Contractors v Employees - Avoiding the Tax and Super Pitfalls

Mark Chapman

Thursday 8 February 2024

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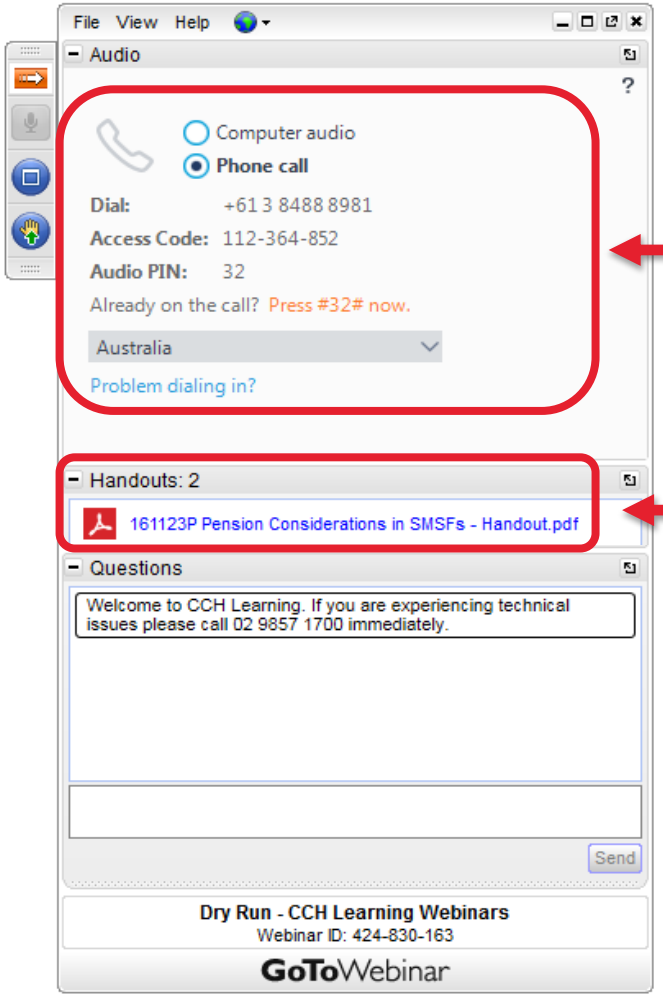

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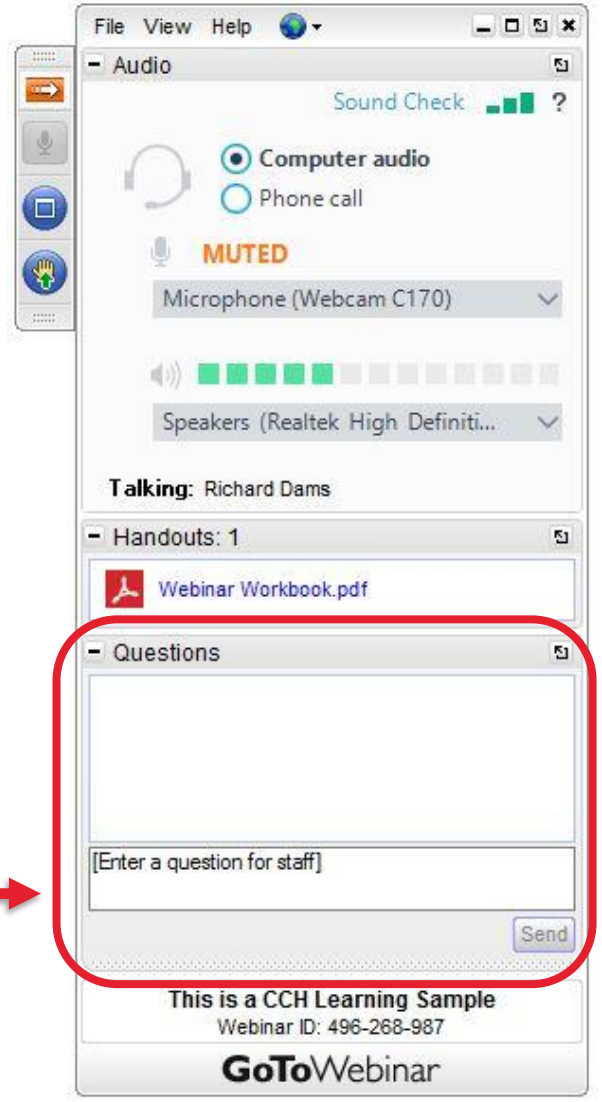

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Your Presenter

- **Mark Chapman**
- Director of Tax Communications
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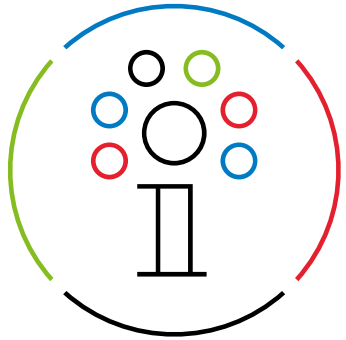
Today's session will cover



Contractors v Employees: Avoiding the Tax and Super pitfalls

- The impact of structuring worker engagement on PAYG(W), FBT and Super Guarantee liabilities
- How do recent court cases impact the decision-making process?
- New ATO guidance which must be considered by employers, and how it differs to previous guidance
- Why avoiding PAYG(W) doesn't necessarily mean that an employer also avoids super guarantee liabilities
- Compliance and documentation – what you need to do to avoid ATO challenge
- Costs and penalties of getting it wrong

Why does it matter?

- The tax obligations facing the two types of worker are very different.
- The burden of getting the decision right rests with the hiring business.
- If a worker is an employee, the hiring business needs to:
  - withhold tax (PAYG withholding) from their wages and report and pay the withheld amounts to the ATO
  - pay super, at least quarterly
  - report and pay fringe benefits tax (FBT) if fringe benefits are provided.
- If the worker is a contractor:
  - they generally look after their own tax obligations, so there is no need to withhold tax from payments to them unless they don't quote their ABN to the hiring business.
  - there is no requirement to pay superannuation on their behalf but the hiring business may still have to pay super for individual contractors if the contract is principally for their labour (see later slides)
  - there are no FBT obligations.

Why does it matter?

- The consequences of getting the decision wrong (ie treating somebody as a contractor when they are really an employee) include penalties and charges such as:
  - PAYG withholding penalty – for failing to account for tax from worker payments
    - The penalty incurred is equal to the amount that should have been withheld or paid.
    - Company directors hold legal responsibility for ensuring their company fulfills its PAYG withholding obligations. If a company fails to meet its PAYG withholding obligations in full by the due date, the director automatically becomes personally liable for a penalty equivalent to the unpaid amount.
  - super guarantee charge, made up of
    - 200% of super guarantee shortfall amounts plus the original amount – the amount of super contributions that should have been paid into a complying fund
    - interest charges of 10% per annum
    - an administration fee of $20 per employee, per quarter

Why does it matter?

- The Fair Work Act prohibits "sham contracting arrangements", where an employer treats a worker as an independent contractor in an attempt to avoid meeting employee entitlements. It is illegal for a business owner to convert staff into contractors. Employers who try it can face prosecution for tax evasion and can be penalised for flouting superannuation laws and avoiding workers compensation laws.
- In addition, the employer needs to consider workplace entitlements including the following:
  - Sick leave
  - Annual leave
  - Workcover
  - Minimum rates of pay
  - Compensation for unfair dismissal
  - Payroll tax issues
- The worker then needs to consider:
  - GST obligations
  - Personal Service Income rules

The implications of contractor v employee

- If the worker is treated as an employee of the engaging entity, then:
- Consequences for the engaging entity
  - Report via Single Touch Payroll
  - Withhold amounts under the PAYG withholding regime
  - Make superannuation contributions or be liable for the superannuation guarantee charge
  - Meet fringe benefits tax obligations for benefits provided
  - Not entitled to claim input tax credits for wages paid
- Consequences for the worker
  - Not entitled to an ABN in relation to that employment
  - Not entitled to register for goods and services tax (GST) and no GST reporting obligations in relation to that employment

The implications of contractor v employee

- If the worker is treated as a genuine independent contractor, then:
- Consequences for the engaging entity
  - Report via Taxable Payments Annual Reporting as legislated or on a voluntary basis if they satisfy the turnover-threshold test
  - If the worker satisfies the extended definition of employee (see later slides), make superannuation contributions or be liable for the superannuation guarantee charge
  - If the engaging entity and worker are both registered for GST, claim eligible input tax credits
  - If the worker does not quote an ABN when required, or the parties enter into a voluntary agreement, withhold amounts under the PAYG withholding regime
- Consequences for the worker
  - Make provision for income tax through PAYG instalments, if required
  - Entitled to apply for an ABN
  - Register for and paying GST, if required
  - Consider the personal services income implications

PAYG(W) – employee v contractor

- The ATO can argue that there is a deemed employer/employee relationship if the relationship indicate that it is essentially employee-like.
- There is no definition of an “employee” in any tax legislation. The relevant test for determining whether an individual is an employee for PAYG withholding is the common law test.
- Traditionally, the Courts have applied the “multifactorial” approach to work out the distinction between employee and contractor. This consisted of a wide-ranging review of all aspects of the work arrangement, whether they were reflected in the contract or not.
- Relevant factors before, during and after the time the contract was entered into needed to be considered, including mode of remuneration (eg, hourly), the right of a person to delegate work to others and representation as part of the payer’s business (eg wearing a uniform with the businesses logo).
- However, a series of recent court cases such as the Personnel Contracting case (Construction, Forestry, Maritime, Mining and Energy Union v Personnel Contracting Pty Ltd) and Jamsek case (ZG Operations Australia Pty Ltd v Jamsek) now emphasise that the contract between the business and its workers is the most important element.

PAYG(W) – employee v contractor

- The Personnel Contracting case dealt with a labour hire company that engaged workers to supply labour to building industry clients. In 2016, Personnel Contracting engaged the services of Mr McCourt and offered him work at a building site operated by Hanssen Pty Ltd, one of Personnel Contracting's major clients.
- Mr McCourt commenced basic labouring work on site with Hanssen, without signing a contract but under its direct supervision. He subsequently ceased working with Personnel Contracting and Hanssen on 30 June 2017.
- Mr McCourt and the Construction, Forestry, Maritime, Mining and Energy Union (CFMMEU) commenced proceedings against Personnel Contracting for compensation and penalties under the Fair Work Act (FWA), claiming that he was a "common law employee" of Personnel Contracting, who had not paid him in accordance with his industry entitlements.
- Ultimately, the case ended up before the High Court, which said that the Court's role was to characterise the relationship by examining the totality of the relationship **having regard to the parties' rights and obligations contained in the written contract**.
- The Court said that where the parties had comprehensively committed the terms of the relationship to a written contract (and neither party disputed the validity of that contract), the characterisation of their relationship must be based on that contract rather than the subsequent conduct of the parties.

PAYG(W) – employee v contractor

- In the *Personnel Contracting* case, the High Court rejected the traditional multifactorial approach, saying that an examination of all the dealings between the parties over the entire history of their relationship was unnecessary and inappropriate.
- However, it did note that examination of post-contractual conduct is permissible in certain circumstances. This might be where the contract was not in writing, or only partly in writing, or where the terms of the written contract were being challenged as invalid (such as sham) or varied.
- The High Court concluded a crucial factor was the extent and degree of control exercised by the 'employer'. When considering both the degree and nature of that control (and whether the worker was performing work in the business of the employer), attention needs to be given to the following contractual aspects:
  - the way the worker was paid
  - the provision and maintenance of equipment to do the job
  - the obligation to work and the hours of work
  - the provision for holidays
  - the deduction of income tax
  - the ability to subcontract the work.
- How the above is applied to the worker on a day to basis is largely irrelevant (unless there is no contract or there are indications that the contract was sham).

PAYG(W) – employee v contractor

- The Commissioner was not a party to this case, which concerned entitlements under the FWA. Nevertheless, the ATO later released Taxation Ruling TR2023/4 to provide guidance on the question of who is an employee for PAYG purposes, which replaces TR 2005/15, its former and now outdated review of the subject.
- TR 2023/4 reflects the High Court decisions in both the *Personnel* case and the *Jamsek* case (the latter was another recent case decided along similar lines).
- TR 2023/4 confirms that "where the worker and the engaging entity have comprehensively committed the terms of their relationship to a written contract and the validity of that contract has not been challenged as a sham nor have the terms of the contract otherwise been varied, waived, discharged or the subject of an estoppel or any equitable, legal or statutory right or remedy, it is the legal rights and obligations in the contract alone that are relevant in determining whether the worker is an employee of an engaging entity. Evidence of how the contract was performed, including subsequent conduct and work practices, cannot be considered for the purpose of determining the nature of the legal relationship between the parties."

TR 2023/4

- Whether a person is an employee — under the ordinary meaning of the term — of an entity is a question of fact to be determined by reference to an objective assessment of the totality of the relationship between the parties, having regard only to the legal rights and obligations which constitute that relationship.
- The task is to construe and characterise the contract at the time of entry into it. Recourse may be had to events, circumstances and things external to the contract which are objective, known to the parties at the time of contracting and assist in identifying the purpose or object of the contract.
- It is the legal rights and obligations in the contract alone that are relevant, where the validity of that contract has not been challenged as a sham, nor have the terms of the contract otherwise been varied, waived, discharged or the subject of an estoppel or any equitable, legal or statutory right or remedy.
- A contract will be a sham if it is not a legitimate record of the intended legal relationship between two parties, but instead is ‘a mere piece of machinery’ serving some other purpose (often to act as a façade and deliberately obscure the true legal relationship for third parties).

TR 2023/4

- Evidence of how the contract was performed, including subsequent conduct and work practices, cannot be considered for the purpose of determining the nature of the legal relationship between the parties.
- Notwithstanding the above, evidence of how a contract was actually performed may be considered to establish the contractual terms or to challenge the validity of a written contract.
- A useful approach for establishing whether a worker is an employee is to consider whether the worker is working in the business of the engaging entity, based on the construction of the terms of the contract. However, this should not be approached as a 'checklist' exercise. In addition, the label which parties choose to describe their relationship is not relevant to the characterisation of the relationship.
- The fact that the worker is conducting their own business, including having an ABN, is not determinative — they may separately be an employee in the business of another entity.

TR 2023/4

- The usual factors that indicate employee or contractor status are explained in the Ruling as follows:
  - At its core, the distinction between an employee and an independent contractor is that:
    - an employee serves in the business of an employer, performing their work as a part of that business
    - an independent contractor provides services to a principal's business, but the contractor does so in furthering their own business enterprise; they carry out the work as principal of their own business, not part of another.
  - control and the right to control
    - An employer generally has a right to control how, where and when its employee performs their work. The importance of control in this context lies not in its actual exercise, but rather in the contractual right of the employer to exercise such control.
  - the ability to delegate, subcontract or assign work
    - where a worker has an entirely unfettered right to delegate, subcontract or assign their work to others, in the absence of countervailing considerations, the existence of this right will be a very strong indicator against the worker being an employee. Where the right is fettered, the other terms of the contractual relationship will need to be considered.

TR 2023/4

- The usual factors that indicate employee or contractor status are explained in the Ruling as follows (cont'd):
  - whether the substance of a contract is to achieve a specified result
    - where the substance of a contract is to achieve a specified result, there is a strong (but not conclusive) indication that the contract is one for services (contractor)
  - provision of tools and equipment
    - the provision of assets, equipment and tools by a worker, and the incurring of expenses and other overheads, may be an indicator that the worker is an independent contractor.
  - risk
    - Where the worker bears little or no risk of the costs arising out of injury or defect in carrying out their work, they are more likely to be an employee. On the other hand, an independent contractor bears the commercial risk and responsibility for any poor workmanship or injury sustained in the performance of work. However, a clause in a contract that requires a worker to take out public liability or indemnity insurance will likely be a neutral factor in determining the nature of the relationship between the worker and the engaging entity
  - generation of goodwill.
    - Where a contract between a worker and engaging entity prevents any goodwill from accruing for a worker's possible business, this may indicate that the worker is instead serving in the engaging entity's business (an employee).

PCG 2023/2 – the compliance approach

- The Guideline will be particularly relevant for situations where a worker's correct classification is less obvious.
- It outlines the ATO's risk framework for worker classification arrangements, based on the actions taken by the parties when entering into the arrangement. Parties can self-assess against this risk framework to understand the likelihood of the ATO applying compliance resources to review their arrangement.
- A review may be the result of proactive case selection based on particular risk factors and information known to the ATO, or the result of an unpaid superannuation query received from a worker (including where they believe they satisfy the extended definition of employee).
- As such (and unlike the ruling), the Guideline can be used **both** in PAYG(W) compliance and superannuation guarantee compliance (see later slides)
- The Guideline sets out four risk zones which will determine the level of compliance resources dedicated to it – white (very low), green (low), yellow (medium) and red (high)

PCG 2023/2 – the compliance approach

- The Guideline assesses each of three factors in determining the risk scores:
  - The parties' arrangements, intentions and understanding
  - The conduct of the parties
  - Advice received
- An arrangement can fall into the very low-risk category if the entity voluntarily meets employer obligations regardless of their view of the worker's classification.
- Where there has been a 'significant deviation' of the arrangement, the party will need to reassess their risk rating. This may include:
  - ensuring that both parties understand the impact of the changes on their working arrangement and classification
  - ensuring the contractual rights and obligations agreed by the parties reflect the changes in the working arrangement
  - ensuring that, if the classification has changed, all parties understand the tax, superannuation and reporting consequences of the new classification, and
  - ensuring that new client-specific advice (whether from the ATO, the engaging entities' in-house counsel or an appropriately qualified third party) has been obtained to confirm the classification in light of the new circumstances.
- The Guideline contains six practical examples illustrating the application of the risk score approach.

PCG 2023/2 – the compliance approach (example 1 from the PCG)

- *A manufacturing business entered into a contract with a software engineer, Brett, to design, develop, test and install a new software program. The business intended to engage Brett as an independent contractor and the terms of the comprehensive written agreement between the business and Brett support this.*
- *For the purposes of the Guideline, the following facts were relevant:*
  - *the business had a record of discussions with Brett in which it highlighted that he was being engaged differently from the business' employees and why he was a contractor and not entitled to superannuation*
  - *the business had procedures in place to ensure the terms of contracts and the tax and superannuation implications for its workers, including Brett, were explained, understood and acknowledged*
  - *neither Brett's nor the business' subsequent actions suggested any deviation from the contracted arrangement; Brett acted consistently with that arrangement, including invoicing for his work using an ABN and charging GST*
  - *the business had obtained professional advice from an employment lawyer regarding the arrangement with Brett and their resulting tax and superannuation obligations, which indicated that the classification was correct and Brett did not satisfy the extended definition of employee for superannuation purposes, and*
  - *the business complied with all the tax and reporting obligations arising from its engagement of Brett as a contractor.*
- *The arrangement is rated in the **very low-risk** zone. No further compliance resources will be applied to scrutinise whether Brett should instead have been classified as an employee of the engaging entity.*

PAYG(W) – employee v contractor

- The government (on 4 September 2023) introduced the *Fair Work Legislation Amendment (Closing Loopholes) Bill 2023.* This Bill aims to close loopholes that undermine pay and conditions and to improve work health and safety laws in the Commonwealth jurisdiction.
- Although it was given royal assent, the Act did not include the originally proposed measures to introduce, for Fair Work purposes, a statutory definition of "employee". This aspect of the original proposal will now need to be considered by Parliament in 2024.
- This original Bill states that the meaning of 'employee' and 'employer' will be determined by "reference to the real substance, practical reality, and true nature of the relationship between the parties". This would require the totality of the relationship between the parties, including not only the terms of the contract governing the relationship but also the manner of performance of the contract, to be considered in working out whether there is a relationship of employment or one of principal and contractor.
- Therefore, this measure effectively seems to re-establish the multi-factorial test (ie looking at the totality of the employment relationship) to determine whether a person is an employee or contractor.
- The potential introduction of a Fair Work "employee" definition, emphasising the "multi-factorial" test, appears at odds with the tax approach, as set out in TR 2023/4. It also suggests that employers will need to keep sufficient evidence of their workers status to take account of the Fair Work assessment, the common law (contractual) assessment (relevant to tax/superannuation, among other things), and the extended definitions relevant for other purposes (e.g. section 12 SGAA).

PAYG(W) – employee v contractor

- Businesses should note the importance of keeping proof set out in TR 2023/4, not just by putting in place a written contract but also establishing that the worker performs their duties in accordance with the written contract.
- Therefore, any written contract should be as comprehensive as possible and should align with the rights and responsibilities of both the worker and the business, as practiced on a day-to-day basis.
- Written contracts should be available for inspection by the ATO and constantly monitored for accuracy, eg making sure the workers' performance does not deviate from the terms of the contract.
- The business should also consider obtaining written professional advice on any proposed contractor arrangement, to make sure that the terms of the contract justify a contractor arrangement and that the tax and superannuation outcomes have been discussed and agreed.
- The worker should also be made aware of the professional advice (preferably in writing).

PAYG(W) – employee v contractor

- Matters to be considered by the contract for services and other legal agreements:
  - A clear statement of the relationship between both parties
  - The contractor's rights and obligations related to plant and equipment, ie what equipment the contractor is expected to provide and what will be supplied by the contracting business and at what cost.
  - Who is responsible for the big risks, eg litigation? It is recommended that the contract places this responsibility in the hands of the contractor to the extent that the litigation arises from the performance of the contractor.
  - Who is liable for public indemnity? It is recommended that the contractor has their own insurance covering these risks
  - PAYG(W). It should be made clear that the worker is a contractor and hence PAYG(W) will not be deducted.
  - Are there any guaranteed minimum hourly rates? This is not recommended because it can be inferred that there is an employee/employer relationship.
  - Who has control? It is recommended that the contractor be given the power to sub-contract out to their own employees/other contractor
  - Restraints of trade. Are there any restraints of trade that may infer an employer or employee arrangement?

Superannuation Guarantee

- The Superannuation Guarantee (Administration) Act 1992 (Cth) (SG Act) requires businesses to make superannuation contributions for the benefit of 'employees'. However, this captures **both** employees at common law **and** persons who are captured by the extended definition of 'employee' which is:
- **'If a person works under a contract that is wholly or principally for the labour of the person, the person is an employee of the other party to the contract'.**
- The purpose of this expanded definition is to reach beyond the traditional employment relationship and capture independent contractors who principally provide their own labour to meet obligations under a contract.
- Superannuation Guarantee Ruling SGR 2005/1 explains when an individual is deemed to be an 'employee' under the extended definition in the SG Act. The ATO considers that an individual works under a contract that is 'wholly or principally for the labour of the person' – and is, therefore, a deemed 'employee' - where:
  - the individual is remunerated (either wholly or principally) for their personal labour and skills
  - the individual must perform the contractual work personally (there is no right of delegation)
  - the individual is not paid to achieve a result

Superannuation Guarantee

- While businesses will sometimes attempt to contract their way out of SG obligations, the ATO and courts take a much broader view of the situation and will always attempt to discover the true nature of the arrangement or relationship.
- Inserting clauses into a contract which state that the businesss is not responsible for making superannuation contributions on behalf of a worker will not be effective at releasing the business from its SG obligations if the worker is classified **either** as an employee at common law **or** under the expanded definition.

Superannuation Guarantee

- In order to avoid SG, contractors can run their business through a company or a trust.
- This is because it has traditionally been the ATO's view that SG support would not need to be provided for an independent contractor engaged through an interposed entity (e.g., a company or trust).
- This view is supported by the following statement, contained in paragraph 13 of SGR 2005/1:
- "Where an individual performs work for another party through an entity such as a company or trust, there is no employer-employee relationship between the individual and the other party for the purposes of the SG Act, either at common law or under the extended definition of employee. This is because the company or trust (not the individual) has entered into an agreement rather than the individual…"

Superannuation Guarantee

- Dental Corporation Pty Ltd v Moffet [2020] FCAFC 118
- The dangers of engaging contractors directly was illustrated in this recent Full Federal Court decision.
- This case dealt with whether a taxpayer dentist (working as an independent contractor for a dental practice) fell within the extended definition of an 'employee' for SG purposes and, therefore, was entitled to SG support (despite not being considered an employee for common law purposes) from the dental practice.
- Importantly, the Full Federal Court held in favour of the taxpayer (i.e., he had an entitlement to SG support).

Superannuation Guarantee

- Dental Corporation Pty Ltd v Moffet [2020] FCAFC 118 (cont'd)
- Under the Services Agreement, Dr Moffet's remuneration structure involved Dental Corporation paying him a percentage of patient fees monthly. Dental Corporation operated on the basis that Dr Moffet was engaged as an independent contractor (rather than as an employee) and, on this basis, did not provide him with any accrued leave entitlements or SG support.
- Although the court found that Dr Moffet was not an employee for common law purposes (hence the claim for annual leave was denied), the court agreed with Dr Moffet's contention that he was entitled to SG support on the basis that he fell within the extended definition of an 'SG employee' under S.12(3) which states:
  - "If a person works under a contract that is wholly or principally for the labour of the person, the person is an employee of the other party to the contract."
- The relationship between Dr Moffet and Dental Corporation was direct – ie, there was no intermediary entity – so it is essential that all such relationships are indirect.
- In this example, if Dental Corporation had engaged with a company owned and run by Dr Moffet, SG would not have arisen.

Superannuation Guarantee

- Note the outcome of the *Roy Morgan Research* case (2011 ATC 20-282) demonstrates that this approach is not infallible.
- In that case, the business was still engaging the individuals to perform the work even though the payments were being directed to a company.
- Therefore, it is essential for the business to engage the taxpayer's entity, as well as directing payments to it.

Superannuation Guarantee – Penalties and Remission

- As per earlier slide, if an employer fails to make the required superannuation contributions in full and an SG statement is not lodged within 28 days after the relevant quarter, a penalty can be levied consisting of:
  - Super Guarantee Charge – Pt 7 penalties of 200% of the original amount (on top of the original amount)
  - A nominal interest component (currently 10% per annum) of the shortfall amount from the beginning of the quarter in which the contribution was required to be made until the lodgement of an SGC statement
  - Administration fee of $20 per employee per quarter
- The terms of remission for penalties are considered in PSLA 2021/3, which notes that an employer should only be considered for penalty relief where they have a turnover of less than $50 million and they:
  - took voluntary action to comply with their obligation to lodge SG statements
  - do not have a history of lodging SG statements late
  - have lodged no more than four SG statements after the lodgment due date
  - have no previous SG audits where they were found to have not met their SG obligations, and
  - have not previously been provided with penalty relief.

Superannuation Guarantee – Penalties and Remission

- Penalty relief would not be appropriate where the employer has:
  - been issued with an SGC default assessment
  - lodged more than 4 SG statements after the lodgment due date, or
  - previously been issued with an SG education direction.
- Following the principles set out in PS LA 2021/3, it is possible for penalties to be remitted in full where there is overall good compliance behaviour and the business has a turnover of less than $50m.
- An employer cannot apply for penalty relief, and an employer cannot specifically object to a decision not to apply it.

Questions?

Alison Wood
CCH Learning Moderator

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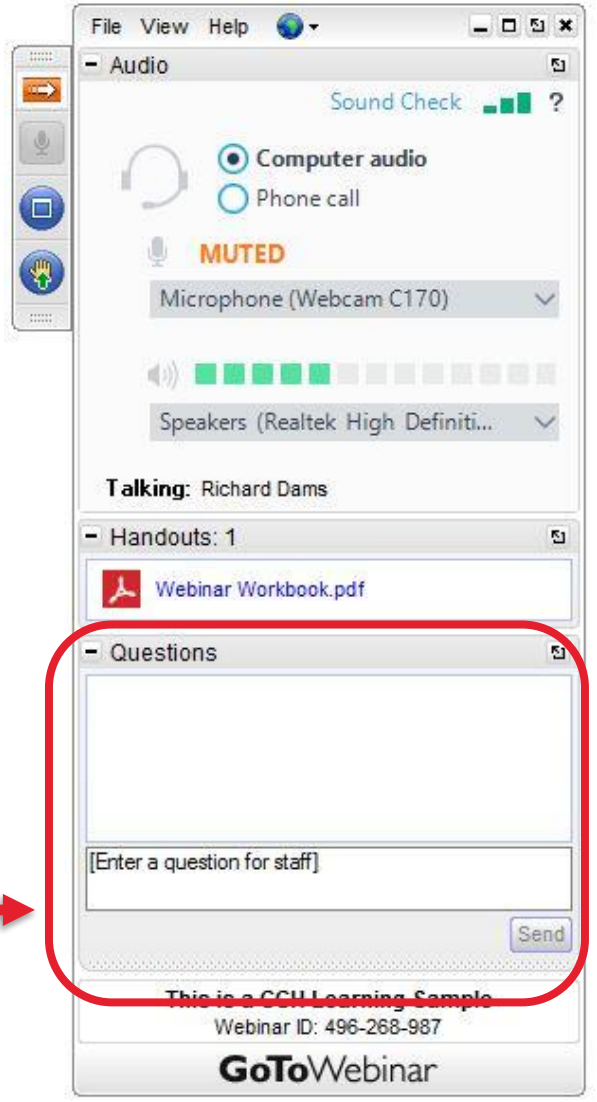

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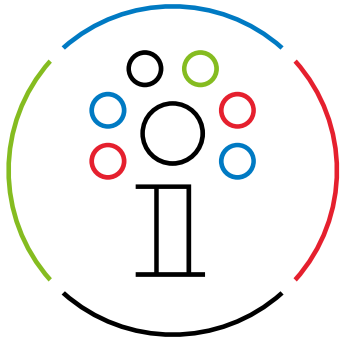

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Questions?

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- **Mark Chapman**
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