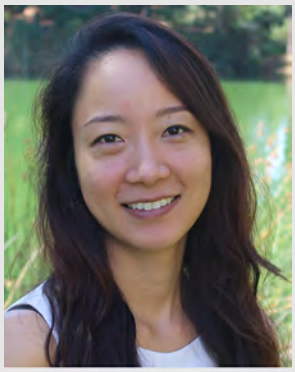
It's All in the Drafting: Australia's Ambiguous Personal Service Income Regime

by Christina Allen



Christina Allen

Christina Allen is a lecturer at Edith Cowan University in Perth, Australia.

In this article, the author reviews Australia's personal service income regime to highlight uncertain directions that tax laws can take.

Tax laws continuously grow and evolve in response to other complex laws. For example, U.S. IRC chapter 1, subchapter K provides tax rules that govern limited liability partnerships. This form of business vehicle is relatively new compared with companies, trusts, and partnerships. It has been argued that preferential tax treatment of passthrough entities motivated the demand for a new entity type, which led to the inception of LLP laws.[1] Setting aside the rationale behind using these different legal entities as business vehicles, the U.S. taxation system has responded to new legal structures employed to carry on business.

Australia has adopted a new personal service income (PSI) tax regime that creates a new class of workers through tax laws. The regime was introduced in 2000 and provides for circumstances under which independent contractors or business owners/managers can be treated as if they were employees for taxation purposes.[2] The PSI regime looks to curb tax-induced choices of legal entities that provide services under performance contracts instead of employment. Although this regime targets dependent contractors in Canada, there are no prevailing laws governing dependent contractors outside the tax system providing extended employee benefits in Australia.

The regime may be compared to the off-payroll working rules, also known as IR35, in the United Kingdom. While both eliminate intermediaries that derive income from personal services, the IR35 rules operate to only penalize disguised employment as an integrity measure. It does not seek to disturb industry relations of the binary employee-contractor system. Conversely, the PSI regime, which is housed in the general branch of tax laws, does not examine whether the income in question is from an office or employment. Instead, the regime uses a threshold test for intermediaries based on new legislative criteria to distinguish independent contractors from individuals running independent businesses.

In the past few decades, the industry trend has rapidly changed. People have been moving away from employer-employee relations to avoid legal obligations imposed on employers, such as retirement benefits, vicarious liability, and protection against unfair dismissal. These obligations vary from country to country. In 2018 the Australian Senate's Committee on the Future of Work and Workers recommended that the definition of employees be broadened to include gig workers as a means to extend employee

[1] *See, e.g.*, William C. Brown, "A Primer on Income Tax Compliance for Multistate Pass-Through Entities and Their Owners," 67(4) *Tax Law.* 821 (2014).

[2] Income Tax Assessment Act 1997, Part 2-42.

benefits.[3] However, this recommendation has not been adopted, and Australia maintains the common law distinction of employees and independent contractors.

Also, the industry representation group for independent contractors has opposed the concept of dependent contractors in Australia.[4] Given the foregoing, some may wonder why Australian taxation rescinds the legal entitlements of select independent contractors by penalizing the structures they set up to organize their business affairs. In other words, how it can be justified that some businesses providing services are different from those that may have different structured capital constituents if these businesses require entrepreneurship and bear business risks similar to the owners of a restaurant or a pharmacy?

The PSI regime is not like the U.S. tax laws governing LLPs. In the case of U.S. LLPs, the public demanded a new form of legal entity, and the government responded by providing LLP laws before the tax codes were incepted. But in Australia, the regime adopted a unilateral approach for revenue collection objectives. The Australian Constitution provides no limitations in drafting tax laws in this manner. However, viewing tax laws as social contracts between the government and its citizens, the Australian approach is worth reconsidering. Studies on the legal system's internal coherence as a whole may also be necessary.

There is no simple answer to how tax laws ought to be drafted. The PSI regime can therefore be used as an experiment to explore tax laws' effectiveness. Considering that they are exceedingly complex, making daily tax obligations burdensome, it is necessary for ordinary citizens and professionals to step back from time to time to explore appropriate ways to develop tax laws. This article explores how the PSI regime came about and the changes it brought to the business environment.

Antiavoidance and Political Compromise

It is undesirable for similar legal forms to result in varying tax outcomes. The interposition of legal entities for tax purposes should be addressed by effective integration of corporate taxation and tax rates.[5] Unlike the system applicable to C corporations in the United States, Australian company taxes are adjusted to the marginal tax rates of resident individuals upon receiving dividends. Because the corporate tax rate set is lower than the top marginal rate, interposing private companies provides deferred tax liabilities and the income can be alienated to family members. Income can also be alienated through trust distributions or partnerships that pay salaries to family members. Although trusts and partnerships are fiscally transparent, alienated income tends to reduce the overall tax liability.

The use of legal entities has been traditionally considered an inappropriate mechanism for receiving PSI. Courts consider income earned by an individual as inalienable income that must be assessed to the individual taxpayer.[6] Tax offices then employ antiavoidance provisions to bypass legal entities once those entities are established as vehicles used for reducing or avoiding tax liabilities. Tax offices have achieved remarkable success against doctors and pharmacists who were allowed under statute to carry out their practice using personal accounts in the past.[7]

The attack on intermediaries has been further extended to cover service providers such as IT professionals, engineering consultants, construction workers, and workers in the transport industry who were providing services as independent contractors instead of employees. Two cases are worth noting. The first case,

[3] Australian Senate, Select Committee on the Future of Work and Workers, "Hope Is Not a Strategy — Our Shared Responsibility for the Future of Work and Workers," at viii and [4.129] (2018).

[4] Independent Contractors of Australia, "International Labour Organisation Endorses Independent Contractors" (June 18, 2006).

[5] *See, e.g.*, David G. Duff, "Income Taxation of Small Business: Toward Simplicity, Neutrality and Coherence," in *The Dynamics of Taxation* (2020).

[6] See *Federal Commissioner of Taxation v. Everett*, (1980) 143 CLR 440. In this case, however, the court decided for the taxpayer who assigned his partnership income to his wife on the basis that his equitable interest in the share of the partnership income was irrespective of the extent of his personal exertion.

[7] *Peate v. Federal Commissioner of Taxation*, (1966) 116 CLR 38; *Federal Commissioner of Taxation v. Hollyock*, (1971) 125 CLR 647; and *Federal Commissioner of Taxation v. Gulland, Watson v. Federal Commissioner of Taxation*, and *Pincus v. Federal Commissioner of Taxation*, (1985) 160 CLR 55.

Tupicoff,[8] dealt with using disguised employment to receive commissions from an insurance company, something IR35 rules would seek to strike out. In the second case, *Bunting*,[9] the taxpayer was an independent contractor working on projects. Although the commissioner was successful in both instances, the latter case highlighted the need to seek those carrying out tax avoidance, rather than affirming tax law principles that can be used against individual taxpayers deriving income under performance contracts. The inconsistency witnessed in the subsequent cases showed the difficulty of applying antiavoidance provisions, particularly in instances in which the companies' facts-and-circumstances-based legal status was commercially justifiable.[10]

Although the antiavoidance provisions were generally effective against cases displaying tax manipulation, policymakers were facing a different dilemma. In the 1990s, when the incoming coalition government inherited the Labor government's decreasing budget deficit, the Labor opposition pressed the government for fiscal responsibility on public administration. The decreasing withholding tax base, which was a major source of tax revenue, was characterized by a shift from traditional employer-employee relations to flexible worker arrangements. Although the government did not intend to arbitrarily amend the definition of employees at first, its tax policy soon shifted to support the government's election promise to reduce the corporate tax rate.

In 1999 the coalition government introduced a new tax withholding and installment system called "pay as you go," which taxed independent contractors based on the estimate of their upcoming annual liabilities. To pass its long-awaited tax package, including the new goods and services tax legislation, the government negotiated with the Australian Democrats for political support. The package was also intended to reduce the corporate tax rate to 30 percent in instances in which the Australian Democrats had campaigned against the use of intermediaries for receiving PSI.

The taxation review committee was a watershed in the introduction of the PSI regime. In its final report, the committee provided detailed rules on how a new system outside the antiavoidance provisions could be implemented without requiring a tax avoidance purpose.[11] Anchored on the rationale that the regime would provide the same tax treatment for equivalent economic activities, the suggested model targeted not only disguised employment as in *Tupicoff*, but also legitimate contractors who depend on a limited number of payers as in *Bunting*. The proposal caught the industry's attention, and the industry suggested the government strengthen existing tax laws and improve tax administration. However, the government introduced the regime without consultation as a countermeasure to the corporate tax rate reduction, both becoming effective on July 1, 2000.

How Does the PSI Regime Work?

In the past, antiavoidance rules were considered difficult to change because of high administrative costs. Similarly, the PSI regime requires the examination of statutory criteria on a case-by-case basis by taxpayers or, upon request, the commissioner. The self-assessment criteria have proved to be challenging. This is because new rules have been laid down to facilitate identifying a segment of independent contractors for different tax treatment, but without the court devising clear principles to define alienable PSI. Therefore, individuals offering services to clients in the Australian tax environment inevitably face a high administrative burden.

Self-assessment comprises four tests, and an individual must satisfy at least one of the tests to avoid application of the PSI regime. The first test, based on the nature of contracts, requires deriving at least 75 percent of PSI from results-based contracts to satisfy all three features listed — remuneration based on results, self-supply of equipment and tools, and liability for any

[8] *Tupicoff v. FCT*, (1984) 4 FCR 505.

[9] *Bunting v. FCT*, (1989) 24 FCR 283.

[10] *See, e.g.*, *Daniels v. FCT*, (1989) 20 ATR 1120; *FCT v. Rippon*, (1992) 24 ATR 119; *Egan v. FCT*, [2001] AATA 449; and *Mochkin v. FCT*, [2002] FCA 675.

[11] Australia, Review of Business Taxation, *A Tax System Redesigned* (Final Report), at 286-294 (July 1999).

defective work. This test is difficult for many professionals and trade workers to prove because they rely on a few major projects to earn income.

If the results test fails, taxpayers can either explore the remaining three tests or make an application to the commissioner to ascertain whether the PSI regime can be imposed on them. This will depend on whether PSI is derived from one source.

If less than 80 percent of income is from one source, self-assessment will continue based on the number of unrelated clients offered services through public invitations, the employment of workers contributing to at least one-fifth of principal work, and the use of business premises. While these tests exclude doctors and pharmacists who use business premises to service walk-in customers and generally have one or more assistants, it is not easy for service provides in other industries to share the burden or work, unless they are subcontracting or employing others.

If 80 percent or more of the income is from one source, the commissioner of taxation may allow individuals or businesses not to apply the regime. This generally depends on unusual circumstances. For instance, a business may work on a large project in a particular year despite its general practice of serving multiple clients. Although these criteria seem to be inspired by the facts and circumstances courts use to distinguish employees from independent contractors, they result in outcomes that account for independent contractors that not only would have been officeholders or employees in the absence of service contracts, but also operate independent businesses primarily for a small number of clients.

If the PSI regime applies, a counterfactual is postulated to treat the individuals performing services as if they are employees. The notable effect is to assess them on income derived by business vehicles — companies, trusts, and partnerships. Deductions are also limited by reason of business expenses being regarded as private expenses in the hands of employees. For example, rent expenses, mortgage interest payments, rates, and land taxes cannot be claimed as home office expenses of employees. However, as recommended by the taxation review committee, the costs for maintaining an interposed entity are deductible. In terms of retirement benefits, deductions are allowed for personal contributions or retirement benefits made on behalf of legitimate employees. If a spouse or family member is an officer or employee of the intermediary by providing ancillary services, the retirement benefits provided for them cannot be deducted. Also, tax credits available to taxpayers making spousal contributions are barred because the payments are not actually made by them, but by the intermediary.[12]

Readjusted income and expenses affect the overall income on which tax liability is calculated in the marginal income tax rate system for individual taxpayers. Revised income also affects the public healthcare levy, child care payments for split families, and higher education loan repayment amounts, which are all calculated based on taxable income. However, other fiscal laws, such as fringe benefits tax, goods and services tax at the federal level, and stamp duties and payroll taxes at the state level, operate independently of taxable income. No change has been made to recognize the new class of workers created under the PSI regime. The laws governing industry practice, such as employment and labor relations and registration of Australian business numbers, also remain unchanged.

Where to From Here?

Nearly a decade after the PSI regime was introduced, the Board of Taxation undertook a post-implementation review. It released its report in 2009.[13] The industry submissions uniformly complained about the difficult and complex legislative criteria prescribed under the regime, while tax offices no longer considered PSI derived through interposed entities as high risk and reduced their compliance responsibilities accordingly.

The board concluded that the design of the regime was flawed and could not fulfill its legislative intent. To better target disguised employees, the board suggested new standards based on whether businesses operate with an

[12] *See Taneja v. FCT*, (2009) 77 ATR 605.

[13] Australian Board of Taxation, "Post Implementation Review Into the Alienation of Personal Services Income Rules: A Report to the Assistant Treasurer" (Oct. 2009).

Australian business number or provide services under contracts other than employment contracts. The board added that PSI can be measured by the Nordic method of imputing a rate of return on business assets by considering residual profit as labor income or domestic transfer pricing to distinguish property-related income.

The recommendation questioned the need for the regime because antiavoidance provisions already exist, and the modified version would be efficient in finding disguised employment entered into legally, similar to the IR35 legislation.

The government has not adopted the board's recommendations. The PSI regime remains ambiguous in the absence of a precise policy rationale and explanation of how its operational features support the legislative intent. The Australian government seems to have taken an unwise approach to tackling tax-driven alienation of income by creating new worker category standards that have no unique legal standing in law or in reality for tax collection. This raises the question whether drafting tax laws in this manner is indeed socially legitimate. Because structural changes to the tax law, such as corporate tax rate reduction, may not always be feasible, alternatives for raising revenue can be sought. Nevertheless, the burden remains of outlining how good tax laws can be drafted. ■