the report | explanatory memorandum

November 2005

Personal Services Income

In a recent Administrative Appeals Tribunal (AAT) case, *Nguyen and Anor and Commissioner of Taxation*, the AAT has found that fees paid to a company for providing computer consulting services were in fact personal services income. Consequently the income was held to be directly assessable for each of the individuals providing the services.

The taxpayer (Mr Nguyen) set up a company, Vivi PC Supplies and IT Consultants Pty Ltd (VPS), providing computer consulting and other IT services. In late July 1998, VPS entered into an agreement with a recruitment firm for the provision of consulting services by Mr Nguyen. Under the agreement, Mr Nguyen's services were contracted to the Australian Tax Office (Tax Office). The Tax Office paid fees to the recruitment firm, which in turn paid fees to VPS. This contract concluded in March 2003, after which Mr Nguyen became an employee of the Tax Office.

In the income years ended 30 June 2002 and 30 June 2003, VPS employed four consultants, all contracted to external companies on similar agreements. For these two years, the company derived in excess of $545,000 and $432,000 respectively. VPS paid each of the four consultants a wage for services rendered and Mr Nguyen's wife received a $14,950 wage as an administration officer.

Tax Office audit

In 2004, VPS was audited and the Tax Office reported the following:

- VPS passed no personal services business tests;
- all of the income was derived by the four consultants individually through their own efforts and each should be assessed on their own personal services income under section 85–15 of the *Income Tax Assessment Act 1997* (ITAA 1997); and
- no principal work was completed by Mr Nguyen's wife and consequently the $14,950 paid to her in both years was not an allowable deduction.

In line with the audit's outcome, the Tax Office issued Mr Nguyen and his fellow contractors with amended assessments for the 2002 and 2003 income years.

Mr Nguyen objected to his assessments on the grounds that VPS was conducting a personal services business because more than 80% of the company's income was from more than one source. The Tax Office rejected the objection and Mr Nguyen subsequently appealed to the AAT.

The AAT first considered whether or not the income earned by VPS was personal services income as outlined by section 84–5. If the AAT held that VPS was in fact carrying on a personal services business, the income earned by VPS would not be attributed to the individuals.

Personal services business test

In accordance with the diagram shown in section 87–5, a taxpayer will be deemed to be carrying on a personal services business test if they satisfy ONE of the following four situations:

- results test:
  - you work to produce a result(s); AND
  - you provide the tools and equipment necessary (if any) to produce the result(s); AND
  - you are liable for the cost of rectifying any defective work;
- unrelated clients test:
  - none of your clients pay you 80% or more of your personal services income (PSI) in the year of income; and
  - you have two or more unrelated clients (who were obtained as a result of you making offers to the public at large or to a section of the public);
- employment test:
  - none of your clients pay you 80% or more of your PSI in the year of income; and
  - you engage an individual(s) or an unrelated entity(ies) to perform 20% or more (by market value) of the principal work; or
  - you employ an apprentice for at least half the year;
- business premises:
  - none of your clients pay you 80% or more of your PSI in the year of income; and
  - you exclusively use business premises that are physically separate from your home, or from the premises of the person for whom you are working.

In the taxpayer's personal case, the agreement with the recruitment firm was clear in showing that more than 80% of Mr Nguyen's personal services income came from the Tax Office contract. This finding made it impossible for VPS to satisfy the 'unrelated clients test', the 'employment test' and the 'business enterprise test' as outlined above. As this agreement was mirrored by the three other consultants, VPS needed to satisfy the 'results test' in section 87–18 in order to show that it was carrying on a personal services business.

The contracts the VPS consultants worked under didn't specify or require a produced result and consequently the AAT held that they were more akin to contracts of employment. This was supported by the facts that Mr Nguyen was paid an hourly rate on the basis of fortnightly timesheets, he worked under the direction of a supervisor and he had virtually no autonomy over his activities.

The AAT held that VPS was unable to satisfy any of the four personal services business tests and affirmed the Tax Office's amended assessments.

For further information, please review *Nguyen and Anor and Commissioner of Taxation* [2005] AATA 876, at: <www.austlii.edu.au/au/cases/cth/aat/2005/876.html>.

Car Parking Expenses

In ATO ID 2005/246, the Tax Office has stated that the usual prohibition on deductions for cost of car parking at the primary place of employment does not apply in the instance where the taxpayer travels to their primary place of employment from a different place of employment. Under paragraph 51AGA(1)(d) of the *Income Tax Assessment Act 1936*, car parking expenses at the taxpayer's primary place of employment are an explicitly denied deduction.

In the ID, the Tax Office contemplates an individual taxpayer who is employed at two unrelated places of work, one being part-time employment (approximately two hours a day) and the other full-time. Each day, the taxpayer works an hour of part-time employment, works a full day at their primary place of employment and then works another hour at their morning's workplace before returning home. While working at their primary place of employment, the taxpayer incurs car parking expenses.

The Tax Office referred to Miscellaneous Tax Ruling MT 2027 which states that for FBT purposes, the nature of travel between home and work does not change merely due to incidental tasks that are 'undertaken en-route in the travel from home to work'.

However, the Tax Office was satisfied that in the situation under review, clearly more than incidental tasks were being carried out by the taxpayer between their home and their primary place of employment. Consequently, the car has not been used by the taxpayer solely to travel between home and their primary place of employment. In turn, the deduction for car parking expenses would not be denied under paragraph 51AGA(1)(d) on that basis.

For further information, please review ATO ID 2005/246 — Deductions: Car parking expenses relating to a primary place of employment, at:

<http://law.ato.gov.au/atolaw/view.htm?find&docid=AID/AID2005246/00001>.

'Tax Advice' Deduction Denied

In a recent case, *Drummond v. Commissioner of Taxation*, the federal court has affirmed the Tax Office's assessment and held that the taxpayer was unable to claim a deduction of $49,550 for taxation advice provided by a solicitor in establishing a superannuation fund.

In December 1998, the taxpayer (Mr Drummond) was advised by his accountant that he could make a contribution to a non-complying superannuation fund and claim a corresponding tax deduction for that contribution. The accountant recommended a solicitor who could set up such a fund and provide the relevant tax advice. The solicitor, Mr Bonnell, had obtained a ruling from the Australian Tax Office and an opinion from a Queen's Counsel stating that such a contribution to a superannuation fund was deductible.

In March 1999, the taxpayer engaged the services of Mr Bonnell to set up the superannuation fund, and prepare the associated documents (trust deeds, loan facility agreements and deed of contribution).
Mr Bonnell issued the taxpayer with two letters:

- a letter dated 22 March 2005, which outlined the costs of the engagement; and
- a letter dated 22 March 2005, which outlined the tax advice.

The taxpayer and Mr Bonnell agreed that the superannuation fund would be established for a fee of $450 and his overall fees would be 10% of the $500,000 superannuation contribution made by the taxpayer (balance of $49,550).

The transactions put in place by Mr Bonnell were, essentially:

- Mr Drummond made a $500,000 contribution to the P. Drummond Superannuation Fund.
- The super fund then used this contribution to purchase 500,000 $1 units in the Drummond Investment Unit Trust.
- This $500,000 was on-lent by the trust to the taxpayer's wife, Mrs Drummond.

Denial of deduction

Due to the decisions in *Harris v. FCT* [2002] and *Prebble v. FCT* [2003], the taxpayer was unable to claim a deduction for the $500,000 contribution. In *Harris*, the federal court denied the taxpayer a deduction for a similarly structured contribution as it was held that a person couldn't be a director and an eligible employee of a company at the same time and consequently take advantage of the provisions in section 82AAA of the *Income Tax Assessment Act 1936*.

In the letter that outlined the cost of the engagement, Mr Bonnell wrote:

> *I will provide two invoices. The first invoice will be for $450.00, our usual costs for providing basic superannuation plan documentation and this will not be deductible. The balance of our fee will be charged for tax advice and will be wholly deductible.*

Consequently, even though the superannuation contribution was no longer an allowable deduction, the taxpayer claimed a deduction for the $49,550 paid to Mr Bonnell for tax advice under section 25–5 of the *Income Tax Assessment Act 1997*.

The Tax Office disallowed the deduction and the taxpayer objected. The matter was ultimately heard in the Administrative Appeals Tribunal (AAT). The AAT denied the deduction on the grounds that no tax advice had been provided. The AAT added that if, in fact, some tax advice had been provided, it was incumbent on the taxpayer to establish the part of the $49,550 attributable to tax advice. The taxpayer again appealed and the matter was heard before the federal court.

The federal court concluded that the AAT had erred in concluding that no part of the $49,550 fee related to the provision of tax advice. It was clear to the federal court that some of the advice provided to Mr Drummond in regard to the implemented structure was eligible tax advice as the advice was for the purposes of section 25–5.

However, no deduction could be granted as the taxpayer failed to produce evidence of what proportion of the fee related to tax advice as opposed to any other services. Rather, the taxpayer had followed an 'all or nothing' approach which resulted in the whole amount being held to be capital and the appeal being dismissed.

For further information, please review *Drummond v. Commissioner of Taxation* [2005], at:

<www.austlii.edu.au/au/cases/cth/federal_ct/2005/1129.html>.

Defending against a Takeover

In ATO ID 2005/265, the Tax Office has confirmed that capital expenditure incurred by a taxpayer in defending its business against a possible takeover qualifies as deductible expenditure under paragraph 40–880(1)(d) of the *Income Tax Assessment Act 1997*.

In the case under review, a company incurred capital expenditure by analysing and evaluating a proposal by the majority shareholder to acquire all of the remaining shares. This capital expenditure included legal fees, advisory costs regarding an expert's valuation report and notification of its minority shareholders. The proposal was not recommended by the board to the taxpayer's minority shareholders and the bid proposal ultimately lapsed.

Paragraph 40–880(1)(d) provides a deduction for capital expenditure incurred by a taxpayer in defending their business against a takeover where that business is carried on for a taxable purpose. A takeover is defined under the *Corporations Act 2001* and includes a process in relation to an acquisition of shares in a company regardless of whether the shares are actually acquired.

The following types of expenditure may be included in the deductible capital expenditure as allowed under paragraph 40–880(1)(d):

- legal and accounting costs;
- stockbrokers fees;
- media consulting fees;
- costs of independent evaluations of the takeover offer; and
- printing, advertising and mailing of documents produced for shareholders.

Even though the takeover bid may ultimately be unsuccessful, the taxpayer is entitled to claim a deduction for the capital expenditure they incurred in defending against the takeover. As required by paragraphs 40–880(2)(a) and (b), the deduction is limited to 20% of the total expenditure in the income year in which it is incurred and for each of the next four income years.

For further information, please review ATO ID 2005/265 — Capital allowances: Business related costs — to defend your business against a takeover, at:

<http://law.ato.gov.au/atolaw/view.htm?find&docid=AID/AID2005265/00001>.

Lodgment Responsibility

In ATO ID 2005/257, the Tax Office states that where an appointed liquidator has control of the financial records relating to the income tax affairs of the company, the liquidator is required to lodge the company's income tax return for the full income year.

Under section 254 of the *Income Tax Assessment Act 1936*, a liquidator is responsible for the income tax requirements and liabilities of the company from the time of their appointment. Consequently, even if a liquidator is only appointed part-way through an income year, it is responsible for the lodging of an income tax return for the full income year. The liquidator's responsibility overrides the Public Officer's lodgment responsibility under section 252.

Taxation Determination TD 94/68 outlines where the responsibility lies in cases where a receiver, as well as a liquidator, has been appointed to the company. Broadly, the Tax Office will place the lodgment responsibility on the party that has control over the financial records of the company.

For further information, please review ATO ID 2005/257 — Income Tax: Who is responsible for lodgment of a company return when a liquidator has been appointed? at:

<http://law.ato.gov.au/atolaw/print.htm?find&docid=AID/AID2005257/00001>.

GST — Guarantees and Indemnities

In draft ruling GSTR 2005/D2, the Tax Office provides a detailed explanation of what it believes is a guarantee or an indemnity for the purposes of sub-regulation 40–5.09(3) item 7 of the GST regulations.

Under section 40–5 of the *A New Tax System (Goods and Services Tax) Act 1999* (the GST law) a financial supply is treated as an input taxed supply for GST purposes. A financial supply is defined in regulation 40–5 of the GST regulations. Sub-regulation 40–5.09(3) provides details in relation to types of interests, the provision, acquisition or disposal of which can be financial supplies.

Specifically, sub-regulation 40–5.09(3) item 7 provides that an interest in or under a guarantee, including an indemnity (except a warranty for goods or a contract of insurance or reinsurance) is a financial supply.

Part 5 of Schedule 7 to the GST regulations provides examples of things that are included under item 7. The examples provided are:

- an indemnity that is not a contract of insurance;
- a surety bond that is a guarantee; and
- a performance bond.

The GST law does not provide a definition of a guarantee, an indemnity or the terms included in Schedule 7. Hence, the Tax Office attempts to define the terms in this draft ruling in order to ensure that taxpayers can correctly classify these interests for GST purposes. That is, whether or not to define them as input taxed (financial supplies).

Guarantees (financial supplies)

A guarantee is a contractual arrangement under which the guarantor agrees to make good the obligation of the principal (i.e. debtor) to the creditor if the principal defaults. That is, the guarantor has secondary responsibility in relation to the obligation of the principal. A guarantee can be a recompensed or a non-recompensed guarantee. A recompensed guarantee is where the surety is paid a fee by the principal in order to make the guarantee. Such an arrangement is common in a commercial environment. However, it is not common within a family company, for example, where the directors of a family company guarantee the company's obligations (this is a non-recompensed guarantee).

Indemnities (financial supplies)

An indemnity is an arrangement between three parties where the surety takes the primary responsibility for an obligation that arises in relation to a third party, i.e. the creditor can recover from the surety regardless of whether or not the principal defaults. Like a guarantee, an indemnity can be recompensed or non-recompensed.

Warranties for goods (not financial supplies)

A warranty for goods is an agreement under which the provider of the warranty agrees to make good defects for goods provided to a customer if the goods are not of the standard warranted by the supplier.

An extended warranty on goods is where a fee is paid to a third party in order for the third party to agree to make good any faults in goods sold by a retailer for a specified time period.

As a warranty does not have the characteristics of:

- a guarantee (i.e. the nature of the risk is not a credit risk); or
- an indemnity (i.e. there is no right to be indemnified);

it is not a financial supply for the purposes of the GST law.

Contracts of insurance (not financial supplies)

A contract of insurance is an arrangement under which an insurer agrees to pay the insured an amount upon the occurrence of a certain event, i.e. the insurer has primary liability under the contract. There is a requirement that a contract of insurance is entered into in writing.

Note that life insurance is a financial supply.

Contracts of reinsurance (not financial supplies)

Reinsurance is the method insurers use in order to lay off or cede part or all of their risk under an insurance policy.

Note that the reinsurance of a life insurance policy is a financial supply.

Surety bonds that are guarantees (financial supplies)

Surety bonds are commercial products by which the surety undertakes to secure certain obligations owed by a principal to a creditor and have the character of a guarantee.

Reinsurance of surety bonds (financial supplies)

The reinsurance of a surety bond relates to an arrangement under which the risk of the surety is ceded partly or wholly to another entity. The reinsurance of a surety bond has the same character as the surety bond.

Indemnities that are not contracts of insurance (financial supplies)

An indemnity that is not a contract of insurance includes a commercial indemnity where one entity agrees to make good the loss of a second entity in circumstances that do not involve a third entity. However, if this indemnity is made for consideration, it may be a taxable supply.

Performance bonds (financial supplies)

A performance bond is an undertaking by a person to make good a contractual obligation of another person to a third party, generally upon proof that the other person has failed to perform the relevant obligation. A performance bond can be conditional or unconditional.

It should be noted that a performance bond is only a financial supply if it satisfies the characteristics of a guarantee.

For further information, please review draft GST ruling GSTR 2005/D2 — Goods and services tax — guarantees and indemnities, at: <http://law.ato.gov.au/atolaw/results.htm?&basic=GSTR%202005/D2>.

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