the main work that generates the personal services income. It is the work that you must perform under contract and that you are paid for. It does not include support work. For example, principal work does not include bookkeeping, banking or secretarial duties, unless that is the main work that you do for customers.

PSI rules

Part 2-42 of the *Income Tax Assessment Act 1997* (ITAA 1997) that specifically looks at the taxation of PSI.

! 'PSI rules' in earlier publications were referred to as 'PSI law', 'PSI legislation', 'PSI measures' or 'Alienation of PSI' – all terms have the same meaning.

PSI rules apply

This occurs when you receive PSI and you:

- have not passed any of the tests, and
- do not have a determination from us.

If you are a sole trader this means you:

- won't be able to claim certain deductions against your PSI
- need to meet certain tax return obligations.

If you are a company, partnership or trust this means you:

- won't be able to claim certain deductions against the PSI
- need to meet certain tax return obligations
- need to attribute (treat as belonging) the income to the individuals who performed the services (that is, you can't retain the profits within the business)
- may have additional pay as you go withholding obligations.

! 'PSI rules apply' – in earlier publications we said 'not a personal services business' or 'not a PSB' – all terms have the same meaning.

PSI rules don't apply

This occurs when you receive PSI and you pass one of the tests (or have a determination from us). Whether you are a sole trader, company, partnership or trust, this means the only change in your tax obligations is you will have certain tax return obligations for the PSI you received.

! 'PSI rules don't apply' – in earlier publications we said 'personal services business' or 'PSB' – all terms have the same meaning.

Relative

This means:

- your spouse – see *spouse*
- your (or your spouse's) parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child
- the spouse of one of these people.

Results test

This test looks at whether you receive payment on achieving a specific contracted result or outcome. You use it to work out if the PSI rules apply.

Salary or wages promptly paid


Means paying an amount before the end of the 14th day after the relevant PAYG payment period from the date when the PSI was generated. For example, if your business lodges activity statements quarterly and you generated PSI in the January to March quarter, promptly paid would be if the salary or wages were paid to the individuals who performed the services by 14 April (14 days after the end of the first quarter, 31 March).

Spouse

Includes a person who, although not legally married to you, lives with you on a genuine domestic basis as your husband or wife. Such a person is commonly referred to as a 'de facto spouse'. Under Australian law your husband or wife cannot be the same sex as you.

The tests include:

- results test
- unrelated clients test
- employment test
- business premises test.

 'The tests' in earlier publications were referred to as the 'personal services business tests' or 'PSB tests' – all terms have the same meaning.

Unrelated clients test

This test looks at whether the income you received is from two or more clients who are not connected or related. You use it to work out if the PSI rules apply.

You/your

Where personal services income is paid to a company, partnership or trust, the words 'you' and 'your' refer to this business. Otherwise the words 'you' or 'your' refer to you personally.

MORE INFORMATION

For more information:

- visit our website at **www.ato.gov.au/business**
- phone us on **13 28 66**
- refer to
 - *Personal services income – basic information you need to know* (NAT 72468)
 - *Personal services income for sole traders* (NAT 72511)
 - *Personal services income – avoiding common mistakes* (NAT 71560).

To obtain industry specific information, visit our website at **www.ato.gov.au/PSI**

For copies of our publications:

- visit **www.ato.gov.au/onlineordering**
- phone us on **1300 720 092**.

If you do not speak English well and want to talk to a tax officer, phone the Translating and Interpreting Service on **13 14 50** for help with your call.

If you have a hearing or speech impairment and have access to appropriate TTY or modem equipment, phone **13 36 77**. If you do not have access to TTY or modem equipment, phone the Speech to Speech Relay Service on **1300 555 727**.

