



Australian Government

The Board of Taxation

POST IMPLEMENTATION REVIEW INTO THE ALIENATION OF PERSONAL SERVICES INCOME RULES

A report to the Assistant Treasurer

the **board** of **taxation**
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the **board** of **taxation**

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FOREWORD

The Board of Taxation is pleased to submit this report to the Assistant Treasurer following its post-implementation review into the alienation of personal services income rules. The Board has considered whether the rules have been effective in achieving the goals of greater equity and neutrality in taxing income from personal services.

The Board established a Working Group chaired by Mr Keith James to conduct the review. The Board conducted consultation with stakeholders and received assistance from officials from the Treasury and the Australian Taxation Office. The Board would like to thank all those who so readily contributed to assist the Board in conducting the review.

The Board would like to express its appreciation for the assistance provided to the Working Group by officials from the Treasury and the Australian Taxation Office.

The *ex officio* members of the Board – the Secretary to the Treasury, Dr Ken Henry AC, the Commissioner of Taxation, Mr Michael D’Ascenzo, and the First Parliamentary Counsel, Mr Peter Quiggin PSM – reserved their final views on the issues canvassed in this report for advice to Government.

On behalf of the Board, it is with great pleasure that we submit this report to the Assistant Treasurer.

SIGNED

Richard F E Warburton AO
Chairman, Board of Taxation

SIGNED

Keith James
Chairman of the Board’s Working Group

EXECUTIVE SUMMARY

The Board of Taxation has undertaken a post-implementation review into the alienation of personal services income rules.

The alienation of personal services income rules are aimed at ensuring that the taxation of personal services income applies equally, regardless of the arrangements under which the income is earned, and that neither 'business-like' deductions, income splitting nor tax deferral are available to entities that are not genuinely conducting a business enterprise.

The key issues before the Board were to establish if the legislation is having its intended effect and whether its implementation can be improved.

The Board's key findings are as follows:

- The alienation of personal services income rules have gone some way to achieving their intention of improving integrity and equity in the tax system.
- However, the extent of improvement in the integrity and equity in the tax system provided by the rules is in the Board's view inadequate.
- The difficulty in applying the rules and associated uncertainty, together with a limited level of compliance activity by the ATO, has diminished their efficacy in achieving their policy intent.
 - There is evidence of a low level of compliance. An unintended consequence of the ATO not being seen to be widely monitoring and auditing compliance with the alienation of personal services income rules is that it may have contributed to complacency among some taxpayers and advisors. The ATO considers that personal services income is a low risk to revenue, however, if low compliance is allowed to continue, it may undermine integrity and equity of the tax system. The Board accepts that monitoring of compliance activity on personal services income is made difficult by the absence of information from other sources on the taxpayers who should be reporting that they have personal services income.
 - The difficulty in applying the rules that determine whether or not the taxpayer is a personal services business leads to a degree of uncertainty or 'greyness' around the rules, that provides opportunities for taxpayers to interpret them in their favour. Complex attribution rules and associated

pay-as-you-go withholding obligations have also contributed to the costs of compliance.

- A key focus of the rules, in addition to addressing alienation of personal services income, is to ensure that taxpayers claim the appropriate deductions. While there was some initial reduction in incorrect claiming of deductions it continues to be an area of concern, in particular payments to associates for non-principal work.
- The rules were intended to reduce the Commissioner's reliance on Part IVA of the ITAA 1936 to deal with tax avoidance through the alienation of personal services income. The large number of taxpayers who assess themselves as personal services businesses means that the Commissioner continues to need to rely on Part IVA to a considerable extent. Taxpayers are also uncertain about the circumstances that would trigger the application of Part IVA once they have passed one of the personal services business tests.

The Board does not consider that the alienation of personal services income rules in their current form provide an acceptable level of integrity and equity. The Board therefore recommends that alternatives to the current provisions be considered, to meet the policy intent of improved integrity and equity.

The Board has suggested a number of options which, either alone or in a combination, could assist in providing greater equity and neutrality in the taxation of personal services income. These are:

- providing some third party information to assist in monitoring compliance with the rules by the ATO by *introducing a reporting obligation*, which could be supplemented by *introducing a withholding obligation*;
- addressing the alienation of income by entities deriving personal services income by *extending the attribution rules to personal service businesses*;
- *clarifying and simplifying the deduction provisions*;
- clarifying the rules around who is affected by the rules, possibly by *implementing the tests of 'employee-like manner' as originally recommended by the Ralph Report*; or
- *introducing a deemed labour income approach* which would focus on distinguishing that part of an entity's income that is derived from an individual's labour from the part that is a return to their business assets or capital.

A key issue to be considered when assessing the options is whether to focus on those providers of personal services income who have 'employee-like' characteristics rather than those who operate in a 'business-like' way, or whether to focus more broadly on the providers of personal services income.

Consistent with the terms of reference, the Board recommends that these options be considered further in the context of the Review of Australia's Future Tax System headed by Dr Ken Henry.

CHAPTER 1: INTRODUCTION

1.1 On 3 June 2009, the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, the Hon Chris Bowen MP, asked the Board of Taxation to undertake a post-implementation review into the alienation of personal services income rules and to report its findings and recommendations to the Government by the end of October 2009. As part of that request, the below terms of reference were provided to the Board.

TERMS OF REFERENCE

Background

1.2 The alienation of personal services income rules were introduced to improve the integrity of the tax system. The rules resulted from calls for greater equity and neutrality in the taxation of personal services income.

1.3 The changes came out of recommendations of the *Review of Business Taxation*. The rules are designed to improve integrity by addressing both:

- the capacity of individuals and interposed entities (providing personal services of an individual) to claim higher deductions than employees providing the same or similar services; and
- the alienation of personal services income through an interposed entity.

1.4 Even if a taxpayer's income is not affected by these rules, the general anti-avoidance provisions may still apply to schemes to reduce income tax by income splitting.

1.5 The Government has become aware of significant stakeholder concerns that the personal services income rules may not entirely achieve the goals of greater equity and neutrality in taxing income from personal services.

Scope of the review

1.6 The Board of Taxation is requested to undertake a post-implementation review¹ into the alienation of personal services income rules. In undertaking the review, the Board is also to:

- examine the operation of the rules to determine whether the rules are achieving their desired policy outcome;
- identify any problems with the operation of the rules; and
- if appropriate, consider options for improving the rules.

1.7 In conducting the review, the Board is to:

- have regard to the Review of Australia's Future Tax System headed by Dr Ken Henry;
- seek public submissions and consult widely; and
- produce a final report by 31 October 2009 so that any findings and recommendations can inform the Panel undertaking the Review of Australia's Future Tax System, which is due to report by the end of 2009.

THE REVIEW TEAM

1.8 The Board appointed a Working Group of its members comprising Mr Keith James (Chairman), Mr Peter Quiggin and Mr Curt Rendall to oversee this post-implementation review.

REVIEW PROCESS

1.9 As requested by the terms of reference, the Board sought public submissions addressing the terms of reference and consulted widely with interested stakeholders.

1.10 In its invitation for submissions, the Board clarified that the intention in undertaking post-implementation reviews is not to reopen debates about the merits of

¹ The standing terms of reference for a post-implementation review requires the Board to consider whether the legislation: gives effect to the Government's policy intent, with compliance and administration costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure; is expressed in a clear, simple, comprehensible and workable manner; avoids unintended consequences of a substantive nature; takes account of actual taxpayer circumstances and commercial practices; is consistent with other tax legislation; and provides certainty.

a particular policy or measure, but rather to establish if the legislation is having its intended effect and to find out whether its implementation can be improved.

1.11 The Board invited submissions by 27 July 2009. It received 13 submissions, eight of which were made by associations, four by accounting professional bodies and one by an individual. The names of those who made public submissions are listed in Appendix A.

1.12 To supplement the feedback obtained from submissions, the Board organised three workshops with tax practitioners with expertise in this area of the law. Workshops were organised with the assistance of the professional accounting bodies in Melbourne on 11 August, in Sydney on 24 August and in Canberra on 2 September. In total, around 30 tax practitioners attended these workshops.

BOARD'S REPORT

1.13 The Board has considered the issues raised by stakeholders in their submissions and at the consultation meetings. However, the Board's recommendations reflect its independent judgment.

CHAPTER 2: BACKGROUND ON THE ALIENATION OF PERSONAL SERVICES INCOME RULES

POLICY DRIVERS

2.1 At the time the Ralph Report was conducted in 1999, the use of interposed entities to alienate payments in respect of personal services was increasing, as was the use of contractors rather than employees in some industries.

2.2 Personal services income is 'alienated' when an entity (a company, trust or partnership) is interposed between the individual and the person paying for their services, so that the interposed entity derives the income rather than the individual. The entity can then be used to distribute income to owners or beneficiaries of the entity who provide none or very little of the personal services. Some of the income may also be left in the entity. If the entity is a company, it will incur tax at the company tax rate and so deferring tax at potentially higher personal tax rates.

2.3 The Ralph Report referred to some taxpayers who were operating in an 'employee-like manner' who were using an entity or holding themselves out to be a contractor in order to claim deductions not generally available to an employee, such as home-to-work travel expenses or payments to an associate.

2.4 These practices were seen to raise significant issues of equity and a threat to the income tax base. The use of such arrangements to reduce tax liabilities of individuals meant that people in substantially the same financial and work situation would be paying significantly different amounts of tax.

2.5 Prior to the enactment of the alienation of personal service income rules, the general anti-avoidance provisions in Part IVA had to be relied upon to prevent income splitting and access to additional deductions. Part IVA could only be applied on a case-by-case basis and required an assessment by the Commissioner that the dominant purpose of entering into the arrangement was to gain a tax benefit.

2.6 In broad terms, Part IVA could be said to allow income splitting which was not undertaken with a dominant purpose of obtaining a tax benefit, and to prohibit income splitting which was undertaken with such a dominant purpose. While some principles emerge from the cases, they were heavily dependent on the individual facts,

such as in the cases of Mr Mochkin² who was able to prove that the dominant purpose of his scheme in 1992 was not that of obtaining a tax benefit, or of Mr Ryan³, who was able to prove that he did not receive tax benefits from a superannuation scheme in 1995-1997. Being so fact-dependent, ensuring compliance by ruling and audit action was very resource-intensive.

2.7 It was against this background that the Ralph Report recommended a more systematic approach that would be set out in legislation, rather than solely relying on Part IVA.

RALPH REPORT RECOMMENDATIONS

2.8 The Ralph Report recommended that where a company, trust or partnership is interposed between a person or entity requiring services and the person who performs the services, the services should be treated as income of the service provider where 80 per cent or more of work is for one service acquirer or services are provided in an 'employee-like manner'. The recommendations also sought to limit the deductions of such an entity.

2.9 As recommended by the Ralph Report, payments received by an interposed entity should be treated as income of the service provider where:

- the interposed entity receives 80 per cent or more of its receipts in respect of personal services from one service acquirer during the income year;
- the services are provided in an 'employee-like manner' as determined by a range of specified criteria; or
- the interposed entity is unable to obtain from the Commissioner of Taxation a decision that the 80 per cent / one service acquirer test should not apply.

2.10 The Ralph Report noted that a range of criteria would need to be taken into account in determining if the services are provided in an 'employee-like manner'. These criteria would include:

- the level of control exercised by the service acquirer;
- whether the services are also contracted to the public at large;
- the use of substantial income producing assets;
- the extent of infrastructure provided by the interposed entity;

² See *FC of T v Mochkin* [2003] FCAFC 15, 2003 ATC 4272.

³ See *Ryan v FCT* 2004 ATC 2181.

- whether incidental services are provided in conjunction with the sale of trading stock;
- whether more than one person actually provides the required services; and
- the degree of entrepreneurial risk in the way services are provided.

2.11 Payments in respect of personal services were to include amounts that are wholly or predominantly for the labour or skill of an individual who performs that labour or exercises that skill, including those rendered to provide a specific result or outcome.

POLICY INTENT OF THE APPROACH ADOPTED

2.12 The alienation of personal services income rules are designed to improve the integrity and equity of the tax system by addressing (a) the capacity of individuals and interposed entities providing personal services of an individual to claim higher deductions than employees providing the same or similar services, and (b) the alienation of personal services income through an interposed entity, which enables income to be split with other members of the entity, including associates, or retained within the entity, allowing less tax to be paid or tax to be deferred.

2.13 The objective of the rules is not to deter the use of contracting arrangements but to ensure such arrangements do not produce a tax benefit. Rather than adopting the approach recommended by the Ralph Report of defining 'employee-like' characteristics, the approach adopted applies tests to taxpayers' activities to determine if they are operating as a 'personal services business' or not.

2.14 In another departure from the Ralph Report recommendations, the rules allow taxpayers to self assess as a personal services business, even when 80 per cent or more of their income comes from one client, when that income is from producing a result (the 'results test').

LEGISLATION

2.15 The alienation of personal services income rules are located in Part 2-42 of the *Income Tax Assessment Act 1997* and in Division 13 in Schedule 1 to the *Taxation Administration Act 1953*, and took effect from 1 July 2000.

- Part 2-42 of the *ITAA 1997* contains Divisions 84 to 87.
 - Division 84 defines the term personal services income.

- Division 85 limits the entitlements of individuals to deductions that can be claimed against personal services income.
 - Division 86 introduces rules governing the income tax treatment of personal services income paid to interposed entities, including deductions available against that income.
 - Division 87 determines when an individual or entity is conducting a personal services business. If they are a personal services business, Divisions 85 and 86 do not apply.
- Division 13 in Schedule 1 to the TAA 1953 introduces pay-as-you-go (PAYG) withholding obligations for attributed personal services income.

2.16 The rules set out a number of tests that are designed to allow contractors and entities that earn personal services income to self assess or seek a determination from the Commissioner that they are carrying on a personal services business, and therefore are not affected by the measures.

2.17 Even if a taxpayer's income is not affected by these rules, the general anti-avoidance provision may still apply to schemes that are aimed at reducing income tax by income splitting or deferring tax by allowing income to be retained within the entity.

Assessment of personal services income

2.18 Personal services income is defined in the Act as income that is mainly a reward for an individual's personal efforts or skills (or would be mainly such a reward if it was the income of the individual who did the work).

2.19 As explained in a taxation ruling by the ATO⁴, the definition requires a determination as to whether the income, if it was derived by an individual, would be mainly a reward for that individual's personal efforts or skills rather than being generated by the use of assets, the sale of goods, or by a business structure.

Assessment of a personal services business

2.20 The legislation sets out tests under which the individual or entity can self assess whether they are a personal services business for the purpose of the provisions. If they are a personal services business, the limits on deductions, the attribution rules and PAYG withholding obligations do not apply. A determination can also be sought from the Commissioner to confirm whether or not an individual or entity is affected by the measures.

⁴ TR 2001/7 Income tax: the meaning of personal services income

The results test

2.21 All taxpayers earning personal services income are able to self assess whether or not they are a personal services business against the 'results test'.

2.22 To satisfy the 'results test' the taxpayer must:

- work to produce a result;
- provide plant and equipment or tools of the trade (if required); and
- be liable for rectification of any defects in work performed.

2.23 The 'results test' was enacted in 2001 and replaced the 'further grounds test'. Taxpayers are allowed to self assess whether the 'results test' is satisfied, regardless of whether 80 per cent or more of the individual's personal services is from one client. This is in contrast with the 'further grounds test', which although based on the same criteria as the 'results test', could only be applied by the Commissioner in making a determination.

2.24 As noted by the then Treasurer in his press release⁵, the 'results test' is based on traditional criteria for distinguishing independent contractors from those contractors who work essentially in the same way as employees. The introduction of the 'results test' substantially reduced the number of taxpayers who would have been required to apply for a personal services business determination from the Commissioner. This amendment was aimed at reducing the compliance costs for independent contractors who would have been able to meet the 'further grounds test' had they applied for a determination. It was estimated to have no cost to revenue.

The 80 per cent rule and personal services business tests

2.25 If an individual or entity does not satisfy the 'results test', and they earn less than 80 per cent of their income from a single source during the income year, then they may self assess against the other personal services business tests.

- Broadly, the other three personal services business tests require that the individual or entity:
 - had two or more unrelated clients who were obtained as a result of making offers or invitations to the public at large or to a section of the public (unrelated clients test);
 - had separate business premises (business premises test); or

⁵ Treasurer's press release No. 051 of 9 July 2001

- had an employee who performed at least 20 per cent of the principal work by value of the business (employment test).

2.26 If the taxpayer earns less than 80 per cent of their income from a single income source during an income year and can satisfy one of the personal services business tests, they will not be affected by the alienation of personal services income measures. Conversely, if 80 per cent or more personal services income is earned from a single source and the results test is not met, the alienation of personal services income measures apply.

Personal services business determination

2.27 Where an individual or entity earns more than 80 per cent of the personal services income from a single client and they can not meet the results test, they may seek a determination from the Commissioner that they are operating a personal services business. If a determination is granted, the individual or entity is outside the measure.

2.28 In making the determination, the Commissioner may consider any unusual circumstances that exist in the income year in question.

Additional withholding obligation

2.29 If the alienation of personal services income rules apply, an entity has additional PAYG obligations for the amount attributed to each individual who performed the services.

2.30 Where personal services income received by the personal services entity is not paid out as salary or wages it will be attributed to the individual providing the services (less deductions available to the entity), and gives rise to a withholding obligation. A personal services entity is required to work out the amount to withhold from the attributed personal income and pay and report to the ATO on a quarterly or monthly basis, depending on the size of the withholder.

2.31 Where it is paid out as salary and wages the entity will have the normal PAYG withholding obligations. The measures did not impose PAYG withholding obligations on service acquirers.

Financial impact

2.32 The estimated revenue to be raised by the measures, as described in the Explanatory Memorandum, was \$190 million in 2000-01, \$290 million in 2001-02, \$435 million in 2002-03 and \$515 million in 2003-04. Small upfront compliance costs were anticipated to arise primarily from taxpayers and their advisors having to familiarise themselves with the new provisions. Compliance costs were also noted for taxpayers who choose to apply for a Commissioner's determination and for the

interposed entities required to pay amounts during the income year under the PAYG withholding system (for personal services income attributed to an individual under the rules).

ADMINISTRATION OF THE PROVISIONS

2.33 Individuals in receipt of personal services income (not including income received as an employee) are required to indicate this on their income tax return. They are asked whether or not they are a personal services business and if so, which test was passed. They must also complete the Business and Professional Items Schedule, as for the purposes of the income tax law they are considered to be in business regardless of whether they have passed a personal services business test or not. As the schedule is designed for individuals who are in business, such as sole traders, it contains labels for business deductions that would not be available to an individual who is not a personal services business.

2.34 Data provided by the ATO indicates that in 2008 around 368,000 individuals and entities declared personal services income in their income tax returns, with an 80 per cent increase in the number of taxpayers declaring personal services income in 2004 (associated to an extensive education campaign run by the ATO), and subsequently levelling off around 370,000 per annum since 2006.

2.35 Of those declaring personal services income in 2008, 73 per cent (268,000) were assessed as personal services businesses, and consequently the alienation of personal services income rules did not apply to them. Most personal services businesses self assessed on the basis of the different tests (mainly through the results test) and only a limited number were assessed by a determination from the Commissioner:

PSB determination by Commissioner	0.6%
Results test	88.2%
Unrelated clients test	9.6%
Employment test	0.6%
Business premises test	1.0%
Total PSBs	100.0%

2.36 For those taxpayers returning personal services income, deductions claimed for rent and motor vehicles expenses and the amount of retained earnings held in companies decreased significantly in 2001, following the introduction of the alienation of personal services income rules, and have since levelled off.

2.37 Entities need to work out the amount of additional PAYG withholding for each business activity statement they are required to submit. The ATO has introduced simplified ways to work out the attributed income amount for additional PAYG withholding, including using a percentage based on the previous year's reporting.

CHAPTER 3: THE OPERATION OF THE ALIENATION OF PERSONAL SERVICES INCOME RULES

3.1 This Chapter reports feedback received from stakeholders on the operation of the rules and compliance data made available by the ATO.

ARE THE OBJECTIVES OF THE RULES CLEAR?

3.2 Some stakeholders noted a lack of clarity in the objective of the rules. There was broad understanding that the rules were intended to impose a PAYG withholding obligation on attributions of personal services income and limit the availability of deductions for those who earned personal services income but could not meet any of the personal services business tests.

3.3 The structure of the current provisions whereby the income is initially determined to be personal services income, rather than income from a business structure, and then taxpayers can self assess whether they are a personal services business, created confusion for some stakeholders. Some stakeholders queried why the rules were concerned at all with personal services income and did not instead focus solely on 'employee-like' situations.

3.4 There was some confusion even among tax advisers about the implications for taxpayers who meet a personal services business test. In particular, a number of stakeholders noted the uncertainty regarding the interaction between the alienation of personal services income rules and the general anti-avoidance provisions (Part IVA). As noted in the submission by the Institute of Chartered Accountants in Australia:

In the Institute's view, the potential application of Part IVA is not a consideration or risk factor that is well understood by all tax advisors involved in advising their clients about the impact of the APSI rules. There is anecdotal evidence that some tax advisors consider that Part IVA does not have a role to play once a taxpayer has satisfied one or more of the PSB tests in Division 87. In contrast, there are other tax advisors who are unsure about the potential application of Part IVA and therefore adopt an overly cautious approach to advising their clients in this area.

3.5 Some of the uncertainty about the intent and application of the rules arises from the level of knowledge and understanding among tax advisers. The Board observed that most tax advisers at the consultations had only a few clients affected by the rules and so they were not as familiar with them as with other parts of the tax law.

Consultations undertaken in Canberra with some tax practices that had numerous clients affected by the rules elicited a much better understanding of the rules and raised a number of issues in implementing them that had not been raised in other forums.

ARE THE RULES EXPRESSED IN A CLEAR, SIMPLE, COMPREHENSIBLE AND WORKABLE MANNER?

3.6 A number of stakeholders find the rules difficult to apply. CPA Australia noted that the main problem with the personal services business tests appear to be that they are difficult to apply, particularly in respect of the 'results test'. It notes that the results test is arguably the least understood test and yet this is the only test where taxpayers can self assess in cases where they receive more than 80 per cent of their income from one source. It notes that some contractors simply tick the 'results' box on the ATO form even though they may not in fact meet the criteria specified in the alienation of personal services income rules.

3.7 Feedback obtained at the workshops confirmed the view about the rules being difficult to apply. Stakeholders noted that too many rules and tests add to the confusion. The fact that the rules are poorly understood provides scope for abuse. In some instances taxpayers are reluctant to accept that they are not as independent or self-employed as they thought they were. Because the rules have room for interpretation, this creates an incentive for 'opinion shopping'.

3.8 Some stakeholders, such as the Taxation Institute of Australia (TIA), noted the difficulty in applying the definition of 'personal services income', in particular in determining when income is derived mainly from the efforts and skills of an individual, as opposed to generated from a business structure.

3.9 Stakeholders have also noted that the provisions on PAYG withholding are complex and hard to comply with, requiring quarterly and in some instances monthly calculations of attributed income and withholding tax payable. Compliance costs are significantly increased when taxpayers do not report their PAYG obligations on time, either because they are not aware of them or because they shift in and out of scope of the rules during a year. The issuance by the ATO of a Practice Statement containing simplified methods for calculating withholding on attributions of personal services income has not fully addressed these concerns.

3.10 Even stakeholders who support the continuation of the rules in their current form, such as Master Builders Australia, acknowledge that there is complexity evident in the application of the rules.

DO THE RULES TAKE ACCOUNT OF ACTUAL TAXPAYER CIRCUMSTANCES AND COMMERCIAL PRACTICES?

3.11 The Association of Professional Engineers, Scientists & Managers Australia (APESMA) and the TIA, amongst other stakeholders, have argued that the results test fails to take into account the particular circumstances of taxpayers. They submit that knowledge workers (that is workers, such as consulting professionals, who produce intangible property or provide advice or services using their intellect) are disadvantaged under the alienation of personal services income rules compared to workers who produce tangible property.

3.12 Similarly, these stakeholders submitted that the results test fails to take into account commercial practices, in particular the fact that in some industries, like information technology (IT), it is customary for the service acquirer to provide the equipment (typically a computer) and for the contractors to be paid by hours worked. With respect to the latter, stakeholders have argued that in IT, parties to a contract can agree on the required outcome or result, but cannot predict how long it will take to get it done, hence the practice is for pay to be on the basis of hours worked.

DOES THE LEGISLATION GIVE EFFECT TO THE GOVERNMENT'S POLICY INTENT?

3.13 There are mixed views on the efficacy of the rules. A number of stakeholders, such as the Housing Industry Association (HIA), Independent Contractors Australia and the Civil Contractors Federation consider that the alienation of personal services income rules are working appropriately and are meeting their policy intent. As noted in the submission by the HIA:

HIA considers that there is currently no difficulty or dissatisfaction with the Alienation of Personal Services Income provisions of the Income Tax Assessment Act. HIA believes that the rules have worked well and have fully addressed the issues (originally raised in the Ralph Report in 1999) about which the Government was concerned. So far as HIA is aware, there is no evidence to suggest that the provisions are not effective, have led to unforeseen outcomes, or require improvement.

3.14 On the other hand, some stakeholders such as the Australian Council of Trade Unions (ACTU) consider that the alienation of personal services income rules do not adequately or effectively distinguish those workers who genuinely carry out their own businesses from those who are working in a dependent or controlled way and should be treated for taxation purposes as employees.

3.15 The Construction, Forestry, Mining and Energy Union (CFMEU) argued that the legislation has failed to achieve the policy intent of reducing the extent of bogus contracting.⁶ It notes that the extent of bogus contracting, where individuals providing services in an ‘employee-like manner’ are treated as contractors rather than employees for tax purposes, has not been reduced since 2000, but has at best been stable and may have increased. Quoting statistics sourced from the 2008 ABS *Forms of Employment* survey, it notes that out of the 967,100 independent contractors working in all industries in November 2008, 79 per cent (761,500) had no employees; 54 per cent (517,900) had only one contract; 35 per cent (338,300) were not able to sub-contract their own work; and 27 per cent (260,500) were not usually able to work on more than one active contract. The last estimate is contrasted by the CFMEU with the Productivity Commission lower bound estimate of 230,000 dependent contractors in 2001.⁷

3.16 CPA Australia, amongst other stakeholders, noted that the growth of ‘contractors’ in recent times does not appear to be tax driven, but instead appears to be more related to changes in the economy more generally, such as down-sizing and cost reductions by larger companies as employment costs have increased.

3.17 Some stakeholders also raised the issue of taxpayers acting on the basis of poor advice from colleagues or head contractors. Contractors are being induced into non-employee arrangements as a means to increase their take home pay (not affected by employee-related deductions such as withholding), and also by the expectation of being able to access additional income tax deductions compared to employees.

3.18 Other stakeholders consider that the alienation of personal services income rules have been successful to some extent, but, as noted above, suggest there is scope for the rules to be improved to minimise their undue complexity and associated compliance costs while still being effective in addressing the concerns over excessive deduction claims and income splitting by some groups of taxpayers.

WHAT IS THE EXTENT OF COMPLIANCE WITH THE RULES?

3.19 As noted in the previous chapter, about 368,000 individuals and entities declared personal services income in their income tax returns in 2008. It is difficult to

⁶ The Board notes that reducing the extent of bogus contracting was not the policy intent of the measure; rather, the intent was to limit the avoidance of income tax that occurs through the alienation of personal services income.

⁷ Productivity Commission, *The Role of Non-Traditional Work in the Australian Labour Market*, Commission Research Paper, 2006. Dependent contractors are defined in the lower bound estimate of the Productivity Commission paper to include self-employed contractors: who do not have control over their own working procedures *and* the terms of whose contract prevent them from subcontracting their work; *or* who do not have control over their own working procedures *and* whose contract prevents them from working for multiple clients. The Productivity Commission notes that the lower bound estimate is the more realistic one, given that it accords with ATO estimates of employee-like contractors, and that it is based on tests that would be applied by Australian courts and tribunals.

determine whether this is an accurate reflection of the size of the 'personal services income population' that is potentially affected by the rules. However, data from the ABS records over 1 million independent contractors as at November 2008.⁸ While acknowledging the differences in definitions and methodology between the ABS and the ATO data, the data does nevertheless suggest that there is significant underreporting of personal services income in income tax returns.

3.20 The ATO undertook a review of 11,000 contractor entity records from labour hire firms in 2008. Data matching allowed the ATO to find that of the 11,000 entities, over 8,000 did not declare that their income was personal services income. It is difficult to extrapolate this finding to the larger personal services income population because contractors offering their services through labour hire firms were targeted because they were considered likely to be affected by the alienation of personal services income rules. However, it again suggests that there is significant underreporting of personal services income.

3.21 In 2008-09 the ATO undertook compliance activities on 231 cases identified as high risk and predominately selected from the data provided by labour hire firms with potential tax adjustments of over \$5,000 each. Of the 164 cases reviewed, 138 voluntarily disclosed that they were not compliant with the alienation of personal services income rules during a review of their activities. Of the 67 cases that were audited, 55 cases were found to be non-compliant. That is, of the sample subject to compliance action, 83.5 per cent were found to be non-compliant. In total, 193 cases were found to be non-compliant and \$4.8 million was raised. The average net amount of primary tax per case was \$18,800 and average penalties and interest of \$6,000 were raised in each case. An average of \$4.4 million per year was raised in the preceding four years as a result of the ATO's compliance activities.

3.22 The ATO has noted that deductions for wages and superannuation contributions for an associate (usually a spouse) are the most prevalent deductions that are disallowed in whole or in part, because they relate either to non-principal work or only partially to principal work. Other deductions that are frequently incorrectly claimed are motor vehicle expenses, travel expenses and living away from home allowances.

3.23 Currently, a limited compliance program is being undertaken by the ATO which may assist in identifying suitable cases to assist in clarifying when Part IVA will apply following the introduction of Part 2-42. Providing further guidance in relation to Part IVA and income splitting is also under consideration. The ATO has issued a

⁸This includes 967,000 independent contractors in their main job and 134,000 people who were independent contractors in their second job. Independent contractors are defined as those who operate their own business and who contract to perform services for others without having the legal status of an employee. They are engaged under a contract for services (a commercial contract), whereas employees are engaged under a contract of service (an employment contract). Source: ABS *Forms of Employment* 6359.0 - November 2008.

discussion paper to the National Tax Liaison Group in relation to Part IVA and income splitting as part of this work.

DEVELOPMENTS SINCE THE RULES WERE INTRODUCED: GROWING USE OF CONTRACTORS

3.24 There are indirect indications that since the alienation of personal services income rules were introduced the use of contractors has continued to grow. As noted before, the ABS estimated more than 1 million independent contractors in November 2008. As a reference, the Productivity Commission (ibid) estimated the number of self-employed contractors at 740,000 in 2001 and at 788,000 in 2004. As indicated at paragraph 3.15, the CFMEU also noted in its submission the apparent growth in the number of dependent contractors.

3.25 The Board heard that the drivers of the spread of contracting were not the perceived tax advantages to the contractor, but rather the advantages to those acquiring personal services income. A number of reasons were put forward. For some acquirers it was the desire to avoid employment 'on costs' such as payroll tax, workers' compensation payments and Superannuation Guarantee contributions. However, based on the anecdotal evidence collected through consultations, this varied, with some service acquirers paying workers' compensation and other 'on costs' for contractors. This may reflect different definitions used across the States and Territories and the Commonwealth.

3.26 Another key driver was broader workplace relations considerations. The ability to easily terminate or not renew the contract was cited as a key factor. For the construction industry some considered that the ability to not bear the costs of paying for employees for what could be protracted periods between construction projects or during wet weather was an important consideration in using contractors. The CFMEU noted in its submission that the culture of 'no ABN no start' was widespread in the construction industry, which was reinforced by not having stringent business tests as a requirement for the issuing of ABNs. The CFMEU also noted that a July 2009 examination of job vacancy advertisements' requirements clearly indicates that the 'no ABN no start' practice is commonplace.

3.27 The Board heard that the use of an entity was also driven in some instances by the service acquirer, in particular some large corporations (and parts of the public sector), preferring to make contracts with entities to save on administrative and compliance costs associated with having ongoing employees.

3.28 While the impetus for the continued growth of contracting may not be the perceived tax benefits available to the contractor, they do appear, in some industries at least, to act as an inducement to the taxpayer to agree to the arrangement.

Other related measures: prescribed payment system (PPS) and The New Tax System (PAYG)

3.29 Another factor that the Board considers relevant to the increase in contracting arrangements is the transition from the PPS to the PAYG system.

3.30 The *A New Tax System (Pay As You Go) Act 1999* replaced five payment and reporting systems (including pay as you earn, the PPS and the reportable payment system (RPS)) with one comprehensive PAYG system. The PPS and RPS were introduced in 1983 in an attempt to stem income tax evasion in a number of traditionally cash-based industries using:

- deduction at source; and
- third-party reporting of income to the ATO.

3.31 Under PAYG:

- businesses pay quarterly instalments (based on income actually received) after the end of the quarter or, in some cases, annually; and
- employees and similar workers have tax withheld from the payments they receive.

3.32 Businesses that register for GST (whether company, sole trader or other) pay their income tax in four quarterly instalments, at the time they remit their GST payments (or claim their GST refunds). Non-GST payers make quarterly PAYG payments. Non-GST payers, as a general rule, remit amounts based on income actually derived in the quarter, or annually for very small businesses that are not registered for GST.

3.33 Withholding arrangements apply to payments to employees and other office holders. In addition, withholding applies to a payment to a worker from a labour hire firm, for work performed for a client of the labour hire firm.

3.34 Withholding also applies to payments for contracted work or services where businesses and workers voluntarily agree that withholding will occur and when payments requested on an invoice do not include quotation of an ABN. The extent to which such voluntary withholding arrangements have been adopted is very limited. There were 23,300 voluntary agreements for withholding in 2008. As a result, for many contractors there are no withholding arrangements at source in place. This may also act as an encouragement to enter into a contracting arrangement.

3.35 The New Tax System also introduced ABNs as a whole-of-government initiative. The purpose of ABNs is to make it easier for businesses to conduct their dealings with the Australian Government. The Commissioner, as the Australian

Business Registrar, is developing measures to address integrity concerns that the register contains ABN holders who are not entitled to an ABN.

CHAPTER 4: BOARD'S ASSESSMENT

4.1 The Board's assessment of the effectiveness of the alienation of personal services income rules in addressing the integrity and equity issues is based on the information it has collected from stakeholders and the ATO. Clear themes emerged from the consultation process.

4.2 The Board considers that the alienation of personal services income rules have gone some way to achieving their intention of improving integrity and equity in the tax system. This is indicated by the ATO's advice to the Board that claims for rent and motor vehicle expenses and the amount of retained earnings held in companies decreased significantly in 2001 and have levelled off since. However, the extent of improvement in the integrity and equity in the tax system provided by the provisions is in the Board's view inadequate. There are four key issues that the Board considers are contributing to this:

- poor compliance with the rules;
- uncertainty about how the rules interact with Part IVA, with the Commissioner having to continue to rely on Part IVA to address the alienation of personal services income;
- the lack of clarity around deductions that can be claimed; and
- the rules are difficult to apply, in particular the application of the tests for a personal services business and the complexity of the PAYG withholding obligations on attribution.

POOR COMPLIANCE

4.3 There is evidence that the rules have not reached far enough into the potential population of taxpayers who were intended to be affected by the rules, to properly achieve their aim of improving integrity and ensuring equity between taxpayers. The very high 'strike rate'⁹ of ATO compliance activity of 83 per cent, notwithstanding it is the result of targeting the compliance activity to high-risk taxpayers, points to poor compliance.

⁹ Strike rate is defined as the number of tax returns adjusted by the ATO as a proportion of the number of tax returns subject to an ATO review.

4.4 ATO audit activity has concentrated on entity records from labour hire firms. While the Board understands that from a cost-benefit perspective, it is efficient for the ATO to focus its monitoring and auditing compliance activity on high-risk taxpayers and to use third party reporting to assist in this activity, an unintended consequence of the ATO not being seen to be widely monitoring and auditing is that it may have contributed to complacency among some taxpayers and advisors. That is, while the Board accepts the ATO view that the alienation of personal services income is a low risk to revenue, if low compliance is allowed to continue, it may undermine the integrity and equity of the tax system.

4.5 The Board accepts that the ATO's monitoring of compliance activity on the alienation of personal services income is made difficult by the absence of information from other sources on the taxpayers who should be reporting that they have personal services income.

4.6 On the other hand, the Board considers that the incentives to alienate personal services income, particularly for those with annual incomes below \$80,000, have been diminished as a result of the reduction of income tax marginal rates since 2003. There are also costs involved in running an entity that act as a disincentive to alienate personal services income.

UNCERTAINTY IN RELATION TO PART IVA

4.7 A major area of uncertainty relates to the purpose of the rules as an anti-avoidance provision directed at alienation of personal services income and its interaction with Part IVA.

4.8 As noted in Chapter 2, one of the drivers behind adopting the rules was to reduce the Commissioner's reliance on the application of Part IVA to deal with the alienation of personal services income as this approach was regarded as labour intensive and inefficient.

4.9 However, data provided to the Board by the ATO indicated that 73 per cent of taxpayers who return personal services income in their income tax return self assess as meeting one of the personal service business tests. As a result, the Commissioner continues to have to rely heavily on Part IVA to address the alienation of personal services income. In this respect, the rules have not met one of their stated aims.

4.10 Taxpayers and their advisers are uncertain about the circumstances that would trigger the application of Part IVA once they have passed one of the personal services businesses tests. Others wrongly assume that Part IVA does not apply to them once they have passed one of the personal services business tests.

4.11 The Board also considers that the use of the term personal services 'business' has added to the confusion. The use of the term 'business' has led some taxpayers to

assume that they are a business for other purposes of the tax law. They may then assume that their income is not personal services income, which cannot be alienated, but instead assume that it is business income, where the same restrictions on alienation do not apply. However, while they may have met one of the tests to be regarded as a personal services business, the income remains income from personal exertion and therefore cannot be alienated.

4.12 As noted before, the ATO has advised the Board that a limited compliance program is being undertaken which may assist in identifying suitable cases to help in clarifying when Part IVA will apply following the introduction of Part 2-42. Providing further guidance in relation to Part IVA and income splitting is also under consideration. This may go some way to address this significant area of confusion.

UNCLEAR REGIME FOR DEDUCTIONS

4.13 The Board considers that the regime specifying the deductions available for individuals subject to the rules is unclear. As a result of the confusion around the deductions available, there is anecdotal evidence that some taxpayers wrongly consider that they would be able to access additional deductions if they were engaged as contractors rather than as employees and seek access to one of the personal services business tests, such as the 'results test', to be out of scope of the rules. The restrictions on payments to associates are another area of confusion for taxpayers.

4.14 In the Board's view the current administrative arrangements for the reporting of personal services income further add to the lack of clarity around deductions, in that they must complete the Business and Professional Items Schedule yet they are not entitled to 'business-like' deductions where they have not passed a personal services business test or obtained a determination from the Commissioner.

COMPLEXITY AND UNCERTAINTY

4.15 The rules appear in some circumstances to be confusing, which can lead to uncertainty in their application and inconsistent outcomes. The lack of clarity in the rules that determine whether or not the taxpayer is a personal services business leads to a degree of uncertainty or 'greyness' around the rules, that provides opportunities for taxpayers to interpret them in their favour.

4.16 It is the Board's view that the application by taxpayers of the four personal services business tests to their own circumstances means that the alienation of personal services income rules are not applying to some taxpayers as they should. This is particularly so for the 'results test'. The personal services business tests are not a recognised or reliable indicator of whether an entity is carrying on a business and the

Board considers that the 'results test' in particular is not an accepted indicator of whether a person is carrying on a business.

4.17 Complexity is added to this because the income tax laws in relation to a personal services business and to an independent contractor or employee are not mutually exclusive. A taxpayer may still be considered to be an employee for other purposes even if they meet one of the personal services business tests.¹⁰

4.18 Further to this, the 'results test' can lead to outcomes that are seemingly inconsistent with the intent of the rules. There is an apparent bias in the operation of the rules towards industries or activities which can produce 'tangible' results versus those that produce 'intangible' results. The former can more readily meet the 'results test' – the overwhelming rule relied upon to determine status as a personal services business – or can arrange the provision of their personal services so that they can meet the test.

4.19 The operation of the attribution rules and the associated PAYG withholding obligations is overly complex. The difficulty of complying strictly with these rules also undermines compliance.

OVERALL ASSESSMENT

4.20 The Board does not consider that the alienation of personal services income rules in their current form provide an acceptable level of integrity and equity nor are they relieving the Commissioner from reliance on the application of Part IVA.

4.21 The Board therefore recommends that alternatives to the current rules be considered to address the problems identified in this Chapter and meet the policy intent of improved integrity and equity. These alternatives are discussed in the next chapter.

¹⁰ Taxation Ruling 2005/16 *Income Tax: Pay As You Go – withholding from payments to employees* sets out the circumstances when a person would be considered an employee, and clearly shows that a person could pass one of the personal services business tests yet still be considered an employee for the purposes of PAYG withholding from payments to employees.

CHAPTER 5: OPTIONS FOR IMPROVING THE RULES

5.1 There are a number of options that should be considered for improving the operation of the rules and enhancing their efficacy in addressing the key concerns raised in Chapter 4, that is poor compliance with the rules, confusion over the interaction with Part IVA and the Commissioner having to continue to rely on the application of Part IVA, the lack of clarity around available deductions and the complexity of the rules.

5.2 The Board offers a number of options that it considers would address the shortcomings of the current rules and their administration, and these are set out below. Some options may increase compliance costs for certain groups of taxpayers and the Board has concerns about further adding to the cost of complying with the tax law. However in this case the Board sees this as a necessary trade-off to address the current poor compliance with the rules and to achieve an acceptable level of integrity and equity in the operation of the rules.

5.3 Before assessing individual options, the Board considers that a key consideration is whether the desired approach should seek to target those taxpayers who do not meet the personal services business tests as in the current approach, or those taxpayers who meet the Ralph Report 'employee-like' criteria, or whether the focus should be on the appropriate taxation treatment of personal services income.

5.4 A focus on personal services income could help to clarify that this type of income is treated differently to income derived from capital in that it cannot be alienated; that is, personal services income is always to be attributed to the taxpayer who provided the services and it should be taxed at the taxpayer's marginal tax rate. It could therefore clarify that interposing an entity, acquiring an ABN or providing the services under a contract other than a contract of employment does not change the taxation treatment. This approach could also prove more robust; if the forces that are driving the trend towards greater contracting continue, then a focus on an employee or someone who shares characteristics with an employee may be increasingly irrelevant.

5.5 On the other hand, a focus on personal services income intensifies the need to distinguish such income from income derived from a business. Personal services income is income that is mainly a reward for an individual's personal efforts or skills. This is distinguished from income which is generated by a 'business structure'. However, drawing the line where income ceases to be personal services income and becomes income generated from a business structure is difficult, and taxpayers'

circumstances may change from year to year, pulling them in or out of personal services income. The '80/20' rule was an attempt to make a clearer distinction.

5.6 An approach that would make this distinction unnecessary is to not differentiate between personal services income and income from a business structure, or to treat some personal services income as generated in an 'employee-like manner', but instead to differentiate between income from capital and income from labour.

5.7 Under this approach, the objective is to distinguish which part of an individual's income is derived from their labour and which part is a return to their business assets or capital. That part of the income derived from labour would be attributed to the person who supplied the labour. The return to capital could be returned to the owner(s) of the capital, which may differ from the person who provided the labour.

5.8 In principle, there are two potential approaches for implementing this option: either starting by imputing a rate of return to business assets and treating the residual business profit as labour income (as it is done by the Nordic countries – see Appendix B), or starting by applying a domestic transfer pricing rule to any labour services provided by the self-employed worker to the entity and treating the residual business profit as a return to capital.

5.9 There is precedence in the application of domestic transfer pricing rules in the context of service trusts used by professional practices. A service trust is used to employ administrative (and sometimes professional) staff and to provide office premises, equipment and a range of services to the professional practices for a fee. The ATO has provided guidance on the circumstance under which these service trusts (and the fees they charge to the professional practices) are acceptable arrangements.

5.10 Service trust profits are typically not distributed to partners or practitioners personally, but to associated entities of the practitioner. The application of the ATO guidelines on acceptable fees limits the potential for alienation of labour income from partners via the transfer of profits to the service trusts.

5.11 Domestic pricing rules such as those applicable in professional practices could be made applicable more extensively under this option. Rules based on an imputed return on capital, with labour income as residual, may be easier to implement across the different sectors of the economy and with reduced administrative costs (see Appendix B on the Nordic experience).

5.12 Attributed returns on labour income as a result of the application of the domestic pricing rules would be reported as salary payments under this option, subject to instalments or PAYG withholding obligations as applicable. To the extent that labour income is appropriately reported, the scope for accessing undue deductions and splitting income via the use of entities would be severely restricted.

5.13 While this option is well suited to self assessment and may result in greater equity in the taxation of labour income, it would be a significant shift from the existing taxation system to affect only a small number of taxpayers. Attempting to 'graft' it on to the rest of the taxation system may give rise to unintended consequences and further uncertainty and complexity.

5.14 However, the Board considers that there a number of options that could improve the operation of the alienation of personal services income rules and that fit more readily into the current taxation structure. These are set out below.

ADDRESSING POOR COMPLIANCE

Introducing a reporting obligation

5.15 The Board has identified poor compliance as a key reason for its view that the rules are not as effective as they could be. The Board therefore considers that a direct way to address this is to provide the Commissioner with better means of identifying those taxpayers who should be reporting personal services income in their income tax return.

5.16 One option is to introduce a reporting obligation on the payer and / or a corresponding obligation on the payee.

5.17 This option is aimed at making the ATO's compliance activity more cost-effective and improving overall compliance with the rules. A reporting obligation would facilitate data matching, assist in identifying high risk taxpayers and assist compliance activity by the ATO to determine those taxpayers who should be declaring personal services income. It could also lead to a higher level of voluntary compliance with the rules by providing information on the number and value of contracts that a taxpayer earning personal services income enters into in a year.

5.18 The reporting obligation could arise when a business makes a payment for the provision of labour services. The report could include identifying information, such as the ABN of the payer and the payee. Under this option, payers could be required to provide an annual summary to the ATO and to the payee of payments made (including the payer's and the payee's ABN). This could also assist in identifying those taxpayers who have received most of their labour income from one source; or alternatively a combination of reports from different payers could be used to identify whether a taxpayer has received payments from a number of taxpayers.

5.19 This could assist in identifying those who are unlikely to have passed one of the personal services business tests, as it could allow the ATO to identify, amongst other things, the number of payers for an individual.

5.20 However, this reporting obligation may apply more broadly than to those taxpayers who provide personal services income. It may be difficult for a payer to know whether the labour service that they acquired was provided as personal services income or whether it was provided through a business structure. If the reporting obligation is to apply too broadly, it could result in unnecessarily high compliance costs for payers compared to the compliance risk associated with personal services income.

5.21 An alternative approach would be to link it to other obligations; for example, it could apply where payments are made on the taxpayer's behalf for workers' compensation, payroll tax or Superannuation Guarantee. However, this could result in different outcomes for taxpayers in different States and Territories if the coverage of the schemes differs.

5.22 A threshold could be considered to determine which payers would have the reporting obligation. The threshold could be based on the number of contractors or the length of time each contractor is engaged by the payer. For example, the payer may be required to report payments made to contractors where a contract is for more than one month in any 12-month period. This would contain compliance costs and ensure that one-off payers do not have to report, but may also generate behaviours to seek to be or remain below the threshold. It could also affect the competitiveness of those with the obligation compared with those without the obligation.

5.23 The reporting obligation could apply only to commercial payments and not to those that are private or domestic in nature. The reporting obligation could be similar to current PAYG withholding reporting obligations in respect of employees so as to minimise compliance costs for those payers who already comply with employer obligations.

5.24 An individual in receipt of personal services income could also be required to provide their ABN and their payers' ABNs and payments received on their income tax return. This could facilitate data matching and compliance activity.

5.25 The Board considers that a reporting obligation is an option to support the integrity of the alienation of personal services income rules. It is not specifically targeted at the cash economy. However, the Board accepts that the reporting obligation could also lead to improvements in compliance in this area. An examination of the cash economy is outside the terms of reference of this review and the Board has not examined the issues. Nevertheless, information collected in the course of the review suggests that there could be an overlap between taxpayers who do not report personal services income and those who do not report all or some of their income. However, the Board makes no particular comment on the effectiveness of a reporting obligation to address the cash economy, including compared with other options to address it.

Introducing a withholding obligation on payers

5.26 Consideration could also be given to introducing a withholding obligation on payers, if there was a concern that high levels of alienation of personal services income were combined with other forms of tax evasion such as the cash economy. The withholding obligation would act as a reinforcement of the reporting obligation in industries with low compliance such as construction. A similar approach is currently being considered by HM Treasury (summarised in Appendix B).

5.27 The Board has not sought to design a withholding system. It only recommends that the option of withholding be considered as part of the broader options to generate third party information to assist compliance.

5.28 As payers are currently required to withhold tax in relation to payments made to contractors if the contractor fails to quote an ABN, introducing a reporting or withholding obligation for all payments for personal services may reduce the incentive to be a contractor and acquire an ABN.

5.29 The purpose of a withholding system is to provide for the progressive payment of a person's expected tax liability by withholding an amount from payments at source.

5.30 Withholding obligations would need to be implemented appropriately, in line with existing systems, in order to avoid undue compliance costs. Imposing a withholding obligation on the payer would require them to understand aspects of the contractor's business which they may not be privy to, although the application of related legislation, such as workers' compensation or payroll tax, may already require them to do these assessments.

5.31 There would need to be an objective test to assist payers to determine to whom the withholding would apply. In line with the discussion of a reporting obligation, this could be made by reference to the application of other related legislation such as workers' compensation or payroll tax.

5.32 In addition, the withholding rate would need to be set at a rate that is not too high. A high rate may adversely affect the cash flow of taxpayers, resulting in requests to vary the withholding rate, and in turn increasing administrative costs. However, pre-filling of the withheld or reported amounts into the payee's tax return would reduce their compliance costs.

5.33 This proposal would largely address the problem of taxpayers failing to disclose personal services income on their income tax returns. While there will be an additional compliance burden placed on service acquirers in doing the additional paperwork, the burden will be minimised because many, if not most, service acquirers would have employees for whom they would be already familiar with the reporting and withholding obligations, and could readily extend their existing systems to

accommodate the obligations. Some smaller payers may find the additional reporting and withholding obligations onerous.

GST registration requirement

5.34 Another option to assist compliance is to impose a mandatory GST registration requirement if there is a concern in a particular industry that the alienation of personal services income was combined with other forms of non-compliance such as the cash economy.

5.35 The current GST registration threshold is \$75,000 per annum. Instead of applying this threshold, taxpayers in particular industries where non-compliance with alienation of personal services income rules was accompanied by cash economy concerns, could be required to register for GST if they were not being taxed as an employee. Registration for GST would require that service providers issue a tax invoice, that GST was included in the consideration for taxable supplies that they make and entitle them to claim input tax credits for creditable acquisitions. The ATO would be able to follow up those GST registrations where no GST return was made through a business activity statement. Imposing a GST obligation may also act as a disincentive to enter into a contracting arrangement.

Implementing Ralph Report-like recommendations

5.36 This option could assist in addressing poor compliance through clarifying the rules, particularly the personal services business tests. The 'results test' and the personal services business tests moved away from the recommendations in Ralph. This option would revert back to the original principles and so make it clear that they are directed only at those in an 'employee-like' position.

5.37 A key practical effect of adopting a Ralph Report-like approach would be that the 80 per cent test would apply to all taxpayers in receipt of personal services income. That is, it would remove the 'results test' that is currently used by 88 per cent of personal services income taxpayers who self assess as a personal services business. Compliance would be easier for the ATO to enforce if there was an objective test such as the '80 per cent' test that was the basis for determining tax status, rather than attempting to ensure compliance around a test that is surrounded by a large 'grey area'.

5.38 Removing the results test may also bring more taxpayers into the ambit of the rules, or require them to meet one of the other personal services business tests.

5.39 In addition, for cases where the 80 per cent test might not be met (that is, only one service acquirer), it requires establishing a range of criteria that would be taken into account in determining if the services are provided in an 'employee-like' manner.

5.40 A safeguard arrangement would allow the Commissioner to issue a determination on the facts of a particular case that the 80 per cent test should not apply (subject to the interposed entity demonstrating that it is conducting an independent trade or business).

5.41 Existing definitions could provide guidance to develop this option, such as those being considered by current Council of Australian Governments (COAG) work on payroll tax harmonisation (see Appendix C).

5.42 An advantage of this approach is that it would focus clearly on individuals that are ‘employee-like’; for example, instances where a worker changes employers at least once a year (thus in practice meeting the current unrelated clients test), but for all practical purposes continues to work in an ‘employee-like’ manner and should ideally be subject to the alienation of personal services income rules. As a result, it could address the confusion about whether passing one of the tests as a personal services business means that the taxpayer could be considered to be a business for any other purpose.

5.43 However, this approach would not restore equity between those taxpayers who are clearly ‘employee-like’ and those whose arrangements are less clear, but are still providing personal services income. It is a ‘bright line test’ but it is necessarily arbitrary. For example it could lead to very different tax outcomes for taxpayers who earn 81 per cent of their income from one source and those who earn 79 per cent. As noted above, if recent growth in more flexible workplace arrangements continues, focusing solely on ‘employee-like’ may capture an increasingly smaller part of the intended population.

Amending the ‘results test’

5.44 As noted earlier, the Board has heard that the degree of ‘greyness’ around the test has led to some taxpayers incorrectly assessing themselves as meeting the test. Compliance may therefore be improved if the test is reconfigured to make it less easy to misunderstand or incorrectly apply.

5.45 One option is to add a fourth ‘leg’ to the test to require the taxpayer to have at least two employees. Another option is to make the results test applicable only to those who earn less than 80 per cent of their income from one source.

ADDRESSING CONFUSION OVER INTERACTION WITH PART IVA

5.46 One of the instigators of the alienation of personal services income rules was to reduce the reliance on Part IVA to deal with the alienation of personal services income and overclaiming deductions. As discussed in Chapter 4, Part IVA still needs to apply to a large number of taxpayers who earn personal services income as a result of the way the alienation of personal services income rules operate. Under the current

rules, when an entity is in receipt of personal services income and is not a personal services business, the personal services income must be attributed to the individual providing the services. Personal service businesses are subject to the application of Part IVA provisions.

5.47 The option below seeks to reduce the number of taxpayers earning personal services income to whom the Part IVA provisions need apply.

Extending attribution rules to personal service businesses

5.48 As noted above, the ATO is undertaking a limited compliance program which may assist in identifying suitable cases to assist in clarifying when Part IVA will apply to personal service businesses. Providing further guidance in relation to Part IVA and income splitting is also under consideration.

5.49 The ATO issued a discussion paper to the National Tax Liaison Group in relation to Part IVA and income splitting. This may go some way to addressing the confusion that the Board has observed around this issue. However, any interpretive advice will not address the difficulties and costs for the ATO and taxpayers of progressing the issue of alienation under Part IVA.

5.50 A next step would be to amend the existing alienation of personal services income rules so that personal services income earned through an entity is attributed to the individual or individuals who provided the services. That is, this approach would apply the current attribution regime in the alienation of personal services income rules to all taxpayers in receipt of personal services income, not only those who do not meet any of the tests to be a personal services business.

5.51 This would make it clear that meeting the tests to be a personal services business means that some deductions that are not available to an employee may be available, but that personal services income cannot be alienated.

5.52 This option would address one of the key areas of current uncertainty, the interaction with Part IVA. Its focus is clearly on personal service income, not whether the taxpayer is 'employee-like'. As discussed above, this is a fundamental difference. However, moving to a focus on personal services income rather than 'employee-like' for the purposes of addressing alienation is not a departure from the current policy. Since the alienation of personal services income rules were introduced it was made clear that while the attribution provisions applied to those that could not meet the personal services business tests, arrangements put in place to alienate income could be subject to the provisions of Part IVA.

5.53 This approach may place more pressure on the distinction between income derived from personal services and income derived from a business structure. Only those taxpayers that meet the definition of personal services income would be affected, that is those whose income is mainly a reward for their individual's personal efforts or

skills. The option could be implemented in a way that any return from business assets or capital would not be affected by the attribution regime. As discussed at paragraph 5.8, this could be achieved by applying a domestic transfer pricing rule to the labour supplied, or alternatively by applying an imputed rate of return to any capital and treating the residual as personal services income.

5.54 The approach described here would address alienation more directly than the current provisions, and could simplify the law considerably and make it much easier for the ATO to administer the law as they would no longer need to commit resources to considering where Part IVA will apply.

CLARIFYING THE DEDUCTION RULES

5.55 The current alienation of personal services income rules generally limit deductions of an entity in receipt of personal services income to those that would be available if the personal services income was derived by an employee. In practice there are four deductions of concern in relation to personal services income: payments to associates, superannuation contributions, home-to-work travel and home office expenses. The approach in the current provisions is to deny certain deductions to taxpayers that do not meet one of the personal services business tests.

5.56 However, the Board is concerned that, for some taxpayers, this approach seeks to highlight a difference that may be marginal. For example, the issue of claiming a deduction for home-to-work travel in the construction industry is not so much whether a taxpayer is providing the services in an 'employee-like manner', but as set out in case law, whether the transport expenses can be attributed to the transportation of bulky equipment that could not be left at the workplace rather than to private travel between home and work.

5.57 A deduction or a tax offset for superannuation contributions on behalf of a spouse (not Superannuation Guarantee or employer contributions) is only available in limited circumstances (such as where the spouse has a low income). The rules setting out the circumstances where a deduction or tax offset is available are set out in Division 290 of the ITAA 97, not in the alienation of personal services income rules.

5.58 Amounts paid to an associate for non-principal work, for example support such as secretarial work, are not available to those in receipt of personal services income that are not a personal services business. In addition, excessive or unreasonable payments to a relative or a partnership in which the relative is a partner may not be deductible even where it is for principal work. This is also the area that the ATO continues to have most difficulty in administering and has been the subject of a number of court cases.

5.59 An option to address the different issues around deductions is to set out clearly when each of the deductions is available. Home-to-work travel and deductions for home office expenses would be available under the guidance provided already by case law. Payments to associates for non-principal work would be allowed only where a case was made out that the work was required in order for the principal to earn assessable income. That may involve the application of tests similar to the personal services business tests currently set out in the law – such as whether there were multiple customers that required invoices to be prepared or debts to be followed up.

5.60 As part of this option, the rules would allow a deduction for a payment to an associate incurred for the purpose of deriving assessable income that is made on an arm's length basis and can be regarded as being commercially in line with the level and skill of the actual work being undertaken.

5.61 An alternative to a specific arm's length rule for personal services income that the Government may wish to consider is a general arm's length rule as recommended in the Ralph Report.

5.62 The existing rules for superannuation contributions could be modified so that a deduction is available regardless of whether the work done is principal work or administrative work, but the deduction could be limited to the amount that needs to be contributed in order to avoid a Superannuation Guarantee shortfall for the associate.

5.63 In addition to legislative change, improvements could be made to the administrative arrangements for individuals in receipt of personal services income, either directly or attributed, that are not a personal services business. Instead of completing the Business and Professional Items Schedule which contains labels for deductions only available to those in business, they could instead complete much fewer labels, similar to those for work-related expenses.

5.64 While this approach would maintain some tests that stakeholders have told the Board they find difficult to apply, the tests would only apply to those taxpayers that sought to make payments to associates for non-principal work. They would therefore apply to a much-reduced potential population than the current tests that are applied to all taxpayers earning personal services income.

5.65 This approach would also highlight the similarities in the availability of deductions for some taxpayers, rather than highlighting the differences. This may assist in dismissing the perception that there are significant taxation benefits from being a contractor or operating through an entity.

5.66 A disadvantage of this approach is that it would require very specific provisions to be included in the law. If other deductions became an issue of concern, the law would need to be amended, rather than relying on the principle that is set out in the current rules. It could also lead to tax planning opportunities around the words

used in the law to describe and define the availability of deductions, which the current principle in the law about work-related deductions avoids.

5.67 Another drawback for the proposal is that some of the currently available deductions are sector-specific. For example, specifying in the law that home-to-work travel is an allowable deduction if heavy equipment is required to be carried to the workplace may provide some certainty to the construction industry, but not to other industries.

ADDRESSING COMPLEXITY

Simplifying the PAYG withholding obligations on attributed income

5.68 Suggested options such as replacing the personal service business tests with more objective 'employee-like' tests as suggested in the Ralph Report, extending the attribution rules to all entities in receipt of personal services income, or simplifying the deduction rules, would assist in addressing complexity. Another option would be to simplify the PAYG withholding obligations on attributed income.

5.69 An ATO practice statement, PS LA 2003/6, was developed as a result of taxpayers expressing concern following the introduction of the alienation of personal services income rules about the high compliance costs associated with complying with the PAYG withholding requirements in Division 13. The administrative arrangements permit a personal services entity that has an obligation to withhold not to comply with Division 13, if the entity withholds on the basis outlined in the Practice Statement. The administrative arrangements have assisted taxpayers by providing an easy method for calculating the amount to withhold and not penalising taxpayers who try to go some way to meet their PAYG obligations but nevertheless do not pay the correct amount.

5.70 In addition to the facilities currently provided by the ATO through its Practice Statement, current PAYG obligations on personal services entities in respect of attributed income could be made more flexible through the allowance of annual reconciliation in reporting and payment. Annual reconciliation of PAYG withholding obligations would facilitate compliance in cases where the status of taxpayers (whether covered or not by the personal service business tests exclusions) varies during an income year. The facility would not exempt taxpayers from the withholding obligation on attributed income. It would provide greater flexibility for personal service entities to reconcile errors due to changing circumstances.

5.71 These facilities would be even more important if attribution were to apply to all entities in receipt of personal services income. These facilities would assist compliance with PAYG withholding obligations.

APPENDIX A: LIST OF SUBMISSIONS

The Board received 13 submissions on the post-implementation review into the alienation of personal services income rules from the following parties:

Association of Professional Engineers, Scientists and Managers, Australia

Australian Council of Trade Unions

Civil Contractors Federation

Construction, Forestry, Mining and Energy Union

Courier and Taxi Truck Association

CPA Australia

Housing Industry Association

Iemi, Luigi

Independent Contractors of Australia

Institute of Chartered Accountants in Australia

Master Builders Australia

National Tax & Accountants Association

Taxation Institute of Australia

APPENDIX B: TAXATION OF PERSONAL SERVICES INCOME IN OTHER JURISDICTIONS

UNITED KINGDOM

The Intermediaries Legislation (IR35) was introduced in the UK on 6 April 2000 to eliminate the avoidance of tax and National Insurance Contributions (NICs) through the use of intermediaries, such as Personal Service Companies or partnerships, in circumstances where an individual worker would otherwise, for tax purposes, be regarded as an employee of the client.

The legislation is not targeted at any particular occupation or business sector. It can apply in any business sector. Examples of occupations where people work through service companies run right across the board, including medical staff, chief executives of large public companies, the teaching profession, legal and accountancy staff, construction industry workers, IT contractors, engineering contractors, clerical workers and many others.

The IR35 rules require consideration as to whether the individual would have been an employee, subject to tests or indicators which are similar to those proposed in the Ralph Report. The Pay as You Earn (PAYE) and NIC legislation imposes an obligation on the person engaging the worker (the 'engager') to determine the status of a worker (employed or self-employed contractor) by applying these tests.

Notwithstanding the IR35 legislation, HM Treasury has recently released a consultation paper¹¹ that has noted that there are a substantial number of workers in the construction industry working under employment terms who are presented as self-employed. It has concluded that the best way to address this problem is to introduce legislation. Under the proposed legislation, workers within the construction industry are deemed to be in receipt of employment income unless one of three criteria is met. Any payment made to a worker which is deemed to be employment income will be subject to PAYE and NICs.

The consultation paper proposes the following three criteria as reliable indicators, within the construction industry, of a worker being in receipt of self-employment income:

¹¹ HM Treasury 'False self-employment in construction: taxation of workers', July 2009.

- provision of plant and equipment – that a person provides the plant and equipment required for the job they have been engaged to carry out. This will exclude the tools of the trade that are traditionally provided by the individuals;
- provision of all materials – that a person provides all materials required to complete a job; or
- provision of other workers – that a person provides other workers to carry out operations under the contract and is responsible for paying them.

The consultation paper also notes that HM Treasury recognises the effect that the economic downturn has had on the construction industry and intends that the measures developed as a result of consultation will take effect when the industry is in a stronger position.

NEW ZEALAND

As a result of the introduction of the Avoidance Legislation in 2000, personal services income received by a company is attributed to the individual who derived it, after allowable deductions are taken into account. The attributed amount is deducted from the entity's income for tax purposes.

For attribution to apply all the following criteria must be met:

- 80 per cent or more of the entity's personal services income is from one source;
- 80 per cent or more of the entity's personal services income is derived from the individual or their relative;
- the entity's net income is greater than NZ\$60,000; and
- the business structure does not have substantial business assets (depreciable property costing more than NZ\$75,000 or at least 25 per cent of the company's gross personal services income for the year).

NORDIC COUNTRIES¹²

For the self-employed, taxation of income is split between income from labour (subject to progressive taxation) and income from capital, which is subject to a flat tax rate. As capital can more easily be defined and valued, the rate of return on business assets is calculated and then the residual is treated as income from labour. If the self-employed

¹² Sorensen, P 'The Nordic Dual Income Tax: Principles, Practices and Relevance to Canada' Canadian Tax Journal (2007) Vol 55, No. 3, 555-607

person does not split their income from labour and income from capital, all income is taxed as labour income.

The imputed rate of return on business assets can be calculated using gross assets or net assets.

Under the gross assets method the net financial liabilities of the entity are not deducted from the asset base. The income from labour is calculated by deducting the imputed return to gross business assets (as recorded on the balance sheet) from the gross profits.

Under the net assets method the net financial liabilities are deducted from the asset base. The income from labour is calculated by deducting the imputed return to net business assets (business assets minus business debt) from the net profits (profits after the deduction of interest).

The imputed rate of return is set by the tax authority and may differentiate between business activities to prevent distortion in investments.

CANADA¹³

The Canadian Income Tax Act limits deductions available to companies which derive income from a 'personal service business'. All deductions are denied except for:

- salary, wages, or other remuneration paid to an 'incorporated employee';
- selling and similar expenses that would have been deductible in computing employment income if the taxpayer had been employed and had been required by a contract of employment to pay them; and
- legal expenses incurred in collecting amounts owing for services rendered.

A Canadian personal service business is defined as one where the services of an 'incorporated employee' are provided to an entity in which it could reasonably be concluded that the 'incorporated employee' would be regarded as an officer or employee (that is, an employee as opposed to an independent contractor).

The incorporated employee or a related person must own 10 per cent of the issued shares of any class in the company at any time during the year. Exceptions are where throughout the year the company employs more than five full-time employees or where a company receives the proceeds from an associated company.

¹³ Pennicott, S 'Resolving the personal services income dilemma in Australia: An evaluation of alternative anti-avoidance measures' *Journal of Australian Taxation* (2007) Vol 10(1), 85

APPENDIX C: PAYROLL TAX HARMONISATION

The States are currently undertaking payroll tax harmonisation.

Stage 1 has been completed and includes the adoption of common payroll tax administration provisions and definitions for: timing of lodgement; vehicle allowances; accommodation allowance; fringe benefits; work performed outside a jurisdiction; employee share acquisition schemes; superannuation for non-working directors; and grouping of businesses.

Stage 2 reforms are currently under way and include the harmonisation of definitions and terms in payroll tax legislation (employer is included as a term defined in legislations, however employee is not expressly defined in all legislations).

NSW, Victoria, Queensland and Tasmania have already agreed to reforms as part of Stage 2. WA, SA and the NT are still considering second-stage reforms.

