

NSW/ACT PUBLIC PRACTICE SYMPOSIUM 4 – 5 APR 2017

The Sebel Kirkton Park, Hunter Valley

THANK YOU



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Tax Aspects of Incorporation of Professional Practices

Session 7

Peter C. Adams

IT25 – Scope and application

2017 NSW PPS

- Incorporation of medical practice acceptable where:
 - a company is incorporated in alignment with the terms of AMA by-laws (**personal responsibility for medical diagnosis, treatment, etc resides with medical practitioner**), and
 - effect of incorporation is **nothing more than reduction of MP's earnings by the amount of an appropriate superannuation cover**
- Cash basis accounting applies to company unless *Henderson* situation exists
- Income earned that is collected after incorporation generally to be included in MP's personal assessable income (but no action to be taken if included in company's income)



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IT2503 + Addendum – Supplement to IT25

- IT25 applies unless inconsistent with IT2503
- Incorporation is acceptable where:
 - there is nothing in the relevant State or Territory law to prevent incorporation;
 - there are sound business or commercial reasons for incorporation;
 - there is no diversion of income from the personal services of the professional practitioner to family members or other persons; and
 - the only advantage for income tax purposes is access to greater superannuation benefits.



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IT2503 + Addendum – Supplement to IT25

Taxable Income of the Company

- Incorporation is acceptable to ATO where it does no more than reduce a professional's income by the amount of an appropriate superannuation cover
- Strictly speaking this means practice company should have no taxable income - total income, after expenses, should have been fully paid out to the professional person by way of a salary.



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Taxable Income of the Company

- Not possible to determine with accuracy what should be paid as salary and what set aside as superannuation to produce a nil taxable income in company.
- Further difficulty is when taxable income exceeds accounting income
- Because of these and similar factors, practice company may well (inadvertently) disclose taxable income.

IT2503 + Addendum – Supplement to IT25

Taxable Income of the Company

- ATO position - retention of profits in a practice company is generally not acceptable.
- Purported main object of incorporation of obtaining superannuation must not be frustrated or diminished.
- Retention of profits would generally put in doubt the very basis on which arrangements are acceptable, viz., the provision of superannuation benefits.

IT2503 + Addendum – Supplement to IT25

Taxable Income of the Company

- Limited Exception
 - where bona fide attempt has been made to break even and practice company has a small taxable income, it should distribute all its taxable income, to the professional person as franked dividend, in the following year.
- Where a practice company does not make a bona fide attempt to distribute its income to the professional person as salary prior to year-end, its income will be treated as that of the professional practitioner as an anti-avoidance sanction

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Taxable Income of the Company

- Where, a practice company has insufficient funds to meet an income tax liability, professional person can lend funds interest-free to the company to pay the income tax.
- Acceptable, but loans must not be repaid by practice company
- Loans must be written off without claiming deduction
- Effectively, income tax liability of practice company is paid by the professional person in a non-deductible way.
- Does write-off result in capital loss? – nature of CGT asset

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Practice Company Losses

- Common to incorporate part way through financial year.
- If towards end of year, the income of practice company may not be adequate to cover superannuation contributions calculated on an annual salary basis
- Generally results in a loss by company in its first year
- If such a loss is returned by the practice company it should be recouped in following financial year before any salary is paid to professional practitioner

IT2503 + Addendum – Supplement to IT25

Shareholders and Directors of Practice Companies

- Associates / spouses as shareholders and/or directors?
- Professional practitioners may be unwilling to undertake roles in practice company conferring particular duties and liabilities on directors under companies legislation.
- Only acceptable for income tax purposes where allowed by relevant law or by-laws and non-professional director does not receive remuneration as a director in any form, profits or superannuation benefits

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Shareholders and Directors of Practice Companies

- Arm's length payments to associates for bona fide services are allowed
- However, pursuant to decision in *Ryan's* case, TD 2005/29 states superannuation contributions made by a personal services company for an associate of the main service provider is allowable even if in excess of reasonable remuneration for the services rendered by the associate

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Goodwill

- Can practice company purchase goodwill of professional's practice with funds from professional's family trust?
- Shares in practice company is held for benefit of the professional practitioner
- ATO view - difficult to see why company must pay amount to professional for goodwill.

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Investments

- Purchase of income producing property not acceptable
- Purpose of acceptable incorporation to provide the practitioner with a higher level of superannuation benefits than sole practitioner or partner – not intended that property from non-practice source would be held by practice company.
- Practice company may own assets used in the practice, for example, offices – If it holds unacceptable investments, income from practice is treated as professional practitioner's income

IT2503 + Addendum – Supplement to IT25

Basis of Accounting

- Aligned with treatment espoused in IT 25
- Cash basis accounting applies to company unless *Henderson* situation exists

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Sessional Fees From Public Hospitals

- Where a hospital has authority to and does contract with a medical practice company for the services of the doctor employed by the company, the sessional fees paid by the hospital for those services would be assessable income of the company.
- However, where a contract is between a hospital and the medical practitioner the fees would be assessable income of the medical practitioner and should be included in the medical practitioner's own return of income.

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Keyman Insurance

- Generally, premiums for keyman insurance would not be deductible in practice companies as those companies should terminate on the death or permanent incapacity of the professional practitioner.
- However, in practices where such termination would not occur, e.g. where there is more than one professional practitioner in the practice company, keyman insurance premiums may be deductible
- IT 155 principles apply

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Incorporation and PSI – IT2639

Scope and effect of IT 2639 on Incorporation of practices

- IT 2503 – Incorporation is acceptable if it does nothing more than reduce the professional's income by the amount of an appropriate superannuation cover
- IT2639 - PSI is income earned predominantly as direct reward for individual's personal efforts by provision of services, exercise of skills or application of labour

Incorporation and PSI – IT2639

Scope and effect of IT 2639 on Incorporation of practices

- If the practice company has at least as many non-principal practitioners as principal (equity) practitioners, then income is considered to be derived from business structure - not within scope of IT 2503 and does not need to comply with IT 2503
- If practice company has fewer non-principal practitioners than principal (equity) practitioners and derives PSI – within scope of IT 2503 and must comply with IT 2503
- No automatic extension of IT2639 principle to PSI Regime

Incorporation and the PSI Regime

- A special tax regime was inserted in 2001 as Div 84 of ITAA 1997 to prevent individuals from reducing tax by alienating their PSI to an associated company
- PSI regime has the following main effects:
 - PSI is included in assessable income of the individual whose personal efforts or skills generated the income
 - Restrictions on deductions otherwise claimable to broadly correspond to only the deductions available to employees

Personal Services Income (PSI)

- [Part 2-42 ITAA 97](#)
- Is there an employment relationship. If so the PSI rules do not apply
- Is personal services income being earned ([s 84-5 ITAA97](#) and [TR 2001/7](#)) directly or via an entity
 - mainly ie over 50% from personal services
 - not from the supply of goods, use of an asset or business structure
- The PSI rules only apply where personal services income is being earned and a personal services business (as defined) is not being carried on



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Incorporation and the PSI Regime

The PSI regime does not apply if:

- the income is not PSI
- the income is derived as an employee or office holder, or
- the income is derived as part of a personal services business (PSB)



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Incorporation and the PSI Regime

- Income which is mainly a reward for an individual's personal efforts or skills is the individual's *personal services income* (PSI), regardless of whether it is income of another entity (eg a company, trust, partnership, etc)
- PSI does not include income that is mainly generated by use of assets, sale of goods, or a business structure.

Incorporation and the PSI Regime

- PSI included in individual's assessable income may be reduced by certain deductions to which PSE is entitled
- The reduction consists of two elements:
 - deductions to which PSE is entitled relating directly to the PSI (excludes entity maintenance deductions and wages paid to the individual)
 - the part (if any) of PSE's entity maintenance deductions exceeding PSE's *assessable* income from sources other than PSI
- PSE is not taxed on PSI of individual, but still entitled to deductions offset against individual's PSI in calculating the individual's assessable amount

Incorporation and the PSI Regime

- Where an individual generates PSI the individual's deductions relating to that income are generally restricted to the amount that they would be entitled to deduct if the income had been received as an employee
- This means, for example, that the individual cannot deduct rent, mortgage interest, rates or land tax relating to their residence or associate's residence

Incorporation and the PSI Regime

- PSI regime does not prohibit deductions to the extent that they relate to:
 - gaining work (eg advertising, tendering, quoting)
 - insuring against loss of income or earning capacity
 - personal superannuation contributions

Incorporation and the PSI Regime

- Individual cannot deduct payments to an associate to the extent they relate to gaining or producing individual's PSI.
- However, this prohibition does not apply if amount relates to engaging associate to perform part of principal work for which individual's PSI is received
- Individual also cannot deduct superannuation contributions made on behalf of an associate, to the extent that the associate's work relates to gaining the individual's PSI but does not form part of the principal work for which that income is received.

Incorporation and the PSI Regime

- PSE is not entitled to a deduction that relates to gaining or producing an individual's PSI unless either:
 - the individual could have deducted the amount if the entity's circumstances had applied to the individual, or
 - the entity receives the individual's PSI in the course of conducting a PSB
- This general rule is modified by specific provisions covering deductions for entity maintenance costs, superannuation, salary or wages promptly paid, and income of the entity which has been included in an individual's assessable income.

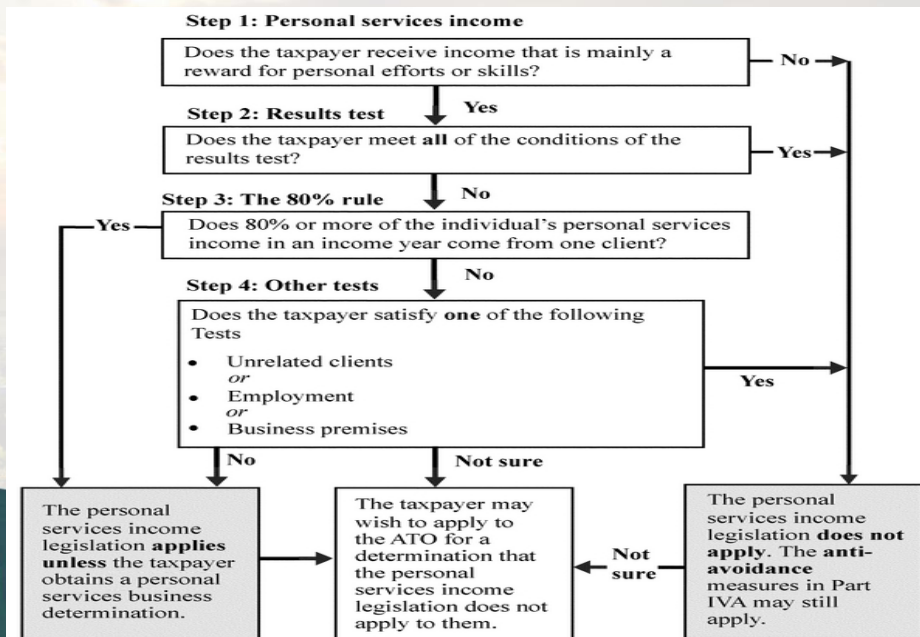
Incorporation and the PSI Regime

2017 NSW PPS

- Income from a genuine PSB is exempt from PSI regime.
- There will be a PSB if:
 - the “results” test is satisfied;
 - OR
 - less than 80% of the PSI is from one source (i.e. 80% or more of PSI is from two or more sources), and
 - Unrelated clients test is satisfied; or
 - Employment test is satisfied; or
 - Business premises test is satisfied;
 - OR
 - PSB determination is obtained from the Commissioner

Incorporation and the PSI Regime

2017 NSW PPS



Incorporation and the PSI Regime

- To satisfy results test, an individual must satisfy following conditions in relation to 75% of PSI during the year:
 - the income is for producing a result (eg delivering a completed software component, by contrast with performing a week of programming work)
 - the individual is required to supply the plant and equipment or tools of trade (if any) needed to perform the work, and
 - the individual is, or would be, liable for the cost of rectifying any defect in the work performed
- For each of these conditions, industry custom and practice will be taken into account.

Incorporation and the PSI Regime

- If results test is *not* satisfied, it is necessary to consider the 80% rule:
 - if 80% or more of an individual's PSI is from one entity, income will be subject to the PSI regime unless he/she obtains PSB determination from Commissioner
 - if 80% or more of the PSI is not from one entity, income will be exempt from PSI regime if the individual also satisfies any of the following tests:
 - the unrelated clients test
 - the employment test, or
 - the business premises test.

Incorporation and the PSI Regime

Unrelated clients test

- service provider gains income from providing services to two or more entities that are not associates of each other and are not associates of the service provider, and
- services are provided as a direct result of the service provider making offers or invitations to the public at large or to a section of the public

Incorporation and the PSI Regime

Employment test

- Employment test is met if at least 20% of principal work generating PSI is performed by a non-associated entity or entities engaged by the individual / PSE
- Employment test can be met by having one or more apprentices for at least half the income year
- Commissioner considers that “principal work” does not include incidental clerical or administrative work

Incorporation and the PSI Regime

Business premises test

- Business premises test met if, at all relevant times during the year, the service provider maintains and uses business premises:
 - at which they mainly conduct activities from which PSI is gained
 - of which they have exclusive use
 - that are physically separate from any premises that the service provider or associate uses for private purposes, and
 - that are physically separate from the premises of the service provider's client or client's associate

Incorporation and the PSI Regime

For PSB Determination one or more of following requirements must be met:

- the individual met, or could reasonably be expected to meet, one or more of the results test, the employment test or the business premises test *and* the individual's PSI was, or could reasonably be expected to be, from the individual conducting activities that met one or more of those tests; or
- but for unusual circumstances applying to the individual in that year, the individual would have met, or could reasonably have been expected to meet, one or more of the results test, the employment test or the business premises test *and* the PSI of the individual was, or could reasonably be expected to be, from the individual conducting activities that met one or more of those tests;

Incorporation and the PSI Regime

For PSB Determination one or more of following requirements must be met:

- the individual met, or could reasonably be expected to meet, the unrelated clients test but because of unusual circumstances 80% or more of the PSI of the individual would have been, or could reasonably have been expected to be, from the same source *and* the PSI of the individual was, or could reasonably be expected to be, from the individual conducting activities that met the unrelated clients test, or
- but for unusual circumstances applying to the individual in that year, the individual would have met, or could reasonably have been expected to meet, the unrelated clients test *and* if 80% or more of the individual's PSI would have been, or could reasonably have been expected to be, from the same entity, this was only because of unusual circumstances applying to the individual in the income year *and* the individual's PSI was, or could reasonably be expected to be, from the individual conducting activities that met the unrelated clients test

Personal Services Income

- If caught by the PSI rules, individuals cannot deduct the following against their PSI (see [TR 2003/10](#))
 - Deductions an employee could not claim ([s 85-10\(1\) ITAA97](#)), unless they relate to:
 - Gaining work
 - Insuring against loss of income or earning capacity
 - Engaging a non-associate to perform work
 - Engaging an associate to perform principal work
 - Workers' compensation premiums etc
 - GST
 - Rent, mortgage interest, rates or land tax for the individual's or their associate's residence ([s 85-15 ITAA97](#))
 - Salary/wages paid to associates, unless they are for performing principal work ([s 85-20 ITAA97](#)) – becomes tax free income for the recipient
 - Superannuation contributions for associates, unless they relate to associates performing principal work ([s 85-25 ITAA97](#))

Case Study - PSI

- Joe is a practitioner.
- He has an ABN and is registered for GST.
- His major client is a medical practice company, A Co.
- It is A Co that arranges all the patient appointments but Joe can accept or reject the work offered to him by A Co.
- He can delegate the work but hasn't this income year.
- He is paid on a time basis for the hours he works as and when he sees and treats patients.
- Joe receives \$154,000 from A Co in the year and \$33,000 from his sessional work at hospitals.



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Case Study - PSI

- Joe has the following expenses (net of GST)
 - Joe pays his wife \$20,000 to do all the secretarial and administrative work related to his business.
 - Materials, medical instruments, occupation specific clothing, etc \$40,000
 - Tax return fees \$1,000
 - Use of his motor vehicle to travel from home to the work site, home visits and hospitals
- **Required:** Complete Items P1 and 14 on Joe's tax return.



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Case Study - PSI

- It first needs to be determined whether Joe is an employee of A Co or his other clients.
- If he is, A Co will have to take PAYG out of the payments to him and also pay superannuation guarantee on his behalf and Joe would not complete Items P1 or 14.
- However, Joe would argue he is not an employee as he has an ABN; is able to delegate the work; has other clients and is able to accept or reject the work offered to him.
- Joe is earning personal services income as he is being paid for his personal exertion. He therefore needs to complete Item P1.
- Item P1 concerns sole traders only - It does not have to be completed where the taxpayer receives his/her PSI through a company, partnership or trust.
- Here Joe is a sole practitioner so he will complete Item P1.
- Joe prints X at Yes - He has received personal services income



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Case Study - PSI

- The ATO is unlikely to regard Joe as satisfying the results test as he does not satisfy the first condition – paid to achieve a result.
- This is because A Co and his other clients are paying him for his hours worked and not for the completion of a specific.
- He is paid for his time as and when he is seeing patients on an ongoing basis.
- He is not getting a set fee for a specific result.
- Therefore Joe will print X at No – P - Did you satisfy the results test
- He prints X at No – C - Did you receive a personal services business determination



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Case Study - PSI

2017 NSW PPS

- More than 80% of Joe's income is received from A Co.
- Therefore he prints X at Yes – Q - Did you receive 80% or more of your PSI from one source and goes to Part B.
- Joe cannot rely on the unrelated clients test or employment test or business premises test as they all require that less than 80% of personal services income is derived from one source.

Case Study - PSI

2017 NSW PPS

- Joe is deriving personal services income and is not carrying on a personal services business.
- He is therefore caught by the PSI rules and denied certain deductions.
- He cannot claim a deduction for the payment of \$20,000 to his wife as she is an associate and is not performing the principal work (she will receive the \$20,000 tax free – [s 85-20](#)).
- He cannot claim rent, mortgage interest, rates or land tax for his home to the extent that some of his medical practice work is conducted from home

Case Study - PSI

- He can claim a deduction for the materials, instruments and work related items
- He can also claim a deduction for the tax return fees.
- Joe should be entitled to claim a deduction for the use of his motor vehicle as he is using his home as a base of operations.
- He has not kept a log book so claims on a cents per km basis $4000\text{km} \times 66\text{c} = \$2,640$.
- Joe prints at section J under P1 the amount of PSI received - $\$187,000 - \$17,000 \text{ GST} = \$170,000$.
- Joe prints at section L under P1: $\$43,640 = (\$40,000 + \$1,000 + \$2,640)$
- At item A under P1 Joe prints $\$126,360 = (\$170,000 - \$43,640)$ and transfers this figure to Item 14 in the primary section of the individual tax return.

Personal Services Income through entity

- Where the PSI rules apply, PSI derived by a PSE is attributed to the individual ([s 86-15 ITAA97](#), [TR 2003/6](#)) except to the extent that
 - the PSI is from a personal services business
 - the entity promptly paid the PSI to the individual as salary or wages
 - the income is non-assessable under other provisions (eg GST)

Personal Services Income through entity

The entity is entitled to certain deductions against the PSI ([s 86-20 ITAA97](#))

- entity maintenance deductions that haven't been offset against other income
- certain car expenses (one car per principal worker)
- super contributions – restricted to super guarantee rate on allowable salary, or no limit if they do > 20% of principal work
- salaries promptly paid (including payments to associates for principal work)
- No double taxation to entity ([s 86-30](#), [s 118-20](#) ITAA97) or on later distribution ([s 86-35\(1\)](#), [s 104-71\(1\)\(d\)](#) ITAA97)



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Personal Services Income

- The personal services entity has withholding obligations in respect of:
 - salary and wages promptly paid to the individual; and
 - the income that is attributed to the individual
- A simplified method allows personal service entities to pay a PAYG(W) amount based on 70% of the gross personal services income received during the payment period



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Personal Services Income

[Taxpayer Alert TA 2016/6 – Personal services income diverted to SMSF](#)

- This recent Alert warns individuals about arrangements purporting to divert personal services income (PSI) to a self-managed superannuation fund (SMSF) to avoid paying tax at personal marginal rates.

Personal Services Income & Part IVA

- Remember even if a taxpayer is exempted from the PSI regime because it is carrying on a PSI business, Part IVA is still potentially applicable.

Example

- A taxpayer who is a professional practitioner, operates via his company and earns personal services income.
- He satisfies the results test.
- He pays himself a small salary and distributes the rest of the monies to his spouse and children who are beneficiaries of the trust and on low marginal rates.
- The Commissioner considers that this arrangement is subject to challenge under Part IVA - the anti avoidance provisions.

Incorporation and the PSI Regime

Even if PSB, Part IVA can still apply to an arrangement if:

- There is a scheme;
- Entered into for a dominant purpose;
- Of deriving a tax benefit

ATO GUIDELINES - Guidelines on allocation of profits within professional firms

- The guidelines will apply if:
 - an individual professional practitioner (IPP) provides professional services to clients of the firm, or
 - is actively involved in the management of the firm and, in either case, the IPP and/or associated entities have a legal or beneficial interest in the firm,
 - the firm operates by way of a legally effective partnership, trust or company, and
 - the income of the firm is not personal services income (PSI).
- The guidelines only apply where the practice income is being generated by a business structure and does not, therefore, constitute PSI.

ATO GUIDELINES - Guidelines - allocation of profits 2017 NSW PPS within professional firms

- Taxpayers will be rated as LOW RISK, and not subject to compliance action on this issue, where their circumstances indicate they meet one of the following guidelines regarding income from the firm:
 - the IPP receives assessable income from the firm in their own hands as an appropriate return for the services they provide to the firm, and/or
 - 50% or more of the income to which the IPP and their associated entities are collectively entitled (whether directly or indirectly through interposed entities) in the relevant year is assessable in the hands of the IPP, and/or
 - the IPP, and their associated entities, both have an effective tax rate of 30% or higher on the income received from the firm.
- If guidelines not satisfied, IPP's arrangement higher risk.
- Higher risk rating, greater likelihood of ATO compliance action

PSI – Part IVA - ATO crackdown

2017 NSW PPS

- **Benchmark 1** - The IPP receives assessable income from the firm in their own hands as an appropriate return for the services they provide to the firm. In determining an appropriate level of income, the taxpayer may use the level of remuneration paid to the highest band of professional employees providing equivalent services to the firm, or if there are no such employees in the firm, comparable firms or relevant industry benchmarks, and/or
- **Benchmark 2** - 50% or more of the income to which the IPP and associated entities are collectively entitled (directly or indirectly through interposed entities) in the relevant year is assessable in the hands of the IPP, or
- **Benchmark 3** - the effective tax rate is 30% or higher on both income from the firm to which the IPP is entitled; and income from the firm to which the IPP and their associated entities are collectively entitled.

Case Study – Professional practices

- A small professional firm has two equal trustee shareholders (with representative individual professional practitioners - IPPs) and generates profits of \$400,000 for the year.
- The three highest paid professional employees at the firm earned \$90,000 each for the year.
- The IPPs at the firm bring in new clients, personally endorse the work of the employees, provide supervisory services, and represent clients in high-risk and high-value matters

Case Study – Professional practices

- The IPP 1 Trust distributes its \$200,000 as follows:
 - \$130,000 to the IPP
 - \$70,000 to IPP 1 Pty Ltd, a company owned and controlled by the spouse of IPP.
- The IPP 2 Trust distributes its \$200,000 as follows:
 - \$75,000 to the IPP
 - \$75,000 to the IPP's spouse
 - \$25,000 to IPP's adult child
 - \$25,000 to IPP 2 Pty Ltd, a company owned and controlled by the IPP's spouse.

Required – Advise whether either of the individual professional practitioners would be considered at high risk or low risk of an ATO audit based on the ATO guidelines

Case Study – Professional practices

2017 NSW PPS

- IPP 1 would be considered low risk – he satisfies both the comparable remuneration and 50% or greater distribution guidelines, even though he does not meet the 30% effective tax rate test.
- IPP 2 would be considered high risk – he does not meet any of the guidelines provided, because he does not receive comparable remuneration, or 50% or greater of the distribution and does not have an effective tax rate of 30% or greater.



NSW/ACT PUBLIC PRACTICE SYMPOSIUM 4 – 5 APR 2017

The Sebel Kirkton Park, Hunter Valley

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