Tax Clarity for Small Business Contractors

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This information is for you if you run your own small business (and you are not an employee) and you are concerned with how tax rules may affect your access to business style tax treatment or your ability to claim business expenses. These tax rules may affect your ability to:

- Claim business expenses as deductions from income tax
- 'Split' pre-tax income with someone else; or
- Retain pre-tax income in your business.

It is important that you have an understanding of the basic tax rules so that you can conduct your commercial activities with reasonable certainty and avoid potential tax penalties if you are unaware of the law.

- **Overview & Background**

Tax rules aim to ensure that all people pay their rightful amount of tax. Historically most individuals have earned their income as employees and are taxed as employees. The differences between employees and businesses are generally clear. In the 1980s and 1990s, however, many people stopped being employees and became small businesses, either working on their own or with a small number of other people. This trend away from employment to small business-independent contracting blurred the line between business tax treatment and employee tax treatment. The blurring appeared to enable some people to pay less tax than other people.

In 2001–02 the tax rules were changed to clarify and create higher levels of certainty in tax treatment for people who earn their income as a small business. This new level of clarity hinges around three tax categories/definitions that are summarised in this publication. The 'business' categories are tax specific.

There are, however, still some areas of uncertainty that the new tax rules could not fix, and that are going through a process of clarification before the courts.

The information provided here is aimed at helping you understand those areas that are straightforward and areas where you need to exercise greater care. Also, be aware that the general anti-avoidance laws prevent you from doing things you would not normally do, just to avoid tax.

2. Tax Categories

As a small business/independent contractor you can work as an individual or through an entity structure---a partnership, trust or company.

Whichever way you work, you will fall into one of three broad tax categories and your tax treatment will be different. The three possible tax categories are:

Business	Personal Services Business	Personal Services Income Earner
Your income is not generated mainly by your personal efforts or skills. It is generated mainly by the sale of goods or through the business structure that you operate..	Your income is mainly generated by your own personal efforts or skills and you are able to pass one of the four personal services business (PSB) tests contained in new tax legislation.	You are not an employee, however your income is mainly generated by your personal efforts or skills and you are unable to pass one of the PSB tests.

3. Which Tax Category Applies To You?

You will need to consider carefully which of these categories applies to you. There are reasonably clear rules, but you need to consider how these fit your own individual circumstances. Some guidance is provided below, along with an indication of where you can find further information.

Business
The Tax Office places you in this category if your income is generated mainly from: (a) The sale of goods <u>or</u> (b) The operations of a business structure It should be relatively clear whether you fall into the first part of this category. It is more difficult to decide if your income is from a business structure. The concept of a business structure for Tax Office assessment purposes comes from cases decided over the years by the courts. An assessment will depend on your individual circumstances. Factors indicating a business structure include: a) Ownership of significant business assets used to generate income---such as a bulldozer, or delivery van operated by a courier driver b) Arm's length workers are engaged to perform a significant portion of the work c) The existence of saleable goodwill in the business d) The size of your operations---the larger it is, the more likely it is to derive income from a business structure.

Personal Services Business
This is where the income earned is mainly through your <u>personal</u> efforts or skills. To fall into this category you need to pass just one of 4 tests contained in the personal services income legislation. The tests are: a) Results test : you can always self-assess this b) Unrelated clients test: to self-assess, no more than 80% of your income should come from one source c) Employment test: same as b d) Business premises test: same as b. You can self-assess (as shown above) or make application to the Tax Office so they can provide a ruling on whether you meet any of the tests.

Personal Services Income Earner
This is also where the income earned is mainly through your personal efforts or skills. You are, however, unable to pass one of the PSB tests and so you are not running a business or personal services business for tax purposes. An example might be an IT contractor who is not an employee but is engaged on a long term contract with a major bank, works solely for that bank and performs work as directed by the bank.

4. Tax implications

There are different tax consequences, depending on which of the three categories you fit into. The major tax consequences are:

Business	Personal Services Business	Personal Services Income Earner
Normal business tax rules apply and you can: a) Claim all business expenses against your income b) Split pre-tax income with other family members, for example by distributing partnership profits to your spouse or paying dividends from your company except where this occurs as a specific tax avoidance scheme. c) Retain profits in your company and pay tax at the corporate rate.	There are no specific restrictions on the deductions you can claim against your income. You are able to claim all normal business deductions. If you are operating through a genuine partnership with your spouse, you can normally split the partnership's pre-tax income with your spouse. [ATO announcement December 2005] If you are operating through a trust or company, the Tax Office's view is that you cannot normally split your pre-tax income with other family members or associates. Nor can you retain profits in your company and pay tax at the corporate rate. With trusts and companies, the area has some uncertainty and the Tax Office's views are being tested through the courts.	There are specific restrictions on the deductions that can be claimed against your income. These relate to deductions such as motor vehicle, mortgage interest or rent on your home and payments to family members who perform non-principal work. Even if you operate through an entity (partnership, trust or company) all net income must be included in your individual tax return. Your entity may be required to deduct tax under PAYG.

Tax Office Determinations
If you are unsure which category applies to you, you can ask the Tax Office for a ruling or for a personal services business determination. If the Tax Office tells you that you are not a 'Business' you can still self-assess to see if you are a 'Personal Services Business.' Discuss this with your tax adviser before making a request for a determination.

No Implications for Non-tax Law
The three categories above only apply for tax purposes.

PAYG
Unless you are a sole trader, you are also likely to have obligations under PAYG.

What to do next?
Seek the advice of a registered tax agent or the Tax Office.

Information from the Tax Office is available from their website www.ato.gov.au or by ringing 13 28 66.

ICA Subscribers may obtain further ATO information on these matters by accessing the online version of this article at:

http://www.contractworld.com.au/reloaded/ica-taxclarity2.php

and following the links.