

Submission to Inquiry into Small Business Employment Senate Employment, Workplace Relations And Education Committee



**The
Institution of Engineers,
Australia**

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Introduction

This submission is in response to section one of the terms of reference of the inquiry into small business employment established by the Senate Employment, Workplace Relations and Education References and Legislation Committees. This submission relates specifically to the impact of Personal Services Income Legislation.

The Institution of Engineers, Australia has over 65,000 members. Around 9,000 of our members are contractors who are affected by the legislation, which limits work related deductions for income generated by personal services, even where that income is earned through a company or partnership. Engineering and IT contractors gain their income from offering their individual personal effort and skill, which is based on their qualifications and experience. The nature of a small engineering contracting business means that these engineers, more often than not, are unable to pass the four tests set out in legislation. The problems our members face with the legislation will impact on their employment opportunities and affect industries that rely on contractors for project work.

Personal Services Income

The Personal Services Income Legislation provides that personal services income is to be treated differently from income gained by other means. It is income that is mainly a reward for an individual's personal efforts or skills. It does not include income that is mainly:

- for supplying or selling goods (for example, from retailing, wholesaling or manufacturing), or
- generated by an income-producing asset, (such as a bulldozer), or
- for granting a right to use property (for example, the copyright to a computer program), or
- generated by a business structure (for example, an accountant working for a large accounting firm).

If personal services income is channelled through a company, partnership or trust (a personal services entity), it is still the individual's personal services income for income tax purposes.

The Four Tests

The four tests provided under the legislation determine if a person is conducting a personal services business. If one or more of these tests are satisfied, income is treated as company income, providing benefits to contractors who are set up in a company structure. The following describes the tests and reasons why they are problematic for engineers and IT contractors.

- **The employment test** (Section 87-25 of the Income Tax Assessment Act 1997) - where the person engages others to do the work and the value of the work they perform or whether the individual employs apprentices for at least half the income year.

This test can be passed if someone employed by the contractor does more than 20% of the principal work. Many self-employed engineering and IT contractors do not employ persons to help them with their principal work. If they do employ someone it is usually to

assist them with administrative work. In some instances engineers will employ sub contractors to assist in their principal work which does not normally meet reach the 20% threshold. The professional nature of engineering work does not lend itself to an apprenticeship arrangement.

- **The business premises test** (Section 87-30 of the Income Tax Assessment Act 1997) - the individual uses and maintains business premises to conduct the activities that gain or produce the personal services income.

Many engineers have set themselves up as a small business and use a home-based office to reduce expenses. They spend much of their time in the field, and have no requirement for separate, mostly unattended offices. As well, IT contractors work from home and have expensive fixed business infrastructure. To move and re-establish premises is an unwelcome and unnecessary expense. Working from home therefore presents a problem for engineers under the business premises test.

- **The unrelated clients test** (section 87-20 of the Income Tax Assessment Act 1997)- relates to how many clients the individual provides services to.

Quite often, self-employed engineers and IT contractors are engaged on projects that run for several years. Having long-term contacts presents a problem under the unrelated clients test, which is based on having two or more clients in a year. Many of these engineers work in specialist areas where there is only one monopoly buyer in each State. In general, the higher the level of expertise, the smaller the number of clients that consultant will work for. Therefore, having a monopoly buyer presents a significant problem for the engineer who must satisfy the unrelated clients test.

- **The results test** (Section 87-18 of the Income Tax Assessment Act 1997)- a person must produce a result related to their employment in an income year.

The results test also proves difficult for many engineers and IT contractors, because of the lack of clarity that exists within the individual requirements. They are as follows.

(1) An individual meets the results test in an income year if:

(a) the income is for producing a result; and

(b) the individual is required to supply the plant and equipment, or tools of trade, needed to perform the work form which the individual produces the result; and

(c) the individual is, or would be liable for the cost of rectifying any defect in the work performed.

Many of our members have problems meeting the results test, particularly 'tools of trade' and 'rectification' definitions. With 'tools of trade' it is not clear whether tools used by engineers, such as calculators, drawing implements and computer design programs, will be acceptable. In terms of 'rectification', it is not clear how an engineer would meet this requirement. Engineering work involves the application of engineering principle to a design or production activity or the provision of advice. There is generally no contractual requirement for an engineer to physically rectify matters that are based on faulty design or advice. If any damage results, a claim will be made on the individuals professional indemnity insurance.

The following are examples provided by some of our members which illustrate some of the problems involved.

1. An Engineering contractor is working for a mining company in an isolated location in the Northern Territory. It is a long term project that requires the contractor to work on site until the project is finished. Due to the nature of the project he is prevented from taking on other projects and will therefore face difficulties with the Unrelated Clients test. He will also face difficulties with the Business Premises Test because it is not cost effective to maintain separate business premises when most of his work is conducted in the field. He does not employ anyone and therefore will not meet the requirements of the employment test.
2. An IT consultant works as a software developer for Telstra. He is employed to work on a range of short-term projects but he only has one contract with the company. He is required to produce different results during the income year aimed at improving Telstra's on-line service performance. Because the consultant only works for one company he will not meet the unrelated clients test. He does not have separate business premises, nor does he employ anyone else.
3. An engineering contractor who already has a contract with a company bids for another contract with the same company in one income year. The total sum of the contracts comes to 80% of the work done in one year. Under the legislation the engineer will not pass the unrelated clients test. He also works from home and does not employ anyone else.

Determinations

In correspondence with the Office of the Prime Minister last year it was suggested to the Institution that our members seek a determination from the Australian Tax Office if they are unsure about whether they will pass any of the tests. This would require a significant number of our members, who are contractors, to seek determinations because of the nature of their work. Determinations can prove extremely costly for members because it requires considerable work from accountants and in some cases lawyers to present a case to the tax office.

For instance, an engineering contractor puts forward a Personal Services Business Determination after being instructed by the Australian Tax Office that his business activities would be affected by the legislation. A determination was prepared and the submission cost over \$2,600 in accountancy fees. The costs of a process like this places unnecessary burden on small business.

Recommendation

The Institution is seeking clarification of the legislation in relation to the specific work practices of the engineering profession. Specifically the Institution is seeking a very clear ruling from the tax office for Engineering and IT contractors, along the following lines:

Unrelated Clients Test

An individual or a personal services entity meets the unrelated clients test in an income year if:

Averaging over a three to five year period the individual or personal services entity gains or produces income from providing services to 2 or more entities that are not associates of each other, and are not associates of the individuals (for example by advertising) to the public at large or to a section of the public provide the services.

The Results Test

An Engineering or IT contractor who is an individual or personal services entity, meets the results test if:

- (a) a result is specified in a contract. A contractor may have a long term contract in which they are required to produce a specific result at the end of a period.
- (b) The contractor has entered into a contract to provide engineering or IT services where there is an agreement between the parties that the contractor to remedy any defect resulting from the provision of those engineering or IT services; or
- (c) the contractor is required to take out professional indemnity insurance as part of the contract.
- (d) the contractor uses tools specific to the engineering and IT professions that are necessary for the contractual work. These tools include: calculators, drawing implements, reference material or computer programs used to design and maintain engineering or IT projects.

Conclusion

Engineering and IT contractors continue to face difficulties with Personal Services Income Legislation. The definitions contained within the four tests fail to take into account the unique circumstances of contractors in these areas. The Institution of Engineers is seeking clarification of the legislation through a ruling from the Australian Tax Office

The impact on engineering and IT contractors is already being felt by our membership. Without further changes contractors will face increased costs which will threaten the viability of their businesses.