PERSONAL SERVICE INCOME 101

The issue of Personal Service Income (PSI) will continue to be a major focus of ATO compliance activities in 2012. Here's what you need to know.

BY JOHN CORIAS

For those small business owners who have not yet caught up with PSI, it essentially relates to individuals earning non-salary income, often via a company structure, through work as a sub-contractor.

There are a number of tests that a company must satisfy in order to not fall under the PSI restrictions. These restrictions limit what a business is allowed to claim in the way of allowable tax deductions as well as access to certain small business concessions. The key tests are for PSI are as follows:

1. THE BUSINESS PREMISES TEST

If you can answer yes to five questions relating to your business premises then you will be exempt from the PSI rules. Essentially if you have a business location separate from your home and your associates/clients and it is used more than 50 percent of the time you will pass this test. Working from home automatically means you fail this test and will need to pass one or more of the other tests.

2. THE RESULTS TEST

You'll pass this test if you provide your own equipment for the work you do, are responsible for fixing your own mistakes and you only receive payment once the work has been completed. Regular payments look like wages income and will be treated as such by the ATO.

3. THE UNRELATED CLIENTS TEST (OR THE 80/20 RULE!)

To pass this test you must receive income from at least two unrelated clients and must obtain your income from services that have been offered to the public at large via advertising. Just listing with a hire agency is not sufficient.

4. THE EMPLOYMENT TEST

If you have employees working for you and performing at least 20 percent of the paid principal work then you will pass this test and not be subject to the PSI restrictions.

Without breaking down each of the tests in too much depth in this article, (each test could easily be an article on its own) let's jump straight into two recent rulings the ATO has made on PSI-related matters to illustrate some key aspects of PSI laws to look at the practical implications of PSI income rules.

The first case concerned the unrelated client's test where the Federal Court has recently confirmed a decision made by the ATO that the taxpayer failed the unrelated clients test for the purposes of the PSI in relation to a drafting business he carried on through his private company.

In this particular case, the taxpayer did not satisfy the requirement of a business to make general offers to the public for their services. The taxpayer directly contacted known associates within his industry for potential work and therefore didn't comply with making offers or invitations to the public at large or a section of the public as required by section 87-20(1)(b). This is part of the unrelated client's test that must be met to escape the restrictions of the PSI laws.

The ATO takes the view that if you are not openly advertising or promoting yourself in the marketplace, then the odds are you are only earning income through one or two contacts and are not really operating a true business. Unless you are able to prove without any doubt, that you have made clear, unambiguous offers to the public of your services then the ATO will treat all income and expenses as non-PSI related income.

The second case (AAT Case [2011] AATA 682) concerned a taxpayer who was operating a small IT business, earning its income through a small number of contracts. These contracts were all through a related group of businesses. The fact that the taxpayer's income all came via a group of associated businesses denied the taxpayer the ability to pass the 80/20 rule and thus be eligible as a PSI-earning business.

The fact that the taxpayer's clients were all related is similar to the reasoning behind the first case mentioned earlier. In sourcing all of his income via a group of businesses the taxpayer demonstrated to the ATO that he had not gone out of his way to market his services to the general public and had relied on a small number of business contacts to secure the contract income. Further, the taxpayer was also heavily penalised by the ATO for not demonstrating reasonable care in making himself aware of the PSI requirements.

By not coming clean and disclosing all of this information as soon as the ATO had made an initial inquiry into this taxpayer's affairs, the taxpayer gave the impression of either neglect or negligence and the ATO had no choice but to penalise them.

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The difference between being caught by the PSI rules or not can be quite substantial in terms of what expenses you can legitimately claim against your business. If your income is designated as being PSI then you cannot pay any wages or income to your associates, essentially meaning your husband, wife or children in most cases.

Additionally, you cannot pay any superannuation on behalf of your spouse, even if he or she really does help out the business with bookkeeping and so on. If you operate using a trust structure then all income after legitimate expenses must be declared as income in your hands, whether as declared wages or a trust distribution at year's end.

The PSI rules are clearly designed to catch taxpayers that have established company structures for what is essentially employment-related income. The benefits in terms of what can and cannot be claimed are often too tempting for some taxpayers. If you have such a company structure and have not met with your accountant to seek out specialist advice on whether or not you satisfy the PSI rules, then I can only urge you to make it a high priority.

The ATO is clamping down in this area and it may only be a matter of time before you as a small business owner get a phone call or letter from the ATO requesting that you satisfy the PSI rules or face a potential audit; something no taxpayer wants to face at any time. DB

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