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# **Using the tax regime to wipe out independent contractors An assessment**

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In the build up to the 2007 election the Rudd ALP specifically targeted the small/micro business, independent contractor sector as being vital to their winning strategy. In part, the Rudd ALP won government because they recognized that in Australia the self-employed sector constitutes a key swinging voter demographic. In fact it is probable that federal government cannot be won without substantial support from this sector.

For the ALP this political reality is a challenge because their core union orientated support base has been traditionally highly antagonistic toward self-employed people. ALP, tax, industrial relations and other policies have historically been orientated toward preventing or limiting self-employment. The Rudd ALP in opposition overturned this, reversing key long-held anti-self-employment policies particularly in the tax area. One of these was the Personal Services Income (PSI) tax laws.

The PSI laws determine when and how a self-employed person can access business style tax treatment. It resolves when tax splitting and income retention in a company structure is allowed or not allowed. This business tax treatment is integral to the financial viability of being a self-employed person. If you cannot claim as tax deductions those legitimate business type expenses incurred in running your business, then a disproportionate tax impost is imposed on self-employed people.

The PSI law (created in 2001) settled the business tax treatment and made irrelevant any accusation that self-employed persons rort the tax system. Accusations that self-employed people rip off the tax system had been a union and ALP platform for almost three decades until 2006. (My 2000 HRN paper covered the broad issues. <http://www.hrnicholls.com.au/archives/vol21/vol21-4.php>)

But it must be noted that when the tax debate over self-employment was at its height in the late 1990s the Australian Taxation Office targeted the tax returns of some 65,000 self-employed

profiled as likely tax avoiders. Only 714 taxpayers were identified as underpaying, requiring additional tax payments of between 1.9 and 11.6 percent. Others were owed refunds. No tax 'ripe off' was found. Instead the audit reported that the level of non-compliance was lower than what could be expected of any random taxpayer audit.

Still, no matter how small a problem, potential tax loopholes need to be fixed.

Howard and Costello confronted the issue in their 2000 tax reform process. It culminated in the 2001 Personal Services Income (PSI) tax laws. Put simply, individual self-employed people only access tax deductions normally available to any individual taxpayer. Self-employed partnerships receive standard business tax treatment. Self-employed people who work through companies or trusts have to be careful. The ATO will test if any income splitting is a legitimate business activity.

The ATO's approach to companies/trusts under PSI has been tested and upheld by the courts as late as 2008. Consequently tax for the self-employed is now pretty much settled. But this tax settlement does not appear to satisfy the industrial relations agenda of the Australian union movement in their desire to prevent or limit self-employment. This old agenda has re-emerged in the Rudd government.

On 16 December 2009, Assistant Treasurer Senator Nick Sherry released a [report](#) of a review into the Personal Services Income tax laws. The review was conducted by the Board of Taxation for the Rudd government. The government has passed the report to the Henry Review of taxation for final recommendations. Senator Sherry's [press release](#) effectively endorses the report as integral to the government's program to stop 'sham' contracting.

The report is badly researched, contains only cursory statistical data and analysis, and is based on outdated and erroneous assumptions about the nature of small business. The government's response---reflected in Senator Sherry's press release---has all the indications of an ALP throwback to the anti-small business agendas of the 1990s. It seeks to reintroduce a process which uses the taxation system to pursue industrial relations agendas. The report also displays an acute ignorance of the nature of business and how self-employed people operate as small businesses.

If any part of the report is implemented, it will result in major increases in small business red tape, substantially increase the levels of confusion over small business taxation, undo the immense progress made on the issue over the last decade, and will do nothing to address or fix sham contract arrangements.

It's an agenda to close down self-employment by making it almost administratively impossible to be self-employed.

Further, implementing this report will breach undertakings made by the Rudd ALP when in opposition. In July 2007, Independent Contractors of Australia asked the Federal ALP the following question:

- *The ALP supports the principles behind the alienation of personal services income legislation. Does this mean that the ALP supports the existing personal services income tax legislation or are changes proposed? If changes are proposed, what would these involve?*

The ALP replied (through the then shadow minister for small business Dr Craig Emerson)

- *No changes are proposed.*

This was a clear statement by the Rudd Opposition that, when in government, the PSI laws would remain as they are. This Board of Taxation report and Senator Sherry's press release indicate that the Rudd Government has every intention of changing the PSI laws---a direct breach of its 2007 undertaking.

What follows are some excerpts from the report and some of its recommendations.

The following is a direct quotation from the report about how to move forward with a new taxation agenda for small business.

- 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.

The report raises several specific options for action:

1. Introduce a whole new regime of reporting on payers and payees. (ie: anyone who does business to business commercial transactions) Require payers and payees to make an annual report to the ATO so that the ATO can match data to see how many clients an independent contractor had in a year.

2. Introduce an entirely new form of withholding obligation on payers. That is, businesses would have to pay tax on behalf of other businesses.
3. Introduce mandatory GST registration and remove the \$75,000 threshold below which small businesses do not have to register for GST.
4. Introduce the 80/20 rule which was proposed by the Ralph Review, thereby treating small business people as if they were employees.
5. Change the results test so that a business must have at least two employees.

Robert Gottlieb from *Business Spectator* has given a practical explanation of the implications.

“Each plumber or computer consultant in Australia will need to differentiate between their income from capital (spanners, shovels and computers) and their income from labour (digging the ditches and writing software).

Under the Sherry-blessed plan, part of the income derived from labour would be attributed to the person who supplied the labour and those people would be treated as employees – not business people. The income earned on capital could be returned to the owner(s) of the capital, which may differ from the person who provided the labour. Have you ever heard of anything more stupid? But the Sherry-blessed plan gets worse.

The plumber and computer person must make an annual report to the ATO so that the ATO can match data to see how many clients they have had in a year. If more than 80 per cent of the business income came from one group then whammo! You are an employee.

And once the plumber and computer consultant are deemed to be employees, all their business deductions will be looked at in a different light. Their customers may be required to deduct tax when they pay the invoice.

And, oh yes, every business must have two employees to be a business.

There are a lot more crazies being considered, but that’s enough to confirm that, potentially, this is a candidate to rank as the biggest attack anyone has ever mounted against the Australian small business community.”

On this issue the Rudd ALP is in great difficulty. Commonsense and understanding of business has flown out the door. They threaten the very entrepreneurship that self-employment, independent contractors, small and micro-business people bring to our economy and society. They display an acute ignorance of the potential adverse political implications for them of what they propose. The threat to the right to control your own work destiny is very real in this tax proposal. Let’s hope it dies the death it deserves.