



## **Submission to the Board of Taxation**

### *Review of Tax System Impediments Facing Small Business*

May 2014

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**To: Board of Taxation**  
**REVIEW OF TAX SYSTEM IMPEDIMENTS FACING SMALL BUSINESS**  
**ICA submission**  
**May 2014**

## **1. Introduction**

### **1.1 Background**

Independent Contractors Australia is pleased to respond to an invitation from Small Business Minister Bruce Billson (16 April 2014) to make a submission to the Board of Taxation's review of the impediments of the tax system for small business.

Specifically, the Board has been asked to "identify features of the tax system that are unreasonably or unnecessarily hindering or preventing small businesses from pursuing and achieving their commercial goals".

ICA has been involved in consultations with the Australian Taxation Office (ATO) on small business issues for more than a decade and has been a member of various ATO consultative committees. Further, ICA has repeatedly assisted small business people when they have had problems with the ATO. As a consequence, we have developed a broad knowledge of the practical issues that small business people have confronted. Further, in preparing this submission, we invited ICA members to send us their stories. Consequently, this submission is built around case studies of actual problems with which people have had to deal. These case studies are 'canaries in the coal mine' demonstrating, we believe, systemic problems within the ATO.

### **1.2 Keeping the balance**

This submission is critical of the ATO's administration of the tax system, but we seek to maintain a balance.

- All the staff we have dealt with at the ATO have been professional, polite, generally well trained and (mostly) competent.
- We recognize that many small business people seek to (and sometimes do) avoid paying the tax that they are required to by law. This predominantly includes (in the small business sector) non-declaration of income (cash economy). ICA recognizes that the ATO is obliged to enforce tax laws robustly, sometimes aggressively. This creates circumstances in which the ATO is, by necessity, placed in conflict with some small business people.
- We recognize that the ATO is called upon to do many other social tasks that complicate its core task of collecting tax. In this respect the ATO does an impressive job. Given the many-layered tasks with which the ATO is charged, the system could easily grind to a halt, yet it does function.

Yet, even with the understandings outlined above, there are certain administrative principles which should apply if the tax system is to function for the good of society. These are:

- The tax system and its administration must strive to maximize voluntary compliance.
- Tax laws and their administration must provide clarity and certainty as to the rules.
- ATO officers must comply with the ATO's own rules and keep taxpayers fully informed of those rules.

Based on our experience, the ATO is failing on each of these principles in relation to small business people.

- The ways in which many of the key laws are administered and interpreted by the ATO are, from the small business person's perspective, unclear, inconsistent, 'unknowable' and seem more a reflection of the imagination of the ATO than anything related to the real life of business in the community.
- Consequently, the ATO is often seen as a bad but dangerous 'joke' and unreliable.
- Such a situation reduces, rather than encourages, voluntary compliance.

We comment in particular on the following issues:

- Allocation and refusal to allocate Australian Business Numbers.
- Failures in relation to basic, core administrative functions.
- Failure of ATO officers to comply with the ATO's own rules.
- Poor policy in relation to compliance in the construction sector.
- An ATO dispute resolution system that is not seen to be open and fair and which allows the ATO to win its claims by commercial intimidation. That is, small business people cannot afford to challenge the ATO because of the costs of litigation.
- Incoherent application of policy in relation to Personal Services Income Tax laws.

#### A note on perhaps why?

At one ATO consultation attended by ICA, the ATO had asked all the small business people around the conference table what everyone wanted from the tax system. There were about fifteen small business people in attendance. When everyone finished speaking, one senior ATO policy officer said:

*"When we consult with big business representatives, they always have highly paid tax lawyers representing them telling us (the ATO) what the law is.*

*When we consult with small business people you are simply asking us to tell you with clarity what the law is!"*

This probably explains a lot.

When dealing with big business the ATO always has to be cautious, even opaque. Big business can and does spend large amounts of money on specialist lawyers searching for legal ways to minimize tax.

However, small business people can't afford the expense of playing such games. For them, the cost-benefit analysis does not stack up. It's not that small business people are more moral than large business people! Rather, pragmatism determines that if the tax laws are clear, fair and reflect business reality, it's easier simply to pay the tax than challenge the law.

So what seems to happen is that the ATO translates its experiences with big business lawyers and applies its caution and opaqueness to its dealings with small business people. This results in unclear rules and processes being applied.

### **1.3 Observations**

However, even with the balanced understanding sketched out above, on the basis of our experiences (demonstrated particularly in the case studies below) ICA makes the following observations.

The ATO is plagued by systemic inefficiency demonstrated by:

- Apparent lack of suitable devolution of authority to the staff dealing directly with small business people.
- Authorised actions not being implemented within required or promised time frames.
- Multiple handling of simple issues by many different ATO officers, indicating confusion and lack of clarity in officers' authority.

What this indicates is a major lack of 'customer' focus. The ATO is a monopoly administrator of the tax collection system. As such, it displays all the behavioural attributes expected from any monopoly—that is, it operates to serve its own internal administrative design rather than the administration being designed to serve customers. In this instance the customers are Australia's taxpayers.

The administration of the ATO can and should be compared to that of the administration of a large bank. A large bank and the ATO have exactly the same challenges. Both

- Are required to comply with highly complex laws overseeing and directing their operations.
- Have to manage huge volumes of financial transactions, all varied and all requiring high attention to detail.
- Are subject to onerous privacy and security requirements.

The difference between a large bank and the ATO, however, is that the bank has a client focus forced upon it by competition. The ATO has a pretence to client focus. If the ATO were a bank, it would lose customers and go out of business.

### **1.4 Genuine dispute resolution**

The brief for this submission is to identify problems. We do this in detail through the case studies that follow. We make one major recommendation as well, however. The ATO dispute resolution processes should be subject to a genuine, independent process removed from the ATO. We believe that this would potentially force the ATO to 'lift its game'. We recommend the following.

We recommend that the proposed Small Business Ombudsman should be the mediator in any disputes that the ATO has with small business people. The ATO should have a statement on correspondence it sends to small business people that:

- If the taxpayer has a dispute with the ATO, then the first step is to seek resolution directly with the ATO.
- If the dispute is not resolved within x days, the taxpayer has the right to refer the dispute to the independent Small Business Ombudsman. The contact details for the Ombudsman should be supplied.
- If the taxpayer does not initiate referral to the Small Business Ombudsman and the dispute remains outstanding for y days, the ATO is required to refer the matter to the Small Business Ombudsman for mediation.

The operation of the Small Business Ombudsman would not prevent the ATO or a small business taxpayer from initiating legal action. But the ATO, at least, should not be able to initiate legal action until such time as mediation had been completed by the Small Business Ombudsman.

## **2. ATO Dispute Resolution**

Most of the disputes that the ATO has with businesses are with small business people. We understand this to be in the order of 70 per cent of ATO disputes. In the main, these are disputes with ‘micro’ business people who are usually self-employed or who may only have 1–5 employees at most.

In such circumstances micro-business people are in a highly vulnerable position. They do not know tax law. They are usually entirely dependent on an accountant for advice. If they find themselves in a dispute with the ATO, they are barely in a position to pay for lawyers and accountants to assert their rights. In such circumstances, the ATO is able to bully such individuals commercially if it so wishes.

During 2013 the ATO began the design and implementation of an Alternative Dispute Resolution (ADR) system. Allegedly this was to allow for a non-legalistic process for the management of disputes. Conceptually, such a system should significantly reduce costs, both for the ATO and for taxpayers in a dispute. ICA has been involved in consultations on the process and has appreciated that opportunity.

So far, ICA has not had feedback from individuals who have been involved in the process, although the ATO says its research indicates that the new system is running well, even though it is early days.

However, from an external ‘broad brush’ perspective the system still looks complex and remains (probably) intimidating to individual small business people.

Mediators in the ADR process are ATO Officers. The ATO claims that the process is independent. However, from the individual small business-person’s perspective the ‘independence’ of the mediator would be highly suspect. The new ADR system looks

like (and is) a tightly controlled process in which the ATO is (effectively) prosecutor, judge and jury—no matter what the nicety of the language!

### **3. Australian Business Numbers Contractor vs Employee ‘decision making tool’**

ICA submits that the ATO’s ‘contractor vs employee decision making tool’ should be closed down.

The ATO’s claim that it has a legislative remit to be a decision-maker over who is an employee and who is not, is highly suspect. In fact, ICA claims that the ATO is acting outside of its legislative authority in having such a tool.

Originally the ‘tool’ was designed and intended as an advisory process. However, it has become the instrument by which the ATO decides who is and who is not allocated an Australian Business Number (ABN).

Without an ABN, a small business person cannot:

- apply for or receive a Business Name Registration;
- tender for work; or
- issue invoices for work (unless they are happy to have some 40 per cent of their payments withheld from them).

That is, individuals denied an ABN are effectively banned from being in business.

Effectively, the ATO decision-making tool has become an administrative instrument through which the ATO has become the sole determiner in Australian society of who can and cannot be in business. The ATO has no legislative authority to act in this way and, by doing so, it is imposing enormous harm on aspiring small business people, the Australian economy and society.

#### **3.1 Luke’s assessment of the ATO’s reasoning**

One ICA member (Luke) undertook an analysis of the ATO’s explanation of its ‘decision making tool.’ Luke looked at the ATO’s website and its explanations of how the ATO judged who is in business and who is not. He compared the reasoning the ATO applied to its examples with his ‘real life’ experiences. Luke found the ATO’s concepts to be simplistic and out of touch with reality. Life and business are more complex and involved than the understandings the ATO seems to have. Luke demonstrates this well. His assessment (published on our website) is submitted as Addendum 1 to this submission.

(Link is here: <http://www.independentcontractors.net.au/Downloads/Taxation/ATO-versus-Luke.pdf>)

#### **3.2 Robert’s story**

Robert is involved with a small industry association and sent us this story of his experience on behalf of his members.

“I am the secretary of ..... and we have many members who use independent contractors. However recently they have seen the ATO conducting audits where

they are making the decision as to whether the individual is a contractor or employee and generally using their site guide for the decision. Recently I attended the ATO office in .... by invitation (focus group) to review a letter the ATO proposed to send out to all employers. The proposed letter was a disgrace and all who attended stated it was an unprofessional document and should be totally redrafted. Funnily we were all paid \$150.00 each to attend and when I asked if we were employees or independent contractors of the ATO, due to them paying us, I got blank stares.”

### **3.3 Journalist has his ABN withdrawn by the ATO**

ICA received a phone call from a member who had been a freelance journalist for five years. He'd had the ATO contact him and withdraw his ABN. No real reason was given other than that some ATO officer thought that, based on the ICA member's recent tax return, he was not self-employed. The ATO officer had apparently applied the 'decision making tool' and without any further reference to the journalist decided the journalist was not self-employed. No reasoning was given. No written report was provided. No request for further information was forthcoming. The ATO officer simply exercised his/her administrative powers of a business decider 'god'!

### **3.4 Joanna is unable to run her business because her ABN was cancelled**

Joanna sent us her story:

“My most recent experience with the ATO was terrible to say the least.

I had an ABN since 2000 and did not get to use it as my employment circumstances had changed. During this time, I expected that given I never used my ABN, the ATO would have cancelled it.

In February this year (2014), I was engaged by a training company to deliver services, for which I required an ABN. If I didn't have an ABN I would not be able to get any work. Fair enough.

I searched the ATO website for ABN application and checked to see if my ABN was current. I couldn't find it, so I assumed the ATO cancelled my ABN.

In the meantime I completed the online ABN questions and answers form which told me I was not eligible for an ABN. I didn't understand why this is the case so I continued with my ABN application. I also advised the training company and they told me that should not be the case.

14 days later I got a call from the ATO tell me (from an APS level 5 employee) they had reviewed my application and were going to deny it as I already had a current ABN. I responded that it was good that I had an existing ABN so now I could go ahead with my training contract. They then told me they (the ATO) were going to cancel it. I asked why and they said because the online Q&A form I submitted said I was not eligible, in addition, that was not one of the reasons I gave for an ABN in the first place.

I explained that if I didn't have an ABN I couldn't get the contract. They said they will cancel the existing one. I spoke to the Executive Level 1 supervisor as well (the APS employee had very poor English skills) and she said this was

ATO policy (to cancel the ABN). I replied ATO policy is not legislation. In the end I hung up the phone as I was sure I was speaking a foreign language as they didn't understand my statement (which I repeated several times): If I didn't have an ABN I cannot obtain a contract with the training organisation – you know... work!

I went ahead with my contract with the training organisation. After 7 days I got a letter from the ATO saying they had cancelled my ABN. Again I contacted them and told them (several times) : if I didn't have an ABN I don't have a contract and asked, what part of that statement did they not understand?. They responded: You need to appeal the decision with the Delegate.

Sorry, I must have been speaking a foreign language as they obviously couldn't understand that in order to get work and pay tax...you know...I needed an ABN.

Again all I heard from them was a script read from a written document.

Again, in my frustration I hung up the phone and contacted the training organisation to advise the ATO would not give me an ABN. They too were incredulous. I cancelled the contract with them.

So now the ATO will be thousands of \$\$\$ poorer because they won't be collecting income tax from me as I don't have the work.

I didn't bother complaining to the Minister, well because basically, I have already wasted enough time. I also know that any letter would be directed to the responsible line area and a standard 2 paragraph response would be prepared by an APS 6 employee who knows absolutely nothing about small business. The letter would be drafted based on a standard script.

I have to say I found my experience with the ATO frustrating as it went nowhere. As far as I am concerned the ATO "policy" cost me \$\$ and business.

The ATO need to get their act together. Actually the Government should outsource the ATO as I don't believe taxpayers are getting value for money from a bunch of insulated bureaucrats that know absolutely nothing about business in Australia."

### **3.5 Hamish muses on the ATO's unrealistic view of business**

Hamish expresses a common frustration:

"I am a professional mining engineer with over 30 years experience in the industry which you can figure would put me in my early fifties. I have been consulting for many years through my company ..... Pty Ltd as an individual consultant and have no intention of taking on additional professional employees. I believe I am well respected and the clients are very satisfied with the results.

But now and as seems to be the trend with the ATO these days, they have introduced absolutely ludicrous tests which threaten to catch many genuine



contractors & also intend to treat it retrospectively! I believe I would currently pass the tests but this may not always be the case & I can't/wouldn't guarantee it. If the opportunity comes along to secure a major assignment and if that assignment accounted for more than 80% of my income for a particular year then so what!? It is considered sound business practice to secure good base load clients to ensure business viability.

In the mining industry, this could easily mean exceeding 80% from one source for a period of time. Why should someone be penalised for securing a sound business contract (by the way, most assignments aren't contracts and can be concluded at any time).

I don't intend to hire other consultants, as I don't want the hassle (as it is in Australia these days), & would intend to remain as an individual specialist so therefore there is only so much work I can take on as an individual consultant.

Let's consider what an employee gets.

- \* Firstly, he or she receives a guaranteed income, every month, on time with the tax already deducted, super paid in, annual leave provisions, sick days etc etc etc. - oh to be so lucky!
- \* The employee has office space, all stationery, computers & associated equipment, training courses/travel etc all provided.
- \* He or she is covered for indemnity by the employer.
- \* Often, cars etc are provided as fringe benefits, the tax being paid for by the company.
- \* When he/she is made redundant, receives in most cases, attractive redundancy pay.

Now what doesn't the employee have to do:

- \* He/she doesn't have to be a tax agent for the govt and collect GST, fill in BAS statements, advertise, market his or her services.
- \* He or she doesn't have to bill clients, wait up to 4 or more months for payment, risk bills not being paid while at the same time paying tax on income billed but not yet received.
- \* Compete for business in a market which has been depressed for a considerable period.
- \* Maintain professional relevance at his/her own expense, ie keep abreast of industry developments, professional affiliation and accreditation.
- \* Risk professional liability.

After re-reading what I have written above, I wonder why I bother! Unless someone has been a contractor/consultant then they have no idea of what the relevant tests should be. Obviously the ATO has no idea as they wouldn't have come up with such a ridiculous set of guidelines.

I have just spent the last year filling out BAS statements and paying tax as I go. I don't necessarily object to the new system, but at the end of the year I look at the books and apart from paying modest salaries and all the tax, there's very little left.

Now I have run companies and understand perfectly what is required for a successful business. I'm just making the point that contrary to ATO opinion, consulting isn't a goldmine!"

## **4. Incompetent and illogical administration and rules application**

### **4.1 Correcting the ATO's clerical error on Susan's tax return took nine months to fix**

Susan told us her story. The ATO had made a clerical error resulting in Susan receiving notification of a probable huge tax bill. The ATO accepted that they'd made the error, but it took them nine months to make the correction and only after a complaint was lodged with the Ombudsman. Here's the letter to the Ombudsman explaining the situation

“To : The Ombudsman

Re:

- Lodgment of complaint against the Australian Taxation Office.
- Failure of the ATO to correct a simple administrative error made by the ATO creating alleged tax liability.
- Request for ATO action to supply correspondence correcting the error and advising of no tax liability.

On (date) my accountant was sent a letter (attached A) from the ATO advising that I had made excess superannuation contributions of \$97,291.17 for the (date) year and that I would be liable for additional tax.

My accountant received the letter on (date) and immediately contacted the ATO advising of a clerical error made by the ATO.

I am Trustee for my own Self Managed Superannuation Fund. Attached (B) is the relevant page from the superannuation return.

Instead of recording \$50,000 as the employer contribution, an incorrect data entry has been made recording the 'opening account balance' of \$147,291.17 as the employer contribution.

After several phone conversations with the ATO on 14, 15 and 17 May, and supplying the attached information, the ATO advised that they had sighted the error and would have it corrected within 21 days. Further that my accountant would receive a letter correcting the error and advising of no tax liability.

What has followed since then is a demonstration of ATO system incompetence that leaves me with no formal advice that I do not have a tax liability.

I don't know if you have ever rung the ATO but such an exercise normally requires putting aside 2-3 hours of waiting time to get through and organising ones working day around this.

I have had phone conversations with the ATO on the following dates  
21 May, 2, 12, 13, July, 31 August, 8, 26, 29 October.

On each occasion the ATO officers with whom I have spoken have been extremely polite, professional, friendly and promising of action and resolution. On each occasion they have advised that they did not have authority to action the correction, but did not seem to know who had authority and have never been able to put me through to someone with the authority. On each occasion they have assured me that the error will be corrected and that I will be advised in writing.

After some 9 months I still do not have ATO correspondence confirming that the superannuation contribution was \$50,000 and that I do not have a tax liability. My concern is that even though the ATO have verbally and repeatedly advised that they accept there has been a clerical error, that if I do not receive written confirmation that in some years the ATO will undertake an audit and I will receive a tax bill. I will then go through this entire time wasting exercise again. Consequently my only course left open seems to be to write to yourself lodging a complaint and seeking action.

The ATO's system incompetence on something as simple as this is extraordinary. I am sure you understand the frustration I am experiencing.”

#### **4.2 Eric can't afford to take on the ATO. He's \$25K out of pocket**

Eric sent us the email below. His case shows how slow the ATO is to address issues and that it can win simply because small business people can't afford the expense of securing their rights. Further, the ATO has little practical understanding of the realities of business.

“I am still in dispute from a tax audit after approx 4 years. I was a subcontractor who went to a direct employee with the same company. I supplied my own vehicle tools and computer software as a subcontractor. When I went to a direct employee none of that changed. I was working as a supervisor in the mines north west of WA.

The ATO claims that I could not claim my vehicles, larger tools and computer as they stated I should not have had to use them. They asked for proof that I used them. I provided letters from the employer's to the ATO. It took 6 months for the ATO to reply and they came back with the same answer. I had to supply the same documentation again. How many times must you send the same documentation?

I wanted to take the matter to court. The \$25K the ATO is taking from me is a lot. But it's apparently going to cost me \$30K to take to court and none of that can be retrieved back by me even if I win. So as I will be another 5K down for the principle and countless days involved. As I am now a small struggling business owner I just can't afford that. How can they walk all over small people like us and take what little we have and work so hard for?”

### 4.3 Where's the ATO logic?

John tells the story of being denied legitimate business expenses for reasons that are illogical and the ATO applied illogic to illogic! His story has two related parts.

#### (Part A)

Small business taxpayer denied all deductions for car used 100% business.

Reason: Car was registered in wife's name. ATO claimed that taxpayer can't have incurred expenses for a car he does not own.

Offer from ATO: The wife can claim the deductions. Except (golly gosh) the wife cannot claim deductions for expenses incurred by another when earning the declared income.

Conclusion: The ATO, having been shown myriad related laws and rulings refuting this bizarre stance, first tried to move the goal posts (probably to 'save face'), then reluctantly allowed deductions. They proceeded to correct the assessment and eventually sent the refund.

#### (Part B)

Taxpayer fined (and paid) thousands of dollars.

Reason: The deductions originally denied (as per dispute in part A) created a "shortfall" which incurred a 20% fine on the balance owed to ATO.

Where's the logic?: There was no shortfall however. But to fight for common sense (in part A) the taxpayer had to first pay the fines attributable to a non-existent shortfall.

Conclusion: Another trip to the claims tribunal and another lengthy wait, ATO surprisingly exclaimed "this fine is based on 20% of nothing" – and agreed to refund. From my experience it seems that – the higher you go in the ATO, the less they know. (He, he, that sounds like a twofold riddle).

### 4.4 Illogic and ATO silly face saving!

Another story from John:

Taxpayer denied 50% of interest deductions for a rental property 100% in his name.

Reason: The collateral used to secure 100% loan for rental purchase was the principle place of residence of taxpayer and wife. Bank insisted wife's name must be on rental property loan. ATO argued that the taxpayer did not incur the expense of all the interest since the wife is liable if husband defaults.

Offer from ATO: The wife is entitled to claim the other 50% interest. Except (golly gosh again), the wife cannot claim an expense for an income producing rental property that she doesn't own.

Conclusion: The ATO, perplexed and confused dug their heels in for months then finally "conceded" (loved hearing them utter that word). BUT – they could only bring themselves to admit this defeat by adding a caveat. That being, taxpayer had to sign a document stating he would never do it again. DO WHAT AGAIN? Taxpayer had simply abided by published ATO regulations as done by thousands of mum and dad investors.

## 5. Personal Services Income Tax Laws

### 5.1 History

Back as far as the 1970s, the ATO has displayed great concern (almost an obsession) with a belief that self-employed people are a threat to the integrity of the income tax system. The key issue was that the PAYE laws only gave the ATO authority to collect income tax where an employer–employee arrangement existed—a legitimate concern! The change to the tax system in 2000 with the introduction of PAYG and BAS resolved the collection (withholding) problem.

But the residual issue related to self-employed people ‘splitting’ income and claiming business-type tax deductions. On this issue the ATO (and unions) churned out constant media reports about self-employed people ‘ripping off’ the tax system. The legislative resolution was the introduction of the PSI rules in late 2001 (amongst considerable political turmoil).

ICA supports the PSI rules. We believe that they are workable, although not as clear as they could be. During 2004 ICA spent nine months working with the ATO on producing a simple explanation of the PSI rules. Our ‘Ready Reckoner’ is here:

[<http://www.independentcontractors.net.au/Members/Secure/Taxation/personal-services-income-tax-ready-reckoner>]

and is included as Addendum 2.

However, ICA also has evidence that the PSI rules and the ATO’s obsession with self-employed ‘income splitters’ is based more on imagination than fact. In 2000, ICA received an ‘off the back of a truck’ ATO document. The document revealed outcomes of the only-ever-conducted research into the ‘income-splitting problem’.

During 1997 and 1998, the ATO identified 65,000 independent contractors they profiled for investigation. In all, 55,000 tax return reviews were initiated, 5,403 taxpayers received special targeting and 1,104 tax agents were visited. The result? Just 714 taxpayers received tax adjustments notices, many obtaining a refund for over-payment of tax. Where people had to pay more tax, the increases varied from an additional 1.9 per cent to 11.6 per cent per taxpayer. Reports suggest that the additional tax raised was below that expected of any random audit of taxpayers’ returns. That is, independent contractors were (and are) not robbing the tax system.

It says a lot about the ATO and its attitude to the self-employed that this research has never been publicly released. Fiction and fantasy rules over truth it would seem!

It is with this backdrop that the anger and suspicion displayed by George towards the ATO might best be understood.

### 5.2 George is grumpy

Here’s what George had to say when we asked for feedback for this submission. George gives a good historical background from a personal perspective.

“The ATO has been at this for years. Back in the 1990s when I became “too old and ugly” and given the flick by a previous employer, I checked around with acquaintances to see how to get work to tide me over until retirement. In those

days (if they aren't still here) older people in my particular profession had no show of getting staff employment, but there was contract work around (companies didn't have to pay "entitlements").

The answer was that you had to set up a Company to avoid trouble with the tax man. If you didn't, they'd cream you sooner or later.

So I set up the company and things went along fine until the early 2000s when some genius in the ATO decided that if you ended up with only one employer for most of the year then you must be an employee, notwithstanding the intent of the legislation or supplying the client with equipment, vehicle, office etc. and taking the other normal business risks and hazards (i.e. clients not paying you on time or sometimes at all) and paying the Govt. costs and endless Govt. pointless paperwork required to operate your own company - the Personal Services Income farce. So I asked for an ATO "ruling" which, surprise, surprise, went against me. Being a slow learner, I thought that some idiot had made a mistake, so at considerable cost I put in an appeal (lawyers' picnic) with the only idiot being me for being so presumptuous as to expect common sense (justice?) to prevail. Naturally there were additional ATO charges to pay as well for being such a naughty boy.

So the answer was to close down the company and forgo any chance to employ extra people if future opportunities came up. No winners there, not even for the ATO!

You can't win against the ATO, the people in there can't make any common sense decisions because they have to tick all the bureaucratic boxes that all our over-regulating legislation makes them do. The old adage seems to apply "if you have tax worries, you have no worries". Until the Tax Act is repealed and simplified it will only get steadily worse."

### **5.3 Paul has been put through the 'wringer'**

#### Background

This self-employed person contacted ICA through our website in 2011. We discussed their situation and they supplied us full documentation on their case. When we looked at the details we were not satisfied that the ATO was applying the PSI laws even remotely correctly. We referred the person to the PSI information on ICA's website. They read all the information and responded that this was the first time they felt they understood the rules. They then proceeded to bring this to the attention of their accountant and lawyer and to reargue their case with the ATO.

ICA wrote to the ATO in mid-2011 highlighting this case, suggesting it should be reviewed from the perspective of the ATO's reviewing its process. ICA has not received a response.

Ultimately the ATO would not budge with the self-employed person, leaving the only next step as litigation. The individual could not afford the cost of going to court, which would easily have been in the many tens of thousands of dollars. They have had to give in. The audit by the ATO has already stretched out over almost five years.

ICA cannot speculate as to what the ultimate outcome of a correct application of the PSI rules would have been for this individual. However, we do not believe that, for this individual, justice has been done or has been seen to be done. We do not believe the PSI rules have been applied correctly or, arguably, have even been applied at all by the ATO. We believe the case highlights a serious flaw in the ATO PSI audit process, giving us a low level of confidence in the integrity of process of the ATO on this issue. Given that we have been involved in other cases that have concerned us, the failure by the ATO could arguably be described as systemic.

The audit was of a small business with a turnaround of \$300k per year. It consisted of six staff at its height. The books were quite straightforward and very simple.

The audit should have been conducted within a 60-day period from late 2007. The first notice of assessment paper was received in late 2009. This was around 2 years after the audit notice was first served. The ATO took three years (from 2007) to provide a basic response to letters of objection.

As of mid-2012 the audit is complete, but still requires some removal/review of interest and penalties. This brings the audit and post processing to 4.5 years. This is way too long for a small business audit.

#### Key facts

Here's what Paul said:

“As the ATO started processing the audit in 2007, I had not filed any BASs or tax returns until the ATO clearly concluded the audit. (I did not know which position to file with!) Unfortunately the audit took until 2011 to conclude. As a result I had accumulated penalties and interest charges due to the ATO not meeting their baseline SLA's. Further, the case changed through many ATO officers' hands, making things more complicated.

I have several thousands of dollars worth of business penalties and other personal tax account fines awaiting remit at the moment. These are not of my fault occurring because of the huge slowness of the audit. These are currently under review and discussions have been positive regarding removal of these amounts.

#### Timelines

- 2007: A letter was issued to me from the ATO regarding a PSI audit.
- I operated under a company/discretionary family trust structure with several directors associated with the company.
- Early 2008: An ATO representative attended the office of my then accountant to review all documentation relating to the audit years in question. The representative took the required documentation and no further correspondence was undertaken between my accountant and the ATO until late 2008. (Audit years were associated with a 3-year period)
- The ATO informed my accountant in late 2008 that the original case officer had retired/moved on from the ATO and the case had been transferred to a case officer in another state. This then incurred additional

cost to me as the new case officer requested the same information that was given to the original case officer at the start of 2008.

- The new case officer commenced to process the audit in early 2009. He requested documentation I did not have access to at the time as my accountant was on holidays until the end of January. I explained this to the officer and he continued to phone me daily throughout January and February 2009.
- My accountant supplied information to the officer from around February until June/July from memory. Again this was at additional cost to me as the original officer had this information back in 2008.
- Nothing was heard from the ATO until a notice of assessment paper was handed down in late 2009. As a result I employed the services of a lawyer.
- The notice of assessment outlined that I failed to qualify as a services business and should be processed under PSI legislation. The assessment did not clearly address the procedures (outlined on the ICA website information that I discovered in 2011) and how the ATO should approach such assessment. The 11-step criteria outlined in Taxation Ruling TR 2001/8, clause 10 regarding determination of a business or employee was not clearly referenced by the ATO. At the time my lawyer and accountant missed this criteria, and when submitted again in 2011 the ATO asked why was this not submitted earlier? Hence rejecting the late submission.
- I had filed a notice of objection in late 2009.
- The ATO responded to the notice of objection in late 2010, around one year after the notice of objection was filed. Yet according to their own procedures they should have responded within 30-60 days.
- In late 2010 I filed with the AAT to have my case heard independently. The ATO agreed in early 2011 to remove penalties incurred since 2010. Which was a positive outcome.
- New evidence was submitted pointing to the test cases and procedures outlined on the ICA website in mid-2011. The ATO asked why this evidence was not submitted earlier and rejected the submissions.
- I was left with the option of going to a full AAT mediation or court case, or drop the case. I dropped the case as I did not have the financial means to continue. Also, the ATO was charging interest and fines on late submission of returns, BASs, etc. These were late because I did not know where I stood because of the 4.5 years of the audit process.
- I have filed all returns to date and paid everything in full except for the penalties and interest charges. Some penalties and interest charges have been removed by the ATO, which has been a positive development.

Here are the lessons I have learnt about applying PSI:

- Group directors or individuals need to carefully review the actions of their accountant(s) and lawyer(s). Highly paid consultants are not always experts. Unfortunately individuals will need to review the detail or legislation from time to time to best defend their position.
- Some lawyers and accountants (even with tax accreditation) have a very poor practical understanding of the PSI laws and audit process.

The ATO processes are inefficient, drawn out, and not applied correctly.”



## **6. ATO officers not complying with ATO rules**

ICA has assisted several self-employed people over Personal Services Income tax rules. Each incident involved the self-employed person working through a partnership. In 2005 the ATO issued a ruling that income-splitting in partnerships was allowed. The ruling occurred following court rulings clarifying this situation

ICA explained the ruling here:

[<http://www.independentcontractors.net.au/Members/Secure/Taxation/income-splitting-for-partnerships>] which is attached as Addendum 3.

However, it appears that the ATO doesn't keep its officers informed about its own rulings or that officers ignore the rulings when chasing tax from small business people.

This most recent incident we know about was in 2014.

A highly paid management consultant received a \$300,000 tax bill because the ATO claimed the person failed the Personal Service Income rules. The person had many other investments, including a small farm and was in partnership with his spouse. The ATO did not tell the individual of the tax ruling on partnerships—namely, that with partnerships the partnership automatically passed the specific aspects of the PSI rules relating to this individual.

After five months and money spent on lawyers and accountants the consultant contacted ICA. We pointed out the ruling to our member. When he took the information to the ATO it quite shortly thereafter dropped its claim.

## **7. Compliance in Construction**

As discussed at the beginning of this submission, the ATO has had a near-obsessive attitude (for decades) that self-employed people 'rip off' the tax system. And, as we have submitted, this view is based on unsubstantiated impressions rather than facts. The ATO's obsession has heavily focused on the construction sector. We agree that there are problems in this sector, particularly around non-declaration of income.

Reflective of this obsession is that the ATO automatically denies labourers receipt of an ABN. This is entirely illogical and is in fact a complete breach of the common law. It breaches how the common law approaches investigating and discovering if someone is self-employed or not.

But the ATO's obsession reached a high point in 2011 with the introduction of a system of compulsory transaction reporting in the commercial construction sector. The system requires contractors to report to the ATO the contractors' transactions with self-employed subbies. ICA made a submission to Treasury on the proposed system. Now with the system in place, our submission of 2011 remains valid today. Below is an edited version of that submission.

General Manager  
Business Tax Division  
The Treasury  
SBTR@treasury.gov.au  
25 June 2011

## **Overview**

Independent Contractors Australia views the policy as:

- a move that will make the administration of the business life of an independent contractor so complex as to suppress the capacity for individuals to be self-employed and to force them into becoming employees.
- an exercise in the illegitimate use of the coercive powers of the Australian Taxation Office.

In relation to compliance with the taxation system:

- the Consultation Paper does not demonstrate that independent contractors in the construction sector are any more or less compliant than anyone else operating their own small business.
- the current system of taxation reporting is already robust and it is hard to imagine how anyone can fall through the net, unless they have the criminal intent to defraud the Commonwealth by deliberate non-reporting of income. The planned policy, which introduces massive reporting requirements of all transactions, will not do anything to stop the intentional non-reporting of income. It will simply mean that those who do report and who are already honest in their dealings will be burdened with a huge increase in reporting to the ATO. Nothing will be achieved. The deceivers will continue to deceive!

## **Why the current system works**

The current taxation withholding system is conceptually brilliant in its simplicity and capacity to catch all businesses within the taxation system.

- Entities involved in commercial transactions must have an Australian Business Number which is cross-referenced to individual Tax File Numbers (TFNs). The ATO has the power to cross-reference TFNs with bank account numbers and it does so all the time. Through this integrated cross-referencing system, the ATO is able to track income-reporting in the community with a high degree of accuracy and to profile individuals who are avoiding the full declaration of their income.
- Where an entity does not have an ABN, the payer of an invoice is required to withhold tax from the service provider and remit the tax to the ATO. Therefore it is in the interests of all individuals to have an ABN.
- Where the system breaks down and leads to or encourages non-reporting of income, is where the ATO fails to allocate ABNs to individuals. Where individuals are not granted an ABN, they are more likely to enter the 'black' economy and simply not report their income. Under the intentional policy of restricting the granting of ABNs, tax avoidance through non-reporting will have increased because people are not within the system.

There is nothing in the Consultation Paper or the Government's budget policy paper which indicates how the creation of such a huge transaction reporting system will do

anything to capture the non-reporting of income. All the transaction reporting system will do is capture data on entities and individuals who are already reporting.

### **Business-to-Business reporting only**

The Government intends to limit the transaction reporting scheme to business-to-business transactions only and not apply it to business-to-consumer transactions. However, a massive percentage (perhaps most) of the black economy operates in the business-to-consumer sector of the economy. As examples:

- a handyman fixes leaky pipes in someone's home, is paid cash and does not report the income.
- A retailer sells an item in her store and does not report the sale in her income return.

The business-to-consumer area is where intentional non-reporting has most opportunity to exist and where it exists most. But this area is not subject to the new rules.

### **Specific flaws in the plan**

#### a) The scale of the reporting

Figure 2 (Example of the proposed reporting regime) in the Consultation Paper makes it clear how the reporting system will work. All businesses will have to record and report to the ATO every transaction they have with another business. The increase in red tape this will involve will be massive. Again it will only capture those people in business who already report their income. There is nothing in the scheme that indicates how people who do not report will be captured.

#### b) Definitions of when to report

The Consultation paper states

“The payments that are subject to reporting are payments for a supply, which in this context is a supply made under a contract that is in whole, or in part, for the supply of building and construction services.

However, this **does not** include payments that are solely for the supply of goods or materials, or payments of salary and wages for employees.”

It is clear that the reporting requirements are going to generate a huge level of complexity about definitions of what a reportable “service” is and what a non-reportable “supply of a good or material” is as well as what non-reportable “payments of salary and wages for employees” are.

Anyone seeking to comply with the transaction reporting scheme will have to dissect invoices they receive into things that are a ‘service’ and things that are a ‘supply of a good or material’.

#### c) Time delay in reporting will make the reporting system useless

We ask: Why is submitting a report at the end of the year going to change compliance? When a tax lodgement is done 18 months down the track, there is every chance that the contractor who has been avoiding tax won't be around, will have flown the coop or gone bust. Consequently, the reporting system will not work.

d) The system is able to be subverted

If a project builder wanted to get around the reporting system, instead of having a contract to build a house with a client, it would simply have a contract to *manage* the building of a house at a pre-determined price, then seek permission from the client to engage contractors on their behalf. In this way the transaction becomes personal, and is excluded from the reporting system.

### **PPS**

The Consultation Paper draws on the old and discarded withholding system called the PPS which was used in the construction sector before PAYG was created (including integration with the BAS and ABN). It is clear that the new transaction red-tape reporting system is a return to a hybridized but worse form of the old PPS system. PPS was entirely discredited as ineffectual and wasteful. It was rejected and dumped. The new transaction red-tape reporting system is a return to a version of this discredited PPS system.

### **Conclusion**

This planned red-tape transaction reporting system will add massive compliance burdens and costs to all self-employed individuals conducting their own business in the building sector. It will do nothing to increase reporting and do nothing to stop individuals who do not report their income so as to avoid tax. The answer to the question is that the planned new system should be rejected and not proceed.

**ICA Board of Taxation Submission**  
**Review of Tax System Impediments Facing Small Business**

**Addendum 1: ATO versus Luke**

[Source: <http://www.independentcontractors.net.au/Downloads/Taxation/ATO-versus-Luke.pdf>]

ICA member Luke has done an assessment of the ATOs contractor v employee tool found here:

[http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00326433.htm&page=1#P167\\_15311](http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00326433.htm&page=1#P167_15311).

These first 2 columns are what the ATO says The 3rd column is Luke's real life experience

	<b>(The ATO says )</b> Ahn is an employee (This is fairly accurate)	<b>(The ATO says)</b> Sara is a contractor (This is a freelance IT contractor - Perhaps 10% of IT contractors)	<b>(Luke says)</b> he has no idea what he is except he is generally what is considered a contractor in the IT industry but matches no known statement by the ATO. (The 100,000+ odd IT contractors around Australia who work for an Agency)
<b>Overview of the job performed</b>	A software engineer, Ahn, works for a large business and designs, develops, tests and installs software programs.	A software engineer, Sara, enters into a contract with a retail business to design, develop, test and install a new software program.	A software engineer, Luke, enters into a contract with a retail business to design, develop, test and install a new software program. Details of this are not specified in the contract though and it is usually a straight 3-6 month contract for such and such company at a set hourly rate. The contract is not with this company though, it is with an agency and includes terms such as "I must give 2 weeks notice to terminate the contract" but everyone else, including the agency and the company who I must perform work for but has no signature on my contract can terminate me at a moments notice.
<b>Control over the work</b>	<p>The business allocates work to Ahn and tells him the completion due date.</p> <p>Ahn must complete the work according to the business's established protocols, guidelines and quality standards.</p> <p>Employee characteristic - the business has control over the work.</p>	<p>The contract stipulates the new software program needs to:</p> <p>be operational within six months (specific stages of the project need to be completed by set dates) meet the retail business's requirements and specifications.</p> <p>Sara is able to determine how the work is completed.</p> <p>Contractor characteristic - Sara has freedom in the way the work is done, subject to the specific terms in the contract.</p>	<p>No details are provided on what work must be completed until all contracts are signed and you have turned up to work the first day. Generally you will work as part of a team of contractors and must perform the work as the head contractor specifies, if your good you will be the head contractor. Deadlines will be unrealistic and not set by those people having to perform the work.</p> <p>Contractor Characteristics: Control is usually set by a Contractor project manager and then by a team leader. None of this will be specified in the contract.</p>

<p><b>Ability to sub-contract/delegate</b></p>	<p>Ahn is required to complete tasks as assigned to him by the business. If Ahn is running late in meeting a project deadline, he may be able to assign aspects of his work to other software engineers who work for the business, depending on their workloads. The business pays the other software engineers.</p> <p>Employee characteristic - Ahn cannot sub-contract/delegate the work.</p>	<p>The contract does not stipulate Sara must personally complete the work (the contract focuses on achieving a specific result ie the software program). Sara can pay someone else to complete the work.</p> <p>Contractor characteristic - Sara can sub-contract/delegate the work.</p>	<p>The contract does not give leeway for me to hire another person on my behalf to finish my work. I believe the contract between the Company and the Agency generally gives the agency first right to place someone in my position if I am incapable of finishing the job but I have no such right myself.</p> <p>Contractor characteristic : No IT agency in its right mind would ever let Luke have this ability. But from the Company's perspective the agency does indeed subcontract this work out to me.</p>
<p><b>Basis of payment</b></p>	<p>As Ahn has recently completed his degree, the business has agreed to pay him a higher annual salary. They pay Ahn fortnightly for the agreed standard hours he works plus any agreed overtime.</p> <p>Employee characteristic - Ahn is paid for the time worked.</p>	<p>Sara quoted a price to design, develop, test and install the new software program. Sara will be paid progress payments upon specific stages of the project being satisfactorily completed.</p> <p>Contractor characteristic - Sara is paid for a specific result based on the quote she provided.</p>	<p>Work is paid hourly and quoted over a specific number of months. A quote implies a knowledge of the work to be done prior to a contract being taken. Given the size and scale of most IT projects a project manager and a business analyst is usually contracted for 3-6months just to work out how many IT people are needed over how long.</p> <p>Contractor characteristic - Luke is paid for a specific result at an hourly rate. The duration of the contract is generally the indicator on how long a piece of work will take to complete.</p>
<p><b>Equipment, tools and other assets</b></p>	<p>Ahn uses the computer equipment and software provided by the business. On occasion, as agreed with the business, Ahn will work from home using his laptop to write the end-user documentation and operational procedures.</p> <p>Employee characteristic - the business provides the majority of the equipment and assets required to complete the work.</p>	<p>Sara uses her own computer equipment and software. At designated stages of the project, Sara will use the retail business's computers for short periods of time.</p> <p>Contractor characteristic - Sara provides the majority of the equipment and assets required to complete the work.</p>	<p>Luke uses the computer equipment and software provided by the business. On occasion, as agreed with the business, Luke will work from home using his laptop to write the end-user documentation and operational procedures.</p> <p>Contractor Characteristics - Most large business have Standard Operating Environments and dislike having foreign computers connected into the corporate network. Most corporations will provide a PC and cover software licencing for development. It would be inconceivable that contractors would be able to handle the \$100k+ in software licences to develop offsite given the diverse and often bespoke nature of software systems involved.</p>

<p><b>Commercial risks</b></p>	<p>If there are faults in the work, or it is not completed on time, Ahn is not personally liable. The business would need to pay for rectification.</p> <p>Employee characteristic - Ahn takes no commercial risks.</p>	<p>If the software program does not meet the retail business's agreed requirements or does not perform to specification, Sara will be required to correct the problem at her own expense.</p> <p>Contractor characteristic - Sara takes commercial risks.</p>	<p>If the software program does not meet the retail business's agreed requirements or does not perform to specification, Luke will be required to correct the problem. Because this is a time and materials contract Luke is generally not required to fix at his own expense. If gross negligence is involved, or contract specific deadlines are not met the agency and Luke can be sued for damages and insurance is normally taken out by the agency to cover this.</p> <p>Contractor characteristic - Luke takes some commercial risks if certain conditions in the contracts are not met.</p>
<p><b>Independence</b></p>	<p>Ahn works on an ongoing basis for the business and must complete any work reasonably asked of him within his duty statement.</p> <p>Employee characteristic - Ahn is not operating independently from the business.</p>	<p>Sara has her own website which promotes her services. She has another project to complete after the contract with the retail business is completed and can choose whether she undertakes future projects for the retail business.</p> <p>Contractor characteristic - Sara is operating independently from the retail business.</p>	<p>Luke must regularly seek contracts through agencies, contacts and online to maintain work. Work will rarely be done through the same agency between different contracts.</p> <p>Contractor Characteristics - Work is not ongoing and must be sought after a contract is finished. Multiple contracts at once are a possibility.</p>



**ICA Board of Taxation Submission**

**Review of Tax System Impediments Facing Small Business**

**Addendum 2: ICA's PSI Ready Reckoner**

[*Source:* <http://www.independentcontractors.net.au/Members/Secure/Taxation/personal-services-income-tax-ready-reckoner>]



## Tax Clarity for Small Business Contractors

September 2004

[Updated: February 2006]

This information is for you if you run your own small business (and you are not an employee) and you are concerned with how tax rules may affect your access to business style tax treatment or your ability to claim business expenses. These tax rules may affect your ability to:

- Claim business expenses as deductions from income tax
- 'Split' pre-tax income with someone else; or
- Retain pre-tax income in your business.

It is important that you have an understanding of the basic tax rules so that you can conduct your commercial activities with reasonable certainty and avoid potential tax penalties if you are unaware of the law.

### • **Overview & Background**

Tax rules aim to ensure that all people pay their rightful amount of tax. Historically most individuals have earned their income as employees and are taxed as employees. The differences between employees and businesses are generally clear. In the 1980s and 1990s, however, many people stopped being employees and became small businesses, either working on their own or with a small number of other people. This trend away from employment to small business-independent contracting blurred the line between business tax treatment and employee tax treatment. The blurring appeared to enable some people to pay less tax than other people.

In 2001–02 the tax rules were changed to clarify and create higher levels of certainty in tax treatment for people who earn their income as a small business. This new level of clarity hinges around three tax categories/definitions that are summarised in this publication. The 'business' categories are tax specific.

There are, however, still some areas of uncertainty that the new tax rules could not fix, and that are going through a process of clarification before the courts.

The information provided here is aimed at helping you understand those areas that are straightforward and areas where you need to exercise greater care. Also, be aware that the general anti-avoidance laws prevent you from doing things you would not normally do, just to avoid tax.

## **2. Tax Categories**

As a small business/independent contractor you can work as an individual or through an entity structure---a partnership, trust or company.

Whichever way you work, you will fall into one of three broad tax categories and your tax treatment will be different. The three possible tax categories are:

Business	Personal Services Business	Personal Services Income Earner
Your income is not generated mainly by your personal efforts or skills. It is generated mainly by the sale of goods or through the business structure that you operate..	Your income is mainly generated by your own personal efforts or skills and you are able to pass one of the four personal services business (PSB) tests contained in new tax legislation.	You are not an employee, however your income is mainly generated by your personal efforts or skills and you are unable to pass one of the PSB tests.

### 3. Which Tax Category Applies To You?

You will need to consider carefully which of these categories applies to you. There are reasonably clear rules, but you need to consider how these fit your own individual circumstances. Some guidance is provided below, along with an indication of where you can find further information.

Business
<p>The Tax Office places you in this category if your income is generated mainly from:</p> <ul style="list-style-type: none"> <li>(a) The sale of goods <u>or</u></li> <li>(b) The operations of a business structure</li> </ul> <p>It should be relatively clear whether you fall into the first part of this category. It is more difficult to decide if your income is from a business structure.</p> <p>The concept of a business structure for Tax Office assessment purposes comes from cases decided over the years by the courts. An assessment will depend on your individual circumstances. Factors indicating a business structure include:</p> <ul style="list-style-type: none"> <li>a) Ownership of significant business assets used to generate income---such as a bulldozer, or delivery van operated by a courier driver</li> <li>b) Arm's length workers are engaged to perform a significant portion of the work</li> <li>c) The existence of saleable goodwill in the business</li> <li>d) The size of your operations---the larger it is, the more likely it is to derive income from a business structure.</li> </ul>

Personal Services Business
<p>This is where the income earned is mainly through your <u>personal</u> efforts or skills.</p> <p>To fall into this category you need to pass just one of 4 tests contained in the personal services income legislation. The tests are:</p> <ul style="list-style-type: none"> <li>a) Results test : you can always self-assess this</li> <li>b) Unrelated clients test: to self-assess, no more than 80% of your income should come from one source</li> <li>c) Employment test: same as b</li> <li>d) Business premises test: same as b.</li> </ul> <p>You can self-assess (as shown above) or make application to the Tax Office so they can provide a ruling on whether you meet any of the tests.</p>

## Personal Services Income Earner

This is also where the income earned is mainly through your personal efforts or skills.

You are, however, unable to pass one of the PSB tests and so you are not running a business or personal services business for tax purposes. An example might be an IT contractor who is not an employee but is engaged on a long term contract with a major bank, works solely for that bank and performs work as directed by the bank.

### 4. Tax implications

There are different tax consequences, depending on which of the three categories you fit into. The major tax consequences are:

Business	Personal Services Business	Personal Services Income Earner
<p>Normal business tax rules apply and you can:</p> <ul style="list-style-type: none"> <li>a) Claim all business expenses against your income</li> <li>b) Split pre-tax income with other family members, for example by distributing partnership profits to your spouse or paying dividends from your company except where this occurs as a specific tax avoidance scheme.</li> <li>c) Retain profits in your company and pay tax at the corporate rate.</li> </ul>	<p>There are no specific restrictions on the deductions you can claim against your income. You are able to claim all normal business deductions.</p> <p>If you are operating through a genuine <u>partnership</u> with your spouse, you can normally split the partnership's pre-tax income with your spouse. [ATO announcement December 2005]</p> <p>If you are operating through a <u>trust or company</u>, the Tax Office's view is that you cannot normally split your pre-tax income with other family members or associates. Nor can you retain profits in your company and pay tax at the corporate rate.</p> <p>With trusts and companies, the area has some uncertainty and the Tax Office's views are being tested through the courts.</p>	<p>There are specific restrictions on the deductions that can be claimed against your income. These relate to deductions such as motor vehicle, mortgage interest or rent on your home and payments to family members who perform non-principal work.</p> <p>Even if you operate through an entity (partnership, trust or company) all net income must be included in your individual tax return.</p> <p>Your entity may be required to deduct tax under PAYG.</p>

### **Tax Office Determinations**

If you are unsure which category applies to you, you can ask the Tax Office for a ruling or for a personal services business determination. If the Tax Office tells you that you are not a 'Business' you can still self-assess to see if you are a 'Personal Services Business.' Discuss this with your tax adviser before making a request for a determination.

### **No Implications for Non-tax Law**

The three categories above only apply for tax purposes.

### **PAYG**

Unless you are a sole trader, you are also likely to have obligations under PAYG.

### **What to do next?**

Seek the advice of a registered tax agent or the Tax Office.

Information from the Tax Office is available from their website [www.ato.gov.au](http://www.ato.gov.au) or by ringing 13 28 66.

ICA Subscribers may obtain further ATO information on these matters by accessing the online version of this article at:

<http://www.contractworld.com.au/reloaded/ica-taxclarity2.php>

and following the links.

**ICA Board of Taxation Submission**

**Review of Tax System Impediments Facing Small Business**

**Addendum 3: Income Splitting for Partnerships**

[*Source:* <http://www.independentcontractors.net.au/Members/Secure/Taxation/income-splitting-for-parterships>]

# Income-splitting for partnerships

February 2006

## Important development for partnerships

As of December 2005, the ATO accepts that, in the ordinary case, the tax law does not prevent 50:50 **income splitting** by a genuine partnership conducted by an independent contractor with his or her spouse where there are no unusual features about the partnership or the income split.

Note: The partnership must be genuine and not designed just for tax-scramming purposes. An example of an unusual feature is the splitting of income in different proportions to the splitting of losses.

Before this change the ATO treated partnership income splitting with some suspicion which meant that splitting income could cause an ATO investigation and rejection of the income splitting.

## A typical example

If a trade contractor (plumber, carpenter, etc.) legally operates in a partnership with his or her spouse, the income from the partnership can generally be split 50:50 with the spouse. This can apply for IT professionals, engineers, consultants and so on.

## Why the change?

In 2003, the ATO announced that it would conduct a test case programme on some tax issues for independent contractors which meant taking specific cases to the courts for a ruling. As a result of court rulings, the ATO has reviewed partnership issues.

The ATO recognises that where independent contractors work through partnerships, not only do the partnerships share income but they also share expenses. Further, if the business goes broke, each partner is legally liable for the debts of the business. Partnerships are not a legal construct to enable the avoidance of debts.

## Doesn't apply to companies or trusts

This new rule for partnerships does not apply to companies or trusts. Therefore, the ATO remains cautious and is likely to investigate income splitting and profit retention in companies and trusts. However:

- This only applies to independent contractors who are classified as a Personal Services Business. It does not apply to entities that are classified as Businesses.
- The ATO is continuing the legal test case programme for PSB companies and trusts.

## ICA's view

This development for independent contractors operating as partnerships is most welcome. Partnerships are normally genuine businesses and should be entitled to share income when risk of losses is also shared. There will be many thousands of small partnership which can now approach their business activities with greater certainty on the tax issue. This relieves them of one area of worry and concern.

ICA has supported the ATO test case programme, believing it to be a sensible and genuine approach by the ATO to resolving the issues. The process may take longer than ICA would like, but it is good to see one positive outcome.

ICA looks forward to further clarity coming from the test case program for independent contractors operating through companies and trusts and who are PSBs. In the meantime, independent contractors operating this way should be aware that income splitting and profit retention is a grey area of tax law and could be subject to ATO investigation.

**ICA-ATO communication** The Commissioner of Taxation announced the partnership changes in December 2005. ICA has consulted with the ATO to ensure that we are correct in our facts before making comment. ICA appreciates the ready contact and assistance we receive from the ATO. Our comments and views, however, are our own.