VIC Tax Forum

Contractors – Income splitting, PSI and Part IVA

Presented at the Grand Hyatt Melbourne on 20-21 March 2025

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1. Overview

This paper deals with the important and topical issues of income alienation arrangements, the personal service income rules (**PSI rules**) contained in Division 84 to 86 of Part 2-42 of *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**), and the general anti-avoidance provisions contained in Part IVA of *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**).

Interest in this area has been renewed following the release of *Draft Practical Compliance Guide 2024/D2 Personal services businesses and Part IVA of the Income Tax Assessment Act 1936* (**PCG 2024/D2**) on 28 August 2024.

Broadly, PCG 2024/D2 sets out the Commissioner's view on when the ATO may have cause to apply compliance resources to consider the application of Part IVA of ITAA 1936 to an alienation arrangement where personal services income (**PSI**) of an individual is derived through a personal services entity (**PSE**) that is conducting a personal services business (**PSB**) – essentially where the Commissioner considers Part IVA could apply to alienation arrangements where the PSI rules do not apply.

In practice this area is often misunderstood. The Commissioner acknowledges as much at paragraph 5 of PCG 2024/D2:

> '*we are aware that some taxpayers incorrectly assume that where a PSB is being conducted and the provisions of Division 86 of the ITAA 1997 do not apply, that Part IVA will also not apply to their income splitting or retention of profits arrangements*.'

The aim of this paper is to work back from PCG 2024/D2, all the way to the earliest income alienation arrangement cases, and consider the legal precedents relevant to the topic to answer the fundamental question:

> ***If one of the PSB exceptions to the PSI rules apply, to what extent can a party alienate income?***

To do so, this paper considers the following:

- the scope of the PSI rules;
- PCG 2024/D2 itself;
- selected judicial cases on alienation arrangements; and
- what all this means for income splitting, PSI and Part IVA.

This paper does not consider other issues related to alienation arrangements – such as service entity arrangements, Division 7A and section 100A of the ITAA 1936.

2. The Scope of the PSI Rules

As a preliminary step to the analysis on PCG 2024/D2 and Part IVA later in this paper, it is important to set out the fundamentals of the PSI rules. This paper does not consider or make comment on the requirements of PSI or PSB in detail, however, this section contains the legislative requirements of PSI and PSB for later discussion.

2.1 Personal Services Income

The PSI rules are set out in Divisions 84 to 86 of Part 2-42 of ITAA 1997. Section 84-5 defines ‘personal services income’ (**PSI**) as follows:

> *(1) Your * ordinary income or * statutory income, or the ordinary income or statutory income of any other entity, is your personal services income if the income is mainly a reward for your personal efforts or skills (or would mainly be such a reward if it was your income).*
>
> *(2) Only individuals can have personal services income.*
>
> *(3) This section applies whether the income is for doing work or is for producing a result.*
>
> *(4) The fact that the income is payable under a contract does not stop the income being mainly a reward for your personal efforts or skills.*

Provided income meets the above requirements, for the purposes of the PSI rules, the income is PSI.

2.2 Personal Services Entity

A personal services entity (**PSE**) is a partnership, company or trust that receives the PSI of one or more individuals and is interposed between the individual(s) providing the work or services and the service acquirer.[1]

2.3 PSI derived by a PSE

Where an individual’s PSI is derived by a PSE:

- the PSI is included in the assessable income of the individual rather than the entity, unless the entity pays the income to the individual, as an employee, as salary or wages, by the specified time;[2] and
- the deductions allowable to the PSE are limited to the deductions that would be allowable to the individual in the same circumstances.[3]

[1] Subsection 86-15(2) of the ITAA 1997.
[2] Sections 86-15, 86-20 and 86-30 of the ITAA 1997.
[3] Section 86-60 of the ITAA 1997.

2.4 Personal Services Business

The PSI rules do **not** apply to PSI sourced from the conduct of a 'personal services business' (**PSB**).[4] Division 87 then goes on to define a PSB. Section 87-10 states that the object of Division 87 is to define PSBs 'in a way that ensures that it covers genuine businesses but not situations that are merely arrangements for dealing with the PSI of individuals.[5]

Section 87-15 provides that an individual or PSE conducts a PSB if:

- there is a personal services business determination for the individual or PSE in force for the relevant period; or
- the individual or PSE are able to self-assess that they conduct a PSB because:
  - the 'results test' is satisfied in relation to at least 75% of the PSI; or
  - the '80% rule' is satisfied, and one or more of the remaining PSB tests (unrelated clients test, employment test, or business premises test) are satisfied.

2.4.1 Four PSB Tests

The four PSB tests are:

- the **Results Test** under section 87-18;
- the **Unrelated Clients Test** under section 87-20;
- the **Employment Test** under section 87-25; and
- the **Business Premises Test** under section 87-30.

Results Test

An individual or PSE will satisfy the Results Test under section 87-18 if, in relation to at least 75% of the individual's PSI or, in the case of a PSE, the PSI of one or more individuals that is included in the PSE's income:[6]

- the income is for producing a result; and
- the individual or PSE provides the plant and equipment, or tools of trade needed to perform the work from which the individual or PSE produces the result; and
- the individual or PSE is, or would be, liable for the cost of rectifying any defect in the work performed.

All three limbs must be satisfied to pass the Results Test.

If the Results Test is satisfied, then the individual or PSE conducts a PSB (and there is no need to consider the remaining PSB Tests and 80% rule).

Unrelated Clients Test

An individual or PSE will satisfy the Unrelated Clients Test under section 87-20 if:[7]

[4] Section 86-15(3) of the ITAA 1997.
[5] Section 87-10 of the ITAA 1997.
[6] Section 87-18 of the ITAA 1997.
[7] Section 87-20 of the ITAA 1997.

- during the year, the individual or PSE gains or produces income from providing services to 2 or more entities that are not associates of each other, and are not associates of the individual or of the PSE; and
- the services are provided as a direct result of the individual or the PSE making offers or invitations (for example, by advertising), to the public at large or to a section of the public, to provide the services.

Employment Test

An individual or PSE will satisfy the Employment Test under section 87-25 if:[8]

- the individual or PSE engages one or more entities (other than associates of the individual that are not individuals, or in the case of PSEs, individuals whose PSI is included in the PSE's income) to perform work; and
- that entity performs, or those entities together perform, at least 20% (by market value) of the individual's principal work for that year.

Business Premises Test

An individual or PSE will satisfy the Business Premises Test under section 87-30 if, at all times during the income year, the individual or PSE maintains and uses business premises:[9]

- at which the individual or PSI mainly conducts activities from which PSI is gained or produced; and
- of which the individual or PSE has exclusive use; and
- that are physically separate from any premises that the individual or PSE, or any associate of the individual or PSE, uses for private purposes; and
- that are physically separate from the premises of the PSE to which the individual or PSE provides services and from the premises of any associate of the PSE to which the individual or PSE provides services.

2.4.2 80% Rule

If an individual or PSE does not satisfy the Results Test, then to self-assess as conducting a PSB, the individual or PSE must satisfy the 80% rule, and one or more of the remaining PSB tests set out above (i.e. the Unrelated Clients Test, Employment Test, or Business Premises Test).

Subsection 87-15(3) provides that an individual or PSE will not satisfy the 80% rule if more than 80% of the PSI is sourced from the same entity (or one entity and its associates).[10]

2.5 Satisfying the PSI Rules

Factoring in all the above, the PSI rules can therefore be satisfied by either:

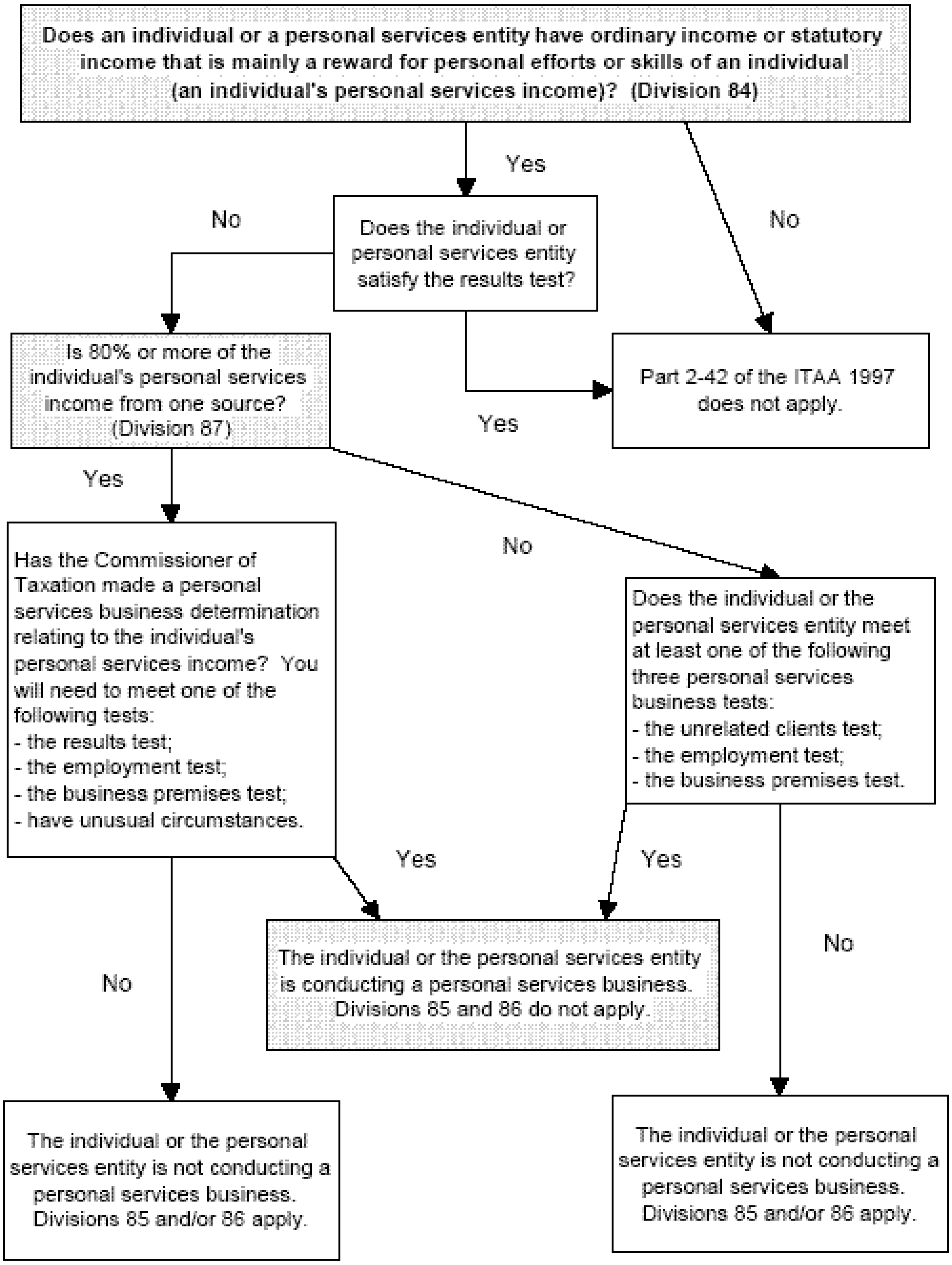
[8] Section 87-25 of the ITAA 1997.
[9] Section 87-30 of the ITAA 1997.
[10] Section 87-25 of the ITAA 1997.

1. the income not being mainly a reward for an individual's personal efforts or skills (i.e. the income isn't PSI at all) (**Category One**);

2. the income is PSI, but it is for 'producing a result' (**Category Two**); or

3. the income is PSI and is not for producing a result, however one of the Unrelated Clients Test, Employment Test or Business Premises Tests are met, plus the 80% Rule (**Category Three**).

A full flowchart of the PSI rules is contained in Paragraph 11 of Taxation Ruling TR 2003/6, and is replicated below:



3. Why were the PSI rules Introduced?

3.1 Ralph Report

In 1998, the Government commissioned the *Review of Business Taxation* that was chaired by Mr. John Ralph AO and documented in the Review's Report (**Ralph Report**).

One finding in the Ralph Report was that *"there is evidence of a significant and accelerating trend for employees to move out of a simple employment relationship to become unincorporated contractors or the owner-managers of interposed entities while not really changing the nature of the employer-employee relationship."*

This alienation of personal exertion income by interposing a company, partnership or trust between themselves and the person paying for the services presented a threat to the income tax base. These arrangements created opportunities to reduce taxation liabilities by splitting income with other individuals (such as a spouse), and claiming work-related tax deductions not otherwise available to an individual.

The Ralph Report proposed to nullify such arrangements (for taxation purposes) by treating the income earned by personal exertion as akin to employment income and taxing it on that basis. Such treatment was to apply in situations where there is a 'fundamental employer-employee relationship'.

3.2 Explanatory Memorandum

On 1 July 2000, the *New Business Tax System (Alienation of Personal Services Income) Act 2000* inserted the PSI rules contained in Part 2–42 into the ITAA 1997. The idea of the PSI rules was to codify the situations in which individuals would pay tax on their PSI, instead of the Commissioner having to apply the general anti-avoidance provisions in the taxation law on a case-by-case basis, which was seen to be 'labour intensive and an inefficient use of ATO resources.'11

From the inception of the PSI rules, the note to section 86-10 stated:

> *The general anti-avoidance provisions of Part IVA of the Income Tax Assessment Act 1936 may still apply to cases of alienation of personal services income that fall outside this Division.*[12]

The Explanatory Memorandum (**EM**) to *New Business Tax System (Alienation of Personal Services Income) Act 2000* gives an insight of parliaments intention with the PSI rules:

> ***Why is there a need for specific rules to deal with issues relating to personal services income?***
>
> *1.12 Apart from the existing general anti-avoidance provisions of Part IVA of the ITAA 1936, there are no specific rules to address the adverse revenue implications which can result when alienation occurs. The courts have held that Part IVA can be used to counter alienation practices. Applying Part IVA has to be on a case by case basis which is labour intensive and an inefficient use of ATO resources.*

[11] Explanatory Memorandum to *New Business Tax System (Alienation of Personal Services Income) Act 2000* at [1.12].
[12] Section 86-10 of the ITAA 1997.

1.13 The rules proposed, in so far as they apply to alienation practices, should produce a similar outcome as that obtained from the application of Part IVA. […]

1.14 The new arrangements will not impinge on any commercial or contractual obligations between parties affected by the measures and will not impact on genuine business undertakings. […]

[…]

1.17 This table compares key features of the income tax regime for personal services income with the existing position.

New law	*Current law*
An individual must include in his or her assessable income any income that another entity (a personal services entity) gains from the individual's personal services, unless certain exceptions apply.	*There is no equivalent specific rule in the existing law. However, case law based on the anti-avoidance provisions in Part IVA of the ITAA 1936 supports the view that personal services income paid to an entity is assessable to an individual.*
The rule above will not apply where the income is gained in the course of conducting a personal services business. A personal services business is conducted where at least one of these tests are met: *· unrelated clients test;* *· employment test; or* *· business premises test.* *However, if 80% or more of income for a particular individual's personal services comes from one source, a determination by the Commissioner is required for the income to be treated as being gained through the course of conducting a personal services business.*	*Part IVA can apply to the alienation of personal services income, irrespective of whether a personal services business exists.*
Part IVA of the ITAA 1936 will continue to have potential application if the new law does not apply. For example, where an individual's personal services income is the income of a personal services entity, which is conducting a personal services business.	*Part IVA can apply. Section 26-35 of the ITAA 1997 limits deductions for payments to associates to reasonable amounts.*

3.3 Intended to be instead of Part IVA?

There is a view that the introduction of the PSI rules altered the bounds of Part IVA (or simply covered the same arrangements as Part IVA would have covered, leaving Part IVA with little work to do).

This view is based on the position that the PSI rules are a specific anti-avoidance provision meant to attack schemes where taxpayers implemented an independent contractor structure, but in substance, there was actually an employee-like relationship. This sentiment somewhat aligns with parliament's statement in the EM that the PSI rules:

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- ‘will not impinge on any commercial or contractual obligations between parties affected by the measures and will not impact on genuine business undertakings;’ And
- “should produce a similar outcome as that obtained from the application of Part IVA”

Continuing this view, the argument is that earning PSI is essentially permitted if it was earned from a ‘genuine business undertaking’ that could satisfy one of the PSB exemptions (being Category Two and Category Three positions). In this way, by introducing the PSI rules as a specific anti-avoidance provision, it is argued that parliament’s intention was that if there was PSI, the PSB exemption tests were intended to be substantively the sole test of whether there was actually any mischief to be undone by anti-avoidance provisions – and on this basis the PSI rules act instead of, and not in addition to, Part IVA.

Challenging that view, the EM and the legislation itself make it clear that parliament always intended for Part IVA to have a residual application where the PSI rules do not apply because a PSB exemption is made out:

> *‘Part IVA of the ITAA 1936 will continue to have potential application if the new law does not apply. For example, where an individual’s personal services income is the income of a personal services entity, which is conducting a personal services business.’*

While parliament clearly intended for Part IVA to have a residual application, it is unclear in *what* situations. Was it to situations that technically satisfied the PSI rules, but in substance did not amount to a ‘genuine business undertaking?

Arguably, the PSB exemptions to the PSI rules (i.e. Category Two and Category Three positions), set the parameters of when parliament generally considered:

- on one hand, PSI to be sourced from genuine business undertakings (and therefore left alone by the PSI rules); and
- on the other hand, when it considered PSI to be sourced from an artificial and contrived structure in order to obtain a tax benefit (and therefore attacked by the PSI rules).

It could be said that had parliament intended to attack alienation of PSI arrangements that met the PSB exceptions (i.e. Category Two and Category Three positions), it would have done so by way of further specific anti-avoidance provisions. Instead, parliament was satisfied that Part IVA was able undo deal with alienation of PSI derived from PSB exceptions (i.e. Category Two and Category Three positions) in the most egregious income splitting situations. However, it is unclear if parliament envisaged Part IVA intersecting with the PSI rules in the same way the Commissioner does in PCG 2024/D2.

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4. What does PCG 2024/D2 say?

PCG 2024/D2 sets out the Commissioner's view on when the ATO may have cause to apply compliance resources to consider the application of Part IVA of ITAA 1936 to an alienation arrangement where PSI of an individual is derived through a PSE that is conducting a PSB.

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4.1 Previous ITs

PCG 2024/D2 references several ATO published materials since Taxation Ruling IT 2121 from 12 December 1984.[13] It is worth noting these ITs (all published between 12 December 1984 and 20 June 1991) have not been withdrawn, and still represent the Commissioner's current views on alienation arrangements.

The Commissioner's release of these ITs was generally in response to judicial cases that considered the application of the general anti avoidance regime (being the predecessor section 260 of the ITAA 1936 that applied for arrangements entered into before 27 May 1981, and Part IVA for any arrangements thereafter) to alienation arrangements.[14]

The next sections of this paper will look at those judicial cases in more detail, however the ITs themselves are beyond the scope of this paper.

4.2 Status of PCG 2024/D2

Off the bat, there are some important points to make:

- PCG 2024/D2 is not law. It is a guideline designed for the ATO to make resource allocation decisions. The Commissioner's own PCG on PCGs (*PCG 2016/1 Practical Compliance Guidelines: purpose, nature and role in ATO's public advice and guidance* (**PCG 2016/1**)) states that PCGs are designed to enable taxpayers to position themselves to be low risk and unlikely to require scrutiny – to safely 'swim between the flags';
- one clear objective of PCG 2024/D2 is to make clear the Commissioner's view that Part IVA can still apply even where a PSB is being conducted and the PSI rules do not apply; and
- PCG 2024/D2 was released on 28 August 2024 and is currently in draft.[15] Although, experience with other recent draft PCGs suggests the finalised version of the guidance is unlikely to be fundamentally different from the draft version.

With that in mind, the PCG 2024/D2 provides useful practical insights into the ATO's current approach to income splitting, PSI and Part IVA.

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[13] *Taxation Ruling IT 2121 Income tax: family companies and trusts in relation to income from personal exertion*, *Taxation Ruling IT 2330 Income tax: Income Splitting, Taxation Ruling IT 2503 Income tax: Incorporation of medical and other professional practices, Taxation Ruling IT 2639 Income tax: personal services income, Taxation Ruling TR 2003/6 Income tax: attribution of personal services income, Taxation Ruling TR 2022/3 Income tax: personal services income and personal service businesses.*

[14] For example, IT 2121 itself was published in light of the decision of the Federal Court of Australia of *Tupicoff v Federal Commissioner of Taxation* [1984] FCA 382.

[15] Expected completion according to ATO's advice under development site is 'to be advised'.

4.3 Who does PCG 2024/D2 apply to?

PCG 2024/D2 applies to alienation arrangements with derivation of PSI through a PSE that is conducting a PSB (i.e. Category Two and Category Three – referred to in part 2.5).[16]

Importantly PCG 2024/D2 does not apply to arrangements where the income of the PSE is not PSI (i.e. Category One – referred to in part 2.5). That is, income mainly generated from the supply and sale of goods, the supply and use of income producing assets (i.e. rent, interest, or capital gains), or from the business structure of the interposed entity.[17] Generally, the ATO acknowledges income splitting of property of businesses where the owner is not selling their personal services.[18]

It is crucial that practitioners and advisors consider the business structure and source of the income flowing through that structure. If the income is either not PSI, or not sourced from the conduct of a PSB, the PCG 2024/D2 does not apply.

4.4 What does PCG 2024/D2 say?

The ATO's long-standing view is the Part IVA has the residual application to income splitting and retention of profits arrangements. PCG 2024/2 explicitly references the note to section 86-10 of the ITAA 1997 stating that Part IVA may still apply to alienation of PSI that falls outside Division 86. As a matter of mechanics, the exemption at subsection 86-15(3) of the ITAA 1997 means that PSI sourced from a PSB falls outside Division 86.

The PCG says based on judicial cases, a scheme where there is a dominant purpose to obtain a tax benefit by alienating PSI (one of the requirements of Part IVA), is likely to include some or all of the following:

- *the use of a PSE as a vehicle that is contractually engaged by the engaging entity to supply the personal services of the individual to the engaging entity*
- *the amount of the distributions paid by the PSE to the individual being less than the amount of the income derived through the PSE from the provision of personal services of the individual*
- *the PSI is distributed in part or in full to one or more associates of the individual who pay tax at a lower rate than if the individual had received the PSI.*[19]

To that end, PCG 2024/D2 provides the following non-exhaustive 'low risk' and 'high risk' indicators that the ATO considers 'may' contribute to potential Part IVA implications for alienation arrangements:[20]

Low-risk Indicator	***Higher-risk Indicator***
The net PSI is distributed to the individual whose personal efforts or skills generated the income and taxed at their marginal rate.	*The net PSI is distributed to another entity so that it is taxed at an overall lower rate than if the individual had received the income directly.*

[16] PCG 2024/D2 at [13].
[17] Ibid at [14].
[18] IT 2330, and *Deputy FCT v Purcell* [1921] HCA 59.
[19] Ibid at [25].
[20] Ibid at [35].

Low-risk Indicator	***Higher-risk Indicator***
The remuneration received by the individual is substantially commensurate with the value of their personal services.	*The remuneration received by the individual is less than commensurate with the value of their personal services.*
Remuneration (for example, salary or wages) is paid to an associate (or a service trust or company) for bona fide services related to the earning of the PSI if that amount is reasonable for the services provided by them.	*The PSB does not distribute any income to the individual who provided the actual services.*
There is a timing difference between the earning of the PSI and the distribution of net PSI to the individual for reasons outside the control of the individual and PSB or where the delay can be explained by circumstances not attributable to tax. (Temporary Deferral)	*The net PSI (or a part thereof) is split with an associate of the individual, thereby reducing the overall income tax liability.*
The PSB makes a superannuation contribution on behalf of the individual, who is an employee of the PSB, for the purpose of providing a superannuation benefit.	*Remuneration is paid to an associate (or a service trust) that is not commensurate with the skills exercised or services provided by the associate.*
There is a temporary retention of profits to acquire an asset for a clear commercial purpose.	*The net PSI (or a part thereof) is retained in the PSB. In most cases, the retained funds are subsequently made available to the individual for their personal use (for example, via a complying Division 7A loan), however, the mere fact that PSI is retained is a sufficiently higher-risk indicator.*

In the next paragraph of PCG 2024/D2 it is stated that the guidance ‘does not establish an acceptable level of income splitting, although ‘the degree to which PSI has been diverted away from the individual is a relevant factor in considering the application of Part IVA, and whether the dominant purpose of the taxpayer in entering into the arrangement is to obtain a tax benefit.’[21]

4.5 Examples

PCG 2024/D2 provides six ‘low-risk arrangements’ and seven ‘higher-risk arrangements.’ The below is an excerpt of some of these examples:

4.5.1 “Steady Eddy” – Eddy the Accountant (low-risk)

The first example is Eddy the Accountant:

[21] Ibid at [36].

Example 1 – interposed trust, no inappropriate diversion or retention of income

44. Eddy is an accountant who provides his personal services through a family trust, Eddy's Accounting Practice (the Trust). Eddy is also the sole director and shareholder of Eddy Accounts Pty Ltd (EA), which he set up to be the corporate trustee of the Trust. EA employs Eddy to provide accounting services. The beneficiaries of the Trust are Eddy, his wife and 2 school-aged children.

45. EA (in its capacity as trustee) enters into contracts with unrelated clients for Eddy's personal services. No services are provided by any other beneficiary. EA employs Maggie who is an associate of Eddy. Maggie provides administrative services under the contracts but does not perform any principal work.[36] The Trust has no substantial income-producing assets or other employees. The Trust is a PSE because its income includes the PSI of Eddy, the individual who does the work.

[36] A reference in this Guideline to 'principal work' means work carried out by an individual (or PSE) that is central to meeting the obligations under the contract with the service acquirer. Principal work does not include associated clerical or administrative work (such as bookkeeping and answering phones) unless the principal work is administrative in nature. See paragraph 26 of TR 2022/3.

46. For the income year, the Trust self-assesses as a PSB because it meets one of the PSB tests and accordingly determines that the PSI rules do not apply to Eddy's PSI. EA pays Eddy a fixed salary which is less than the fee income received for his services and withholds tax and superannuation from those salary payments. Maggie is remunerated for her work in accordance with the relevant State Award. After claiming allowable business deductions, EA distributes the balance of the Trust's net income to Eddy and remits the prescribed amount of superannuation to his superannuation fund and the associated withholding amount to the ATO.

47. This is a low-risk arrangement in the relevant income year because the entire net PSI received by the Trust has been included as assessable income in Eddy's individual tax return through the salary paid by the Trust and the trust distribution to Eddy.

Example 1 overall adds almost zero value. Where all the income is assessed to Eddy personally (whether as a salary or trust distribution), there is no income alienation and no tax benefit in the first place. Further, Example 1 overlooks the reality that practices such as Eddy’s will commonly involve significant outsourcing / contracting in respect of ‘principal work’.

4.5.2 Tran the Solicitor (low-risk)

The next noteworthy example is Tran the Solicitor:

Example 4 – interposed company, temporary deferral of tax

61. Tran is a solicitor who provides his personal services through his company, Tran Prac Pty Ltd (TP), of which he is the sole director. The shareholder of TP is the TRN Family Discretionary Trust whose beneficiaries include Tran, his parents and daughter.

62. TP employs Tran to provide his services as a solicitor and enters into contracts with clients to provide Tran's personal services. All principal work is performed by Tran *and there are no substantial income-producing assets or other employees. TP is a PSE because its income includes the PSI of Tran, the individual who does the work.*

63. During each year, TP pays Tran a salary, and in the lead up to 30 June Tran undertakes an analysis of profits generated through his practice, which identifies an annual bonus amount equal to the profits generated. This amount is calculated and paid to Tran prior to 30 June each year, with appropriate withholding and superannuation payments made by TP. The company self-assesses as a PSB because it meets one of the PSB tests and accordingly determines that the PSI rules do not apply to Tran's PSI. In these circumstances, Tran is at low risk of us having cause to apply compliance resources to review his affairs as the entire net PSI derived by TP has been included in Tran's individual tax return each year.

64. However, in May 2021, Tran undergoes a serious medical procedure that requires a lengthy recovery period. This means he is unable to do any client work or complete administrative requirements, including profit analysis for TP before the end of the income year. In July, when Tran recovers, he undertakes the relevant calculation for the year ended 30 June and directs TP to pay out the profit amount as a bonus to himself by 30 July 2021. For the 2021–22 and subsequent income years, TP resumes its normal profit analysis and distribution pattern. This circumstance results in 2 bonus payments being reported in Tran's 2021–22 individual tax return.

65. This is considered a low-risk arrangement in the relevant income year because the deferral of income derived in the 2021–22 income year was temporary and clearly driven by factors outside the control of the taxpayer. Further, the normal pattern of behaviour resumed in the following years, demonstrating the timing difference was an isolated occurrence.

Tran, like Eddy, passes the PSI tests with flying colours (likely through the unrelated clients test). On the basis that TP has a widespread client base, Tran appears to be conducting a ‘genuine business undertaking’.

Further, Tran has chosen to conduct that genuine business undertaking via TP and the TRN Family Discretionary Trust. What is the benefit / rationale of Tran establishing the TRN Family Discretionary Trust as the shareholder of TP if no income flows to the TRN Family Discretionary Trust from TP because profit is paid to Tran as a bonus?

4.5.3 Hayley the Doctor (low-risk)

The final noteworthy low risk example is Hayley the specialist medical practitioner:

Example 6 – interposed company, retention of profits for commercial purpose

71. Hayley is a specialist medical practitioner, who provides her services to clients through Hayley Medical Pty Ltd (Hayley Medical). She is the sole director and shareholder of the company.

72. Hayley Medical enters into contracts with clients for Hayley's personal services and she performs all principal work under these contracts. Hayley Medical has no substantial income-producing assets or other employees. The income Hayley Medical earns under the contracts is mainly a reward for the personal efforts and skills of

Hayley and is therefore Hayley's PSI. The company is a PSE because its income comprises the PSI of Hayley.

73. For this income year, Hayley Medical self-assesses as a PSB because it meets one of the PSB tests and accordingly determines that the PSI rules do not apply to Hayley's PSI.

74. In each year that it has operated, Hayley Medical has generated profits of over $250,000. During this time, Hayley Medical has paid 100% of the profits of the business to Hayley as either salary, bonuses[37], or directors fees, and each year Hayley has included those amounts in her assessable income.

[37] It is important to note that Hayley Medical has PAYG withholding obligations in relation to any salary, wages or bonuses paid to Hayley. If Hayley Medical does not comply with those obligations, it may be liable for a penalty for failure to withhold or pay a PAYG withholding amount when required.

75. During the 2022–23 income year, Hayley Medical identifies an opportunity to purchase a customer relationship management platform (CRM) that will enable Hayley to provide more efficient personal services to clients. The estimated cost of the equipment is $7,000.

76. To fund the purchase, Hayley Medical retains $7,000 of profits derived from Hayley's personal services in the 2022–23 income year instead of paying the amount to Hayley. The acquisition is made in August of the 2023–24 income year. Due to a sale offer, the purchase price of the CRM is $5,000, rather than the provisioned $7,000. Hayley Medical resolves to pay the $2,000 saving as a bonus to Hayley, with the payment made one week later.

77. This is considered a low-risk arrangement in the relevant income year because the temporary retention of profits to acquire the asset has a clear commercial purpose, being the potential for Hayley to charge more for her personal services, take on more clients, and thereby increase future profits. At the time of retention, the purchase of the equipment was seriously contemplated with the purchase finalised shortly thereafter. Further, the deferral of tax relating to the $2,000 saving was temporary with the prompt payment to Hayley indicating that there was no ongoing tax deferral strategy in place.

In respect of the principle – the decision to retain funds in a corporate to ‘grow the business’ should never be something even close to Part IVA.

The retained amount ($7,000) represents less than 3% of the profits generated by Hayley Medical, and the leftover amount ($2,000) represents less than 1% of the profits generated by Hayley Medical. The example would be better served with more material figures.

To what extent does Hayley’s ‘serious’ contemplation need to be documented for the ATO to be satisfied there was no ongoing tax deferral strategy in place? And where does this leave genuine business decisions to retain profits in a company for unforeseen and unplanned expenses, or retaining cash if the nature of the work undertaken means cash flows are uncertain mistimed with the income year? What if Hayley said that $2,000 was going to be used for working capital to meet other genuine business expenses?

4.5.4 Kelly the Broker (higher-risk)

The examples then move into 'higher risk' with Kelly the broker:

Example 7 – interposed trust, income splitting arrangement

78. Kelly is a broker who previously provided her personal services as a sole trader. During this time, Kelly was found personally liable for defaults of her clients and having made good those defaults, resolves to no longer carry on her business in her own right.

79. Kelly establishes a discretionary trust, the Kelly Trust, through which she will provide her personal services going forward. Beneficiaries of the Kelly Trust include Kelly, her de facto partner, and a family trust (KLY Family Trust) controlled by Kelly. A private company, FTK Pty Ltd (FTK), is also established to act as corporate trustee of the Kelly Trust. FTK (in its capacity as trustee) enters into new agreements with each of Kelly's previous clients for her personal services and all principal work is done by Kelly. FTK also enters into a contract with Kelly for the provision of her services.

80. The Kelly Trust does not have any substantial income-producing assets or employees and depends upon the rendering of Kelly's personal services to generate income. The Kelly Trust is a PSE because its income includes the PSI of Kelly, the individual who performs the principal work.

81. In the income year, a self-assessment determines that the Kelly Trust is a PSB because it meets one of the PSB tests and accordingly the PSI rules do not apply to Kelly's PSI. FTK does not remunerate Kelly for her personal services and resolves to distribute the trust's net income to Kelly and KLY Family Trust in equal amounts. The KLY Family Trust (of which Kelly, her partner and their 2 adult children are beneficiaries) subsequently resolve to distribute its net income to Kelly and the children. Kelly and the children pay tax on their respective trust distributions at their marginal tax rates.

82. The amounts Kelly receives as trust distributions from the Kelly Trust and KLY Family Trust are not commensurate with the value of the personal services that Kelly provided.

83. In this example, although entities have been interposed between Kelly and the clients for clearly commercial purposes – to limit personal liability, Kelly has utilised the interposed entities to distribute Kelly Trust's net income (the net PSI) without regard to the value of her personal services which generated the income.

84. The total amount of tax paid between Kelly and the other beneficiaries is less than would have been paid if Kelly had returned the entire net PSI in her individual tax return. The splitting of Kelly's PSI with an associate, being the KLY Family Trust (and ultimately her 2 adult children) results, overall, in less tax being paid, which is a tax benefit.

85. This example involves the splitting of an individual's PSI and is therefore considered a higher-risk arrangement that brings Part IVA into question. This means that we are more likely to have cause to apply compliance resources to review this arrangement, including a consideration of whether Part IVA should apply.

Example 7 has some similar facts as the case of *Mochkin* (see below). However, the important distinction is that the Kelly Trust 'not have any substantial income-producing assets or employees' (the significance of this will become apparent in the part on *Mochkin*).

The PCG acknowledges that Kelly has restructured for 'clearly commercial purposes', but nevertheless considers this as high risk for Part IVA due to the Kelly Trust making distributions of income 'without regard to the value of Kelly's

4.5.5 Chester the Consultant (higher-risk)

The next significant example is Chester the corporate consultant:

> ***Example 8 – interposed company, retention of profits arrangement***
>
> *86. Chester is a corporate consultant who has provided his personal services to unrelated corporate clients, Company X, Company Y and Company Z, since 2018. In each income year, Chester receives a combined total of approximately $400,000 under contracts with these clients for his services.*
>
> *87. At the beginning of 2023, Chester meets with his accountant to get advice on how to minimise the tax he must pay. Following this advice, at the beginning of the 2022–23 income year, Chester sets up a private company, Consult Chester Pty Ltd (CC), through which he will provide his personal services going forward. Chester is the sole director of CC, and the shareholder is a corporate trustee of a discretionary trust controlled by Chester.*
>
> *88. CC enters into new agreements with Companys X, Y and Z, under which CC agrees to provide Chester's personal services. CC also enters a contract with Chester for the provision of his services to CC. The income CC earns under the contracts is mainly a reward for Chester's personal efforts and skills and is therefore his PSI. CC has no substantial income-producing assets or employees and is therefore a PSE because its income comprises the PSI of Chester.*
>
> *89. During the 2022–23 income year, CC self-assesses as a PSB as it meets one of the PSB tests and accordingly determines that the PSI rules do not apply to Chester's PSI. CC pays Chester $20,000 for his services, an amount that is less than the income it receives for his personal services and which is not commensurate with the value of the services he provided. The net profit is retained by CC and Chester borrows this money from CC on Division 7A compliant terms for his private purposes.*
>
> *90. In this example, the use of the interposed entity does not provide Chester with any additional material commercial or practical benefit as compared to the previous arrangement whereby he was paid directly by clients for services provided. Absent the arrangement, Chester might reasonably have been expected to have continued to personally derive the income from his services. By interposing CC, Chester did not include amounts which would have otherwise been included in his assessable income. The retention of profits in CC results, overall, in less tax being paid, which is a tax benefit.*
>
> *91. This example involves the retention of a significant part of an individual's PSI in a lower-taxed entity and is therefore considered a higher-risk arrangement that brings Part IVA into question. This means that we are more likely to have cause to apply*

compliance resources to reviewing this arrangement, including a consideration of whether Part IVA should apply.

92. *By way of variation, had CC paid Chester an amount that represented a significant part of the PSI derived, for example $380,000, then although Part IVA could still apply, we would be less likely to have cause to apply compliance resources to pursuing Part IVA based on the relative materiality of income retained in the lower-taxed entity. In this example, the taxpayer would be provided with education regarding their compliance obligations and should expect monitoring to ensure future compliance.*

Example 8 has a clear change in business structure for Chester, together with almost the entire amount of income being used for private purposes. Example 8 begins to move into more aggressive income splitting territory.

The examples point about relative materiality is interesting (i.e. if the amount of income being alienated was $20,000). Given the comment, some sort of general materiality threshold in the finalised PCG would be beneficial. Presumably this concept would also apply to Hayley from Example 6.

A final point of interest is the interaction between Division 7A (applying to the arrangements) and an application of Part IVA. Would the 'tax benefit' be reduced by virtue of the interest that Chester needs to pay to CC?

4.5.6 Diana the IT Consultant (higher-risk)

The final significant example is Diana the IT consultant:

Example 9 – interposed company, retention of profit without commercial purpose

93. *Diana is an IT consultant who is employed by JDIT Pty Ltd (JDIT), a private company owned and controlled by Diana and her husband, Joe. Diana and Joe are employees of the company, with Joe undertaking small amounts of administrative work one day a month for a fixed salary. He has other employment income of $174,000 a year from an unrelated employer.*

94. *JDIT enters into contracts with 5 clients to provide Diana's consultancy services and all principal work is performed by Diana. The company does not have any substantial income-producing assets or other employees. The income received by JDIT under contracts is mainly a reward for Diana's personal efforts and skills and is therefore her PSI.*

95. *For each income year, the company self-assesses as a PSB as it meets one of the PSB tests and accordingly determines that the PSI rules do not apply to Diana's PSI.*

96. *Due to the nature of the IT consulting services Diana provides to clients, she must have access to the latest computer software and hardware (IT equipment). The IT equipment that Diana uses is owned by JDIT, and JDIT incurs capital expenditure of $12,000 every 2 years on equipment upgrades.*

97. *In each income year, JDIT receives between $350,000 and $400,000 from contracts for Diana's personal services. Diana is paid a salary of $80,000 which is not*

commensurate with the value of the services she provided. Joe is paid a salary of $5,000 which represents a market value salary for his administrative services. JDIT always retains any remaining profit and invests it in a share portfolio. JDIT has not distributed profits in any year. Diana and Joe live off their respective employment incomes.

98. Although JDIT incurs capital expenditure in upgrading the IT equipment, this simply means that it must retain at least the after-tax cost of the equipment every 2 years. However, the fact that JDIT incurs this expenditure cannot explain the overall scheme as having a non-tax purpose because the amount JDIT retains each year is significantly more than what is needed to fund the IT equipment upgrades.

99. The total amount of tax paid between JDIT, Diana and Joe is less than what would have been paid if Diana had returned the entire net PSI from her personal effort and skills in her individual tax return. The retention of profit in JDIT results, overall, in less tax being paid, which is a tax benefit.

100. This example involves the retention of profits in a lower-taxed PSB and is therefore considered a higher-risk arrangement that brings Part IVA into question. This means that we are more likely to have cause to apply compliance resources to reviewing this arrangement, including a consideration of whether Part IVA should apply.

This example is the foil of Hayley the Doctor in Example 6. The example is interesting in the sense that profits taxed at the corporate rate are not being used for personal purposes (unlike Example 8) and JDIT's operations require some recurring expenditure on equipment.

4.5.7 Takeaways for taxpayers

While these examples can be useful for taxpayers and their advisers (and the ATO advises the list is designed to be 'non-exhaustive'), PCG 2024/D2 is limited by what common business features the examples <u>do not</u> consider:

- no examples consider material income producing assets in the business structure; and
- no examples consider other employees performing principal work (examples 1, 2, and 9 have employees providing administrative services, and example 13 has employees selling goods only).

In this way, PCG 2024/D2 does not really assist taxpayers with more advanced businesses beyond simple single person operations. At least from an ATO guidance perspective, taxpayers and their advisers remain somewhat in the dark on the potential application of Part IVA if they have a mix of PSI, and income sourced from substantial income producing assets or income sourced from employees performing principal work (i.e. a mix of potentially Category One, Two and Three positions for satisfying the PSI rules). Now is an appropriate time to turn to the judicial authorities in this area in the next section.

The ATO's choice of occupation for these examples is also noteworthy, including accountant, solicitor, consultant, engineer, broker. Is the ATO signalling the types of businesses they will be targeting? Just as many other non-professional services industries (think tradespeople, physiotherapists, psychologists, etc) are likely to be subject to PCG 2024/D2 on the basis that they derive <u>PSI</u> through a <u>PSE</u> that is conducting a <u>PSB</u> (i.e. Category Two and Category Three – referred to in part 2.5). Yet, the ATO only mentions the classic professional services industries.

5. What law supports PCG 2024/D2?

PCG 2024/D2 only makes a single reference to a judicial case, *Commissioner of Taxation v Mochkin* (***Mochkin***).[22] In *Mochkin*, the Commissioner was largely unsuccessful on his Part IVA arguments with the Court finding that the dominant purpose of the relevant party to the 'scheme' was not to obtain a tax benefit.

PCG 2024/D2 refers comments made by the primary judge (Sackville J) in *Mochkin* which indicated that it was ***arguable*** the Commissioner ***could have*** been successful in the application of Part IVA had the narrower scheme have been argued, and refers to paragraph 39 of the Full Federal Court's decision. Suffice to say that basing a PCG on 'could haves' is a shaky proposition.

Paragraph 39 in its entirety is set out below:

> *The scope of the scheme as defined by the Commissioner is of considerable importance in assessing whether the primary Judge's conclusion as to the dominant purpose of the scheme was correct. The Commissioner did not suggest at the trial that he could rely, in the alternative, on a narrower scheme than the Ledger scheme. It is arguable, for example, that there was a discrete scheme commencing in 1989, whereby the Taxpayer utilised Ledger to distribute its net income as he directed, without regard to the value of the services he provided to that company. The tax benefit obtained by the Taxpayer in connection with such a scheme might have been the diversion of income that he would have derived from the services he provided to Ledger (whether by way of salary, distribution or otherwise) from himself to other beneficiaries of the No 2 Trust. The advantage from the Commissioner's perspective of a more narrowly defined scheme is, as Hely J remarked in Hart, at 4,626 [85], that:*
>
> > *"[t]he more the scheme can be confined to the essential elements by which the tax benefit is obtained, the more likely it will be that the conclusion will be drawn that the dominant purpose for a person entering into a scheme so defined was to obtain the tax benefit."*
>
> *Of course, for the Commissioner to rely on a scheme defined in this way it would have been necessary for him to show, in accordance with Peabody and Hart, that the definition was not so narrow as to deprive it of all practical meaning.*

The reference in the PCG to *Mochkin* overlooks the final part of paragraph 39. Yes, the narrower a scheme, the more likely the dominant purpose is to achieve a tax benefit. However, if the Commissioner defined the scheme in *Mochkin* more narrowly, it would have been necessary for the Commissioner to show that the definition is not so narrow as to deprive the identified scheme of all practical meaning.[23]

The identification and framing of the scheme is a fundamental aspect of Part IVA, but in any case, this finding by the Court creates an interesting proposition for the Commissioner and PCG 2024/D2 – the Commissioner formed a view on the risks of triggering Part IVA in alienation arrangements yet cites

[22] [2003] FCAFC 15.
[23] Jurisprudence regarding the 'all practical meaning' issue has evolved since Mochkin. Per *Commissioner of Taxation v Guardian AIT Pty Ltd ATF Australian Investment Trust* [2023] FCAFC 3, a scheme need not have commercial or other coherence. However, if a scheme lacks coherence, that may have implications regarding the 'purpose' of the scheme as determined under section 177D.

one paragraph of a single Part IVA case in PCG 2024/D2 (in which the Commissioner was largely unsuccessful).

Of course, the Commissioner has had some prior success undoing alienation arrangements before the PSI rules under the predecessor section 260. Although the Commissioner does not reference those cases explicitly, it is clear he has relied on these historic cases to support his position in PCG 2024/D2.

6. What do the judicial cases say?

6.1 Overview

This section considers the judicial cases that have dealt with alienation arrangements, the current Part IVA regime and predecessor section 260.

Each case turns on its facts. To understand the current position of income splitting, the PSI rules and Part IVA, this section sets out the detailed background facts and findings of the court in each case.

This section considers the following cases in depth:

- *Peate*;
- *Tupicoff*;
- *Three Doctors Case* of *Gulland, Watson* and *Pincus*; and
- *Mochkin.*

This section briefly mentions some cases relevant to alienation arrangements, but not in the context of Part IVA:

- *Phillips*;
- *Everett*; and
- *Galland*.

6.2 *Peate v Federal Commissioner Of Taxation* [1964] HCA 84

The first significant consideration of the taxation of alienation arrangements was the High Court decision of *Peate v Federal Commissioner Of Taxation* (***Peate***) handed down on 12 December 1964.[24]

The Facts

In *Peate*, eight doctors practising in partnership formed a company called A. E. Westbank Pty. Limited (**Westbank**) with the shareholding based on the profit-sharing ratio of the partnership. The eight doctors orally dissolved the partnership and agreed the outstanding fees of the medical practice should be collected by Westbank.[25] At the same time, Dr Peate and the seven other doctors all implemented a similar structure: [26]

- Dr Peate incorporated a company called W. Raleigh Pty. Limited (**Raleigh**) with the shareholders being held by, or on trust, for members of Dr Peate's family;
- Dr Peate entered into an employment agreement with Raleigh where Dr Peate provided services as a medical practitioner and acted as Raleigh's agent for a salary; and
- Raleigh entered into a services agreement with Westbank where Raleigh that Raleigh would, for a fee, arrange with Dr. Peate to serve Westbank as a medical practitioner.

[24] [1964] HCA 84.
[25] Ibid Menzies J at [4].
[26] Ibid Menzies J at [4] and [5].

The effect of the agreements was that Westbank received all patient fees paid, paid group expenses (including deductible superannuation employer contributions for the doctors), and made distributions of what remained in agreed proportions to the doctor's family companies as service fees. The doctors then returned their salary and wages paid to them as income, which was lower than the total income generated from patient fees.

The Arguments

The Commissioner sought to undo the arrangements under the predecessor section 260 on the basis that they had the purpose or effect of avoiding a liability for tax that would otherwise fall upon Dr Peate. Dr Peate proffered that there was several other purposes and effects unconnected with tax that meant the Commissioner's section 260 arguments should fail, including: the protection of individual members of the group against liability for negligence; the making of superannuation provision for employees, including doctors employed to assist the group; the better organization of the group's activities and particularly its methods of accounting; and the making of provision for the doctors' families.

The Outcome

The High Court agreed with the Commissioner and dismissed Dr Peate's appeal, with Menzies J (appearing alone) stating:

> *'The facts stated indicate this purpose and this effect, […] there is a strong prima facie case that the purpose and effect of what was done was to obtain increased tax deductions from assessable income and to divide what would otherwise have been Dr. Peate's taxable income between himself, his wife and his children.'*[27]

Windeyer J (as part of the Full High Court on appeal) made some of the earliest remarks on 'business-like' actions not necessarily being a protection from the general anti-avoidance regime:

> *'A taxpayer may legitimately regard it as a business-like action so to arrange his affairs in the interest of himself and his family as to reduce his liability for taxes. But that does not mean that whatever method he adopts to that end can itself be said to be explicable as an ordinary business or family dealing putting it outside s. 260.'*[28]

Perhaps a sign of times, given it was novel for a professional practice to be carried on by a company, Windeyer J also commented on the holistic consideration of the purpose of all entities within a business structure:

> *'It was argued that the arrangement in this case did not in one of its aspects differ essentially from the mere carrying on by a company of a trading business formerly carried on in partnership and in another aspect from the management and investment of capital assets by a private company and the distribution among shareholders of the income periodically arising. The resemblances seemed to me remote. Whatever may be said of the company, Westbank Pty. Limited separately regarded, the combined and inter-related activities and purposes of it and its companion Raleigh Pty. Limited are certainly remarkable and out of the ordinary.'*[29]

[27] Ibid Menzies J at [14].
[28] Ibid Windeyer J at [3].
[29] Ibid Windeyer J at [2].

6.3 *Tupicoff v Federal Commissioner of Taxation* [1984] FCA 382

The next foray into income splitting arrangements was the Full Court of the Federal Court in *Tupicoff v Federal Commissioner of Taxation* (***Tupicoff***) handed down on 21 November 1984.[30] It is worth noting that at the time of *Tupicoff*, the 'Three Doctors Cases' of *Gulland*, *Watson* and *Pincus* had worked its way through to the Full Court of the Federal Court (the High Court decisions for the 'Three Doctors Cases' was forthcoming, and is looked at below).

The Facts

In July 1970, Mr Tupicoff was appointed as an insurance agent acting on behalf of National Mutual Life Association of Australasia Limited (**NML**).[31] In 1977, Mr Tupicoff approached NML to vary the arrangement. Mr Tupicoff wished to resign his personal appointment, and for a corporate agent controlled by him to be appointed in his place. Following negotiations, NML agreed to the proposal. In 1979, a new company called 'Gary Tupicoff (Insurances Nominees) Pty. Ltd' (**Tupicoff Co**) was incorporated with Mr Tupicoff and his wife as directors, and a new trust called the 'Gary Tupicoff Family Trust' (**Tupicoff Family Trust**) was established with Tupicoff Co as trustee, and Mr Tupicoff, his wife, and children as beneficiaries.[32]

In a similar series of events as seen in *Peate*:

- Mr Tupicoff resigned his appointment as agent acting on behalf of NML;
- Tupicoff Co was appointed as an insurance agent acting on behalf of NML; and
- Mr Tupicoff became an employee of Tupicoff Co and provided insurance sale services for an agreed salary. [33]

The Tupicoff Family Trust had no assets, and the only income of the Tupicoff Family Trust was the commissions paid by NML (and an associated insurance seller). The Tupicoff Family Trust paid Mr Tupicoff a salary, which was lower than the income from commissions, and the remaining income was distributed by the Tupicoff Family Trust to Mr Tupicoff's wife and two children.[34]

The Arguments

The Commissioner sought to undo the arrangements under the predecessor section 260 on the basis that the transactions were a series of pre-ordained steps that had their main purpose and effect of splitting the income of Mr Tupicoff with his wife and children.[35]

Mr Tupicoff argued that while he was aware of the potential tax advantages of this re-structure, there were other significant advantages that motivated him such that the tax advantage was not his main purpose. These other advantages included: to protect and provide family assets; to provide his wife with the prospect of earning a greater income through favourable exercise by the trustee of the

[30] [1984] FCA 382.
[31] Ibid 4855.
[32] Ibid 4856 to 4857.
[33] Ibid 4858.
[34] Ibid 4859.
[35] Ibid 4861.

discretion under the proposed trust deed; and to obtain advantages of limited liability by the use of a corporate trustee.[36]

The Outcome

The Court unanimously agreed with the Commissioner and ruled the arrangements void pursuant to section 260. Beaumont J all but re-stated Wyndam J's comments in *Peate* that the taxpayer's views on their 'business' actions are not necessarily a protection from the general anti-avoidance regime:

> *'The taxpayer seeks to avoid the application of s.260 here by contending that the transactions now attacked may be explained as an "ordinary business dealing" of the kind contemplated by Newton, supra, at p.466. In my opinion, no such explanation is properly open here, any more than it was in Peate. The position may well have been different if the family trust were not part of the scheme. But, in my view, the introduction of the trust as the intended destination of income generated by the efforts of the taxpayer, robs the transactions of any commercial character. The trust, discretionary as it is, provides a strong indication that the real objective underlying entry into these transactions was that of income-splitting between the members of the taxpayer's family.'*[37]

Again, and perhaps a sign of the times where trusts had recently been targeted by the introduction of specific anti-avoidance measures (i.e. section 99B and section 100A), it is noteworthy that the Court placed great emphasis on a discretionary trust being used as the conduit to split income.

A unique aspect of *Tupicoff* compared to the other income alienation cases to that point was that Mr Tupicoff did not provide professional services. However, Beaumont J struck down any potential limitation based on the kind of personal exertion services provided:

> *In my opinion, no matter of principle turns on this distinction. Although, in Peate, Menzies, J. (at p.460) adverted to the point, it is clear that the distinction formed no part of the ratio decidendi in either the Full High Court or the Privy Council.*

6.4 'Three Doctors Case' – *Federal Commissioner of Taxation v Gulland, Watson v Federal Commissioner of Taxation, and Pincus v Federal Commissioner of Taxation* [1985] HCA 83

The 'Three Doctors Case' were three matters heard concurrently in the High Court due to the similar sets of facts and issues in contention: *Federal Commissioner of Taxation v Gulland* (***Gulland***), *Watson v Federal Commissioner of Taxation* (***Watson***), *and Pincus v Federal Commissioner of Taxation* (***Pincus***).[38]

The Facts

Dr Gulland, Dr Watson and Dr Pincus were all doctors conducting their separate medical practice as a sole trader (in the case of Dr Gulland) or in partnership with other doctors (in the case of Dr Watson and Dr Pincus) who undertook changes to their arrangements. There are differences between the

[36] Ibid 4862.
[37] Ibid 4852.
[38] [1985] HCA 83.

cases of *Gulland*, *Watson* and *Pincus,* however the series of transactions in each case are similar to one another (and, in the opinion of the Court, to *Peate*). In each case:

- between 1977 and 1979, the doctor established a unit trust with units held by the trustees of each of their individual family trusts (in the case of *Gulland* the family trust already existed for around a year,[39] but for *Watson* and *Pincus* the family trusts were newly established[40]);
- the trustee of the unit trust acquired the medical practice;
- the doctor entered into an employment agreement with the trustee of the unit trust where the doctor provided services as a medical practitioner for a salary. The agreed salary was much lower than the previous income the doctors earned as sole traders or partners in a partnership;
- the trustee of the unit trust established a superannuation fund for the benefit of the doctors;
- in the case of *Watson* and *Gulland*, the trustee of the unit trust and trustee of the family trust entered into a services agreement;
- following the payment of salary and wages to the doctor, and other practice expenses (including deductible superannuation employer contributions), income flowed to the individual family trust unitholders (either by way of service fee in the case of *Watson* and *Gulland*, or by way of distributions in the case of *Pincus*); and
- the income was then distributed by the trustee of the family trusts to the family of the doctors.

The Arguments

Although Part IVA commenced for schemes entered into after 27 May 1981, the Three Doctors Case still fell to be determined under the predecessor section 260. The Commissioner argued that the facts of *Peate* were so similar to *Gulland*, *Watson* and *Pincus*, that the doctor's arrangements in this case should be void under section 260 on the basis that the purpose and effect was to alter the incidence of income tax for each of the doctors.

As with the prior cases of *Peate* and *Tupicoff*, each of *Gulland*, *Watson* and *Pincus* advanced alternative non-tax considerations, including the establishment of a superannuation fund to which deductible employer contributions could be made by the trustee of the unit trust. In *Watson*, the taxpayer also argued that *Peate* should not apply because:

> *'the standards of ordinary and acceptable conduct have changed since [Peate] was decided two decades ago and practices then unacceptable in a profession are now tolerated for the very reason that persons engaged in a profession would otherwise be in a position of disadvantage, from a taxation point of view, when compared with tradesmen and proprietors of small businesses.'*[41]

Many taxpayers in the accounting and legal profession made the same argument after the ATO published *PCG 2021/4 Allocation of professional firm profits* (**PCG 2021/4**)!

[39] Ibid Gibbs CJ in *Gulland* at [3].
[40] Ibid Gibbs CJ in *Gulland* at [4] and [57].
[41] Ibid Gibbs CJ in *Gulland* at [11].

The Outcome

However, ultimately the High Court by majority dismissed the doctor's arguments and agreed with the Commissioner. The comments of Dawson J with respect to the arrangements in *Watson* are equally applicable across to *Gulland* and *Pincus*:

> *'It served no personal, business or professional purpose, except to the extent that the provision of superannuation benefits could be said to constitute any such purpose. And, as I have said, the provision of superannuation benefits provides no sufficient explanation of the arrangement. The practice which had formerly been the practice of the partnership continued to operate as it had previously. As the primary judge found, the only indication to patients of the existence of a trust was to be found in the account and receipt forms but even when these were received by patients it was long after the services to which they related had been provided. No limitation of liability was achieved. The employment of the doctors by themselves, albeit as trustees, could hardly be said to have wrought any discernible changes in the manner in which the practice was carried on or in the practical relationship of the doctors amongst themselves.'*[42]

This would be the final significant income alienation case considered under section 260 given the commencement of Part IVA. To ensure the treatment of alienation arrangements was consistent between section 260 and Part IVA, the Commissioner quickly published Taxation Ruling IT 2330 Income Tax: Income Splitting stating:

> *'The approach of the Commissioner to the application of Part IVA has been set out on previous occasions. Nevertheless, in the situations where the Courts have decided that section 260 operated to nullify particular income splitting arrangements for income tax purposes, it is to be expected that Part IVA would operate to cancel out any tax benefits if the case were a post-27 May 1981 one. Conversely, in the situations where an income splitting arrangement survives the operation of section 260, it may be expected that it would not be affected by Part IVA.'*[43]

Notably, in a subsequent Federal Court case considering an alienation arrangement for a land broker, *Hans Jurgen Liedig v Commissioner of Taxation* [1994] FCA 1058 (***Liedig***), Hill J made the following comments on section 260 and Part IVA:

> *'[Section] 260 applied and the more recent trilogy of cases in the High Court reported as [Gulland, Watson and Pincus] clearly indicated the application of s. 260 to the use of trusts to derive income which might ordinarily be described as "personal service or personal exertion income". ... There is no reason to doubt that Part IVA of the present Act, replacing s. 260 in respect of schemes entered into after 27 May 1981, would have the same result where, having regard to the various matters referred to in s. 177D of the Act, a conclusion would be reached that a person who entered into or carried out the scheme or any part of it did so for the purpose of enabling a taxpayer to obtain a tax benefit in connection with that scheme.'*

[42] Ibid Dawson J in *Watson* at [52].
[43] Taxation Ruling IT 2330 Income tax: Income Splitting at [41].

6.5 *Commissioner of Taxation v Mochkin* [2003] FCAFC 15

The final significant judicial case this paper considers in detail is *Mochkin*,[44] the single case referenced by the Commissioner in PCG 2024/D2. *Mochkin* dealt with income years ended 30 June 1992 to 30 June 1997, so was subject to Part IVA, but was pre-PSI rules. Unlike the judicial cases discussed above, the Commissioner was **not** wholly successful in applying the general anti-avoidance regime to an alienation arrangement.

The Facts

Mr Mochkin was a stockbroker. In 1987, Mr Mochkin entered a commission sharing arrangement with a firm of stockbrokers called, Bridges Son & Shepherd (**Bridges**). Later that year, Bridges terminated the arrangement due to a dispute about Mr Mochkin's liability for the default of Mr Mochkin's clients failing to complete share transactions.[45]

While Bridges continued litigation against Mr Mochkin personally, Mr Mochkin undertook a series of arrangements:

- in 1987, Mr Mochkin established the Mochkin Family Trust, a discretionary trust with himself, his wife, and their children as beneficiaries, and Daccar Pty Ltd (**Daccar**) as trustee;[46]
- In 1989, Mr Mochkin established the Mochkin Family (No 2) Trust, a discretionary trust with himself, his wife, and their children as beneficiaries, and Ledger Holdings Pty Ltd (**Ledger**) as trustee;[47]
- Daccar and Ledger entered into commission sharing arrangements with different stockbroking firms between 1988 and 1995;[48]
- the Mochkin Family Trust and Mochkin Family (No 2) Trust generated significant income from the commission sharing arrangements;
- Mr Mochkin only received a salary from Daccar or Ledger in one year ($80,000 in the income year ended 30 June 1990), but otherwise Mr Mochkin received a distribution from Mochkin Family (No 2) Trust only in some years. In some years, Mr Mochkin received no income at all;[49] and
- the bulk of the income was ultimately distributed to 'L & M Charitable Trust' (a charitable trust of which Mr Mochkin and his wife were trustees) or 'Tolas Oak Unit Trust' (a related unit trust that carried on a retirement centre business that had $4,000,000 of carry forward losses as at 1993). As Sackville J remarked, this pattern of distributions was very 'tax effective.'[50]

The Bridges litigation was finalised with Mr Mochkin personally making good on the defaults of his clients. After the Bridges affair, Mr Mochkin refused to conduct the stockbroking business on his own account or enter any arrangements that could cause him to be personally liable under the Daccar and Ledger commission sharing arrangements with stockbroking firms. It was clear that Mr Mochkin's prior issues with Bridges caused significant changes to Mr Mochkin's practice and risk management.

[44] [2003] FCAFC 15.
[45] Ibid at [15].
[46] Ibid at [19].
[47] Ibid at [20].
[48] Ibid at [17].
[49] Ibid at [23].
[50] Ibid at [22].

The Arguments

The Commissioner contended that Part IVA applied as follows:

- firstly, that the ongoing net brokerage commissions paid to Ledger should be included in Mr Mochkin's assessable income (**Ledger Scheme**); and
- secondly, that a one off 'finders fee' paid to Daccar by Great Central Mines NL (due to clients of Ledger taking up a placement in the mining company) should be included in Mr Mochkin's assessable income (**Daccar Scheme**).

Although the Commissioner's stated position in IT 2330 and Hill J's comments in *Liedig*, the construction of section 260 compared to Part IVA (even based solely on the structure of the Part and the words used) is plainly different. Sackville J referred to the joint judgment of the High Court in *Federal Commissioner of Taxation v Spotless Services Ltd* [1996] HCA 34 when setting out the operation of Part IVA as follows:

> *'"Pt IVA operates where*
>
> *(i) there is a 'scheme' as defined in s 177A;*
>
> *(ii) there is a 'tax benefit' which, in relation to income amounts, is identified in par (a) of s 177C(1) as an amount not included in the assessable income of the taxpayer where that amount would have been included or might reasonably be expected to have been included in that assessable income for the relevant year of income if the scheme had not been entered into or carried out;*
>
> *(iii) having regard to the eight matters identified in par (b) of s 177D, it would be concluded that there was a necessary dominant purpose of enabling the taxpayer to obtain the tax benefit; and*
>
> *(iv) the Commissioner makes a determination that the whole or part of the amount of the tax benefit is to be included in the assessable income of the taxpayer (s 177F(1)(a)). The Commissioner then 'shall take such action as he considers necessary to give effect to that determination' (s 177F(1))".'*[51]

The scheme identified by the Commissioner under the Ledger scheme was the use of Ledger to receive commissions from stockbrokers for the personal services of Mr Mochkin and the use of Mochkin Family (No 2) Trust to divert income derived from the personal exertion of Mr Mochkin to other taxpayers (including L & M Charitable Trust and Tolas Oak Unit Trust'). With respect to the dominant purpose element, the Commissioner argued:

> *'the only conclusion reasonably open was that the Taxpayer entered into the Ledger scheme for the dominant purpose of obtaining a tax benefit, namely diverting assessable income from himself to other beneficiaries under the discretionary trust. According to [the Commissioner], the scheme bore "ex facie the stamp of tax avoidance": cf Peate v Federal Commissioner of Taxation (1964) 111 CLR 443, at 469, per Kitto J.*[52]

[51] Ibid at [25].
[52] Ibid at [75].

The Outcome

The Court rejected the Commissioner's argument about Mr Mochkin's dominant purpose for the Ledger Scheme on two bases:

- unlike the taxpayers in *Tupicoff* (and *Bunting v Commissioner of Taxation* [1989] FCA 457[53] and *Case W58* 89 ATC 524[54]), Mochkin was clearly unwilling at any time after February 1988 to provide the full range of services essential to generate commission income in his own right;[55] and
- unlike the taxpayers in those cases, the income received by Daccar and Ledger was not generated <u>only</u> by the personal exertion of Mr Mochkin. Daccar and Ledger employed or acquired substantial facilities for which they paid, and the companies also utilised the services of persons other than the Mr Mochkin. [56] As remarked by Sackville J, it was 'substantially more than a one-person operation.'[57]

Sackville J's conclusion on the dominant purpose point for the Ledger Scheme helpfully sets out the requirements of a subsection 177D(b) analysis:

> *'It can readily be concluded that the Taxpayer had tax advantages in mind in choosing a discretionary tax structure as the means of carrying out the scheme. Doubtless, there were other ways in which he could have chosen to conduct the stockbroking business and to immunise himself from personal liability. But the question posed by s 177D(b) is not whether the Taxpayer could have chosen a less tax effective means of achieving his commercial objective of immunising himself from personal liability to the brokers. The question is whether, in view of the matters identified in s 177D(b) it is reasonable to conclude that the Taxpayer's ruling, prevailing or most influential purpose in entering into or carrying out the scheme was to obtain the tax benefit identified by the Commissioner.'*[58]

Ultimately, the Court found that Mr Mochkin established that a reasonable person would not conclude that he carried out the Ledger Scheme for the dominant purpose of obtaining a tax benefit. This conclusion was reached due to Mr Mochkin's change in business practice following the Bridges litigation, and Daccar and Ledger using the services of employees other than Mr Mochkin to perform work. However, for completeness, the Court held Part IVA applied in relation to the 'one off' payment under the Daccar Scheme.

The Commissioner's reference in PCG 2024/D2

As stated above, the Commissioner in PCG 2024/D2 referenced Sackville J's indication in *obiter dicta* that:

[53] A Federal Court section 260 case in favour of the Commissioner.
[54] An AAT Part IVA case in favour of the Commissioner. The taxpayer provided consulting services through a company with a discretionary trust shareholder. The Court held the taxpayer to have entered into and carried out a scheme for the purpose of obtaining a tax benefit and which did in fact produce a tax benefit and the whole of that benefit should be cancelled under sec. 177F(1).
[55] *Mochkin at* [81]
[56] Ibid at [83].
[57] Ibid at [97].
[58] Ibid at [98].

> *'it was arguable [the ATO] could have been successful in the application of Part IVA had the narrower scheme have been argued.'*[59]

To provide the Commissioner's point with full context, the totality of Sackville J's discussion on the narrower scheme in *Mochkin* is set out below:

> *39 The scope of the scheme as defined by the Commissioner is of considerable importance in assessing whether the primary Judge's conclusion as to the dominant purpose of the scheme was correct. The Commissioner did not suggest at the trial that he could rely, in the alternative, on a narrower scheme than the Ledger scheme. It is arguable, for example, that there was a discrete scheme commencing in 1989, whereby the Taxpayer utilised Ledger to distribute its net income as he directed, without regard to the value of the services he provided to that company. The tax benefit obtained by the Taxpayer in connection with such a scheme might have been the diversion of income that he would have derived from the services he provided to Ledger (whether by way of salary, distribution or otherwise) from himself to other beneficiaries of the No 2 Trust. …*
>
> *40 At one point in the argument on the appeal, Mr Maxwell* (Counsel for the Commissioner) *appeared to consider putting forward the narrower scheme as an alternative to the Ledger scheme. In the end, I did not understand him to proceed with that inchoate submission. In any event, it is plainly too late for the Commissioner to rely on an alternative scheme to the one advanced at trial. Mr de Wijn QC* (Counsel for the Taxpayer)*, who appeared with Mr Steward* (Counsel for the Taxpayer)*, asserted that had the Commissioner conducted the trial by reference to alternative versions of the scheme, the Taxpayer would have called additional evidence. Mr Maxwell did not dispute this assertion. It follows that the Taxpayer would be unfairly prejudiced if the Commissioner were permitted to change his case on the appeal so as to rely on an alternative version of the scheme.*

And then later:

> *80 The circumstances of Case W58 would be strikingly similar to the present if the Commissioner had identified a narrower scheme than the Ledger scheme, rather than the one he in fact identified (see [39]-[40] above). As I have noted, the scheme relied on by the Commissioner is said to have commenced in 1987 and to have involved the use of Daccar as the vehicle for receiving commission from the various brokers and for distributing "surplus" funds to the beneficiaries of the No 1 Trust. Ledger itself came into the picture later, as did the No 2 Trust.*

While Sackville J's comments could be interpreted as being arguable that the Commissioner could have succeeded if the narrower scheme was argued, the Commissioner's statement read alone in PCG 2024/D2 is also misleading:

- the narrower scheme was never properly argued in the primary case;
- had it been argued, the Taxpayer would have called additional evidence in relation to the narrower scheme which equally could have changed the outcome;
- the primary judge may not have changed their position on Part IVA in light of the narrower scheme; and

[59] PCG 2024/D2 at [27].

- the Court in the appeal gave no indication that it actually would have changed the outcome of the Part IVA arguments, but rather only focussed on some factors in the Part IVA analysis it may have influenced.

Plainly, the Commissioner has never been successful in a judicial case applying Part IVA to an alienation arrangement where PSI of an individual is derived through a PSE that is conducting a PSB. Yet, the Commissioner appears to rely on Sackville J's comments in *obiter dicta* that are tainted with 'could haves' and 'would haves' to support his position in PCG 2024/D2.

6.6 Other notable cases

The following cases, while not explicitly related to PSI rules, are important to the current position on the alienation of income and Part IVA.

6.6.1 *Federal Commissioner of Taxation v Phillips* [1978] FCA 28

The Full Court of the Federal Court in *Federal Commissioner of Taxation v Phillips* [1978] FCA 28 (***Phillips***) approved the use of associated service trusts by professional entities where the Commissioner sought to disallow the deduction, or alternatively, undo the arrangement under section 260.

An accounting firm in partnership established a service trust to employ non-professional staff and provide equipment and other essential services to the accounting firm. The accounting firm paid a fee to the service trust equal to the costs of the service trust, plus a markup at commercially realistic rates. The Court held that the amounts paid by the partnership to the service trust were deductible because the mark-up represented a reasonable commercial rate for the provision of the services provided by the trust.

The Commissioner acknowledged the deductibility of payments in service entity arrangements, consistent with the *Phillips* decision in Taxation Ruling IT 276 released on 27 September 1978, which was supplemented by Taxation Ruling TR 2006/2 on 20 April 2006.

6.6.2 *Federal Commissioner of Taxation v Everett* [1980] HCA 6

The High Court in *Federal Commissioner of Taxation v Everett* [1980] HCA 6 (***Everett***) approved the assignment of a partner's interest in a partnership to another entity that is subject to a lower tax rate.

Mr Everett assigned part of his interest in the partnership (that carried on a law firm) to his wife. The High Court held that section 260 did not apply, and the assignment was effective to make Mr Evertt's wife taxable on the partnership profits attributable to the assigned interest and to relieve Mr Everett from liability to tax on that same amount.

6.6.3 *Federal Commissioner of Taxation v Galland* [1986] HCA 83

In a similar vein as *Everett*, the High Court in *Federal Commissioner of Taxation v Galland* [1986] HCA 83 (***Galland***) approved the assignment of a partner's interest to a family discretionary trust.

The High Court held the assignment was effective, despite Mr Galland controlling the corporate trustee of the family discretionary trust, and being a potential beneficiary of the same.

The Commissioner acknowledged that valid assignments of partnership interests consistent with the *Everett* and *Galland* decisions are accepted for tax purposes and are not considered to be caught by anti-avoidance provisions in Taxation Ruling IT 2501 on 27 October 1988.

7. The Current Landscape

Now returning to the initial question posed in this paper, if one of the PSB exceptions to the PSI rules apply, to what extent can a party alienate income before there is a risk that the Commissioner will apply Part IVA?

The jury is out.

As a preliminary point, it is abundantly clear that Part IVA is not somehow switched off by the PSI rules. Part IVA does have a residual application when one of the PSB exceptions apply. The note to section 86-10 of the ITAA 1997, parliament's clear stated intention in the EM introducing the PSI rules, and the construction of both the PSI rules and Part IVA, mean no other conclusion can reasonably be reached. As the law is written, the PSI rules are a specific anti-avoidance provision, while Part IVA acts as the 'umbrella' catch-all general anti-avoidance provision.

Have the PSI rules actually codified a simplified approach to alienation arrangements if Part IVA can apply when one of PSB exceptions anyway? In light of PCG 2024/D2, probably not.

Sadly, neither the judicial cases nor the ATO guidance give a magic number for an acceptable level of income splitting. However, the Commissioner in PCG 2024/D2 identifies any situation where '*the remuneration received by the individual is less than commensurate with the value of their personal services*' as a high-risk indicator of the potential application of Part IVA. As seen in *Mochkin*, the 'value' of someone's personal service can be an elusive concept in business structures that go beyond a simple one-person operation, with income producing property and others performing principal work. What is the value of someone's personal services? Is the Commissioners view that the value of someone's personal services is simply what income comes in?

The common thread of the judicial cases where arrangements were undone under the previous section 260 was a significant change in the business structure, but no significant change to the operation of the business (i.e. *Peate*, *Tupicoff* and the *Three Doctors Case*). This very clear 'before' and 'after' analysis has always been a risk point under the general anti-avoidance regime. But it is unclear where this leaves taxpayers who **start** with these kind of business structures from the outset.

It is worth asking, which of the high-risk examples actually run the risk of a successful Part IVA challenge? Of course, that would require a full analysis of Part IVA that just isn't in PCG 2024/D2.

The Commissioner was unsuccessful in *Mochkin*, and the recent cases of *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 and *Mylan Australia Holding Pty Ltd v Commissioner of Taxation (No 2)* [2024] FCA 253 show the technical difficulty for the Commissioner to apply Part IVA when the surrounding context of a transaction or transactions has a sound commercial basis. Unfortunately, the case-by-case nature of Part IVA means there is no simple answer that can apply for everyone.

Unfortunately, this leaves taxpayers (in reality, their advisors) in a position where they must engage with the complex (requiring an in-depth knowledge of Part IVA and likely a legal background) or 'swim between the flags'.

The Commissioner has expanded the role of PCGs in recent times to set what it considers high risk and low risk arrangements (see *PCG 2022/2 Section 100A Reimbursement Agreements*, *PCG 2021/4*, and *PCG 2024/3 Section 99B of the Income Tax Assessment Act 1936 - ATO compliance approach*). The Commissioner's own PCG on PCGs (*PCG 2016/1 Practical Compliance Guidelines: purpose, nature and role in ATO's public advice and guidance*) states that PCGs are designed to enable taxpayers to position themselves to be low risk and unlikely to require scrutiny – to safely ‘swim between the flags.’

So, to answer the question posed, this leaves taxpayers (in reality, their advisors) in a position where they must either engage with the complex (requiring an in-depth knowledge of Part IVA, a legal background and at least some appetite for risk) or ‘swim between the flags’.

The time, energy and cost of being subject to an ATO review or investigation lends itself to trying to stay out of the spotlight. This strategy may be preferable for some taxpayers, but no doubt, not others. For the latter group of taxpayers, while each case runs on its facts, the body of judicial cases suggests prosecuting a successful Part IVA argument in alienation arrangements may not be as easy as the Commissioner makes out in PCG 2024/D2.

8. Acknowledgments

The author would like to thank Tyson Bateman for his assistance with the research and drafting of this paper. All errors are my own.