



Are You Really a Contractor ...Or Attracting the ATO by Alienating Your Income?



How to ensure you're actually an
Independent Contractor and not caught in
the compliance "Minefield"

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Introduction

The purpose of this compliance information and assessment kit is to alert labour based contractors to the business related issues affecting contracting in Australia.

Specifically, it focuses on the critical area of the Australian Tax Office (ATO) compliance and how this affects the engagement of individuals who provide their services to a business as an independent contractor.

These issues are brought about by the lack of (general) understanding on how the Personal Services Income (PSI) Legislation works.

While this Kit isn't a definitive guide in itself, through ContractRight contractors have the option to access an arm's length common law based contracting solution. This engagement framework sits outside of the testing regime of the Personal Services Income (PSI) Legislation and does not attract the attention of the ATO.

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.

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

Among other things, it provides contractors with:

- Higher level of income
- 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 improve productivity or to engage specialist for a specific project

The 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.

It also offers individuals greater flexibility and better net income benefits. However, the "downside" is that contractors and the companies utilising their services must be aware of the traps and pitfalls of entering into largely or wholly labour based contracting arrangements.

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

That said, you're in the clear if you are a contractor who is providing both physical input along with machinery (such as hiring a bobcat or a backhoe); or you quote for work and bear some form of commercial risk, then under these circumstances you are considered to be legitimately running a business.

However...

If you are an individual who provides personal services (labour or intellectual input) then you are automatically caught under the Personal Services Income (PSI) Legislation. This means you must pass the prescriptive validation tests in order to be operating a Personal Services Business (PSB)

If you cannot pass the tests...

.....It means you should pay tax at the same rate as an employee and effectively be treated as an employee for taxation purposes!



“But wait a minute... I have an ABN!!”

Sorry! Simply having an ABN, your own Company, Trust or structure of some description, does NOT necessarily mean you are actually running a business enterprise or compliant at all.

It is a commonly held Myth that having an ABN or an ACN “magically” converts personal services income into business income – this is simply not correct.

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!

When income is generated by an individual via their labour based services and in spite of being invoiced via ABN, Company or Trust it must be taxed at the same rate as though the individual who provides the services was an employee. Access will also be denied to a range of tax deductions normally available to a businesses. It gets worse, if you do claim tax deductions and you are not compliant under the PSI legislation, you are alienating your income and are subject to the tax fraud provisions of Part IV a of the tax act.

Are there Exemptions?

Yes, there are exemptions enabling a contractor to establish that they are running a business enterprise and therefore not caught under the Personal Services Income (PSI) legislation. To qualify as a personal services BUSINESS, at least one of the two following tests needs to be passed.

Exemption Test #1: The Results Test

Recent decisions by the Administrative Appeals Tribunal and investigations by The Black Economy Taskforce clearly indicate many contractors believe they are compliant under the Results Test, but the reality is that many are NOT.

Payment for services based on hourly, daily, piece rate or a fee split in most 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 audited were non-compliant, which exposes the individual and the company using their services to a significantly high level of risk.

And remember, this is an annual test...

If you believe you are compliant and have passed the rules in the past, don’t assume this will apply in the future – the tests must be passed annually.

If your circumstances have changed, you need to make sure you are not inadvertently contravening the rules and should be an employee, or at least pay your personal tax at the same level as though you were 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 your income for personal services delivery is from one entity (e.g. one client) the income will be subject to PSI and you are not running a business.

That is, unless you 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 then you are still not “out of the woods” just yet.

You must ALSO pass one of the following three subtests:

Sub test #1: The Unrelated Clients Test

To satisfy the Unrelated Clients Test, you must provide services to two or more unrelated entities (that are neither associated with each other or you), 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 labour hire companies and other such businesses that arrange to provide services directly for their clients do NOT qualify under this test.

Sub test #2: The Employment Test

You will satisfy the employment test if you engage one or more entities during the income year, and that entity, or those entities together perform at least 20% of the market value of your 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 when an you or your personal service entity, at all times during the income year maintained and used business premises at which you or your entity mainly conducted activities from which personal services income was gained or produced, and were used exclusively by you or your personal service entity to produce your personal services income.

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

- * a relative,
- * 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
- * a company which you control
- * Physically separated from the premises of any of your clients (or associates of those clients) for whom you provide services.

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

What are the Real Risks Associated with non-Compliance?

You could be deemed to be an employee for the purposes of the PSI Legislation and lose all the benefits of tax deductions including tax returns being disallowed with payment of back taxes and fines.

If you used a trust where downstream distributions were made to other parties you face the prospect of their tax returned being disallowed along with payment of back taxes and fines.

NOTE: Ask for our case study based on the experiences of an individual who was actually caught up in exactly this situation with the ATO.

But I work for a Business that Depends on Contractors – they need me!

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 just not worth taking.**

There is a Common Law Solution Available!

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

ContractRight is a third party engagement framework which is a common law, "precedent based" approach that allows you to be legally and compliantly engaged as a self-employed independent contractor.

You 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 and offer strategies and solutions that have stood the test of time since the late 1970's.

If your clients need to achieve business flexibility while utilising your services and those of other contractors as well, then a phone call is all it takes to understand the "why and how" of the way our framework operates.

The ContractRight solution may or may not suit your individual needs, so we are happy to offer an initial free consultation to advice on how to ensure arm's length compliance.

Most importantly, given there is significant benefit to you and if long term sustainability as an independent contractor is critical we will provide you with the appropriate option to suit your contracting 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!

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ContractRight proudly serving our clients nationally.

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

