



So You think You Are A Contractor And Can Split Income

The Three Stages of Being a Contractor

- 1) Qualifying for an ABN – You need to be an enterprise, more than just providing your labour. A ute may help if it is fundamental to your income producing activities but a station wagon or sedan won't help you at all. Just because you have an ABN doesn't mean you can split income from your personal services.
- 2) Personal Services Income (PSI), the 80/20 rule - If you invoice on the result you produce, not on an hourly rate, then you may pass the personal services income, 80/20 rule even if you only have one person that pays you. Alternatively, you may contract to multiple unrelated payers and charge on an hourly rate yet pass the PSI test. If you pass the PSI rules you can pay some of your income to your spouse for doing book work, errands etc but they should keep a diary of the hours worked and the pay rate should be commercially realistic. The PSI rules do not apply if the income you receive is predominantly for the provision of equipment and you are merely the operator of that equipment. For example, a semi-trailer owner driver.
- 3) To qualify to pay your family some of your profits without them working to earn it, you have to be considered a business. For sale of goods this is pretty easy but when the income is earned from your personal services the bar, to be considered in business, is much higher. You would at least need an employee working just as many chargeable hours as you.

Now I know you badly want to argue the point here, especially set me straight on what everyone else is doing. So below I have provided a detail explanation together with links to even more stunningly interesting information.

Worker with a Ute:

At the very basic level you buy a ute and some tools and work for one person under your personal ABN. The important question here is whether you are an employee. The ATO would like to think you are. Take there quick quiz <https://www.ato.gov.au/Calculators-and-tools/Host/?anchor=ECDTSGET&anchor=ECDTSGET/questions/ECDT#ECDTSGET/questions/ECDT>

The ATO recently lost a case on this matter but they have paid it little regard and are now looking for a new test case. Unfortunately, when you have unlimited taxpayer funded funds to fight those very same taxpayers, you can keep on going until you find a judge that will agree with you.

Qian's case (9th January 2019) is summarised by the ATO here <https://www.ato.gov.au/law/view/document?DocID=LIT/ICD/2017/3327/00001> the full story is here <https://www.ato.gov.au/law/view/document?DocID=LIT/ICD/2017/3327/00001> It is an interesting case, there was only \$3,940 at stake, that the taxpayer was going to lose but they had to fight it because if they didn't have an ABN they would lose their ability to earn income after they had just borrowed \$46,000 to buy a van to undertake the work. This is your tax dollars at work, making sure others can't!

An extract from paragraph 89 sums up the findings in Qian's case but the senior member pointed out that just because an activity was found to be an enterprise for the purposes of GST doesn't mean they are a business for the purposes of income tax. Note the van was used by Mr Qian as a courier driver, so predominantly to deliver parcels.

"the fact of Mr Qian's responsibility for the provision and operation of the van, its apparent character as a commercial transport vehicle, the apparently possibility of his income and profit being influenced by his own endeavours and efficiency, and the form of the regular accounting in the "payment summary" documents, combine to favour the conclusion that Mr Qian was conducting an enterprise as an independent contractor."

So at the moment having your own ute that is fundamental to your business ie to carry goods for delivery or to run around from site to site with heavy tools, should qualify you for an ABN as a sole trader. That is where all the income and direct expenses go in your own tax return.

Worker and A Trust or Company:

The simplest way around the question of whether you are an employee or not is to form a company or a trust and have it enter into the contracts. Then the contract cannot be for the services of an individual, which risks being an employer employee relationship and not qualifying even for an ABN. A company or trust will always be entitled to an ABN and not a risk to the payer/employer. All of the risk rests with you, the worker. The heads up is you are probably just being exploited by your employer to get around some of their obligations to employees. A company or a trust is not going to help you income split, your personal services income, without you either employing someone outside the family or the family member you want to split income with actually working in the business producing a result that you are billing the client for.

Splitting Income:

When income is earned by a business the profits can be distributed by its owners as suite. Usually in accordance with their tax brackets. Except for a very limited carve out for partnerships (which will be discussed further down) if income is earned through the personal exertion of the business owner then the income must be taxed in the hands of the person providing the services.

A good example from a contracting programmers point of view would be if they went inhouse for a client and wrote them a particular piece of software then it is income from personal exertion. If on the other hand if they, in their own home or office wrote an application that could be sold to many possible users, the income from those sales would not be from personal exertion but from sale of goods. This means it is business income and can be distributed to other people.

There are two hurdles you need to break through to successfully argue that income earned from personal exertion is generated by a business not by you personally. You need to get through both to be able to split your income without having to show the work that the family member did to deserve the income. The first is the alienation of personal services income rules and then the business income test.

One - Alienation of Personal Services Income Rules:

Commonly referred to as the 80/20 rule. We have a whole booklet on this if you are feeling particularly studious https://www.bantacs.com.au/booklets/Alienation_Of_Personal_Services_Income.pdf There is a flow chart to work through the various tests. The ATO ruling on the matter is TR 2008/1 <https://www.ato.gov.au/law/view/document?DocID=TXR/TR20018/NAT/ATO/00001>

As a quick summary, if you are only working for one payer then unless one of the following apply your income will be taxed as personal services income.

- 1) The services you provide are just ancillary to the provision of an income producing asset such as a truck. It is my opinion that a ute even laden with tools is still just ancillary to the skills you provide in using those tools not the other way around. Yet the same ute (not a van or station wagon) used to carry parcels as a courier driver would pass.

or

- 2) At least 75% of the time you produce a result. That is, you use your own tools if tools are required and you have to fix any mistakes at your own cost on your own time. TR 2008/1 at paragraph 34 and 36

34. The 'results test' will be met where:

(a) The contract is to produce a specified outcome or result and payment is based on performance of the contract (i.e., for producing the outcome or result);

(b) You provide the equipment and tools, if any, necessary for doing the work; and

(c) You bear the commercial risks, including liability for defective work.

36. Paragraphs 87-60(5)(c) and 87-65(5)(c) will be satisfied where there is a liability for the cost of rectifying any defect in the relevant work performed, including situations where action is taken to rectify the error at the individual's or personal services entity's own cost prior to completion of the task or prior to the taking of legal action. This sort of voluntary action reflects the custom and practice in some industries, and is indicative of the entrepreneurial risk of an independent contractor in contrast to the "employee-like" contractor.

or

- 3) You have an ATO ruling that you are a personal services business. Examples would be having business premises away from your home or employees that produce a chargeable result or would have except for unusual circumstances.

If your income is taxed as personal service income, then it will be attributed to your personal income tax return and you will only be allowed the same deductions as an employee with the exception of:

- (a) Costs of gaining work i.e. Advertising, tendering & quoting.
- (b) Workers' Compensation, Public Liability, Professional Indemnity and Income Insurance.

- (c) Payments to others for participation in the business but not a payment to an associate unless it directly relates to the principal work of the business (85-20).
- (d) Superannuation contributions for self and other workers except for associates not performing work that directly relates to the principal work of the business. Note: if an Associate performs work that directly relates to the principal work of the business superannuation contributions can only be made up to the amount required by the Superannuation Guarantee unless that Associate performs more than 20% of the market value of the entity's principal work (refer APSI Act 86-75(2))
- (e) Costs associated with GST.
- (f) If you are operating as a company, trust or partnership deductions are only permitted for maintaining one car per owner who is involved in performing the principal work of the business unless the vehicle is used entirely for business purposes (refer APSI 86-70 (1) and APSI 86-70(2) & (3)).

This means you will not be able to claim rent, mortgage interest, rates or land tax for your or your associate's residence and payments to your spouse or associate for non-principal work such as bookkeeping.

When the business entity has both income from personal services i.e. amounts caught here and other income from other businesses including being in the business of personal services many expenses will need to be apportioned. Further, any maintenance costs of the entity must be claimed against the non-personal services income first.

Now if you pass the tests above you are allowed to pay members of your family for doing work for you even if it is not directly charged to the client. For example, you will be able to pay your spouse for keeping your books and running errands. They will need to keep a diary to show the hours worked and can only be paid an hourly rate consistent with other employees doing a similar job.

If you want to go as far as being able to distribute profits to family members without them working for it then you need to pass the next stage to not be caught by Part IVA as a scheme to minimise your tax.

Two – Scheme with the Dominant Purpose of a Tax Benefit - Part IVA

Just because you manage to get around the PSI rules doesn't mean you are out of the woods yet. The ATO still have Part IVA to use against you by saying that the only reason you are doing things the way you are is to obtain a tax benefit. This is covered in IT 2639 <https://www.ato.gov.au/law/view/document?LocID=%22ITR%2FIT2639%2FNAT%2FATO%22&PiT=9991231235958> The idea is that the income has to be produced from a business structure not just the provision of your personal services. IT 2639 is referred to in TR 2001/8 below paragraph 25. It is not one or the other but both tests that have to be passed to be able to distribute income to family members who are not actually working in the business.

Some relevant paragraphs from IT 2639:

Paragraph 10

a) If the practice company or trust has at least as many non-principal practitioners (see paragraph 11) as principal practitioners, then income is considered to be derived from the business structure.

Paragraph 11. In paragraph 10:

- a. "Practitioners" include both full-time professional and non-professional staff whose function is to derive material fees for the practice. Part-time staff count proportionately. The term does not include administrative, clerical or support staff. For example, a nurse under the direction of a doctor or a legal secretary under the direction of a solicitor are not "practitioners" unless they earn material fees in their own right.

Partnerships are Special:

Partnerships of individuals do not provide any asset protection so it has been successfully argued that if a spouse is a partner then they are exposed to the same risk as the main income earner so they are entitled to a share of the profits. Accordingly, the ATO accepts that profits can be distributed in accordance with the partnership agreement in a partnership of individuals where the income is not passive income and both partners participate in the business, even though one might work much more than the other.

This will not work if you do not pass the PSI rules but it will get you round the Part IVA problem in the last point.

Please note that the above is written with a particular type of contractor in mind. You might not exactly fit that profile. Our booklet on the PSI rules can be found here https://www.bantacs.com.au/booklets/Alienation_of_Personal_Services_Income.pdf Please feel free to come in and argue the case with us.