



Submission to Board of Taxation Review of Alienation of Personal Service Income Tax laws

July 2009

1. Overview and summary

Independent Contractors of Australia has been actively involved in the tax debate since our formation in 2001. One of our long-standing objectives has been to secure tax equity for independent contractors. We believe that, under the combined PAYG/GST/PSI arrangements, Australia probably leads the world in delivering tax equity to independent contractors.

ICA supports the Personal Services Income (PSI) tax system as it currently operates. We see no reason for change of any substance.

We believe that continued efforts are required to educate taxpayers and, in particular, accountants and lawyers about the system. There continues to be a view that the 80/20 rule is the defining issue determining PSI application. This is wrong, as it is the 'results test' that is the primary defining test.

2. Understanding through an historical perspective

We believe that the current PSI review needs to be conducted within an understanding of the tax administrative developments of the last decade and the history that preceded that. PSI is part of the tax reforms that were (in part) designed to resolve the 'independent contractor problem'. A brief historical background, therefore, will aid understanding.

- a) The old Pay As You Earn (PAYE) income tax withholding system originated in the USA during the Second World War. Income tax was developed primarily to fund the Second World War. Australia copied the US system.
- b) Around the middle of the last century, the vast majority of individuals earned their incomes as employees. In administrative terms, PAYE was relatively easy because it imposed obligations on the comparatively small numbers of 'employers' to remit tax on behalf of their 'employees'. Administration of the withholding tax system was administratively and legislatively dependent on the existence of 'employment'. Further, the tax deduction arrangements were designed around the same concepts—that is, by assuming that 'a business' is an employer and an individual income-earner is an 'employee'.
- c) Around the 1980s it was recognized that the numbers of self-employed people had grown substantially. Reliable statistics are not available, but the self-employed sector seemed to constitute up to 10 per cent of the Australian workforce. Where self-employed people are not

structured as Proprietary Limited companies or trusts, no legal 'employment' exists. This effectively meant that, as the numbers of self-employed grew in size, the Tax Commissioner had a reduced legal jurisdiction to require withholding from taxpayers. This same workforce shift created policy confusion over the entitlement of self-employed people to business-style tax deductions.

- d) During the 1990s, the general approach to this diminution of the Tax Commissioner's jurisdictional reach was to take action against independent contractors. It was alleged by some that contractors 'ripped off' the tax system. The response, essentially, was to selectively deny self-employed people the right to access equitable tax treatment. Other approaches tried to bring some independent contractors into the withholding arrangements, for example the Prescribed Payment System (PPS). This was a system of withholding for a narrow band of prescribed industries (eg) construction. It didn't, however, provide an overall solution.
- e) By the end of the 1990s, it was recognized that an aggressive approach could not work. Self-employment/independent contracting was a permanent feature of the economy. Tax aggression against independent contractors distorted the economy and did not resolve the tax system issues.
- f) The tax reform package of 2000 was, in part, designed to resolve the problem. Pay As You Go (PAYG) was created replacing PAYE and PPS which gave the Tax Commissioner legislative authority to require withholding no matter what the legal status of the income-earner. Combined with the Australian Business Number (ABN) system and related administrative and legal arrangements, self-employed people have full withholding responsibilities.
- g) The residual problem after withholding was to define when an individual income-earner had an entitlement to business-style tax deductions, retain income in a company structure and when an individual could pass income to another individual (that is, income split). It is in this area that the Personal Services Income (PSI) issue resides. The PSI laws were passed in late 2001. Although the basics of the law were clear, grey areas remained. It took until about 2008 for high-level legal clarity on these laws to be achieved (see discussion below).

3. Tax Equity

Tax equity for self-employed people is best understood when seen within the context of these historical developments.

Tax equity means:

- All individuals have an obligation to pay and remit income tax in a timely manner.
- The legal and administrative structures within which this is done should not deny or restrict the choices individuals make as to the way they work. That is, the law and tax system should freely allow individuals to be either employees or self-employed.
- Individuals running their own business should be entitled to claim all legitimate business tax deductions.
- The tax system should be as simple to administer as possible, so that self-employed people can know and understand their obligations, thereby maximizing voluntary compliance.

4. A picture of the self-employed/independent contractor sector

There has, in the past, generally been a great deal of confusion over who self-employed/independent contractors actually are. This has confused the tax debate.

This confusion is unnecessary because the matter is established fact at law.

- An independent contractor/self-employed person is an individual who earns his or her income through the commercial contract and not the employment contract.

This is accepted as fact internationally. The International Labour Organisation has found this to be the defining point used across the globe, in both common law and Roman law jurisdictions.

There is a uniqueness, however, in the behavioural profile of self-employed people. 'Business' is usually thought of as a 'system'. That is, the behaviour of a business is somewhat discrete from the individuals who work in the business. The business has a 'life' and 'mind' of its own. For self-employed people, however, the business is them. They are the business. The business's behaviour and the individual's behaviour are one and the same. This conceptual shift in understanding 'what a business is,' presented the essential challenge under PSI. That is, if an individual is a 'business' when is income 'business' income and when is it 'personal' income?

In this context the following terms are interchangeable: self-employed, independent contractor, freelancer, non-employee, micro-business person. The common defining point is that these people use the commercial contract.

How many?

The latest Australian Bureau of Statistics figures are arguably the best statistical figures about the self-employed sector so far produced in Australia (see ICA <http://www.contractworld.com.au/research/ica-numbers4.php>). The 2008 figures follow a review by the ABS of its statistical methodology (see ICA <http://www.contractworld.com.au/research/ica-abs4.php>).

The ABS identifies 2,030,000 self-employed persons (19 per cent of the workforce) and splits them into two sub-classes:

- A: Those who sell goods and/or 'manage' employees (1.1 million). This probably captures the traditional idea of a shopkeeper or a tradesperson who may employ an apprentice.
- B: Those who don't sell goods or manage other people but earn their income solely through their personal effort. The ABS defines these people as 'independent contractors'.

Splitting the self-employed sector into these two sub-groups is helpful for PSI purposes.

- A: The shopkeeper or traditional tradesperson are clear examples of the self-employed group that most people can readily conceive of as 'being in business'. There is something tangible about their business activities because their business can be 'seen'.
- B: The second group is more intangible. They don't have a 'shop front' or a work ute that we can see that seems to distinguish a business. They provide advice or services that can be and often are undertaken by employees. This creates conceptual confusion about 'business.' But this group is very much 'in' business because they use the commercial contract as the vehicle for their transactions with their client(s).

It is this second group to which the PSI laws are mostly directed.

5. Income Splitting and ‘alienation’: how big is the problem? Evidence

ICA is of the view that the ‘problem’ with income alienation was never of the scale assumed. It was a ‘problem’ significantly of imagination, accusation, politics and a tax system that found itself operating in a society and economy that had changed!

This view is based on the only factual audit ever undertaken into the alienation issue. The audit was undertaken by the ATO and, to ICA’s knowledge, was never made public during the critical debate on the issue during 2001 or factored into the debate. The audit showed that the practice of income-splitting was minor.

During 1997 and 1998, the ATO conducted the ‘Alienation of Personal Services Project’. An ATO status report of December 1998 showed the following:

- 65,000 taxpayers were profiled for investigation as likely income-splitters.
- 55,000 notices were sent to taxpayers initiating review of tax returns.
- 5,403 taxpayers were specifically targeted for tax review.
- 1,104 tax agents were visited in the taxpayer’s review process.
- 714 taxpayers were issued adjustment notices.
- Percentage increases in tax paid varied from 1.9 per cent to 11.6 per cent per taxpayer.
- An unspecified number of taxpayers were found to have overpaid tax and were entitled to a refund.

It is understood that the additional tax raised was less than that expected of any random audit of taxpayers’ returns. Further, that the additional revenue generated did not cover the cost of the audit. The conclusion of the audit was that the vast majority of people structure themselves as a business for legitimate business purposes and not for tax purposes.

6. The Creation of the PSI Laws: Confusion and Clarity

The initial design of the PSI laws created difficulty and generated considerable political controversy. The first draft of the Bill applied the 80/20 rule. That is, for a person to be found to be a ‘business’ for PSI purposes, an individual could not earn more than 80 per cent of his or her income from one client. There was significant opposition to this from the self-employed community, as it did not match the reality of business. The bill was changed so that the ‘results test’ was to be applied and the 80/20 rule only came into play if the results test was failed. ICA has found that many people are still not aware of this amendment to the Bill and erroneously believe that the 80/20 rule is still the primary test. This error of understanding is common amongst lawyers and accountants upon whom many self-employed people rely for advice.

Once the Act was passed, its real effect could not be judged until it had been applied in practical situations because there were still areas of the law that we not fully clarified.

In October 2003, ICA received a copy of a private PSI tax ruling from a member. The member had failed PSI and couldn’t understand the reasons as given in the ruling. Neither could ICA. From ICA’s perspective, the ruling was incoherent, legalistic and indecipherable to the normal person. The ruling seemed to bear no relationship to the PSI laws. ICA instigated heavy criticism of the ATO over the ruling. Our argument was straightforward. If we at ICA could not understand the ruling, and we had followed the issues closely, how could an ordinary taxpayer be expected to understand the law?

What followed, however, was an invitation from the ATO for discussions. These proved highly productive and constructive. It transpired that the ATO had a slightly different technical understanding

of the PSI laws to that commonly understood. ICA made the point that the PSI laws would not succeed if ordinary taxpayers did not have a chance of achieving a simple understanding to enable compliance. Up to this point in time, ICA was constantly receiving enquiries from members and the public about PSI. We suggested to the ATO that ICA put together a simple summary of PSI, and the ATO offered its assistance. What transpired was a nine-month liaison with the ATO over the drafting of a 'simple' PSI explanation. The document (attached) is not an ATO-endorsed document, but was put together by ICA with the assistance of the ATO.

Since placing ICA's PSI 'Ready Reckoner' on our website, the number of enquiries we have received about PSI has been very low. The Reckoner was updated in February 2006 after the ATO published a clarification on the treatment of partnerships under PSI as opposed to P/L companies and trusts.

ICA submits the Ready Reckoner as the key part of this submission. We believe that it is an accurate explanation of the PSI laws.

Further, around 2006, the ATO announced that to achieve additional clarity on PSI rules related to P/L companies and trusts it would support a legal test case programme in the courts. The ATO reasoned that it was only fair to taxpayers that the courts be the ultimate decision-maker on the remaining areas of PSI requiring clarification. ICA supported the test case programme.

In December 2007, the result of the first test case was handed down in the Federal Court and found in favour of the ATO's understanding of PSI related to trusts and P/L companies. In February 2009, a second test case also found in favour of the ATO's view.

ICA has produced summaries and commentaries on each of these test cases. They are available on our website (ICA members' access <http://www.contractworld.com.au/newmembers/tax/ica-subs-T43.php>)

With these two test cases ICA believes that, finally, in 2009, there is now significant clarity about the PSI laws. It has taken a long time.

7. The facts of the PSI laws

Taken from ICA's Ready Reckoner, we believe the laws can be summarized simply.

The steps that individual income-earners need to follow are:

1. **Business:** If they clearly profile as a "businesses", PSI does not apply and all normal business deductions apply whether they are an individual, partnership, P/L company or trust. The bulk of the 1 million-plus self-employed people ABS category A: (retailers/trades-people etc) would probably fall into this category.
2. **Personal Services Income Earners:** Those people who are clearly self-employed but operate as individuals (that is, have no structure) are ordinarily likely to be classified as 'personal services income earners' and access income tax deductions as any other personal income earner does. They have no business structure in which to retain income and no capacity (or probably desire) to split income. Most of this group would be in the ABS's 'B' group and, on past ABS data, it is possible that they constitute up to two-thirds of this sector (around 600,000 at a guess).

3. **Personal Services Businesses:** People who fall into the middle category, that is, their 'business' is themselves and are structured as partnerships, P/L companies or trusts are likely to be classified as 'personal services businesses'. They access normal, legitimate business deductions.
- **For partnerships** they can automatically split the income. See ICA link for ATO reasoning (<http://www.contractworld.com.au/newmembers/tax/ica-subs-T38.php>). Once again, on past ABS data, this partnership group possibly constitute around two-thirds of the remaining 300,000 (at a guess) in the ABS's 'B' group — that is, around 200,000.
 - **P/L companies and Trusts** possibly constitute up to 100,000. They have to be very careful. They must pay very close attention to ensuring that they pass the 'results' test. If they cannot pass the results test (or the other subsequent tests), they will fail PSI and will not be able to split income or retain profits, and may be denied some business-type tax deductions.

[Note1: the numbers given are general guesses] [Note2: All PSI rules are subject to general anti-avoidance provisions. (ie) A person cannot structure deliberately to avoid tax.]

It's probably fair to say that, of the 2,030,000 self-employed people/micro-businesses in Australia, the PSI laws give high level clarity to around 95 per cent of them. The remaining 5 per cent (around 100,000 individuals) who structure as P/L companies or trusts and are personal services businesses have to be very careful about how they structure and conduct their business activities. The ATO is likely to target them for PSI tax audits.

8. ICA's position

ICA's view of the PSI laws is one which has developed as events unfolded as described above. At each stage we felt that we could support those aspects of the laws which appeared clear, while reserving judgment on the areas requiring clarification. We believe that a stage has now been reached where a reasonably full knowledge of the laws is possible.

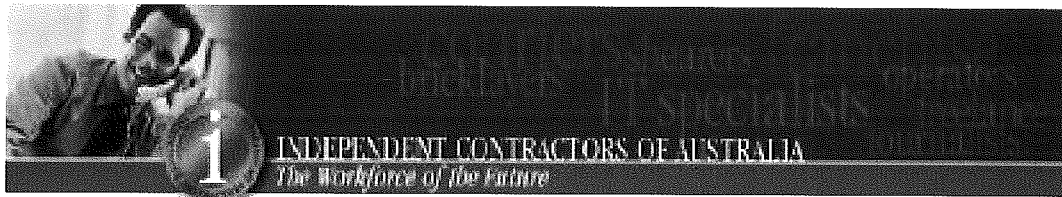
Assuming that ICA's understanding of the laws is accurate, we support these PSI laws.

- On the evidence, the 'alienation problem' did not appear to be a problem of any greater size than other areas of tax compliance. However, we support the closure of potential 'loopholes' so that self-employed people can achieve a measure of clarity about their tax status.
- In the end (after 8 years) the laws quite reasonably split the self-employed sector into categories from which it is possible to gain tax clarity. Tax equity is achieved in a way that allows income-earners to decide the way in which they wish to be structured.

ICA strongly recommends that:

Let the laws settle: These laws should now be left as they are and allowed to do their job. We do not see any reason for the laws to be changed. In fact, change is likely to recreate a hornets' nest of renewed confusion.

Conduct education: We still find people who believe that the 80/20 rule is all-important. Every effort should be made to further educate the self-employed sector (in particular the 900,000 who the ABS defines as 'independent contractors'), as well as lawyers and accountants on the PSI rules. ICA has found our Ready Reckoner to be effective in this regard. ICA would be eager to assist any education programme. [Note; ICA is currently involved in a small business education program for the Department of Innovation]



Tax Clarity for Small Business Contractors

September 2004

[Updated: February 2006]

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
<p>The Tax Office places you in this category if your income is generated mainly from:</p> <p>(a) The sale of goods <u>or</u></p> <p>(b) The operations of a business structure</p> <p>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.</p> <p>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:</p> <p>a) Ownership of significant business assets used to generate income---such as a bulldozer, or delivery van operated by a courier driver</p> <p>b) Arm's length workers are engaged to perform a significant portion of the work</p> <p>c) The existence of saleable goodwill in the business</p> <p>d) The size of your operations---the larger it is, the more likely it is to derive income from a business structure.</p>

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

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
<p>Normal business tax rules apply and you can:</p> <p>a) Claim all business expenses against your income</p> <p>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.</p> <p>c) Retain profits in your company and pay tax at the corporate rate.</p>	<p>There are no specific restrictions on the deductions you can claim against your income. You are able to claim all normal business deductions.</p> <p>If you are operating through a genuine <u>partnership</u> with your spouse, you can normally split the partnership's pre-tax income with your spouse. [ATO announcement December 2005]</p> <p>If you are operating through a <u>trust or company</u>, 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.</p> <p>With trusts and companies, the area has some uncertainty and the Tax Office's views are being tested through the courts.</p>	<p>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.</p> <p>Even if you operate through an entity (partnership, trust or company) all net income must be included in your individual tax return.</p> <p>Your entity may be required to deduct tax under PAYG.</p>

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.