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No. 52 2001–02

Taxation Laws Amendment Bill (No. 6) 2001

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I N F O R M A T I O N A N D R E S E A R C H S E R V I C E S

Bills Digest
No. 52 2001-02

Taxation Laws Amendment Bill (No. 6) 2001

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13 September 2001

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Taxation Laws Amendment Bill (No. 6) 2001

Date Introduced: 30 August 2001

House: House of Representatives

Portfolio: Treasury

Commencement: The formal provisions of the Bill commence on Royal Assent. However, the measures described in this Digest have differing application dates which are outlined in the Main Provisions section.

Purpose

To:

- amend the alienation of personal services income rules to insert a 'results test'
- extend the capital gains discount to listed investment companies, and
- clarify the taxation treatment of payments made as part of the HIH Insurance rescue package.

Background

As there is no central theme to the Bill the background to the various measures will be discussed below.

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Main Provisions

Personal Services Income

The alienation of personal services income (PSI) rules were introduced as part of the integrity measures recommended by the Review of Business Taxation (Ralph Report), although the actual measures implemented departed from the recommendations of the Ralph Report. The measures aim to reduce tax minimisation by people who earn amounts through personal exertion and have this amount channelled through an entity rather than receiving the funds as normal employees and paying PAYG taxation. The advantages of such arrangements are the payment of a lower tax rate when a company is used, the availability of deductions that would not be available to employees and an increased possibility of income splitting.

Under the rules, if a person has PSI it will be taxed in their hands as income even though earned through an entity unless the person is judged to be conducting a personal services business. A person will be taken to be operating a personal services business if:

- they earn 80 per cent or more of their PSI from the one source and have a personal services income determination from the Commissioner in force, or
- they earn less than 80 per cent of their income from one source and satisfy at least one of the following tests:
 - unrelated clients test: income is gained from two or more unassociated clients as a result of offers to the public.
 - employment test: At least 20 per cent of the individual's principal work is performed by an unassociated entity or individual engaged by the taxpayer, or the taxpayer employs an apprentice for at least half of the year.
 - business premises test: During the entire year the individual or entity maintains business premises through which they conduct their business and which are exclusively for their use and are separate from their private premises.

The measures apply for the 2000–01 and later financial years, although the rules will not apply until 2002–03 where the individual or entity had a Prescribed Payments System declaration in force before the final announcement of the new rules (this principally applies to the building industry).

Although the PSI rules have generally been operational since the start of the 2000–01 financial year, following the passage of the Bill containing the rules comment on their application had been relatively subdued. However, this changed as the end of the financial year approached and 'contractors' began to realise the implications of the new measures. Prior to this, most concern had been expressed by employment agencies and their clients who, under the rules, would be treated as employees of the agency. More recently, the

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Transport Workers' Union, owner-drivers and couriers have expressed their concerns with the PSI rules.

In April 2001 the Australian Taxation Office (ATO) released two Draft Rulings dealing with what is a personal service business and the meaning of PSI. However, before these rulings were finalised the Treasurer announced changes for 'independent contractors'. In a Press Release the Treasurer stated:

Even when 80 per cent or more of their income comes from the same entity they can self assess as a personal service business [and so be exempt from the PSI rules] where they derive income from producing a result, where they supply their plant and equipment or tools of trade (if required), and where they are liable for rectification. These are the traditional tests for independent contractors.¹

The Treasurer also stated:

The [PSI] measures apply where a person supplies labour or skills and works predominantly (80 per cent or more) for the one person, with no employee performing part of the work, and no separate business premises. Even in this case it does not affect the independent contractor who can meet the test outlined above.²

Under the Treasurer's announcement the independent contractor test is elevated above the other tests contained in the *Income Tax Assessment Act 1997* (ITAA97) even though no proposal to amend the ITAA97 was announced. Without a change in the legislation, self assessment must be made against the existing legislation and it has been reported that the accounting organisation CPA Australia was recommending that people still seek a determination from the Commissioner to determine their status rather than relying on the Treasurer's announcement and self assessing.³

The Treasurer's announcement did not satisfy many of the groups opposed to the PSI rules. For example, the Information Technology Contract and Recruitment Association (ITCRA) proposed to campaign against the entire PSI regime on the basis that it 'was fundamentally flawed'⁴, while the TWU, owner drivers and couriers planned to continue protests as they had not received a guarantee from the ATO that they were all excluded from the rules. They protested outside Parliament House on 20 August 2001 and placed a ban on delivering government items. Subsequently the ATO ruled that couriers operating under standard industry agreements would be excluded from the PSI rules.⁵

Subsequently, on 30 August 2001 this Bill was introduced to, in part, introduce the independent contractor test into the ITAA97. It has been reported that, 'the ATO says that whilst the changes are not yet law, the Commissioner will accept tax returns prepared in accordance with the proposed changes'.⁶

As noted above, prior to the Treasurer's announcement regarding independent contractors the ATO had released two draft rulings dealing with PSI. On 31 August 2001 the final rulings were released, substantially changed from the drafts to reflect the Treasurer's announcement. Ruling TR 2001/8 deals with what is a personal services business. In

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relation to the independent contractors test (known in the Bill and by the ATO as the results test), the ruling states that whether a person is to be an independent contractor or an employee is to be based on the traditional criteria for distinguishing between the two and lists 11 points that may be taken into consideration, including:

- whether there is a contract for a specific task
- the amount of discretion and flexibility involved (i.e. the degree of control)
- whether the person supplies their own tools and equipment
- the degree of commercial risk involved, including whether the person bears responsibility for poor workmanship
- whether payment is based on performance or hours worked, and
- whether the person may delegate part of the work or employ others to perform work.⁷

This test is essentially the common law test to determine if a person is an employee and involves an examination of the whole relationship rather than the satisfaction of one or more of the points listed.⁸

The measures contained in the Bill and rulings⁹ have generally been well accepted by professional bodies. For example:

- The Taxation Institute of Australia stated: These 112 pages of rulings are highly concessionary and, combined with the law changes introduced into Parliament yesterday, will mean only 166 000 people are likely to be affected. Presumably, these will be principally knowledge workers who are unable to satisfy the so called results (rectification) test.¹⁰
- CPA Australia welcomed the measures as they would provide greater clarity and certainty for many taxpayers and stated, 'the elevation of the results test as the central test goes a long way to reduce the burden for many taxpayers unintentionally affected by the original provisions. This will be a relief for many genuine businesses in Australia.'¹¹

The reaction from some industry groups, while generally in favour of the measures, has also contained some criticism, for example:

- Master Builders Australia's (MBA) National Executive Director stated that the rulings did not completely clear industry confusion and that 'a significant number of those who do not understand the consequences of wrongfully self-assessing will continue to be at risk'.¹² (Also see endnote 8.)
- The Independent Contractors of Australia, which largely represents ICTRA members, stated that on initial impressions the amendments may have fixed most concerns with

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the alienation legislation, although it reserved its right to examine the legislation and rulings in detail before making a final comment.¹³

Agents

As noted above, a further difficulty seen with the PSI rules is that if a person uses a labour hire firm, or other principal, to gain their work and are paid through the principal they will fall within the 80 per cent rule even if they actually work for a number of independent entities. The Recruitment & Consulting Services Association is reported as arguing that the PSI rules do not take account of the agencies merely acting as conduits for arranging work between clients and contractors, rather than the agencies engaging the contractor.¹⁴ This matter was addressed before the 'results test' was announced, with the Treasurer announcing on 29 June 2001 that income would be treated as received directly from the customers if:

- less than 80 per cent of PSI is from services provided to one customer
- at least 75 per cent of the income is received as commissions or results-based payments
- the taxpayer actively seeks customers from their principal, and
- services are not provided from the premises of the principal or their associates.¹⁵

Income Splitting

As noted above, one of the possible benefits of operating through an interposed entity is that it may open up the opportunity to split income by the entity making distributions to people other than the person who performed the work, generally family members. Income splitting can also be achieved by the entity paying a wage from its income, generally at a rate higher than the actual work performed would ordinarily justify.

In TR 2001/8 the ATO outlined its views on the application of the general anti-avoidance provisions (Part IVA of the *Income Tax Assessment Act 1936*) to PSI. First, the ruling notes that Part IVA is more likely to apply to PSI than other sources of income as it relates to personal exertion. The ruling then outlined the matters that would be taken into account in determining if Part IVA would apply:

- the sources of income of the entity e.g. does it employ others and/or have substantial assets or business structure used in the production of income
- the nature of the deductions claimed e.g. does it claim deductions for wages, rented premises, raw materials or stock used in the business
- is the attraction of the business to clients the services provided by the individual rather than the assets or goodwill of the entity

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- whether the interposed entity is unable at law to provide the services required.¹⁶

Commenting on these measures, the Taxation Institute of Australia stated:

Finally, there is a clear warning in both the rulings and the explanatory materials to the new law that any contractor who earns personal service income, whether caught by these measures [the alienation rules] or not, will still be unable to income split or store low-tax profits in companies. The ATO has made it clear that all contractors will be subject to the operation of the general anti-avoidance provisions. Using the government's own figures, more than 1.2 million Australians will need to examine and understand Australia's complex anti-avoidance rules in Part IVA of the tax laws.¹⁷

The explanatory memorandum to the Bill estimates that the changes will cost \$35 million for 2000–01 and each subsequent year.

Amendments to the PSI rules are contained in **Schedule 6** of the Bill. Section 87–15 of the ITAA97, which deals with what is a personal services business, will be replaced by **item 4** which substitutes **new sections 87–15 and 87–18**. **Proposed section 87–15** contains references to the three current tests to determine if a person is running a personal services business and adds the results test. **Proposed section 87–18** deals with the results test and provides that it will be satisfied for an individual if PSI is gained for producing a result, the individual is required to supply plant and equipment or tools of trade to perform the work and the individual is, or would be, liable for the cost of rectifying any defects in the work. Income received as an employee or as an office holder is excluded from the definition. A similar test applies to determine if an entity meets the results test. In determining if the results test is satisfied regard is to be had to the custom and practice in the industry.

Item 6 will repeal section 87–55 of the ITAA97 which deals with the effect of a personal services business determination. This is incorporated in **proposed section 87–15**.

Proposed section 87–40 deals with agents who operate through principals but who bear the entrepreneurial risk for performing the service. The proposed section will apply where:

- the taxpayer is the agent of another entity but not their employee
- the agent receives income from the principal for services performed for third parties
- at least 75 per cent of that income is for commission or fees for services provided by the agent on the principal's behalf
- the agent actively seeks third parties to whom it can provide services on the principal's behalf, and
- the agent does not use premises owned or leased by the principal unless they are used under an arm's length transaction.

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If the proposed section applies, the PSI of the agent gained from the principal for services provided to third parties will be treated as income gained from the customer. Also, for purposes of the unrelated clients test the services provided by the agent on behalf of the principal will be treated as having been supplied by the agent.

Application: For the 2000–01 and later years of income (**item 19**).

Listed Investment Companies

As the name suggests, listed investment companies (LIC) are listed on the Australian Stock Exchange (ASX) and provide investment options that not only invest in a range of areas but which can also be traded on the ASX. The distinguishing feature of LICs compared to other similar investment vehicles is the listed trading of the company which means that investors can readily cash in their holdings, rather than needing to comply with a process stipulated in offer documents which may apply to other forms of managed investments, such as managed funds which operate under a trust structure.

Capital gains tax concessions were introduced as part of the implementation of the government's response to the Ralph Report, with a 50 per cent reduction of nominal gains being available to certain entities which have held the asset for at least 12 months (entities can choose between using the current system with an indexed cost base or including only 50 per cent of the gain for relevant assets). The 50 per cent option applied from 21 September 1999, the date the change was announced.

The 50 per cent option is available to a range of entities under section 115–10 of the ITAA97:

- individuals
- complying superannuation entities
- trusts, and
- life insurance companies in relation to certain assets.

It may be noted that companies are excluded from the concessional arrangements. Since the discount was introduced listed investment companies (LIC) have argued that they should also have the option of using the discount to place them on an equal footing to other investment vehicles, such as managed funds which use a trust structure.

It was announced in the 2001–02 Budget that individual shareholders in LICs would be able to access the 50 per cent discount on any distribution made from capital gains. The measure is estimated to cost \$5 million in 2001–02 and \$20 million per year for the period 2002–03 to 2004–05.¹⁸

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Item 10 of Schedule 4 will insert a **new Subdivision 115–D** into the ITAA97. There will be a LIC capital gain if:

- an event which triggers a capital gain occurs after 1 July 2001 in relation to an asset owned by a LIC
- the asset has been held for at least 12 months and does not have an indexed cost base, and
- the capital gain is included in calculating the LICs net capital gain and this is reflected in its income.

A capital gain will not be eligible for the discount if the company becomes a LIC after 1 July 2001 and it acquired the asset before it became a LIC (**proposed section 115–285**).

A company will be a LIC if:

- it is an Australian resident
- shares are listed on an approved stock exchange, and
- at least 90 per cent of its assets are held in:
 - shares (to a maximum of 10 per cent of a company which is not also an LIC), units, options, rights or similar interests
 - financial instruments such as debentures, bonds and futures contracts
 - assets used to derive interest, an annuity, rent royalties or foreign exchange gains (unless the assets is intangible and has been substantially developed or improved so that its value has increased substantially), or
 - goodwill (proposed section 115–290).

Proposed section 115–280 allows a deduction to be claimed where an amount is received from a LICs capital gain. The deduction may be available where:

- a dividend is received by a resident individual, complying superannuation entity, a trust, partnership or a life insurance company where the dividend is paid in respect of certain assets, and
- all or part of the dividend is reasonably attributable to a LIC capital gain.

The deduction will be 50 per cent (33 1/3 per cent for life insurance companies) of the attributable part of the gain. The attributable part of the gain for an entity will be calculated according to the formula contained in **proposed subsection 115–280(3)**. If the deduction is claimed, the remaining amount is to be included in the calculation of assessable income.

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Application: To LIC capital gains made on or after 1 July 2001 (**item 15**).

HIH

The Bill seeks to clarify the taxation position of payments made from the HIH Support Trust and other support schemes and aims to place recipients of payments from the schemes in the same position as if they had received the payments from HIH. For general information on the HIH matter, refer to the Bills Digest for the Appropriation (HIH Assistance) Bill 2001 (No. 162 of 2000-01).¹⁹

Item 6 of Schedule 5 of the Bill will insert a **new Division 322** into Part 3-35 of the ITAA97. **Proposed section 322-5** provides that payments from the Commonwealth, the HIH Claims Support Trust or from a prescribed body will be treated as if they were made by HIH under the terms and conditions of the insurance policy in force.

Proposed section 322-10 provides that the HIH Trust will be tax exempt, while **proposed section 322-15** provides that the assignment of a right to the Commonwealth from a HIH insurance policy will not constitute a capital gains tax event (i.e. capital gains tax will not be levied on such an assignment).

Part 2 of Schedule 5 will amend the *A New Tax System (Goods and Services Tax) Act 1999* to insert a **new section 78-120** which will place payments from the Commonwealth, HIH Claims Support Trust or a prescribed entity in the same position for GST purposes as if the payments had been made under a contract of insurance with HIH.

Application: For payments made on or after 15 March 2001 (**item 14**).

Endnotes

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- 1 Treasurer, Press Release No. 51, 9 July 2001.
 - 2 *ibid.*
 - 3 *The Australian*, 11 July 2001.
 - 4 *The Australian*, 24 July 2001.
 - 5 *The Australian*, 22 August 2001.
 - 6 Australian Tax Practice, Latest Tax News, 5 September 2001.
 - 7 <http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR20018/NAT/ATO/00006>
 - 8 There has been considerable litigation in many areas of the law to determine if a person is an employee or not and it is often very difficult to determine the likely result in marginal cases.

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A taxpayer self assessing as a contractor in other than an obvious case may therefore leave themselves open to a subsequent ruling from the ATO that they are an employee with associated denial of deductions and penalties. If a taxpayer does not satisfy the personal business tests in the ITAA97, intends to rely on being a contractor and the case is not obvious, they would be in a much safer position if they sought a declaration from the ATO rather than self assessing.

- 9 The other ruling is TR 2001/7 which deals with the meaning of personal services income, see <http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR20017/NAT/ATO/00001>
- 10 Taxation Institute of Australia, Media Release, 31 August 2001.
- 11 CPA Australia, Media Release 31 August 2001, http://www.cpaonline.com.au/01_information_centre/16_media_releases/1_16_0_0_media_index.asp
- 12 Master Builders Australia, Media Release, 2 September 2001.
- 13 <http://www.contractworld.com.au>
- 14 *The Sydney Morning Herald*, 7 May 2001.
- 15 The Treasurer, Press Release, 29 June 2001.
- 16 <http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR20018/NAT/ATO/00006>
- 17 Taxation Institute of Australia, Media Release, 31 August 2001.
- 18 Budget Measures 2001–02, Budget Paper No. 2, p. 22.
- 19 <http://www.aph.gov.au/library/pubs/bd/2000-01/01BD162.htm>

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