

Sent: Sunday, 7 November 1999 6:55 PM
To: fpa.sen@aph.gov.au
Subject: Inquiry into Business Taxation Reform

Hon. Ralph Willis

Ms Helen Donaldson
Secretary
Senate Finance and Public Administration References Committee
SG 60, Parliament House
CANBERRA ACT 2600

Dear Ms Donaldson,

Inquiry Into Business Taxation Reform

I refer to your letter of 20 October, 1999 inviting me to lodge a written submission to the Committee by 29 October, 1999. I regret that due to other work requirements and personal circumstances I have been unable to lodge the submission until now. I hope, that nevertheless, it will still be of use to the committee.

In the Treasurer¹s Press Statement of 21 September, 1999 which accompanied the release of the Ralph Report ³A Tax System Redesigned², and in which he announced the Government¹s response to many of the Report¹s recommendations, the Treasurer also stated that : -

³The Government will give close consideration to other issues raised in the Review, such as the recommendations dealing with the alienation of personal services income and non-commercial losses².

It is my submission to the Committee that the recommendations on alienation on personal services income must be adopted. Not to do so would represent further tolerance of a burgeoning tax loophole that undermines the integrity and equity of the tax system. It would also mean that the Government¹s Tax Package would be patently underfunded and so not achieve the requirement for revenue neutrality in relation to taxation of income from investment and capital gains as required by the Treasurer in his Terms of Reference for the Ralph committee.

Integrity of the Tax System

There can be no doubt that the integrity of the Tax System is being significantly diminished by the continuing Government tolerance of tax avoidance by people who move from employee to contractor status. This was an issue that was raised strongly with me by the Australian Tax Office (ATO) when I was Treasurer in 1995. The ATO's concern was that this change in labour market arrangements was causing serious erosion of the PAYE tax base.

Especially concerning was that about 40% of personal services contractors were in fact ³dependent² rather than ³independent² contractors since they worked largely or exclusively for the one firm and had often been former employees of that firm.

The change in status from employee to contractor cost the revenue in a number of ways. Firstly, PAYE deductions only applied to employees, not contractors. In some industries tax withholding from contractor payments for services was required under the Prescribed Payments Scheme and the Reportable Payments Scheme but that was usually at a lesser rate than would be required with PAYE.

Secondly, although contractors were eventually required to pay tax such payment was much later than it would have been with PAYE. Non-reporting of taxable income was also rife amongst such contractors.

Thirdly, such contractors typically claimed various business deductions that were not available to employees. For instance, in the common case of a contractor's business being based at home, he/she could claim travel to work deductions for journeys from home to the workplace which deductions are not available to employees.

Fourthly, such contractors often used an interposed entity, such as a company or a trust, to split their income with a spouse and maybe other family members, thus considerably reducing the average rate of tax paid, and were able to shelter income from tax by not distributing business income.

The ATO further advised that use of Part 1V A - the general anti-avoidance provision in the Income Tax Act - was not an effective tool for these purposes. The ATO was further concerned that this tax loophole was rapidly widening.

All of this advice to me from the Tax Office - with some updating for the passage of time - has been reiterated in the Ralph Report. In effect the Report's analysis of this problem is only telling the Government publicly what the ATO has been telling it privately, but about which the Government has taken no rectifying action.

In the light of the ATO advice to me I announced in the 1995 Budget the Government's determination to tackle this issue. Initial legislation was

introduced later that year but was not through the Parliament before the election was called, and therefore lapsed. A discussion paper proposing options for more extensive change was substantially prepared but not finalised by the Government prior to the 1996 election.

With the change in Government in March 1996, all Government action in this area apparently ceased. Despite expressing great concern at the supposedly highly detrimental state of the Budget the new Government did not reintroduce our legislation and introduced no other legislation to block major tax avoidance in this area.

Moreover, measures introduced by the Government under the ANTS tax changes would, if unaddressed, make it even easier to exploit this tax loophole.

This is because the current withholding requirements under the PPS and RPS Schemes are to be abolished in conjunction with the introduction of the new Pay As You Go tax system. The new arrangements will mean that the only tax withholding arrangement, apart from PAYE for employees, would be in relation to labour hire arrangements, by voluntary agreement, and for payment on an invoice that does not include an ³Australian Business Number² (ABN).

Given that legislation establishing the ABN provides for its issuance to any Corporations Law company, and that almost all unincorporated enterprises would be likely to meet the broad definition of enterprise needed to obtain an ABN, there will be little tax withholding left apart from PAYE. Consequently, there will be even greater attraction to avoid PAYE by becoming a contractor.

In these circumstances the Ralph Report recommendations to plug this blatant tax loophole are most welcome. The integrity of a tax system is clearly jeopardised if Government continues to tolerate the inequity of people doing the same work, maybe even for the same firm, but with very different levels of taxation depending on their status as employee or as a contractor.

The Government's tolerance of this inequity, despite advice as to its extent and revenue implications, can only be for other policy purposes - which one assumes is furtherance of its Industrial Relations agenda to promote contract relationships at the workplace rather than employer/employee relationships. If Government maintains this policy approach then it must do so in the knowledge that the revenue cost is around half a billion dollars per year and increasing, and that the integrity of the tax system is increasingly being seriously impaired.

Revenue Neutrality of Tax Package

Quite clearly, on the figures presented by the Ralph Report, there is no possibility of the Business Tax Reform package being revenue neutral if the alienation of personal services income recommendations are not adopted.

Over the five years 2000-01 to 2004-05, the Report calculates the revenue to be obtained from restricting the alienation of personal services income at \$m2,410. As against that, the revenue impact of the whole Ralph Package over those 5 years is + \$m400, (\$m370 if year 1999 -2000 is included) so without the revenue from the alienation of personal services income measures the package would be around \$2 billion short of revenue neutrality.

The package of announced measures presented by the Treasurer in his 21 September, 1999 Press Release was shown as having an overall cost to revenue for the 5 years 2000-01 to 2004-05 of \$m 3710 (\$m3820 if year 1999-2000 is included). If all the deferred measures, which include the alienation of personal services income, were eventually included, the package over the 5 years to 2000-01 to 2004-05 is shown as revenue positive by \$m500 (\$m390 if year 2000 is included).

Thus without the alienation of personal services income measures the Government's Tax Package will, on the basis of the Ralph Committee's costings, be around \$2 billion short of the revenue neutrality requirement set by the Treasurer himself. Clearly Government acceptance of the need to restrict the alienation of personal services income is crucial if it is to have any chance of meeting its revenue neutrality requirement.

Report Recommendations

The Report's Recommendations as to how restriction of tax avoidance in this area should be achieved seem to me to be quite reasonable. There are however, a couple of points I wish to make about them.

Recommendation 7.2 (i) recommends that where an interposed entity receives 80% or more of its receipts in respect of personal services from one service requirer during one income year - then the payments received by the interposed entity in respect of the services be treated for income tax purposes as the income of the service provider.

The Report does not explain on what basis the 80% has been adopted but it clearly represents a high proportion of income coming from one source. In such circumstances, the service provider is overwhelming dependant on one source for his income, though he/she may earn some other income, so it is not unreasonable to draw the line at around this level.

Particularly is this so in the context of Recommendation 7.2 (iii) which provides the opportunity for service providers with 80 % or more of income from one source in any one year to seek a decision from the Tax Commissioner that the 80%/ one service requirer rule should not apply to them.

This provision should safeguard the situation of genuine independent contractors who have a long run contract with a service requirer which may mean that much or even all of their income in a year is from one firm. Clearly it would be unfair to treat such persons as employees for tax purposes just because they have a long run contract when it is clear from their work history and/or mode of operation that they are genuinely independent contractors.

Conclusion

On the basis of the Ralph Committee costings the Government's inaction on alienation of personal services income has cost Government revenue well over \$1 billion in the three years to 1999-2000. Had the Government accepted ATO advice to prevent such tax avoidance the revenue would now be part of the tax base and not available for inclusion as a new initiative in a revenue neutral tax reform package

Nevertheless, for the reasons outlined above, I submit that this Committee should, in its Report to the Senate, firmly state that its support for the Tax Package would not be possible without Government acceptance of the Ralph Report recommendations on alienation of personal services income.

Yours sincerely,

Ralph Willis
5 November, 1999