



MASTER BUILDERS
AUSTRALIA

Submission to
The Board of Taxation
on
Post-Implementation Review into Alienation of Personal
Services Income Rules

July 2009

Master Builders Australia Ltd ACN 137 130 182

building australia



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1 INTRODUCTION

- 1.1 This submission is made by Master Builders Australia Ltd (Master Builders).
- 1.2 Master Builders represents the interest of all sectors of the building and construction industry. The association consists of nine State and Territory builders' associations with over 31,000 members.

2 PURPOSE OF SUBMISSION

- 2.1 The submission responds to a letter of invitation dated 16 June 2009 from the Chairman of the Board of Taxation Working Group relating to the Board's review of the provisions of the income tax laws about the alienation of personal services income.
- 2.2 In this submission, Master Builders sets out its view of the effectiveness of the current law relating to the alienation of personal services income and its impact upon members.

3 THE CURRENT RULES AND THEIR POLICY AIM

- 3.1 The current income tax laws relating to the alienation of personal services income stem from the 1999 Review of Business Tax: A Tax System Redesigned (the Ralph Report). The Ralph Report noted an increased use of the technique of employing entities interposed between the person acquiring the services and the individual performing the services. The Ralph Report stated that this practice raised significant issues of equity and posed a growing threat to the income tax base¹. The consequential changes to the income tax law aim to achieve the following policy objectives:
 - 3.1.1 Equity in the equal taxation of individuals
 - 3.1.2 A desire not to impinge upon "real" external contractual relationships or to tax "real" businesses as individuals.
- 3.2 The tax laws provide a series of tests to determine whether or not income is considered to be personal services income and, if so, whether the personal services income rules apply to the particular situation.

¹ *Review of Business Tax: A Tax System Redesigned*, July 1999, page 287

- 3.3 Personal services income is income received as a result of a person's skills, knowledge, expertise or efforts, regardless of whether it is income of another entity (such as a company, trust, partnership or other individual).² Income that is mainly generated from the following sources is generally not considered to be personal services income:³
- 3.3.1 Income from selling or supplying goods such as retailing, wholesaling or manufacturing.
 - 3.3.2 Income generated by an income-producing asset (such as use of a bulldozer, excavator), even if some personal efforts or skills are involved in operating the asset. It is more likely that the income is being generated by the asset rather than personal efforts and skills where the asset is large-scale and essential to performing the work, and is specified in the relevant contract.
 - 3.3.3 Income from granting a right to use property, such as copyright from a computer program or book.
- 3.4 Income from the conduct of a genuine personal services business is exempt from the personal services income regime.⁴ An individual or personal services entity can apply under subdivision 87-B of the *Income Tax Assessment Act 1997* (Cth) for the Commissioner to make a personal services business determination. In broad terms, the Commissioner determines whether or not the four tests discussed below are met, or would have been met but for unusual circumstances.⁵

The results test

- 3.5 The results test is based on the traditional criteria for distinguishing independent contractors from employees. Section 87.1 of the *Income Tax Assessment Act 1997* (Cth) states that:

Regardless of how much of your personal services income is paid from one source, you can self-assess against the results test to determine whether you are an independent contractor. The results test is based on the traditional tests for determining independent contractors and it is intended that it apply accordingly.

² *Income Tax Assessment Act 1997*, s84.5

³ Tax Ruling 2001/7, paragraph 29

⁴ *Income Tax Assessment Act 1997*, Division 87

⁵ The grounds on which the Commissioner may issue a personal services business determination are outlined in sections 87.60 and 87.65 of the *Income Tax Assessment Act*.

- 3.6 To satisfy the results test, an individual must satisfy all three of the following conditions in relation to at least 75% of his or her personal services income:
- 3.6.1 The income is for producing a result or outcome rather than providing services with no predetermined outcome specified or for completing particular tasks. A person who is paid on an hourly basis or daily rate for services would be unlikely to pass this part of the results test.
 - 3.6.2 The individual is required to provide the plant and equipment, or tools of trade, needed to do the work.
 - 3.6.3 The individual is required to rectify defects in the work or to pay damages where physical rectification is not possible.
- 3.7 An individual can self-assess if he or she meets the results test. If the results test is not satisfied, it is necessary to apply the 80 per cent rule.

The 80 per cent rule

- 3.8 If 80 per cent of an individual's personal services income comes from one client (and their associates) in an income year, the personal services income rules apply unless the person receives a personal services business determination from the Commissioner for Taxation as per paragraph 3.4 above.
- 3.9 If 80 per cent or more of the personal services income is not from one entity, there are three additional tests that need to be applied to determine if the personal services income rules apply. These tests are the unrelated clients test, the employment test and the business premises test.
- 3.10 Whilst there is complexity evident in the application of the rules, Master Builders is aware that they are now generally applied satisfactorily by those advising Master Builders' members.

4 THE BUILDING AND CONSTRUCTION INDUSTRY AND INDEPENDENT CONTRACTORS

- 4.1 The building and construction industry is diverse, with employment in businesses ranging from a few people in family-owned firms to hundreds of people in major firms that perform work domestically and internationally. However, nearly all firms are small businesses (404,352 non-employing firms or firms employing between 1

and 19 people). There are some medium sized firms (2,709 firms employing between 20 and 199 people) and a small number of large firms (127 firms employing 200 or more people).⁶ The construction industry is project-based and exhibits highly volatile characteristics that have a profound affect on its structure and the way it operates. Intense price competition and low profit margins keep fixed overheads low and have spawned the growth of the subcontracting system.

4.2 Independent contractors play a fundamental part in the building and construction industry due to its volatility and fluctuations, increasing labour costs and the move towards specialisation. The Cole Report⁷ recognised that contracting is a legitimate, important form of business activity and working arrangement. Commissioner Cole also found that “the trend to contracting has been accepted by significant numbers of workers”,⁸ which accords with industry’s view.

4.3 The 2006 Productivity Commission report⁹ highlighted the positive role non-traditional work plays in the labour market for employers and employees. A warning was made against attempts to regulate and restrict access to non-traditional employment. The Productivity Commission found that the use of self-employed contractors in the construction industry is notable, with almost a quarter of the workforce engaged in this form of work. Non-traditional work fulfils two important roles in the labour market:

4.3.1 it frequently provides a bridge between unemployment and permanent employment for those who prefer permanent employment to non-traditional work; and

4.3.2 non-traditional work provides a means by which people can continue working though they are unable to undertake permanent employment for reasons related to choices about education, child rearing or partial retirement.¹⁰

4.4 In the building and construction industry, business uses independent contracting arrangements to deliver the following efficiencies:

⁶ ABS Catalogue No 8155, November 2007, Table 2.1, page 22

⁷ The Final Report of the Royal Commission into the Building and Construction Industry <http://www.royalcombi.gov.au/hearings/reports.asp>.

⁸ Ibid at paragraph 277, Chapter 23, Volume 9.

⁹ Productivity Commission 2006, *The Role of Non-Traditional Work in the Australian Labour Market*, Commission Research Paper, Melbourne, May, p 62.

¹⁰ Ibid at p xxiv.

- 4.4.1 contractors can enter the industry with very little capital outlay resulting in a very competitive environment, as barriers to entry are low;
- 4.4.2 the system provides an important opportunity for skilled tradespersons with the necessary motivation to significantly increase their earnings with their income directly related to their efficiency in the actual time they work;
- 4.4.3 the system is administratively simple and reduces supervision considerably as the principal contractor does not incur the administrative overheads of employing staff;
- 4.4.4 there is an incentive to solve problems which develop on site quickly and effectively, as contractors do not get paid for delays, while employees, on the other hand, have little incentive to solve such problems;
- 4.4.5 a contractor quotes a price for a job which reflects the situation in regard to work on hand and the market price reflects the level of demand;
- 4.4.6 results based contracts are generally more efficient than time costed labour working towards the same ends;
- 4.4.7 the production process requires a variety of tasks that require different skills at different points in time and the completion of these tasks to a certain level of quality can be easily monitored, so it is well suited to the work of contractors;
- 4.4.8 due to the fluctuations in demand in building and construction, there is much competition between firms and there can be much uncertainty about demand, so many firms prefer to use contract labour;
- 4.4.9 the current skills shortage in the industry means that contractors are able to mobilise quickly and more efficiently place themselves to meet the needs of companies, projects and the industry at a particular time;

- 4.4.10 regional variations in prices paid to contractors encourages mobility of those contractors which helps to achieve and improve balance within regional markets; and
- 4.4.11 the housing sector, which predominately uses contractors, has, unlike all other sectors in the construction industry, not faced any major stoppages or strikes as a contractor is bound by the contract he enters into in respect of the work to be performed and has an incentive to get on with the job.

5 INTERACTION BETWEEN ALIENATION OF PERSONAL SERVICE INCOME RULES AND INDEPENDENT CONTRACTOR TESTS

- 5.1 As noted in the previous section, the evidence highlights the positive role independent contracting plays in the labour market. Given the importance of independent contracting to the efficiency of the building and construction industry it is crucial that the alienation of personal services income rules do not impinge on legitimate independent contracting arrangements. In addition, it is important to recognise that the basis of independent contracting in the industry is not principally tax driven. As Pennicott¹¹ has noted:

Major incentives for income splitting (and retention of PSI) include the difference between the company tax rate and the top individual marginal tax rate, and the progressive individual tax scales which encourage income splitting in order to obtain more than one tax-free threshold and multiple progressive tax scales. Although there has been a recent reduction in tax rates, these incentives still remain for high income earners. However, entities are not always chiefly used for income splitting purposes (for example companies may be used for limiting liability).¹²

The predominantly smaller contractors in the industry do not use incorporation or other business structures as devices for income splitting as a matter of course because, as indicated in this extract, these are tax planning measures used by high income earners, not small contractors operating in the building and construction industry. Advantages of separate business structures are explicable by reasons other than tax.

¹¹ S Pennicott *Resolving the Personal Services Income Dilemma in Australia: An Evaluation of Alternative Anti-Avoidance Measures* Journal of Australian Taxation (2007) (10) 1 p53

¹² Id at 102

- 5.2 In previous submissions on independent contracting, Master Builders has advocated the need for greater certainty and consistency in this regard so that an individual conducting a business does not find him or herself treated as an independent contractor for one purpose and not another.¹³ Uncertainty may also leave some industry participants open to a contravention of the provisions of the *Independent Contractors Act 2006* (Cth) and cause further complication in the application of the sham contracting arrangements in the *Fair Work Act 2009* (Cth).
- 5.3 In Master Builders experience the certainty sought by the industry about the status of independent contractors has not been achieved.
- 5.4 In relation to the independent contractor legislation Master Builders put forward the view that the legislation should be drafted with three essential underpinnings:
- 5.4.1 That the ordinary common law test as established in *Stevens v Brodribb Sawmilling Co Pty Ltd*¹⁴ be stipulated as the main basis upon which the distinction between a contractor and an employee is assessed.
 - 5.4.2 Secondly, external indications of the status of contractor be used as a reinforcement of the common law test or otherwise. A strong indicator, for example, could be the existence of a personal service business determination being in effect for the particular individual (section 87-60 *Income Tax Assessment Act, 1997*). It should be noted, however, that Master Builders does not advocate that the personal services income test in the ITAA be used for other purposes. Master Builders believes that the personal service business test is best used as a means to reinforce the common law tests. This is important in the context of the building and construction industry where a person may in any one financial year operate either as an employee or as a subcontractor. Depending upon the nature of the project, their status will not be a static matter.
 - 5.4.3 Thirdly, having regard to the common law test and other statutorily recognised criteria, the independent contractor could choose to be registered with a dedicated Commonwealth agency. The

¹³ Master Builders Submission to the House of Representatives Standing Committee of Employment, Workplace Relations and Workforce Participation – *Independent Contracting & Labour Hire Arrangements – Are they Working*, March 2005

¹⁴ (1986) 160 CLR 16

application for registration could be accompanied by a certificate from, say, a legal practitioner to the effect that, having regard to the statutory criteria, the contractor should be registered and for which particular project or job if the contractor is an individual who also works from time to time as an employee. This process would, therefore, require minimal Government supervision save for some random audits, for example. It would operate to take into account the dynamic nature of the contractor status and would permit registration as a contractor for a limited time period or only in respect of particular projects.

- 5.5 These propositions were outlined in more detail in Master Builders March 2005 submission¹⁵ and address the concern that the absence of a codified definition will cause uncertainty about whether an independent contractor is an employee and entitled to the benefits of employment.
- 5.6 Master Builders' position is for the uncertainty that may be encountered by the application of the common law test to be ameliorated by a Government agency that could register contractors on the basis of their status relating to a particular relationship, with a record of its duration. This would also mean that the need for the current sham contracting regime was ameliorated and that enforcement would be better directed.
- 5.7 It remains Master Builders' policy that the common law should be retained, but external indicators of the status of "contractor" should be used as a reinforcement of the common law test or otherwise. Other groups have suggested that the existence of a personal services business determination under the *Income Tax Assessment Act 1997* should automatically classify the principal in that personal service business as being a "contractor". Whilst this test is appropriate in the tax and workers compensation areas, for general workplace relations the existence of such a determination should merely be one more indicator in the criteria brought to account in applying the common law test.
- 5.8 The common law test is used on a daily basis and it is rare that the common law does not provide an answer to the question of whether a person is operating as a contractor or as an employee. Other tests proposed should **supplement** the common law test, not displace it, including the personal services business test.

¹⁵ Supra note 13

Hence, Master Builders believes that the test fits well within a structure where its use would supplement other tests that will enable the *Independent Contractors Act* to work with greater certainty.

6 CONCLUSION

- 6.1 There is no evidence that the alienation of personal services income tests are adversely affecting Master Builders members.
- 6.2 Independent contracting arrangements deliver an impressive number of efficiencies (see paragraphs 4.4.1 - 4.4.11 of this submission); are a legitimate and important form of business activity and working arrangement; and are positive for both employers and employees.
- 6.3 Incorporation or moves to independent contracting are largely driven by factors other than tax planning.