

**SENATE ECONOMICS LEGISLATION
COMMITTEE**

**CONSIDERATION OF LEGISLATION
REFERRED TO THE COMMITTEE**

*A New Business Tax System (Alienation of Personal Services Income)
Bill 2000;*

*A New Business Tax System (Alienation of Personal Services Income)
Tax Imposition Bill (No.1) 2000; and*

*A New Business Tax System (Alienation of Personal Services Income)
Tax Imposition Bill (No.2) 2000*

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Secretariat

Peter Hallahan, Secretary
Alistair Sands, Research Officer
Angela Lancsar, Executive Assistant

SG.64, Parliament House
Canberra ACT 2600

Tel: 02 6277 3540

Fax: 02 6277 5719

Contents

Membership of the Committee	iii
Report	
Reference of the Bills to the Committee	1
The Committee’s Inquiry	1
The Bills	1
Definition: “Alienation of Personal Services Income”	1
Background	2
Measures in the Bills	3
Diagram 1: Methodology for determining whether the taxpayer is operating a legitimate personal services business	5
Comparison of key features of new law and current law	6
Issues in evidence	8
The personal services business tests	9
Deductions	14
Transitional Period	15
Comparison of Revenue Forecasts	16
Recommendation	16
Labor Senators’ Minority Report	17
Australian Democrats’ Minority Report	21
Appendices	
Appendix 1: List of Submissions	27
Appendix 2: List of Witnesses Appearing Before the Committee	29

REPORT

Reference of the Bills to the Committee

1.1 The New Business Tax System (Alienation of Personal Services Income) Bill 2000 and two related Tax Imposition Bills (No.1 and No.2) were introduced into the House of Representatives on 13 April 2000. Following a report by the Selection of Bills Committee, the Senate referred the Bill to this Committee on 10 May 2000 for examination and report by 5 June 2000.¹

1.2 In particular, the Committee was asked to appraise the effectiveness and impact of the Bills on anti-avoidance measures.

The Committee's Inquiry

1.3 The Committee invited a number of interested parties to make submissions on the Bills, in addition to advertising the inquiry on the Parliament website. The Committee received nine submissions, as well as supplementary submissions, to the inquiry (see Appendix 1). The Committee held a public hearing on the Bills in Canberra on 23 May 2000. The witnesses who appeared at the hearing are shown in Appendix 2.

The Bills

1.4 The Bills introduce measures designed to strengthen the integrity and fairness of the tax system. Originating in the Review of Business Taxation (RBT) (also known as the "Ralph Review") in July 1999, the measures are aimed at preventing individuals from reducing their tax by diverting or "alienating" their income to a company, partnership or trust. The measures also seek to limit work-related deductions available for such entities.

1.5 The Government explained that the reason for introducing the two Tax Imposition Bills was to safeguard the legislation against possible constitutional challenge.²

Definition: "Alienation of Personal Services Income"

1.6 Alienation of personal services income (PSY) refers to situations where a person's income from their own personal effort or skill is paid to through an entity (eg, company, trust, partnership). By "alienating" income in this way through an interposed entity, the person may gain tax advantages (mainly income splitting and larger deductions) which are not available to other taxpayers earning personal services income. In addition to reducing their tax bill, individuals who alienate their income can also gain access to a number of income-tested government payments, as well as avoid other obligations such Medicare levy and superannuation surcharges.³

1 Selection of Bills Committee Report No. 7 of 2000, dated 10 May 2000.

2 Second Reading Speech.

3 See Review of Business Taxation, *A Tax System Redesigned: More certain, equitable and durable*, Report, July 1999, pp. 287-288.

Background

The Review of Business Taxation

1.7 The Review of Business Taxation (RBT) – the Ralph Review – examined the issue of alienation of personal services income, finding that the use of interposed entities posed a growing threat to the tax base. The Review also pointed to the equity implications between those who can take advantage of alienated income arrangements and wage and salary earners who cannot:

The use of such arrangements [interposed entities] to reduce the tax liabilities of individuals means that people in substantially the same financial and work situation would be paying significantly different levels of taxation.

It is clearly inequitable that some taxpayers should be reducing their tax liability by using interposed entities to alienate income while other taxpayers also deriving personal services income, including ordinary wage and salary earners, pay the correct amount of tax.⁴

1.8 The Review recommended, among other things, that legislation be adopted to deal with people who sought to alienate their income despite supplying services in an *employee-like manner*.⁵ This was in accordance with the RBT's guiding principle that economic transactions having the same economic substance should be taxed similarly, irrespective of their legal form.

1.9 In particular, the Review discussed the Victorian payroll tax arrangements as a model for establishing criteria to determine whether personal services income related to services performed in an employee-like manner.⁶

Parliamentary committee inquiry

1.10 A subsequent parliamentary inquiry into business taxation reform, conducted by the Senate Finance and Public Administration References Committee, examined both the Review's findings and recommendations.⁷

1.11 In relation to the alienation problem, the evidence to the inquiry divided into those who endorsed the Review's risk assessment – “a burgeoning tax loophole” in the words of former Treasurer Ralph Willis – and opponents, comprising building and housing industry bodies. Opponents criticised the measures for penalising legitimate operators, particularly in the building and construction industry which features widespread use of “specialist contractors”. Similar lines of argument emerged in the evidence to this Committee on the Bills.

4 RBT, *A Tax System Redesigned*, p. 287.

5 RBT, *A Tax System Redesigned*, p. 290.

6 RBT, *A Tax System Redesigned*, p. 291.

7 Senate Finance and Public Administration References Committee, *Report of the Inquiry into Business Taxation Reform*, November 1999, pp. 47-48.

Measures in the Bills

1.12 The Bills apply to personal services income (PSY) which is defined as income received mainly as a reward for personal efforts or skill.

1.13 The Bills seek to:

- ensure that income for the provision of personal services (ie, personal services income), whether paid directly to an individual or channelled through an interposed entity, will be treated for taxation purposes in the same way; and
- clarify the deductions available (both for individuals and other entities) in the gaining of personal services income.⁸

1.14 The aim of the measure is to ensure that an individual's assessable income for tax purposes includes PSY received through a personal services entity, where that PSY has not already been paid by the entity to the individual as wages or salary.

1.15 The Bills define in some detail the circumstances under which the new measures will apply. The determining factor is whether an individual or entity is said to be conducting a personal services business. To this end, the Bills prescribe the criteria or tests to determine this status.

The personal services business tests

1.16 The measures in the Bills will apply to individuals and interposed entities that receive 80 per cent or more of their PSY from one source, unless the Commissioner of Taxation determines that the income is from a personal services business (PSB). The measures will also apply to individuals and entities that receive less than 80 per cent of their PSY from one source but do not self assess as a PSB.

1.17 The Bills establish three tests for self-assessing if an individual or entity qualifies as a PSB:

- Having two or more unrelated clients (the "unrelated clients test");
- Having one or more employees (the "employment test"); and
- Having separate business premises (the "business premises test").

1.18 Only one of these three tests needs to be met to qualify as a PSB.

1.19 Individuals or entities that cross the 80 per cent income threshold must request the Commissioner to determine that their income is from a PSB. The grounds on which the Commissioner must be satisfied to provide a PSB determination are:

- i. That the "employment test" or the "business premises test" are met or
- ii. But for unusual circumstances, one of the three PSB tests could be met or

8 NBTS (APSI) Bills 2000, *Explanatory Memorandum*, p. 7.

- iii. That the individual or entity is producing a result, supplies their tools of trade and is liable for the cost of rectifying defective work (this can be called the “results test” or “fourth” test).

1.20 In making a determination in relation to the fourth test, the Commissioner is able to have regard to industry custom and practice.⁹ Diagram 1 outlines the steps involved in self-assessing and seeking a determination in relation to the tests.

1.21 The *Explanatory Memorandum* to the Bills includes numerous examples to illustrate the operation of the new rules under different circumstances.

Deductions

1.22 The Bills limit the deductions an interposed entity and individual can offset against both an individual’s income and personal services income (PSY). This is aimed at ensuring that deductions are limited to those that would be allowed if the individual had been an employee and the expenditure was incurred in relation to the individual’s activity.

1.23 The existing tax arrangements for work related deductions for individual income earners are applied to personal services entities, unless the entity gains the individual’s PSY in the course of running a personal services business. Deductible items under current tax arrangements, such as insurance, workers compensation and the cost of obtaining a job, still apply.

Transition

1.24 To minimise the compliance costs during the shift to a new tax system, transitional provisions will apply. The Commissioner will, for a two year period ending July 2002, be able to declare that the new rules will not apply to contractors under the Prescribed Payments System who had payee declarations with the Commissioner as at 13 April 1999. The Government justified the transitional arrangements on the grounds:

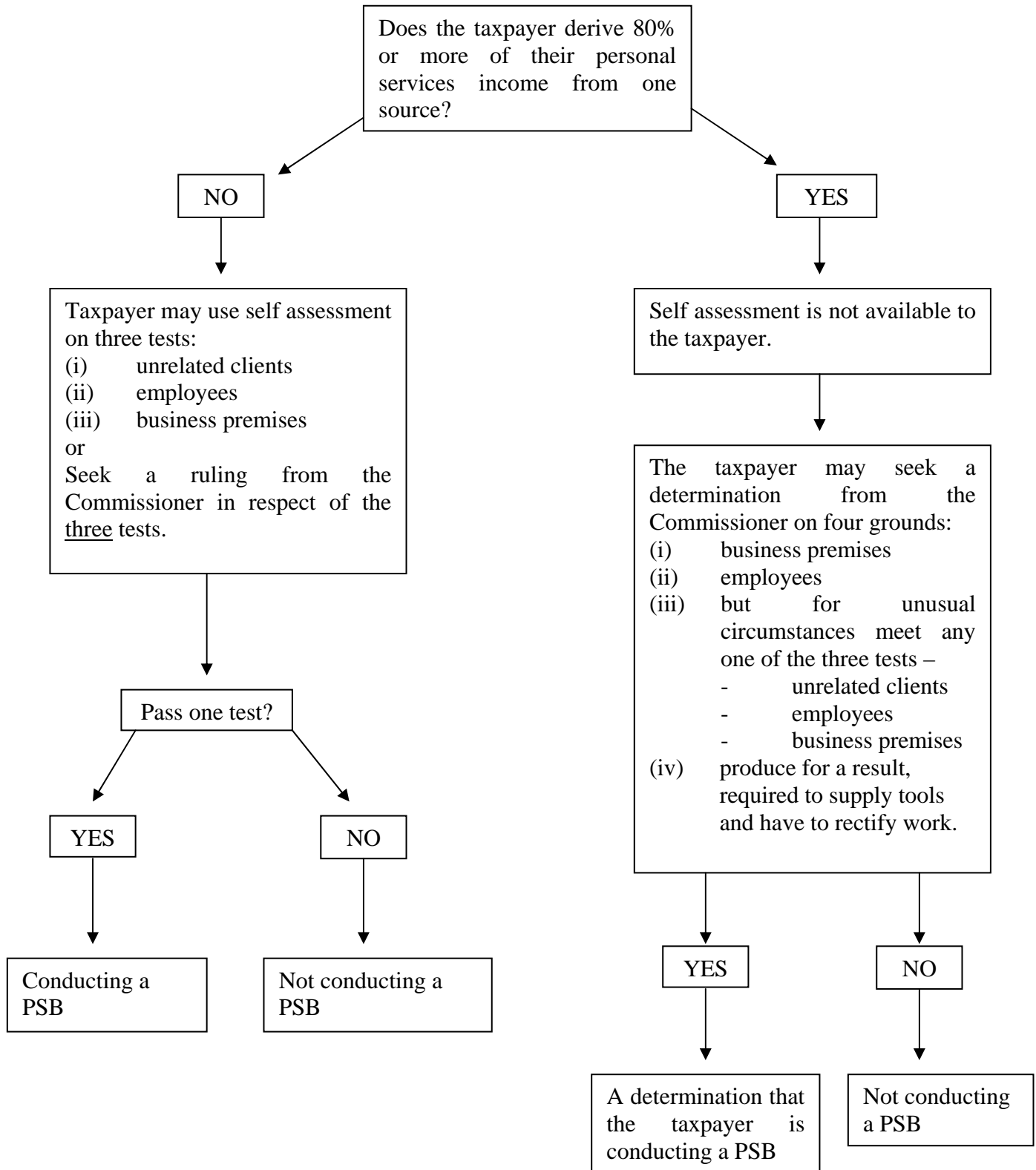
...that taxpayers under the Prescribed Payments System are currently subject to withholding arrangements and are specifically recognised as independent contractors under the tax law.¹⁰

1.25 The transitional arrangements also take into account the expected impact on the ATO’s workload of processing requests for individual determinations prior to the Bills introduction on 1 July 2000. In addition, taxpayers and their advisers are involved in gearing up for the New Tax System changes, such as GST and Pay As You Go (PAYG) from 1 July 2000 and a number of business tax reforms from 1 July 2001.

9 Second Reading Speech.

10 Second Reading Speech.

Diagram 1: Methodology for determining whether the taxpayer is conducting a legitimate personal services business (PSB)



Comparison of key features of new law and current law

1.26 This table compares key features of the income tax regime for personal services income with the existing position.

<i>New Law</i>	<i>Current law</i>
An individual must include in his or her assessable income any income that another entity (a personal services entity) gains from the individual's personal services, unless certain exceptions apply.	There is no equivalent specific rule in the existing law. However, case law based on the anti-avoidance provisions in Part IVA of the ITAA 1936 supports the view that personal services income paid to an entity is assessable to an individual.
<p>The rule above will not apply where the income is gained in the course of conducting a personal services business. A personal services business is conducted where at least one of these tests are met:</p> <ul style="list-style-type: none"> • Unrelated clients test; • Employment test; or • Business premises test. <p>However, if 80% or more of income for a particular individual's personal services come from one source, a determination by the Commissioner is required for the income to be treated as being gained through the course of conducting a personal services business.</p>	Part IVA can apply to the alienation of personal services income, irrespective of whether a personal services business exists.
If 80% or more of income for an individual's personal services is from one source, the Commissioner can determine that the income is gained in the course of conducting a personal services business. Such a determination can be obtained by applying to the Commissioner in an approved form.	Generally, an individual or entity can apply to the Commissioner for a private binding ruling to determine how the existing laws apply.
Personal services income of an entity will not be included in an individual's assessable income under the new rules, where the income of the entity is promptly paid as salary or wages to the individual who performed the services.	<p>The Commissioner does not apply Part IVA where the income is paid as salary to the individual.</p> <p>However, the entity has until the end of the income year to pay that salary.</p>

<i>New Law</i>	<i>Current law</i>
<p>An individual cannot deduct amounts that relate to his or her personal services income if he or she would not be able to deduct these amounts as an employee deriving the income. Amounts specifically not deductible include certain payments to associates and certain amounts relating to the individual's residence.</p>	<p>Deductions are recognised to the extent they are allowable under the tax laws, in particular, section 8-1 of the ITAA 1997. On application of Part IVA, the Commissioner can make compensating adjustments to allow deductions to an individual. However, there is a perception that an individual who performs services through a business structure or as an individual contractor is able to deduct substantially more amounts than an employee would in a similar situation.</p>
<p>The amount of personal services income of an entity included in an individual's assessable income is reduced by the entity's deductions that relate to this income. However, these deductions are limited to those allowable to an individual under the new rules.</p> <p>Also, there are amounts which are specifically not deductible, these include:</p> <ul style="list-style-type: none"> • Certain payments to associates; • Car expense or FBT paid for a car fringe benefit for more than one car of which there is private use; and • Entity maintenance expenses up to the amount of non-personal services income as these expenses are deducted first against that income with any excess being deductible against the personal services income. 	<p>Under Part IVA some of the deductions claimed by a personal services entity are allowed to the individual based on what is considered fair and reasonable to allow.</p>
<p>Deductions of a personal services entity that relate to income other than personal services income, can only be used to reduce this other income.</p>	<p>If the Commissioner applies Part IVA, those deductions are not allowed to reduce personal services income.</p>
<p>Where more than one individual provides their services through a personal services entity, the rules apply on a worker by worker basis. This prevents individual service providers escaping the regime by simply 'teaming-up'.</p>	<p>The Commissioner can apply Part IVA to counter 'teaming-up' arrangements.</p>

<i>New Law</i>	<i>Current law</i>
The personal services entity is subject to the PAYG withholding system on personal services income that is not paid as a salary.	There is no equivalent provision for income attributed to an individual.
Part IVA of the ITAA 1936 will continue to have potential application if the new law does not apply. For example, where an individual's personal services income is the income of a personal services entity, which is conducting a personal services business.	Part IVA can apply. Section 26-35 of the ITAA 1997 limits deductions for payments to associates to reasonable amounts.

Issues in evidence

1.27 During the hearing, views differed as to the legislative measures required to achieve the objective of addressing the alienation of PSY. Evidence divided largely into those who support the thrust of the legislation but believe it will be ineffective in addressing avoidance; and those concerned about the effect of the Bills on not only legitimate operators but also the building, housing and information technology (IT) sectors of the economy.

1.28 Pointing to the fragile state of the building industry, the MBA also claimed that the Bills will undermine the specialised subcontract system upon which the industry depends.¹¹ Witnesses from the information technology (IT) sector also predicted that the Bills might exacerbate the current skills shortage in Australia's IT industry, driving local contractors abroad while discouraging overseas IT specialists from entering Australia.¹²

1.29 In the view of the Master Builders Association (MBA), the legislation operates upon a principle that treats legitimate independent contractors differently to other businesses for tax purposes. The MBA also saw the legislation as logically incoherent:

...this particular legislation assumes that certain business are operating *legitimately* and then imposes certain tests which ... if those legitimate businesses do not pass deems them, at least for income tax purposes, to be operating *illegitimately*.¹³ [emphasis added]

1.30 Other witnesses, however, differed in their assessment of the Bills. The Australian Chamber of Commerce and Industry (ACCI) indicated that the measures, if applied properly, should not affect genuine independent contractors adversely, although difficulties might occur with "borderline" cases. The ACCI expected additional costs to be passed on to the market but stated that this is the natural response of "any market" to anti-avoidance

11 Submission No. 5, p. 3.

12 Australian Contract Professions Management Association Ltd (ACPMA), Submission No. 2 and Supplementary Submission No. 2A; IT Consultants & Recruitment Association, Submission No. 7.

13 Evidence, p. E3.

measures: as tax advantages are lost service providers will either pass on additional costs or stop providing services.¹⁴

1.31 In terms of the taxation liability of individuals, the Treasury estimated that the impact of the measures, when averaged out over the target population, is likely to be between \$2000 and \$2500 on each individual contractor. This estimate is the average effect. Due to the range of industries and entities covered by the Bills the actual impact would, in the Treasury's view, "vary enormously from case to case".¹⁵

1.32 Apart from industry impacts, three main issues were raised:

- whether the tests would address alienation or discriminate against legitimate PSBs;
- the availability of deductions; and
- the need for a transitional measure.

1.33 The Committee examines these three major issues in turn.

The personal services business tests

1.34 The impact of the tests for determining a personal services business was the most contentious feature of the Bills in the evidence. The evidence focused on how the proposed tests compare with those discussed in the Ralph Review. Opinion differed over the impact of the tests on addressing alienation of PSY and whether amendments are required to strengthen or simply fine-tune the Bills.

The Bills compared with the Ralph Review

1.35 Appearing as an adviser to the Construction Forestry and Mining Union (CFMEU), the Hon. Ralph Willis stated that the approach adopted in the Bills diverged from that in the Ralph Report:

The Ralph Report was concerned to ascertain whether the supposed contractor was operating in an *employee-like* manner. This legislation applies the opposite test: whether the contractors are acting in a *business-like* manner. [emphasis added]¹⁶

1.36 Consequently, Mr Willis claimed that this divergent approach produced weak tests, undermined the anti-avoidance thrust of the legislation and altered the basis upon which the Government's revenue forecasts were made.

1.37 Departmental witnesses stated that the criteria adopted in the Bills reflect the approach adopted in the Ralph Review. While the Government had modified the Ralph approach better to meet its aims, the tests provided the same degree of "coverage" recommended in the Ralph Review. In explaining the tests, Mr Greg Smith representing Treasury stated:

14 Evidence, p. E13.

15 Evidence, p. E22.

16 Evidence, p. E29.

They are modifications but have the same idea – to establish a distinction between when personal services are provided in the course of conducting a personal services business and when they are not. We have no reason to believe otherwise that that we would essentially be drawing a very similar boundary with these measures as were implicit in the costing done for Ralph.¹⁷

1.38 In contrast to the tests in the Bills, the CFMEU favoured the adoption of the Ralph Review’s proposed criteria which are a “comprehensive test” based on the Victorian payroll tax. That model provided for the “most robust test” available and benefited from having detailed criteria.¹⁸

1.39 However, other witnesses criticised both the Victorian model and the criteria discussed in the Ralph Review. The Housing Industry Association (HIA) considered that more detailed criteria – “a multiplicity of tests” – would not be helpful.¹⁹ The ACCI stated that the original tests proposed in Ralph and later by the Treasurer would not only have penalised legitimate operators but would also have had major ramifications for the economy:

I think the problem of applying the rules as they were originally designed is that it would have caused enormous efficiency losses in the economy and what you would have ended up with was having deemed people employees who were in no sense employees. The final analysis would have been that the effect on the economy would have been extremely negative.²⁰

1.40 Treasury officials stated that the control test used in Victoria is a decade old and does not reflect major changes in employment relationships over that time. Moreover, the tests in the legislation rely on objective criteria as opposed to the value judgements involved with the Victorian tests:

The evidence we had was that the Victorians had enough difficulty as it was with their tests and that we would be better to have more objective tests.²¹

1.41 The so-called “fourth” or result test is also viewed as including “implicit issues” that serve as a control test in a manner not dissimilar to that in the Victorian legislation.²²

The adequacy of the tests

1.42 The CFMEU stated that the tests would pose “no barrier” to contractors intent on alienating their PSY. In the CFMEU’s view, each test is fundamentally flawed in the following way:

- the unrelated clients test would fail to catch the high proportion of building industry contractors who change employers at least once a year;

17 Evidence, p. E15.

18 Evidence, pp. E30-31.

19 Evidence, p. E26.

20 Evidence, p. E14.

21 Evidence, p. E16.

22 Evidence, p. E16.

- the employment test is flawed because it does not exclude associates, nor will it prevent income splitting as it will be hard for the ATO to identify the division of labour in a partnership; and
- the business premises test is similarly flawed in that it is seen as open-ended, allowing contractors to erect artificial “premises” to satisfy the test.²³

1.43 The CFMEU also claimed that the limited requirement for only one of the three tests to be met to qualify as a personal services business compounds their inherent weaknesses. The CFMEU argued that the tests are flawed or “flimsy” to such an extent that even if all three tests had to be met, the Bills would fail to address current levels of tax avoidance:

It will not be too difficult for lots of creative people with all their accountants assisting them to en masse avoid the so-called crackdown on the tax avoidance in our [the building] industry.²⁴

1.44 Rather than attacking avoidance, the CFMEU claimed that measures would result in large scale avoidance: “I predict that [the] cash economy will be back in a very big way in the building industry”.²⁵

1.45 Although it had not modelled the impact of the legislation, the CFMEU asserted that, given the weakness of the tests will result in tax avoidance flourishing, the Government’s revenue forecast for the Bills is “very substantially overstated”.²⁶

1.46 Other witnesses, however, did not consider the tests to be weak. The Housing Industry Association (HIA) stated that the tests are “fair and reasonable” and “will protect genuine contractors without letting tax dodgers off the hook”.²⁷ In the MBA’s view, the tests are appropriate in each case for determining whether or not an entity is operating as a PSB. However, the MBA considered that the tests are selective and fail to cover the full range of circumstances in which contractors operate genuine PSBs.²⁸

The 80 per cent threshold

1.47 The ACCI and HIA endorsed all four tests but questioned the way the 80 per cent income threshold applies to the fourth personal services business test.

1.48 The Bills require that personal services businesses that earn 80 per cent or more of their income from one source must seek a determination from the Commissioner as to whether the measures affect them. Both the ACCI and HIA interpreted the legislation as *limiting* the application of the fourth “result” test to individuals or entities that cross the threshold. These bodies believed businesses that earn under 80 per cent would be excluded from seeking a determination from the Commissioner using the fourth test.

23 Submission No. 3, pp. 4-7.

24 Evidence, p. E28.

25 Evidence, p. E28.

26 Evidence, p. E30.

27 Submission No. 4, p. 2.

28 Submission No. 5, p. 5.

1.49 Both bodies recommended that the fourth test should be available to all individuals or entities that wish to self-assess or seek a determination from the Commissioner, regardless of the proportion of income earned from a major source. As the Bills stand, only three tests are open to self-assessment. The Commissioner of Taxation can consider the so-called fourth test in making a determination on a personal services business request.

1.50 In addition, the ACCI stated that the three self-assessing tests do not represent the full range of legitimate independent contractors, arguing that the inclusion of the fourth test in the legislation recognises this limitation.²⁹ Including the fourth test under self-assessment would reflect business reality better. It would also avoid difficulties arising over borderline cases and therefore prevent genuine contractors being treated differently to their actual business circumstances.

1.51 Departmental witnesses pointed to potential compliance problems with inclusion of the fourth test for self-assessment purposes. It is seen as resting on different criteria compared to the other three tests. Whereas those tests are said to employ “objective criteria”, the third test introduces “a degree of subjectivity in determining the answer”³⁰ and is open to value judgements.³¹

1.52 If available for self-assessment purposes, the subjective nature of the test could pose compliance risks. For those reasons, it was considered that the test should be restricted to the Commissioner’s determination powers.

1.53 According to the ACCI and HIA, if the Bills are passed unamended, personal services businesses that generate less than 80 per cent of their income from one source could be left in the awkward situation of not knowing precisely their taxation liability because they cannot seek a Commissioner’s determination.³² Presumably this situation could impact on business certainty and long-term business planning.

1.54 Departmental officials stated that no-one is excluded from approaching the Commissioner to request a private binding ruling on their personal services business status. Individuals or entities that earn 80 per cent or more of their income from one source must seek a determination. But this does not prevent others from seeking a ruling from the Commissioner.

...we have the private binding ruling system and it is quite open for a taxpayer who is seeking certainty around their affairs to approach the tax office for such a ruling.³³

1.55 In relation to the so-called fourth test, the ATO confirmed that it can only be used as a ground for making a determination by the Commissioner in cases where an individual or entity earns 80 per cent or more of their income from one source.

29 Evidence, p. 11.

30 Evidence, p. E24.

31 Evidence, p. E32.

32 Evidence, p. E11.

33 Evidence, p. E35.

1.56 One sector that appears to illustrate the potential limitations of the test regime in the Bills is the financial planning industry. According to the Financial Planning Association (FPA), the majority of financial planners receive 100 per cent of their income from one source even though they provide services to many private clients. This reflects the way the industry is structured to meet the requirement of the Corporations Law that agents must be licensed dealers or exempt dealers. Due to the burden involved in licensing, many agents act as representatives of licensed dealers. Under this structure, an agent may have several clients but can only receive income from a licensed or exempt dealer; in other words, the dealer operates as a “middleman” between agent and client.

1.57 In the FPA’s view, while agents would satisfy the unrelated clients test of the legislation they would nonetheless be obliged to request a determination because more than 80 per cent of their income came from one source. Not only would this place agents under considerable pressure and possibly reduce agent numbers, it could also impact administratively upon the ATO and the Australian Securities and Investment Commission if agents applied for licences.³⁴

1.58 The FPA, therefore, proposed amending the Bills to exempt individuals who earn 80 per cent or more of their income from one source on the basis that their income is “results driven” rather than “service driven”. Under the FPA proposal, “results driven” would be defined as income received through “trail commission” (a payment method common in the financial industry) and/or income that is not directly attributable to the work performed.³⁵

1.59 In relation to the FPA’s concerns, the ATO stated that some of the income of financial planners would be treated as PSY under the new rules. The ATO rejected the FPA’s proposal, that results-based income should be exempt, on the ground that it was contrary to the intent of the Bills, namely, that results-based remuneration be subject to PSY measures.

1.60 The ATO also indicated that, while the Corporations Law allows agents to act for multiple principals, it considered agents that derive 100 per cent of their income from one source would be subject to the measures similar to other service providers:

Those planners who work exclusively through one licensed dealer are similar to an insurance salesperson who exclusively sells the products of one company and a person who works exclusively through a labour hire firm for a number of service acquirers.³⁶

The two/four test option

1.61 The Committee assessed the viability of including the fourth test under self-assessment but making it necessary for two of the four tests to be met to satisfy the personal services business requirements. This option may minimise the compliance risk associated with the fourth test being able to be self-assessed.

34 Submission No. 4.

35 Submission No. 9, p. 4.

36 ATO response to FPA Submission (Submission No. 9), 1 June 2000.

1.62 At present the legislation requires that only one test be met: either one of the three self-assessing tests, or the fourth test for those who cross the threshold and must seek a determination from the Commissioner.

1.63 Neither industry nor official witnesses supported this option for the same reason. The four tests are intended as separate and distinct tests.³⁷ Each test is seen as providing sufficient coverage to satisfy the characteristics of a genuine personal services business. To require individuals or entities to meet two of the four tests could discriminate against some genuine businesses.³⁸ Such an approach would implicitly suggest that each individual test is not a sufficient criterion in its own right for demonstrating that an individual or entity is a personal services business.³⁹ For example:

You may well be in a situation where someone who quite clearly is holding themselves out as a business with unrelated clients [ie, the “second test”] – and it could be 20 such unrelated clients – would fail all three of the other tests...⁴⁰

Deductions

1.64 IT contracting and recruitment representatives expressed concerns about the legislation’s restrictions on deductions. In particular, IT industry bodies claimed that the Bills are “silent” as to whether fringe benefits, such as Living-Away-From-Home-Allowance, can be allowed as a legitimate deduction against personal services income. These bodies also argued that under the new rules work-related expenses would not be deductible:

As this legislation is written now you cannot do a company reimbursement on a laptop and a mobile phone, which are absolutely essential tools of the trade, because of the limitation of the expenses within that personal services entity.⁴¹

1.65 In response, the ATO indicated that these witnesses were mistaken in believing that the new rules would prevent IT professionals from claiming work-related costs as deductions. The Bills would not stop individuals or entities claiming deductions against personal services income for business related expenditure. One of the outcomes sought under the legislation is that:

Deductions allowed to the entity (and individuals where an entity is not interposed) are limited to those that would be allowed if the individual had been an employee and the expenditure was incurred in relation to the individual’s activity.⁴²

1.66 Items such as laptop computers and mobile phones would remain deductible items provided they are used for business purposes. This is consistent with tax treatment of employees under current law.

37 ACCI, Supplementary Submission No. 6A.

38 ACCI, Supplementary Submission No. 6A.

39 Evidence, p. E24.

40 Evidence, p. E24.

41 Evidence, p. E8.

42 ATO response to question on notice, 30 May 2000.

1.67 However, the Bills do *not* allow fringe benefits to be used as tax deductions. The ATO outlined the reason for this approach:

Fringe benefits, by their nature, include benefits for private use. Under the measure as announced, no deductions would be allowed for the provision of fringe benefits because an employee cannot get a deduction for providing benefits to themselves. To allow deductions for fringe benefits would seriously threaten the integrity of the measure. In particular, to recognise the provision of exempt benefits and benefits taxed at less than their market value, would undermine the measure's objective of treating the personal services income as income of the individual for tax purposes.⁴³

1.68 The ATO pointed out, nonetheless, that the Bills recognise widespread practice in the community by providing an exemption to allow deductions for one car for private use and for fringe benefits on that car. This exemption is limited to *one* car. If an entity provides additional cars that are used partly or solely for private use, the entity cannot claim deductions for those additional cars.⁴⁴

Transitional Period

1.69 The proposed two year transitional provision attracted criticism on the grounds that it would be exploited by tax rorters who would have the luxury of time to rearrange their business structures to escape the legislation. The CFMEU likened the provision to a “two-year tax holiday”.⁴⁵ It also claimed that one of the Government's justifications for the provision – the logistical burden on the ATO of processing requests for determinations before July 2000 – overstated the case. The CFMEU maintained that ATO should not need two years to get its house in order to cope with the legislation.⁴⁶

1.70 The ACCI, on the other hand, told the Committee that the two-year transition may be warranted for particular industries. While on general principles the ACCI advocated the implementation of tax reforms “sooner rather than later”, it did accept that there is a case for examining the circumstances facing individual industries, such as the construction sector, and providing transitional arrangements.⁴⁷

1.71 Departmental witnesses from the Treasury and ATO also pointed out that the administrative impact of the legislation should not be seen in isolation. The Bills are one part of the raft of reforms being introduced:

...we should not forget what has been agreed to by the government and publicly announced: the new entities regime, consolidated groups, a simplified tax for small business, new depreciation regimes.⁴⁸

43 ATO response to question on notice, 30 May 2000.

44 *Explanatory Memorandum*, 1.181, p. 51.

45 Evidence, p. E28.

46 Submission No. 3, pp. 7-8.

47 Evidence, p. E13.

48 Evidence, p. E35.

1.72 The Treasury and ATO witnesses advised the Committee that the cumulative impact of these new measures on not only the ATO but also taxpayers and the tax industry was taken into account in deciding on the two-year transitional provision.

1.73 In terms of its revenue implications, official witnesses advised that the provisional measures would cost \$190 million per year over the two-year period.⁴⁹ The table below compares the revenue forecasts made in the Treasurer's announcement of the measures at 11 November 1999 and those included in the Explanatory Memorandum to the Bills.

Comparison of Revenue Forecasts

	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005
Treasurer 11/11/99	\$380m	\$480m	\$495m	\$515m	\$530m
Explanatory Memo.	\$190m	\$290m	\$435m	\$515m	

Recommendation

1.74 The Committee recommends that the Senate pass the Bills.

Senator the Hon Brian Gibson
Chairman

49 Evidence, p. E22.

LABOR SENATORS' MINORITY REPORT

Labor Minority Report

Due to the limited time Labor Senators have had to review both the report and the evidence provided to the committee, Labor Committee members reserve their position in regards to the New Business Tax System (Alienation of Personal Services Income) Tax Imposition Bill (No 1) 2000 and related Bills.

As an observation though, it is clear that this Bill doesn't represent the Treasurers original announcement or intent in regards to the need to put in place effective measures to countenance the use of interposed entities in order to avoid tax as fore shadowed in the Treasurers original press release No 74 of the 11 November 1999. As a consequence, the Government's failure to proceed with its own announced policy intention seriously compromises the Government's often stated claim that business tax changes need to be revenue neutral.

Furthermore the proposals in these Bills fall far short of the recommendations contained in the Governments own Review of Business of Taxation Chaired by Mr John Ralph.

Senator S Murphy
Deputy Chair

Senator G Campbell

SENATE ECONOMICS LEGISLATION COMMITTEE

Australian Democrats

Minority Report: Senator Andrew Murray:

Australian Democrats

*New Business Tax System (Alienation of Personal Services Income) Tax
Imposition Bills (Nos.1 and 2) 2000 & Related Bills*

June 2000

Minority Report: Senator Andrew Murray: Australian Democrats
New Business Tax System (Alienation of Personal Services Income) Tax Imposition Bills
(Nos.1 and 2) 2000 & Related Bills

The Bills

The *New Business Tax System (Alienation of Personal Services Income) Tax Imposition Bill (No.1) & Related Bills* (the Bills), have cross party support in their intent. These bills seek to introduce greater equity into the tax system by preventing individual tax-payers from diverting or alienating their personal income, derived from their labour, efforts and skills, to another interposed legal entity, in order to reduce their tax burden. In other words, wage earners have been passing themselves off as businesses. Other wage and salary earners with similar work arrangements, but operating in the PAYE tax system, have been paying higher tax rates. These 'alienation of personal services income' practices have constituted unfair tax avoidance.

The Australian Democrats have long advocated legislation like this as a tax reform measure. For many years now, the integrity of the income tax system has been threatened as employees by any other name have exited the PAYE system, thereby increasing the burden on those who remained. Organisations such as the CFMEU have also been strong advocates of these tax reforms, since their members paying PAYE have been unfairly disadvantaged in competing for work, where this device has been used to undercut work rates. When in July 1999 the Ralph Report (the Review of Business Taxation) recommended that this practice be ended, since it threatened the tax base and was unfair, and the Coalition Government accepted that recommendation, there was immediate support from the Democrats.

As usual, implementation has posed problems. The difficulty any government was going to face was how to outlaw the alienation of personal services income without unfairly including genuine contractors and businesses in the provisions. The Government have apparently consulted extensively in arriving at the balance in their tests for categorising personal services income, but a number of witnesses criticised their eventual tests as 'too weak'.

The Revenue

There have been three separate estimates of revenue.

	2000-2001 \$m	2001-2002 \$m	2002-2003 \$m	2003-2004 \$m
Ralph Report 6/99	380	480	500	520
Treasurer's Press Rel 11/99	380	480	495	515
Bills' EM 5/00	190	290	435	515

These are very substantial sums, to be clawed back from taxpayers not paying their fair share. These estimates still fall far short however of the loss to revenue of \$2.2 billion a year estimated by Sydney University's Australian Centre for Industrial Relations Research and Training.

The prime difference for us to attend to however in considering these Bills, is not the difference between ACIRRT and Ralph, but between the Treasurer's announcement in November 1999, and the EM for the Bills in May 2000. This difference is primarily because the measure is delayed for certain payees for two years. (For 140 000 contractors registered under the Prescribed Payments System [PPS] at 13 April 1999.)

As the Majority Report outlines, this two-year transitional measure will cost \$190m a year. Frankly, the evidence presented for this delay is unconvincing, and the Democrats will propose shortening the transitional period proposed to one year. We have no doubt that if the ATO needs additional resources for this task, for \$190 million in revenue a simple cost-benefit analysis will show that it is worth the effort.

More worrying was the statement from a former Treasurer of the Commonwealth, that the "revenue forecast ... has been very substantially overstated."⁵⁰ If Mr Willis is right, a substantial blow to projected revenue would result.

His criticism is primarily because he views the tests to be used for determining tax status as too weak, and the process of administration as suspect. He fears that the taxpayers targetted will evade the tax net and defeat the purpose of the legislation.

The Personal Services Income Tests

It is difficult to tighten the tests without pulling in genuine contractors. Nevertheless, the Australian Democrats will give further thought to this issue. In a more general sense, we are concerned that the approach of the legislation seems to differ substantially from the approach of the Ralph Report. As identified by Mr Willis, the report was concerned to ascertain by a very comprehensive test whether the supposed contractor was operating in an employee-like manner. The legislation applies three very simple tests to determine whether contractors are acting in a business-like manner.

One of the propositions facing us is to require, under self-assessment, two (not one) of the three tests to be satisfied, otherwise the Commissioner must make a ruling using the fourth test as well. This will provide a greater measure of direct involvement from the Commissioner. That has its downsides as a matter of administrative practice, but it may be necessary in the early years of the scheme, to ensure maximum effectiveness. However that does not deal with the danger that under self assessment, people may simply not comply with the test criteria, even as a result of error. The Democrats will therefore assess whether we should recommend an audit report.

Sharp criticism was directed toward the 'unrelated clients' test. It was suggested, by Mr Willis, that that test would be able to be satisfied by virtually anyone. The test certainly appears to be loosely drafted and arguably it would be very easy for a tax avoider to produce a set of circumstances at very low cost which resulted in them meeting that test.

Audit Report to the Parliament by the ATO

In order to establish the effectiveness and application of the new personal services tax regime, it may be wise for a percentage of those who claim to meet the tests under self-assessment, to be physically audited. A random sample not exceeding 2 500 would probably be sufficient. This would need to be completed in the early stage of the new regime, to determine the truth of self-assessment, and to suggest better ways of administration, and of testing these matters.

Senator Andrew Murray

APPENDIX 1**LIST OF SUBMISSIONS**

- No.1 Mr G A Taylor
- No.2 Australian Contract Professions Management Association Limited
- No.2A Australian Contract Professions Management Association Limited
- No.3 Construction, Forestry, Mining and Energy Union – Construction and General Division
- No.4 Housing Industry Association
- No.4A Housing Industry Association
- No.5 Master Builders Association
- No.5A Master Builders Association
- No.6 Australian Chamber of Commerce and Industry
- No.6A Australian Chamber of Commerce and Industry
- No.7 Information Technology Consultants and Recruitment Association
- No.8 Australian Council of Trade Unions
- No.9 Financial Planning Association

APPENDIX 2**LIST OF WITNESSES
APPEARING BEFORE THE COMMITTEE****Monday, 23 May 2000****Committee Room 1S6, Parliament House, Canberra**

Grinsell-Jones, Mr Alan, National Director, Industrial Relations, Master Builders Australia

Harnisch, Mr Wilhelm, Deputy Executive Director, Master Builders Australia

Murray, Mr John, Executive Director, Master Builders Australia

Levings, Mr John, Director, Australian Contract Professions Management Association Ltd

Mudge, Mr John Damian, Director of Taxation, Australian Contract Professions Management Association Ltd

Thomas, Mr David, Chairman, Australian Contract Professions Management Association Ltd

Moon, Ms Sheryle, President, IT Contract and Recruitment Association

Kates, Dr Steven, Chief Economist, Australian Chamber of Commerce and Industry

Quach, Mr Brendan, Economist, Australian Chamber of Commerce and Industry

Butler Mr David, First Assistant Commissioner, Business Tax Reform Implementation, Australian Taxation Office

Chapman, Mr Steve, Deputy Commissioner, Small Business, Australian Taxation Office

Smith, Mr Michael, Assistant Commissioner, Small Business, Australian Taxation Office

Smith, Mr Greg, Executive Director, Budget Group, Department of the Treasury

Morschel, Ms Ruth, Director, Tax Services, Housing Industry Association Ltd

Simpson, Mr Glen Ives, Director, Industrial Relations and Legal Services, Housing Industry Association Ltd

Sutton, Mr John David, National Secretary, Construction Division, Construction, Forestry, Mining and Energy Union

Wainwright, Mr Raoul David, Legal/Research Officer, Construction and General Division, Construction, Forestry, Mining and Energy Union

Willis, Mr Ralph, Adviser, Construction, Forestry, Mining and Energy Union

Butler Mr David, First Assistant Commissioner, Business Tax Reform Implementation, Australian Taxation Office

Chapman, Mr Steve, Deputy Commissioner, Small Business, Australian Taxation Office

Smith, Mr Michael, Assistant Commissioner, Small Business, Australian Taxation Office

Smith, Mr Greg, Executive Director, Budget Group, Department of the Treasury