

# Independent Contractors and Tax: The Facts

## Ken Phillips

Some people claim that independent contractors and their clients use non-employment to avoid tax and other statutory obligations. It's a claim that doesn't match the facts.

### INCOME TAX

The big ticket item is income tax. Do independent contractors rip off the tax system?

Under the old PAYE tax system, there was a problem. The tax office only had statutory power to require tax instalments to be sent to them regularly if a worker was a common-law employee. This 'withholding' system ran into trouble during the 1990s because of the big increases in the number of independent contractors for whom withholding could not be enforced. This created cash-flow issues for the government. The tax office responded by trying to force everyone to be an employee—a nonsense task.

The issue was resolved with the scrapping of PAYE and its replacement with PAYG, an improved legislative and administrative structure for securing withholding payments. The PAYG system has three legs: it requires withholding for employees and company directors; it has separate requirements for independent contractors engaged directly and administratively uses the Australian Business Number for this; and it has a provision for independent contractors using labour hire where no ABN is required and the labour hire company must remit withholding tax to the tax office. It's pretty simple really—and a world first.

The second tax issue is whether independent contractors access lower rates of tax than they should and higher tax deductions than they should. The

accusations of contractor rip-offs have a long history. But the only tax audit ever done on this matter has proved that there was no abnormal problem. In the late 1990s, the tax office audited some 65,000 tax payers who fell into this category. After an expensive audit process, some 700 people had to pay more tax and an undisclosed number had to receive refunds. The extra revenue was minimal and the audit team was closed down. Despite these facts, in 2000, the 'Ralph Review' of contractor tax, relying mainly on unverifiable as-

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sumptions, still claimed that there was a problem. The issue became highly politicised and had a strong industrial relations element to it.

The core problem is that tax officials have difficulty conceiving of an individual as a business. 'How can an individual have goodwill?' they ask. But the problem they face is that this is precisely what is occurring in modern economies. It is a massive social movement where individuals don't want to work 'in' businesses where they are controlled by bureaucratic and class-based structures. People want to 'be' a business; their own business. This is what independent contractors are. They are the ultimate small business, a business of 'me'. Tax officials and tax systems

world-wide will have to come to terms with this social movement.

The Australian solution is, however, mostly workable under the Personal Services Income Tax legislation of 2001. The tax office now has three administrative definitions of a business. There can be a 'Business', a 'Personal Services Business', or a 'Personal Services Income Earner'. Confused? Well isn't tax supposed to be confusing?

A Business can access all tax deduction entitlements, split income and retain profits in the company. A Personal Services Business can access all deductions but can be in a grey area on splitting income and retaining profits—the tax office is running legal test cases in an effort to resolve the grey. A Personal Services Income Earner can access tax deductions but not split income or retain profits. No-one in any of these categories is seen as an employee. The Website [www.contractworld.com.au](http://www.contractworld.com.au) has a good explanation.

### STATE PAYROLL TAX

State payroll tax legislation varies significantly and tends to be impossibly complex to understand. Independent contractors working directly for a client probably need to be included in the clients' payroll tax declarations, or maybe not. A leading test case on the Victorian provisions in the early 1990s saw the High Court declare that it was unsure and felt that the legislative provisions could mean almost anything the payroll tax officials wanted them to mean. With independent contractors using labour hire, however, it is clear that tax obligations apply.

### WORKERS' COMPENSATION

This is a legislative mess which requires a complete rethink and an overhaul comparable to that applied to the income tax system. Aus- ▶

tralian workers' compensation schemes are a contorted form of insurance. Under normal insurance, the person that is covered takes out the policy and pays the premiums. Workers' compensation covers lots of people (workers) but gets other people (businesses) to pay the premiums.

All States' workers' compensation schemes have a firm policy that independent contractors are not to be covered. Presumably this is because they accept that independent contractors are businesses and are therefore not allowed to pay premiums.

But oddly, the workers' compensation schemes in each State have a vast array of 'deeming' provisions which describe a whole range of independent contractors who must be in the schemes but who would not ordinarily be in the schemes. These 'deeming' laws vary between States and have no consistency. The consequence is that people who are not allowed to register for workers' compensation might have to be declared, or might not have to. Confused again? Well, so are lots of people.

In New South Wales, for example, over the last twelve months, the workers' compensation authority has been busily issuing back-dated bills to businesses who believed that workers' compensation coverage of the independent contractors they used was prohibited. This is occurring in an environment where the NSW scheme is several billions of dollars in the red and the workers' compensation authority has issued a discussion paper stating that the laws are unclear. A potential political backlash is brewing. South Australia faces a similar situation—also emanating from desperate attempts to fix a debt exceeding half a billion dollars.

Unions often claim that independent contractors dodge workers' compensation. But the problem seems to be that the schemes are flawed in their core structure and that it cannot be decided who is 'in' and who is 'out'.

## OCCUPATIONAL SAFETY

All independent contractors are in

the occupational health and safety net in every State and Territory. The legislative structures vary from State to State, with some better than others, but the essential elements are the same. Every independent contractor has responsibilities to work safely. Every business has responsibilities to provide safe work environments for independent contractors.

About the only area where there is an issue is in ideas of 'contracting out.' When businesses contract-out commercial activities to other businesses, commercial obligations transfer with them. As independent contractors are businesses themselves, these same commercial principles apply. Many in the business community have fallen into the trap of believing that transfer of commercial obligations also involves transfer of OHS obligations. This is a dangerous error.

OHS obligations are never eliminated or transferred but will involve shifting, changing and partnering of OHS obligations. Under any contracting-out, parties need to pay special attention to their contractual relationships to ensure that appropriate safety systems are integrated into a whole. To do otherwise exposes workers to risk and exposes companies and their managers to potential litigation.

## EQUAL OPPORTUNITY AND ANTI-DISCRIMINATION

All independent contractors are within this net. The legislation is quite clear. Independent contractors cannot discriminate nor be discriminated against. There is one difference, however.

The principles of vicarious liability under employment law hold that employers are responsible for their employees' actions. If an employee commits an act of discrimination, then the employer is charged and held responsible. No vicarious liability applies to independent contractors—they are held responsible for their own actions.

## COMMERCIAL LAW

Independent contractors fall squarely under the obligations and protections of commercial law. They can sue and be sued. They can access trader-to-trader small claims processes under State fair trading acts. They have obligations to behave within the free market rules of the Trade Practices Act, but also have free market protections under the Act. They are, in every sense, treated at law as mature adults, running their own business. This is what it means to be an independent contractor.

## INDUSTRIAL RELATIONS AND EMPLOYMENT LAW

Unions allege that independent contractors escape industrial relations regulations. They are correct. But their howls of anger do not serve independent contractors' interests.

Independent contractors are not employees who allegedly need the power of the collective to run their lives. Independent contractors do not begrudge employers, employees and unions having their own processes. But independent contractors deny others the attempt to have them pulled into employer–union warfare.

Independent contractors want and need to get on with business—that's their business ... getting on with business. A business does not succeed by having war with clients. Business is made by working with clients to provide a service and secure sound financial outcomes all round.

The Federal Government's proposed Independent Contractors Act will make the common-law facts clear that independent contractors and their clients are not within industrial relations and employment law jurisdiction.

*Ken Phillips is director of the IPA's Work Reform Unit. He has specialist knowledge of independent contractor issues.*

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