

11 October 2024

Ms Sally Cummins
Small Business
Australian Taxation Office

By email: SBPAGConsultation@ato.gov.au

Dear Ms Cummins,

Draft Practical Compliance Guideline PCG 2024/D2 – Personal services businesses and Part IVA of the Income Tax Assessment Act 1936

The Tax Institute (TTI) welcomes the opportunity to make a submission to the Australian Taxation Office (ATO) in relation to [Draft Practical Compliance Guideline PCG 2024/D2 \(draft PCG\)](#). The draft PCG addresses an important area of tax law and one which the draft PCG at paragraph 5 implicitly acknowledges is not universally well understood. It is within the context of the need for greater certainty for taxpayers in this area of tax law that we make this submission.

In the development of this submission, we have consulted with our National Small and Medium Entities Technical Committee to prepare a considered response that represents the views of our broader membership.

In our submission we have been guided by:

- the general role played by ATO Practical Compliance Guidelines (PCGs). We note that PCGs “[...] represent material on how the ATO will allocate its compliance resources according to assessments of risk and may outline administrative approaches that mitigate practical difficulties relating to the operation of tax laws.” ([PCG 2016/1 - PCGs: role in ATO’s public advice and guidance](#), paragraph 23); and
- the need for greater certainty, particularly for small business taxpayers.

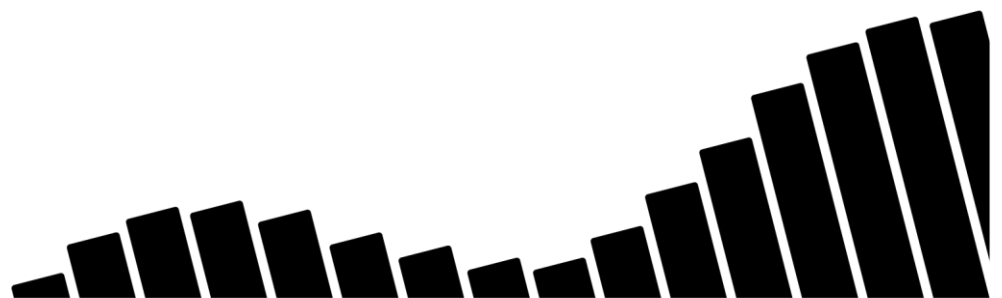
In this regard, we include several specific comments in relation to the guidance in the draft PCG and, in particular, our comments on how we feel a number of the low and higher risk examples could provide even further helpful guidance to taxpayers by elaborating on particular fact patterns. Our comments are set out in **Appendix A**.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all.

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If you would like to discuss any of the above, please contact our Senior Counsel – Tax & Legal, Julie Abdalla, on (02) 8223 0058.

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Yours faithfully,

A handwritten signature in black ink, appearing to read 'Todd Want', with a stylized flourish at the end.

Todd Want

President

APPENDIX A

We have set out below our detailed comments and observations on the draft PCG for your consideration.

Existing guidance and judicial decisions

It would be helpful if footnote 7 in paragraph 6 of the draft PCG explicitly referenced the details of the “existing guidance and judicial decisions” that have “made clear that Part IVA can apply to alienation arrangements involving income splitting and retention of profits where the dominant purpose of a participant in the scheme was to obtain a tax benefit”. Such an inclusion would assist taxpayers in understanding whether the use of the word “existing” here should be interpreted as indicating that the “existing guidance and judicial decisions” mentioned in footnote 7 are directly relevant to the concept of personal services business (**PSB**) and the potential application of Part IVA to this concept, which is the subject of the draft PCG.

While it is acknowledged that there are references to ATO guidance and judicial decisions in the footnotes to paragraph 5 of the draft PCG, with the exception of Taxation Ruling TR 2022/3: *Income Tax: personal services income and personal services businesses*, these references appear to refer to guidance and judicial decisions that were published *prior* to the introduction of the personal services income (**PSI**) regime, and therefore prior to the introduction of the concept of PSB.

It is acknowledged that there are other implicit references in the draft PCG to the fact that pre-PSI guidance and judicial decisions are considered by the ATO to be relevant to PSBs and Part IVA (including at paragraphs 21 to 23 of the draft PCG). However, an explicit identification of which specific “existing guidance and judicial decisions” refer to PSBs in the footnote to paragraph 6, and which do not so refer to the concept of PSB, may reduce confusion for taxpayers who do not have an intricate understanding of Australian income tax law and its history, and may reasonably expect to find a discussion of PSBs in all of the referenced guidance and judicial decisions in the draft PCG.

Examples relating to low-risk retentions of profits by PSBs

The inclusion of low-risk examples is helpful. However, it would also be helpful for taxpayers for the draft PCG to provide further details (by way of additional and more detailed examples) of when the commercial reality of different scenarios involving the retention of profits would also feature in the low-risk example list. Providing further detail and examples would also be consistent with the stated objectives of PCGs at a general level as this would help “[...] outline administrative approaches that mitigate practical difficulties relating to the operation of tax laws.” ([PCG 2016/1 - PCGs: role in ATO's public advice and guidance](#), paragraph 23).

Our view is that the current examples in the low-risk list category (Examples 1 to 6) of the draft PCG are rather limited in scope. For example:

Example 6 of the draft PCG appears to suggest that retention of profits is low risk only where the purchase of a specific asset for a specific amount can be identified as needing to be made in the following year. We consider that the draft PCG should include more detailed examples that demonstrate a sensible tolerance for the retention of profits from general working capital.

Examples in the low-risk category should include situations that reference the reality that taxpayers may need to retain profits, for example, to meet ongoing costs. While the ability to retain profits to meet ongoing costs with no adverse tax consequences may be a necessary part of the cashflow management of any entity, it is particularly necessary that entities that bear such costs but may not generate income for certain periods of time are able to retain profits to meet these costs. This applies equally to personal services entities (**PSEs**) that are conducting PSBs.

There are various reasons why a taxpayer may find themselves in a situation where they are not currently generating income but continue to have ongoing costs (e.g. perhaps because they are taking a break from an income generating activity for personal reasons or being paid on an instalment or irregular basis and their ongoing costs must be paid on a regular and more frequent basis). In any such circumstances, they will need to consider the impact of such a mismatch on their cashflow.

For example, it would be reasonable for a PSE conducting a PSB (**PSB entity**) with \$5,000 overheads to be able to retain profits to meet these costs in the next financial year. This is particularly relevant where the PSB entity anticipates that it will not receive any revenue in the short term. If, for example, the PSB entity anticipates that it will be paid for a contract in September of year two, then it should be able to retain profits in year one to meet its overheads until such time as it receives the relevant amounts due under the contract.

The benefits of including such an example in the low-risk category of the draft PCG include that:

- a PSB entity may be concerned that without such a safe harbour it may run the risk of Part IVA applying merely because it seeks to retain profits to cover its overheads for the time being;
- such a situation is reflective of the type of cash flow management approach that a PSB entity might be reasonably expected to undertake, at least at certain points in time during the life of its operations; and
- it would send a clear signal that in such a situation, the relevant PSB entity would not be expected, for example, to fully distribute its profits and then once distributed immediately borrow back these amounts in an attempt to mitigate the risk of Part IVA applying to its operations. Further, any such course of action (i.e. immediately distributing any profits and then borrowing funds to meet ongoing costs) could be (depending on the circumstances) considered a more artificial and contrived means of meeting future costs than retaining profits for this purpose.

Accordingly, we consider that including a reference to the commercial reality of taxpayers' decision-making processes in relation to cashflow management is a missing piece in the low-risk examples in the draft PCG. Put another way, not including an example along the above lines may potentially contribute to unintended negative impacts on PSB entities that need to manage their cashflow and may potentially expose them to unnecessary increased tax risk.

In relation to Example 4, we note that the retention of profits is considered low risk in a situation where there is a deferral of tax due to the inability of the personal services provider (Tran) to calculate the profits and direct the PSB entity to pay Tran a bonus before year end due to their ill-health. In our view, the draft PCG should also consider other situations in which bonuses or dividends may not be paid out prior to year-end as being low-risk. For example, it may be impracticable for a PSB entity to both determine its profits and distribute all relevant profits prior to year-end. In such a case, it would be reasonable for a sensible time lag to be permitted. We suggest that an example is included that provides for a, say, one-year time period for PSB entities to finalise their accounts within a reasonable period after year end in such circumstances.

Examples relating to higher risk arrangements

It would also be helpful if the examples in the higher risk arrangements section incorporated other commercial factors that may have influenced a decision to retain profits in a given year. For example, Example 13 of the draft PCG appears to suggest that the PSB entity, here BLD Pty Ltd, should pay a bonus or salary to Tom equal to the net PSI made by BLD Pty Ltd for the relevant year. However, given BLD Pty Ltd is in a loss position for the relevant income years from its other (non-PSI) operations, paying a large amount of net PSI to Tom as a salary may reasonably be considered to constitute a risk to both BLD Pty Ltd and Tom (as this may result in it having difficulties paying its creditors, entering into insolvent trading, and breaching directors' duties etc).

It is suggested that commercial factors of this kind are incorporated into the fact patterns of such higher risk examples so that a clearer picture can emerge of situations in which taxpayers can more readily identify when it would be reasonable for the ATO to consider that compliance resources may apply in such higher risk scenarios.

Continuing the discussion on Example 13, if it is commercially prudent for Tom to trade through a company (such as to manage commercial and asset protection risks) and the underlying business activities of the company go through the ordinary ebbs and flows of being in business (such as years where profits may be made, and years where losses may be made), it would be useful to understand when such profits and losses from the businesses within the company could be offset in a manner which is not considered higher risk.

In addition, were Tom to operate several businesses as a sole trader (as opposed to through a company), then subject to meeting the non-commercial loss rules in Division 35 of the *Income Tax Assessment Act 1997*, Tom may be able to offset any losses arising in one business activity against profits derived during the relevant income year(s) from other business activities. We consider that it would be helpful to contrast why this type of scenario would be acceptable when the equivalent type of scenario conducted through a company (such as BLD Pty Ltd) could be considered higher risk. Examples of such an approach would provide taxpayers with clearer guidance that reflects the commercial realities they are likely to encounter.

Concluding comments

We appreciate the opportunity to provide feedback on the draft PCG. We acknowledge that this is an area of tax law that is need of greater clarification and consider that expanding the number and/or scope of the examples in the low and higher risk categories in the draft PCG so that they factor in the types of commercial reality in which, at least some, taxpayers will find themselves, will assist taxpayers in navigating this area of tax law and make better informed decisions.