



Are Your Contractors Really Contractors?



How to ensure you and your business ARE compliant as you walk through the Independent Contractor “Minefield”

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Introduction

The purpose of this compliance information and assessment kit is to alert businesses to the issues and risks affecting the deployment of labour based contractors in Australia.

Specifically, it focuses on the critical area of Australian Tax Office (ATO) compliance, the Personal Services Income (PSI) legislation and the issues affecting the engagement of independent contractors who provide labour based services to your business. It also touches on the Fair Work Act and the SHAM contracting provisions therein.

In spite of the Personal Services Income (PSI) legislation being enacted in 2000 there is a lack of (general) understanding on how the legislation actually works and what it is designed to achieve.

There are significant risks to any business in creating an employment relationship when directly engaging labour based contractors to provide their services. However a better way to deploy these contractors is via the ContractRight framework. This is an arm's length, precedent based and lawful way for a business to deploy contractors who want to provide labour based services.

The ContractRight framework sits outside of the testing regime of the Personal Services Income (PSI) Legislation and does not attract the attention of the ATO.

While this information Kit isn't a definitive guide, it provides background to the problems associated with non-compliant contractor engagement along with details of the robust and tested ContractRight solution.

Background

Over the past 35 years, there has been a distinct shift away from the traditional model of an employer-employee relationship. Australia's workforce now comprises 2.4 million self-employed individuals. <http://www.civilsociety.org.au/smallbusiness.htm> In fact 30% of the Australian private sector workforce are independent contractors or self-employed. This is highlighted by the rise in individuals participating in the so called casual "gig economy".

Contracting has appeal to both individuals and the organisations engaging them.

Among other things, it provides contractors with:

- Improved net financial return
- Flexibility and personal freedoms
- The satisfaction of using hard-won skills and imparting the knowledge and wisdom gained in many years in the workforce.

In many cases businesses are looking for more flexibility in managing their workforce. This may be due to variable revenue performance due to highs and lows in market conditions, or the need to gain productivity improvements or to engage specialist for a specific project

Using an Independent Contracting model ... and avoiding financial RISK

The Independent Contracting model certainly offers greater flexibility for a business to manage the highs and lows in business performance. However, the 'downside' is that contractors and companies must be aware of the traps and pitfalls of entering such arrangements.

Traps and pitfalls that, frankly, can put you at financial risk.

That said, you're in the clear if you engage a contractor who is providing both physical input along with machinery (such as hiring the operator of a bobcat or a backhoe). Under these circumstances, the individual is considered to be legitimately running a business.

However...

An individual who provides personal services (labour or intellectual input) is automatically caught under the Personal Services Income (PSI) Legislation.

If this is so...

It means you should treat the individual as an employee for the purposes of paying tax and other liabilities.



"But wait a minute... they have an ABN!!"

Sorry! Simply having an ABN, Company or a Trust structure of some description, is NOT necessarily going to ensure compliance at all.

Contractors, even those working through a company structure, ABN or family trust can fall foul of the alienation of Personal Services Income (PSI) testing rules.

The PSI rules are designed to ensure that contractors REALLY ARE in business for themselves rather than being quasi-employees. This is to stop them from paying less tax than their salaried colleagues and also claiming the benefit of tax deductions.

Under these rules, unless certain conditions are met, the Tax Office treats any income derived from personal exertion as income earned "by the individual" rather than income earned "by the business".

Tax Deductions Denied!

This means that an individual's personal tax rates will apply to the business income and access will be denied to a range of tax deductions normally available to a businesses.

Are there Exemptions?

Yes, there are exemptions enabling contractors to establish that they are running a business and not caught under the Personal Services Income (PSI) legislation. To qualify as a personal services BUSINESS, at least one of two tests needs to be passed along with considering the Court applied Multi-Factor tests. If an individual qualifies as a Personal Services Business most employment based liabilities for the business using their services are reduced or in some cases entirely eliminated.

Exemption Test #1: The Results Test

Recent decisions by the Administrative Appeals Tribunal and investigations by The Black Economy Taskforce clearly indicate many businesses believe that an ABN is a business licence and automatically makes the arrangements compliant. Furthermore many businesses and contractors believe their arrangements are also compliant under the Results Test, but the reality is that in many cases this is NOT correct.

Payment for services based on hourly, daily, piece rate or a fee split, in the vast majority of cases do not meet the results test. Payments of this nature are considered to be the exchange of time for money and not payment for an outcome such as quoted work. A recent case brought by the Fair Work Ombudsman dispelled the notion that an individual engaged as a commission only salesperson passed the Results Test. The position of the ATO had been that commission only does not meet the Results Test (in most circumstances) and following the Fair Work finding this position is not likely to change.

The obligations, documentation and intent behind the engagement need to be considered and formulated correctly in order to ensure compliance. Many engagements are

incorrectly documented and in fact are de facto employment contracts. Under scrutiny, they have little or no relevance to independent contracting, as they do not consider common law and established legal precedence.

You cannot “contract out” of state or federal regulations (it’s the law) and in our experience 97.2% of all independent contractor agreements we’ve reviewed were non-compliant, which exposes the individual and the company using their services to a high level of risk.

And remember, the PSI tests need to be considered annually...

If you believe an individual is compliant and has passed the rules in the past, don’t assume this will apply in the future. Remember this is a test that must be passed each and every financial year.

If the circumstances have changed, you need to make sure you are not inadvertently engaging a contractor when they should be classified as an employee.

Exemption Test #2: The 80% Rule

The 80% rule is commonly known as the 80/20 Rule and states that if 80% or more of an individual’s income for personal services delivery is from one entity (e.g. one client) the income will be subject to PSI and they are not running a personal services business.

That is, unless they obtain a personal services business determination from the taxation commissioner.

Even if more than 20% of the personal services income is derived from another unrelated source the individual is still not “out of the woods” yet.

They must ALSO pass one of the following three subtests:

Sub test #1: The Unrelated Clients Test

To satisfy the Unrelated Clients Test, the individual or entity must provide services to two or more unrelated entities (that are neither associated with each other nor the individual or personal service entity), and the services are provided as a direct result of making offers or invitations (e.g. advertising) to the public at large. Services offered through recruitment/labour hire companies and businesses that arrange to provide services directly for clients do NOT qualify under this test.

Sub test #2: The Employment Test

An *individual* will satisfy the employment test if he or she engages one or more entities during the income year, and that entity, or those entities together perform at least 20% of the market value of the individual's principal work for the year.

A *personal service entity* will satisfy the employment test in an income year if it engages one or more other entities to perform work (other than individuals whose personal services income is included in the entity's ordinary or statutory income or associates of the entity that are not individuals). The value of work performed by those entities must exceed 20% of the market value of the entity's principal work for the income year.

For partnerships, the value of work performed by one partner for another in generating any personal services income is taken into account. Both an individual and a personal service entity will also satisfy the employment test if they have one or more apprentices for at least 50% of the income year.

Sub test #3: The Business Premises Test

The business premises test will be satisfied by either an individual or personal service entity if at all times during the income year they maintain and use business premises at which the individual or entity mainly conducts activities from which personal services income is gained or produced; and that are used exclusively by the individual or personal service entity to produce their personal services income.

The business premises must be physically separated from any other premises that is used for private purposes by the individual or personal service entity or any of their associates, which includes:

- * a relative or a spouse,
- * a partner or a partnership of which you are a partner,
- * a trust of which you are a trustee or a beneficiary, or company which you control
- * Physically separated from the premises of any of their clients (or associates of those clients) for whom they provide services.

NOTE: A home office does not satisfy the business premises test.

What are the Real Risks Associated with non-Compliance?

Your business could be deemed to be the employer of the individual and be liable for statutory employment obligations including superannuation, holiday pay, sick leave and long service leave.

This could lead to legacy obligations for payment of PAYG taxation instalments on behalf of the individuals incorrectly classified as independent contractors rather than employees.

You could be accused of Sham Contracting and be subject to investigation, prosecution and fines levied by the Fair Work Commission.

You could also be deemed the employer for the purposes of Payroll Tax and Work Cover obligations.

But My Business Depends on Contractors – I need them!

Naturally, you can pursue your own solutions to achieve compliance. However, it is not an overstatement to suggest that this area can be a 'minefield', and the risks and financial penalties for getting it wrong are significant and not worth taking.

However there is a Solution Available!

If you are in any doubt about how you engage contractors, there is a robust, tested and lawful solution available.

ContractRight is a third party engagement framework which based on an established precedent allowing you to deploy independent contractors compliantly. They are engaged outside the testing regime of the PSI legislation while satisfying the ATO as to the bona fides of the engagement.

We SPECIALISE in consulting in the compliance space to provide engagement clarity and where appropriate offer strategies and solutions that have stood the test of time since the late 1970's. If you need to achieve business flexibility and productivity improvements then a phone call is all it takes to understand the "why and how" of the way we work with you.

The ContractRight solution may or may not suit your individual needs, this is why we offer an obligation free assessment to provide clarity on how arm's length engagement might work for your business.

Most importantly, given there is significant benefit to your business and if long term sustainability is critical we will provide you with the appropriate option to suit your business requirements.

In other words, a sense of certainty and security that you're not going to be caught out, even though your intentions were to do everything right.

For more information contact the team at ContractRight!

Phone: 1300 358 431

Email: contact@contractright.com.au

Web: www.contractright.com.au

ContractRight is Smart Proven Lawful - enabling Businesses to ensure clarity and contractor compliance in an age of increasing regulatory complexity & uncertainty.