Chapter 7
Sham contracting

7.1 Employers engage in sham contracting when they mischaracterise an employment relationship as an independent contracting arrangement.

7.2 By doing so, employers are able to avoid obligations which apply under the *Fair Work Act 2009* (the FWA, the Act) when workers are accurately characterised as employees, such as payment of minimum wage rates, various leave entitlements, penalty rates and shift loadings.[1]It is a deliberate strategy to disguise an employment relationship as a commercial contract.[2]

7.3 Sham contracting is illegal, but rife.[3] As an avoidance strategy it has considerable consequences which extend beyond the disadvantage suffered by the workers concerned, who are deprived of the security associated with direct, permanent employment and instead placed in precarious arrangements.

7.4 This chapter explores the practice through case studies, looks at inadequacies in the law which perpetuate the problem, and sets out concrete ways in which to address the issue.

The effect on workers

7.5 The committee heard that it is not uncommon for businesses to only engage workers who have a legal company structure in place.[4] This puts tremendous pressure on workers, outlined in case studies presented by witnesses and submitters below.

7.6 The construction industry has been plagued by sham contracting for many years.[5] One example provided by the Construction, Forestry, Mining and Energy Union (CFMEU) suggests that employers at times exhibit quite flagrant disregard for the law, requiring ongoing employees to become contractors:

> [I]n 2016, Darwin-based concreting company JGA Concreting Pty Ltd, required a number of its concreting employees to obtain ABNs and work on a "sub-contract" basis even though the substance of the working arrangements continued to be that of employer/employee…the company has ceased remitting PAYG tax payments for these workers, is not making superannuation contributions and no longer takes account of the ABN workers for payroll tax purposes. One long term employee has complained

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1 The Electrical Trades Union of Australia, *Submission 197,* p. 14.

2 Construction, Forestry, Mining and Energy Union, *Submission 200,* p. 11.

3 On the prevalence of sham contracting see Maurice Blackburn Lawyers, *Submission 157,* p. 7. CFMEU, *Submission 200,* p. 11; Ballarat Regional Trades and Labour Council, *Submission 186,* p. 5.

4 CFMEU, *Submission 200,* p. 14.

5 CFMEU, *Submission 200,* p. 11.

> that no superannuation contributions have ever been paid for him over many years employment with the company…Semi-skilled concreting and labouring duties are ordinarily incapable of being carried out on a legitimate sub-contract basis as the work requires the direction and control associated with an employment relationship and is non-delegable.[6]

7.7 Similar examples can be found in much other industries as well, as seen in evidence provided by the United Voice union (UV).

7.8 United Voice is an organisation representing over 120 000 Australian workers. United Voice property services members work as cleaners, security officers, parking attendants, caterers, prison officers, life guards, gardeners, gate keepers and others.[7] The union characterises much of its members' work as insecure and low paid with labour hire and sham contracting frequently featuring.[8]

7.9 Whilst employers in the sector have in the past had a chequered history in relation to compliance with their obligations under the relevant award,[9] there is now a recognised trend toward shifting business operations beyond the coverage of the award through sham contracting:

> Contracting out of labour has the general effect of reducing workers' pay and conditions. This reduces the pay and conditions of those engaged through these arrangements and also the pay and conditions generally in sectors where there is significant use of a contracted or labour hire workforce. This is done through a variety of mechanisms…. In the industries which employ United Voice members contracting and labour hire is used precisely because it is prepared to avoid loadings and penalties in contravention of the award and also avoids costs associated with redundancy, and by not 'owning' employees avoids more systemic costs associated with service such as long service leave and the health costs associated with an established permanent workforce.[10]

7.10 UV related the example[11] of Academy Services Pty Ltd, a company providing cleaning services to businesses in the Adelaide CBD:

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6 CFMEU, *Submission 200*, pp. 11–12.

7 http://www.unitedvoice.org.au/industries/property-services (accessed 4 September 2017).

8 United Voice, *Submission* 203, p. 1.

9 https://www.fairwork.gov.au/about-us/news-and-media-releases/2016-media-releases/may-2016/20160530-pioneer-personnel-litigation (accessed 4 September 2017).

10 United Voice, *Submission 203*, p. 9.

11 United Voice, *Submission 203*, p. 10.

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Case study 1: Academy Services

Academy Services Pty Ltd is a company supplying cleaning services to premises mainly in the Adelaide Central Business District. Academy Services is based in Adelaide but operates interstate. Academy Services has made a collective agreement with United Voice: the Academy Services and LHMU Cleanstart Union Collective Agreement 2008 ('the Cleanstart Agreement').

Academy Services has a long history of non-compliance and questionable practices, evidenced by numerous interventions by United Voice's South Australian branch. The company's business model involves both the direct employment of employees, and the engagement of entities it regards as "franchisees".

These franchisees are paid a flat rate per hour of about $28 per hour. They are required to have Australian Business Numbers ('ABNs') and engage other persons to perform the work allocated to them, or to part perform that work. The franchisees typically do not provide holiday pay, sick leave or any other employment related entitlements. They are required to provide their own insurance. The franchisees sign contracts identifying them as franchisees with a series of formal terms consistent with a franchise arrangement. The hourly rate is above the base rate of the Cleanstart Agreement and the Cleaning Services Award 2010, but the work the franchisees typically undertake is at times when loadings or penalty rate would be required to be paid.

Despite the pretence that the cleaning work is being performed by an independent contractor, the hours of work, and their work duties, are dictated by Academy Services. Franchisees are required to perform work exclusively for Academy Services. Academy Services provides all the equipment and materials required for the work. Payments are made periodically in a similar pattern as wages and not on invoices submitted per job.

The franchisees do not engage with building owners or occupiers. This is done exclusively by Academy Services. Academy Services controls all records pertaining to the work done by the franchisees. While franchisees engage employees, Academy Services retained the right to terminate the individual workers *'employment'* with the franchisee.

The success of Academy Services' business model is that it has its own employees working during non-penalty periods, and the franchisees work during penalty periods. The flat fee it pays franchisees is above the base rate that should apply but well below the more significant penalty rates at which the work should be paid.

To date, the Fair Work Ombudsman has failed to intervene.. United Voice has taken cases against Academy Services and has ongoing litigation against Academy Services in the Federal Court.

Academy Services' conduct highlights several key issues in relation to labour hire in the cleaning industry. First, cleaning is an industry where labour hire predominates, very few cleaners are directly engaged by the owners of the workplaces that they clean and maintain. Change of contract and turnover of the work force is a regular feature of the sector. The Cleanstart Agreements are an attempt to provide some security of employment in an industry where contracts change frequently; however, these provisions are often ignored.

7.11 In discussing the impact of sham contracting on the labour market throughout the industry, UV says:

> Critically, contracting and labour hire makes collective bargaining difficult, bargained outcomes harder to maintain and in the majority of cases labour hire is used to undercut the bargained rate in a workplace or sector due to the ability to regularly replace a cohort of workers effectively collapses standards and bargained outcomes. Contracting, sub-contracting, and labour hire operates as a significant feature of the labour market whose effect is to reduce standards to the award safety net and, frequently, to a standard effectively below the award. This creates a competitive logic that dictates that anything more than the minimum is excessive and decreased labour costs are a reasonable expectation of a user of labour. United Voice has observed that this has been an important factor in the collapse of pay and conditions in areas such as cleaning, hospitality and security.[12]

Inadequacies in the legislation

7.12 Sham contracting is made easier by inadequacies within provisions of the FWA which apply to the practice. It is also inadvertently encouraged by taxation laws which provide a financial incentive for employment arrangements to be hidden in some cases.

7.13 The FWA 'prohibits the deliberate disguising of an employment relationship as a contract for services.'[13] The Act also prohibits the dismissal of employees and their subsequent re-engagement as independent contractors who then perform the same or similar work.[14]

7.14 However, provisions of the Act pertaining to sham contracting, specifically section 357, suffer from considerable limitations, as explained by the CFMEU:

> Section 357 is infringed through the making of a representation. The CFMEU has advocated for many years for a "strict liability" type provision that provides for a civil penalty in circumstances where a person who is an employee at law is treated by the employer as an independent contractor. However, as the Act stands, the mere fact that an employment relationship exists but the employee is nonetheless treated as a contractor, does not establish a breach of the section. Whilst the High Court has recently determined that it is immaterial that the misrepresentation was as to the relationship between the employee and the employer or a labour hire company, the misrepresentation requirement is still central to the operation of the section.[15]

12 United Voice, *Submission 203,* p. 11.

13 Ms Jenny Lambert, Director, Education and training, Australian Chamber of Commerce and Industry, *Proof Committee Hansard,* 9 June 2017, p. 11. See also section 357, FWA.

14 CFMEU, *Submission 200,* p. 12.

15 CFMEU, *Submission 200,* p. 12.

7.15 This means that an employer can avoid section 357 of the FWA by proving 'that they did not know and were not reckless as to the representation.'[16]

7.16 The Electrical Trades Union of Australia (ETU) also pointed to recent High Court decisions which only serve to highlight the 'problematic' nature of sham contracting provisions as they stand under the FWA, suggesting that the provisions are too complex and too broad. Employers are able to exploit these shortcomings, the ETU submits, and thereby evade liability.[17]

7.17 Furthermore, Maurice Blackburn Lawyers warned that employees with legitimate entitlements may be failing to seek legal advice based on the assumption that they are not employees, as no definitive test exists at common law differentiating an employee from an independent contractor.[18]

7.18 Adding to this, the burden of proof effectively rests with the employee, because no statutory presumption exists in the Act presuming the worker to be an employee in the event of a dispute:

> This means that the onus effectively rests on the worker to establish, with reference to the common law 'multi-factor test', that they are in fact an employee and not an independent contractor.[19]

7.19 Achieving this, the National Union of Workers (NUW) points out, is an onerous process which many employees would find difficult to understand, let alone enforce. This is particularly the case for newly arrived migrants.[20]

7.20 The NUW cites the high-profile case of Mr Pedro Vannea, who was engaged by a labour supply company, Royal Bay International Pty Ltd, which was in turn contracted by Baiada, as an independent contractor. Royal Bay created a company for Mr Vannea, 'Pedro Vannea Pty Ltd'.

7.21 Mr Vannea boned poultry for below minimum wage over a number of years. Being an independent contractor, Mr Vannea also forewent shift loadings, penalty rates, superannuation, and other benefits applicable to employees under the FWA.[21]

7.22 This arrangement only began unravelling for Royal Blue and Baiada after Royal Blue terminated the contract in January 2014—Mr Vannea was deemed to have taken too many days off after a workplace injury. Following an application to the FWC by the NUW on Mr Vannea's behalf, the FWC ruled that the Mr Vannea was an employee incorrectly characterised as an independent contractor.[22]

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16 Maurice Blackburn Lawyers, *Submission 157,* p. 8.

17 ETU, *Submission 197,* p. 15.

18 Maurice Blackburn Lawyers, *Submission 157,* p. 8.

19 National Union of Workers, *Submission 198,* p. 4.

20 NUW, *Submission 198,* p. 4.

21 NUW, *Submission 198,* p. 4.

22 NUW, *Submission 198,* p. 4.

Committee view

7.23 The committee notes with concern that the Act permits employers the opportunity to prove that mischaracterisation of employees as independent contractors was not done knowingly or recklessly. The fact that the FWA leaves the onus on workers—including some of the most vulnerable workers in society—to prove otherwise is in the committee's view an unacceptable burden. The committee is of the view that this fact alone is responsible for many instances of sham contracting going unchallenged, because it is self-evidently and notoriously difficult for workers to navigate the system and take on deep-pocketed companies.

7.24 The committee particularly notes that there may be many employees who may have been mischaracterised as independent contractors over a period of years. These workers, in situations where their contracts were terminated, may have been deprived of the right to significant redundancy pay.[23]

7.25 The issue of "who is an employee?" has been extensively considered by courts including the High Court. The criteria used are variable and in some instances contradictory, for example, the criteria in the Vabu[24] decision were seen as exhaustive but have been modified in practice, such that what is accepted by the ATO as an employment arrangement is denied to be such by the FWC or the Federal Court.

7.26 Furthermore, the committee notes evidence provided by Maurice Blackburn Lawyers regarding the absence of a definitive test at common law differentiating independent contractor from employee relationships. The committee is firmly of the view that the existence of economic incentives encouraging sham contracting over employment and these must be addressed as the root cause of the growth of sham contracting, the Act must be amended to clearly set out a statutory definition of 'employee' and 'contractor'. This would provide clarity and 'enable individuals to determine the nature of their employment without recourse to the Common Law test.'[25]

Weak civil penalty regime

7.27 The Australian Chamber of Commerce and Industry (ACCI) argues that the Act, through the Fair Work Ombudsman (FWO), actively and effectively enforces provisions relating to sham contracting:

> An employer, whether they are conducting a labour hire business or a business of another kind, has obligations under the Fair Work Act, as well as many other laws. Failing to comply can result in penalties, reputational damage, exposure to liability, back pay and potential litigation.[26]

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23 See Maurice Blackburn Lawyers, *Submission 157,* p. 8.

24 *Hollis v Vabu Pty Ltd* [2001] HCA 44.

25 Maurice Blackburn Lawyers, *Submission 157,* p. 8.

26 Ms Jenny Lambert, Director, Education and training, Australian Chamber of Commerce and Industry, *Proof Committee Hansard,* 9 June 2017, p. 11. See also section 357, FWA.

7.28 Others disagree, pointing out that the increasing prevalence of sham contracting in itself suggests that the penalties for non-compliance with existing provisions under the Act are not providing an adequate disincentive.[27]

7.29 The ETU's submission explained that the civil remedy for sham contracting established by the FWA is virtually powerless in dealing with employers who engage in the practice. This is especially the case when the Act is compared with similar statues, such as the *Competition and Consumer Act 2010*:

> Unlike ASIC [Australian Securities and Investments Commission] and the ACCC [Australian Competition and Consumer Commission], the FWO does not have the power to seek an order disqualifying directors or officeholders from managing corporations for a relevant period; and there is no licensing regime with applies to employers generally (or labour hire agencies more specifically).[28]

7.30 The regime is, as described by the ETU, 'manifestly weak', and contains broad loopholes for employers and corporations to reduce or avoid their obligations under the Act entirely.[29]

Taxation incentives

7.31 In the first instance, some employers misuse sham contracting to avoid the safety net provisions of the FWA and the award system, as well as the industrial system more broadly. The CFMEU explains:

> By attempting to disguise an employment relationship as a commercial contract, employers are also seeking to remove their workers from other legal regulatory regimes that depend on employment status for their operation. For example, the application of taxation laws - such as the obligation to remit PAYG payments, pay payroll tax or utilise an ABN or the alienation of personal income rules – as well as the coverage of workers compensation and occupational health and safety laws and superannuation guarantee provisions, can all be thrown into question by the use of sham contracting arrangements.[30]

7.32 The practice carries broader economic implications however. The CFMEU estimates that sham contracting cost the public purse almost $2.5 billion in 2011 in the construction industry alone.[31] A 2012 Fair Work Building and Construction (FWBC) report indicated that approximately 13 per cent of contractors exhibit typical employment features and may be misclassified as independent contractors:

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27 Ballarat Regional Trades and Labour Council, *Submission 186,* p. 5.

28 ETU, *Submission 197,* p. 15.

29 ETU, *Submission 197,* p. 15.

30 Construction, Forestry, Mining and Energy Union, *Submission 200,* p. 11.

31 CFMEU, *Submission 200,* p. 11.

> Overall this equates to a workforce in the building and construction industry comprised of 61% employees, 34% genuine independent contractors and 5% possibly misclassified contractors.[32]

7.33 Furthermore, employers are not alone in deliberately disguising employment relationships as contractual ones, with some workers seeking to exploit ineffective taxation laws which make the practice lucrative. The CFMEU submitted that:

> Ineffective taxation laws, including the 'alienation of personal services income' (APSI) provisions, are contributing to the sham contracting problem. These rules were introduced ostensibly to reign in revenue lost through the use of companies, partnerships and trusts to disguise income generated by the personal exertions of individual taxpayers. The use of these legal forms allows reduced or deferred tax liabilities through income splitting and work-related deductions not available to employees, and the retention of income in the entity to take advantage of lower tax rates.[33]

7.34 This behaviour is seen across a variety of industries and is not confined to white collar sectors such as IT or consultancy:

> In industries like construction, it is common for people to use a $2 company to provide their services, concreting, plasterboard work and the like, in what is essentially an employee-like fashion.[34]

7.35 It is clear that the incentives provided by 'alienation of personal services income' tax provisions do little to curb sham contracting.[35]

Committee view

7.36 Like other corporate avoidance strategies, sham contracting will not be curbed until and unless the penalties for engaging in the practice outweigh the financial gains which motivate it. The committee strongly urges the government to review how taxation laws may be incentivising the misrepresentation of employment arrangements as contracting relationships for financial gain.

Recommendation 20

7.37 **The committee recommends that the *Fair Work Act* be amended to ensure that all workers have the protections of the Act and access to the labour standards, minimum wages and conditions established under the Act.**

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32 *Working arrangements in the building and construction industry*, available at: www.abcc.gov.au/sites/g/files/net666/f/FWBC_Working%20arrangements%20in%20building%20and%20construction_research%20report_D..._0.pdf (accessed 24 July 2017).

33 CFMEU, *Submission 200*, p. 13.

34 CFMEU, *Submission 200*, p. 13.

35 CFMEU, *Submission 200*, pp. 13–14.

Recommendation 21

7.38 **The committee recommends that the government review taxation law, including 'alienation of personal services income' provisions, with a view to addressing unintended incentives for sham contracting.**

Recommendation 22

7.39 **The committee recommends that the *Fair Work Act 2009* be amended to make sham contracting a strict liability offence.**

Recommendation 23

7.40 **The committee recommends that the existing penalty regime for sham contracting be reviewed with a view to increasing penalties to create a more effective disincentive.**

Recommendation 24

7.41 **The committee recommends that, where the legal status of a worker is in dispute, the party asserting that the worker is an independent contractor be required to establish this by demonstrating that the worker is operating a business and not working under that employer's control.**