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Submission to Commonwealth Parliamentary Tax and Revenue Committee Inquiry into whether the Australian Taxation Office is subject to too much scrutiny

11 March 2016

Terms of the Inquiry

The Federal Parliamentary Tax and Revenue Committee is inquiring into the scrutiny arrangements that apply to the Australian Taxation Office (ATO), with particular regard to:

- "removing inefficiency and duplication
- reducing cost to government
- the 'earned autonomy principle' set out in Stage 2 of the Public Management Reform Agenda."

According to media reports, http://www.smh.com.au/business/the-economy/federal-inquiry-asks-if-there-is-too-much-scrutiny-of-the-ato-20160209-gmp9js.html the inquiry has been initiated following complaints from the Tax Commissioner that the ATO is subject to too much scrutiny.

Summary of Position of Independent Contractors Australia

Independent Contractors Australia (ICA) believes that, in relation to the ATO's treatment of self-employed small business people, the ATO is subject to too little scrutiny rather than too much. This submission details why, calls for more scrutiny and suggests the form that such scrutiny should take.

Specifically, ICA calls for:

- Increased powers and resources for the Inspector-General of Taxation to oversee the processes of the ATO.
- The creation of a Small Business Tax Tribunal that has oversight of the ATO's interpretation of the legal facts and its application of tax law to self-employed small business people.

Further, increased scrutiny as proposed will:

- Force the ATO to address its ingrained systemic inefficiencies.
- Facilitate improved ATO efficiency, thereby creating government cost savings.

ICA holds the position that the ATO has not earned the right to have the 'earned autonomy principle' applied to it.

This submission:

- Draws heavily on case studies of individual self-employed people who have been subject to what we believe is oppressive, unfair, unjust and possibly illegal treatment by the ATO.
- Seeks to summarise the cases and situations for ease of reading. However, by necessity, some level of detail is required for our points to be conveyed properly.
- Supplies two previous submissions to reviews of the ATO (Board of Taxation, 2014 and Inspector-General of Taxation, 2015) which provide details of the case studies and situations.

The key point is that the ATO requires more robust scrutiny than is currently the case in relation to its handling of small business people. This is required because the ATO consistently demonstrates that, in its dealings with small business people, it cannot be trusted to act fairly and with due and proper process. In some case, arguably, it appears that it cannot be trusted to act within the law.

Small business people are in a highly vulnerable position when the ATO makes accusations against them. The ATO has huge resources to prosecute its case whereas small business people lack the resources (financial, informational and legal) to defend themselves. It is often the case that the ATO prevails because small business people cannot defend themselves. The result is injustice. Because of the huge inequality in bargaining power, independent oversight and scrutiny of the ATO is required to ensure that a measure of justice prevails.

‘Out there is the enemy’

1. Preamble: A counter-productive ATO culture requires scrutiny

A long-standing Australian Taxation Office employee once explained that when she first started working for the Office as a young junior she was taken aside by a senior supervisor who counselled her saying, ‘remember, out there is the enemy’.

The supervisor’s comment grants an insight into the ingrained, historic culture of the Australian Taxation Office—a culture that substantially remains today in many respects and which demonstrates why the ATO requires robust scrutiny of its operations and decisions.

The ATO has a hard job. It has to collect money from Australians, many of whom don’t want to hand over the money and go to great lengths not to hand over the money. Dealing with this every day, it is understandable that the culture of the ATO becomes one of seeing the public as ‘the enemy’. However, effective tax collection systems depend on maximizing voluntary compliance—that is, ‘fostering willing participation’ by the population. Voluntary compliance hinges on the population viewing the tax system as having fair, equitable transparent rules applied in a consistent and open manner.

But, in relation to small business people, independent contractors and the self-employed, the approach, culture and behaviour of the ATO is aggressive and oppressive. It could even be argued that it is possibly a form of scamming such people; perhaps, at worst, in defiance of tax law itself. The ATO treats such people as ‘the enemy’ and routinely commits acts of unfairness and injustice against them.

These accusations against the ATO by us, Independent Contractors Australia, may understandably be viewed as extreme, even unreasonable. However, they are views and conclusions based on our close review of a number of actual cases. In this submission we present examples of cases as evidence. (Refer, in particular, to case studies in the accompanying submissions A & B.)

We believe that the aggression occurs because the ATO is able to act as a commercial bully when it so chooses. That is, it can make an allegation against an individual, interpret the law and apply review processes to suit its desired outcomes, knowing that the individual is not in a position to be able to afford an adequate legal defence through the courts.

In relation to the objectives of this parliamentary inquiry and based on our experiences of the ATO in this area, the ATO requires considerably more independent scrutiny and oversight than is currently the case if the integrity of the tax system is to be secured and enhanced.

Our observations and comments about the ATO are exclusively focused on the ATO’s approach to self-employed small business people and are not a commentary on the ATO’s approaches in relation to medium and large businesses.

2. Profiling the 'people'

ICA argues for the rights of self-employed people. According to analysis http://www.independentcontractors.net.au/Research/How-Many/independent-contractors-how-many of Australian Bureau of Statistics (ABS) data, there are some two million self-employed people in Australia.

The ABS splits the self-employed into two groups of around

- 990,000: Independent contractors (people who do not employ others)
- 1,010,000: Other business operators (people who do employ others)

in addition

- Independent contractors are often called freelancers, micro-businesses, contractors, independent professionals, sole traders and many other terms.
- 'Other business operators' employ, on average, five people each.

Of the two million self-employed people, around

- two-thirds (1,333,000) operate as individuals or through partnerships.
- one-third (667,000) operate through company or trust structures.

Counter to what many claim is confusion over defining what a self-employed person is, the definition is clear at law and in practice. A self-employed person is identified as a person who gains his or her income through the commercial contract as opposed to the employment contract. That is, the person is a commercial business.

Even where individuals operate through a company or trust, most commonly the income of self-employed people is ultimately declared and taxed as personal income.

But herein lies the difficulty that the ATO has with self-employed people, particularly independent contractors. The ATO generally can conceive of a 'business' as being one where people are 'employed' in the business. But where a person is a 'business of one', the ATO seems to have conceptual difficulty with such a notion, which in turn underpins its approach. There is, in our experience, a high level of suspicion amongst ATO officers about such 'businesses of one'. We believe that it is this suspicion which drives much of the mistreatment of self-employed people by the ATO.

3. Independent Contractors Australia's previous submissions

Independent Contractors Australia has been active for many years making submissions to reviews of small business tax policy and the ATO's treatment of small business people. Our submissions have all been based on an accumulation of case studies.

a) *The Board of Taxation (BOT) in May 2014* conducted the Review of Tax System Impediments Facing Small Business.

In our submission (See attachment B) http://www.independentcontractors.net.au/Downloads/Taxation/ICA-Submission-Board-of-Taxation-May-2014.pdf we criticized the ATO for:

- Its processes for refusing to allocate and for cancelling Australian Business Numbers.
- Its failures in relation to basic, core administrative functions.
- Failing to ensure that ATO officers comply with the ATO's own rules.
- Having a dispute-resolution system that is not seen to be open and fair and which allows the ATO to win its claims by financial intimidation. (That is, small business people cannot afford to challenge the ATO because of the costs of litigation.)
- Incoherent application of policy in relation to Personal Services Income Tax law.

Specifically, we asked for:

- Rapid introduction of a genuine, independent disputes-mediation mechanism.
- Cessation of the ATO's denying ABNs to individuals.
- The closure of the ATO's employee–contractor online 'decision-making' tool.
- Repair of the poor ATO administration of small taxpayers' issues.
- Proper, correct and consistent application of the ATO's own rules on PSI by its officers.

The BOT itself made many recommendations, including:

- Fixing (in its words 'relaxing') the ABN requirements.
- Fixing the employee–contractor tool (again, in the BOT's words, "The Board endorses the ATO review of the tool").
- Rationalising and simplifying the PSI rules (this is really linked to the contractor–employee distinctions).

We supported and endorsed these recommendations.
http://www.independentcontractors.net.au/Current-Issues/Taxation/digging-out-the-ato-board-of-taxation-review-recommendations

b) In January 2015 the Inspector-General of Taxation (IGT) issued a parallel report on *Managing Tax Disputes*. We also supported and endorsed those recommendations.
http://www.independentcontractors.net.au/Current-Issues/Taxation/inspector-generals-report-slams-the-ato

In the report the IGT stated that:

- The ATO has an unfair process.
- Matters are not objectively considered by the ATO.
- There are significant barrier to justice.
- There is an urgent need for reform and respect for taxpayers.

Subsequent to the BOT and IGT reports and recommendations, the Commissioner of Taxation has made a number of public claims about how the ATO is undergoing a reform process—one where the ATO is more understanding and is working with small business people. In particular, it was claimed that:

- The employee decision-making tool is/has been reviewed and reformed.
- Decisions on ABN allocation are/have been improved.
- The ATO has introduced an Alternative Dispute Resolution process.
- PSI rules are being reviewed.

Our experience and observation is that, rather than improving the situation, it has become worse since early 2015. Specifically:

- The Alternative Dispute Resolution (ADR) process is not genuine. It is a 'talkfest' process in which the only resolution open to the taxpayer is to concede to the ATO's predetermined position/s. In fact, the ATO now calls this 'In-House Facilitation'. The pretence of having an independent dispute resolution has been dropped.
- ABN allocation/withdrawal continues to be illogical and/or inconsistent.
- The employee decision-making tool continues to operate as before.
- The PSI rules may be subject to review, but the process is conducted at a snail's pace with no change 'on the ground'.

c) ICA's tracking and commentary on small business tax issues goes back to our formation in 2000. Here's some of our commentary on PSI issues from 2007 for example. http://www.independentcontractors.net.au/announcements/important-federal-court-decision-ato-psi-results-test-for-companies-and-trusts

d) Most recently *the Inspector General of Taxation (December 2015) conducted a Review into the ATO's Employer Obligations Audits.* The IGT has not yet released a report, however ICA made a submission (See Attachment A) http://www.independentcontractors.net.au/Downloads/Taxation/Submission-ICA-IGT-Review-Dec-2015.pdf that we include as part of our submission to this inquiry.

In our IGT submission we reiterated our points from the BOT submission (as per above) and made recommendations. Most specifically we asked the IGT to step in and consider doing the following:

- Establish a template process based on common law for ABN allocation, for the PSI results test and to override the online 'decision-making tool'.
- Publish the template and provide a layperson's explanation about the processes on the IGT website.
- Make it clear to self-employed people that if they are confronted with an ATO assessment on an ABN, the 'results' test or the decision-making tool, and if the ATO does not apply the common law processes as recommended by the IGT, the individual can appeal to the IGT on the grounds of failure of due process.

In our submission to the IGT we provided two confidential case studies that demonstrated unfairness in the process used by the ATO and, we believe, sufficient evidence to suggest that that ATO breaches, or at least ignores, both tax law and due process. We summarise those situations further below and add additional information that makes us suspicious about the integrity of the ATO.

We provide this substantial background to demonstrate our experiences and to support our view that the ATO cannot be trusted to act fairly, or even to act within the law, or at least be seen to act within the law in relation to small business people and that, as a consequence, increased scrutiny and oversight of the ATO is required.

4. The stated position of the Tax Commissioner: A claim to reform

The current Tax Commissioner (see below) has recognized the need for a culture within the ATO that 'fosters willing participation' and says that there is an ATO

cultural reform programme underway. The Commissioner has been making much of a claim that the culture of the ATO has changed or is changing through its 'Re-Inventing the ATO' programme.

In March 2014 the Commissioner stated https://www.ato.gov.au/Media-centre/Speeches/Commissioner/Commissioner-s-address-to-TIA/

> "By 2020 our goal–our vision–is to be …a leading taxation and superannuation administration known for our contemporary service, expertise and integrity."
>
> "At the heart of it is cultural change".
>
> To help us achieve our mission and vision, we have set up a 2020 Program Office to support cultural change and to coordinate and align all of our activities.
>
> For those taxpayers who have a tax debt, we are using behavioural insights in our communications with them to encourage voluntary payments. We are changing the language, structure and layout of a number of debt letters to increase payment compliance by being clearer about what the taxpayer needs to do and the consequences of not paying.

Given our experience during 2014 and 2015, the ambitions of the Commissioner have not been achieved or advanced in relation to small business people. In fact we have observed a decline in the ATO's culture and processes.

The Commissioner has lauded improvements in audit processes for large businesses:

> One of the significant achievements in the past year has been the implementation of independent reviews for income tax audits for large businesses…The service involves a review of the technical merits of the audit case before the ATO's position is finalised. A senior officer from our Law Group, not the Compliance Group, conducts the review... This officer is independent of the audit process and comes in with a 'fresh set of eyes'…'

Based on our experiences, such attempts in the small business space for Alternative Dispute Resolution have verged on being a form of a scam. In fact the ATO has stopped referring to the process as ADR and now calls it 'In-House Facilitation'. The process for small businesses is not genuinely independent and is orientated to reinforcing the ATO's position on the small business person.

The Commissioner has been vocal in the media (*Sydney Morning Herald*, December 2015) http://www.smh.com.au/comment/chris-jordan-tax-avenger-leads-the-hunt-for-millions-spirited-overseas-20151211-glldq4.html going after big multinational businesses not paying tax, saying:

> "I've brought a different approach. I say 'Look at it holistically, what's the real world practical activity going on', not what someone's devised on a whiteboard."
>
> "Don't be trapped by the technicalities of the law."
>
> "I know the stories companies build up for tax purposes. "Sometimes I giggle at companies because I've been there, building up the stories," as a top tax adviser at private firms.

While such an approach may be applicable to large businesses that can afford armies

of lawyers, such an approach is not legitimate for small businesses. It is not sufficient for the ATO to ignore the 'technicalities of the law' yet we believe that this is what is occurring. Instead of applying clear law to small business situations, we have observed what we consider to be the ATO's 'smell test'.

In this respect we note the comments in the March 2014 Report from the Committee on Tax and Revenue (2013 Annual Report of the Australian Taxation Office) which stated:

> "It should remain the priority of the ATO to collect revenues due, within the absolute principle of fair treatment and respect for taxpayers."
>
> "As a government agency, the ATO is bound by model litigant rules, which require it to only start court proceedings if it has considered other methods of dispute resolution."

Our observations in relation to small business treatment is that these principles are too frequently not applied, if applied at all.

Case studies and Situations

5. Personal Services Income & Income Splitting
The mystery of the disappearing ATO website link

With the major reforms to the administration of the income tax system in 2000, where PAYG replaced PAYE, the Tax Commissioner for the first time had clear legal authority to require income tax withholding from all self-employed people. ICA strongly supported this.

The residual issue related to whether individual self-employed people could split income, retain profit in entities and the like. This was legislatively resolved in September 2001 with the passing of the Personal Services Income (PSI) laws which hinged around the application of the results test and so on. However, there remained lack of clarity about how the ATO would/should interpret the laws. During 2003–04 the ATO ran a series of test cases before the courts to bring clarity to the legal situation and to guide the ATO's actions.

On 13 December 2005, the then Tax Commissioner published a seminal statement on the ATO's website that delivered considerable clarity. This statement cited court decisions from the test case programme that gave direction to the ATO and made it clear that:

- Profit (income) splitting through partnerships was a normal part of partnership business and acceptable from a tax perspective.
- Retaining profit in companies and other related activities were subject to considerable scrutiny by the ATO.

ICA found this statement gave considerable, improved clarity to self-employed people on the tax implications of their business structures. It was an important statement in that it also made it clearer to ATO officers what should be accepted and what could be challenged.

At some stage, however, that statement mysteriously disappeared from the ATO website. ICA only became aware of the disappearance after we noted a considerable uplift in the ATO's aggression towards self-employed people on PSI and related issues. What occurred (and is still occurring) is that the ability of self-employed people to cite the statement in defence of their business activity has been removed.

Most particularly we have evidence of the ATO denying self-employed people their legitimate right to distribute profit/income through their partnership/s to the partners. In our observations of those situations, the self-employed people have not engaged in any unusual activities or structures in relation to their partnership/s. Large tax bills and penalties, in the hundreds of thousands of dollars, have been imposed on such people.

Quite recently the 'missing link' has been re-discovered. An ICA member, clearly with considerable Internet acumen, sourced the Tax Commissioner's 2005 statement through a US website that archives important websites.

The Tax Commissioner's statement of December 2005 is reproduced below. Assuming that the statement we've sourced and reproduced is accurate, its rediscovery clarifies a great deal. It certainly accords with our recollections of the statement when it was first released. We are not aware of any ATO statement that has rescinded the statement. However, we are aware of ATO decisions against self-employed people that are inconsistent with or stand in opposition to the Commissioner's statement.

This is a situation that creates suspicion about the ATO. An important statement of clarity 'disappears', thereby putting taxpayers who seek to act within the law at a major disadvantage when it comes to determining what the law is.

This is a situation that supports our submissions for enhanced independent scrutiny of the ATO.

6. Allegations of Fraud

We are aware of situations where the ATO has alleged fraud against self-employed people. Such an allegation is, of course, very serious. However, in the instances we have seen, the ATO does not provide any substance or facts to back up its allegations of fraud.

We observe that if the ATO is to investigate a self-employed individual's tax they can, in the normal run of events, only review the last two years' tax returns once a tax return has been accepted. However, if fraud is involved, the ATO can go back and review multiple years of tax returns. It is these sort of circumstances with which ICA is familiar.

The ATO alleges fraud, then proceeds to review many years of an individual's tax returns, which permits the ATO to issue very large unpaid tax claims and penalties, frequently in the hundreds of thousands of dollars. In such circumstances the self-employed person is in a highly vulnerable situation. They literally face bankruptcy, are unable to understand the tax law, are unable to afford legal advice (which would

easily run to tens of thousands of dollars itself) and face allegations of (criminal) fraud where the details of the allegations are not stated.

ICA asked a lawyer for assistance to explain the issue of fraud and how the ATO should behave when making such allegations. We received the following opinion:

> I believe there is an argument to be made that the ATO is making a jurisdictional error every time they use "fraud" as the pretext for revisiting a tax assessment that is over two years old.
>
> The way the Act reads is that the ATO can revisit an assessment if there is fraud. See INCOME TAX ASSESSMENT ACT 1936 - SECT 170 "Amendment of assessments" http://www.austlii.edu.au/cgi-bin/sinodisp/au/legis/cth/consol_act/itaa1936240/s170.html?stem=0&synonyms=0&query=fraud Go down to Item 5.
>
> That makes the fraud a jurisdictional fact that must be established before the ATO can revisit the assessment.
>
> If the ATO reasonably suspects fraud, and intends to follow that line of thinking, they must establish, by Probative Evidence, that there is a fraud:
>
> *"... bound, as a matter of law, to act on the basis that any conduct alleged ... should be established, on the balance of probability ... by some rationally probative evidence and not merely raised before it as a matter of suspicion or speculation "(Minister for Immigration and Ethnic Affairs v Pochi - (1980) 31 ALR 666 at 685)*
>
> When the ATO embarks on establishment of that jurisdictional fact, they must afford procedural fairness to the taxpayer (it was once called "natural justice").
>
> A landmark case for the application of the notion of procedural fairness is *Kioa v West* [1985] HCA 81
>
> In *Kioa v West* the High Court dealt with the case of a Tongan couple who had outstayed their temporary entry permits. The Court held that procedural fairness had been denied when renewal of the permits had been refused. Mason J stated that:
> *"the law has now developed to a point where it may be accepted that there is a common law duty to act fairly, in the sense of according procedural fairness, in the making of administrative decisions which affect rights, interests and legitimate expectations, subject only to the clear manifestation of a contrary intention."*
>
> I can find no clear manifestation of a contrary intention in ITAA36, ITAA97 or the Tax Administration Act. If my search has been complete, we can say with assurance that the ATO owes procedural fairness to the taxpayer when it is considering a matter that may have significant impact on the rights and obligations of the taxpayer. That would include establishing the jurisdictional fact that fraud has taken place.
>
> So the ATO should invite comment from the taxpayer in regards to the suspicion of fraud. If it does not offer that procedural fairness, then it imports a reviewable jurisdictional error into its processes.
>
> The ATO is well aware of its requirements to provide procedural fairness (see the Taxpayers Charter https://www.ato.gov.au/about-ato/about-us/in-detail/taxpayers--charter/taxpayers--charter---what-you-need-to-know/) but if it just ignores that

obligation, then there could be a misfeasance in public office by the Minister.

In *Sanders v Snell* (1998) 196 CLR 329, the High Court concluded that the Minister could issue specific instructions to a bureau (to terminate the employment of its executive officer) but the majority found the Minister is bound to accord natural justice to the executive officer before issuing the direction. The Court opined that an action in misfeasance in public office could lie in respect of a significant failure to do so.

This legal view raises our concerns about the operations of the ATO. Assuming, as explained above, that the ATO has a duty to accord procedural fairness, ICA has not seen such procedural fairness occurring where allegations of fraud have been made by the ATO toward self-employed people. In these circumstances, and from a layperson's perspective, the ATO looks like it is conducting a scam. Certainly if the ATO were a private business behaving in such a manner, we would refer the ATO to the Australian Consumer and Competition Commission for investigation. But as the ATO is a wholly owned government monopoly, it behaves as monopolies often behave—at the least unethically and immorally, but at worst possibly illegally as well.

This is a situation that supports our submissions for enhanced independent scrutiny of the ATO.

7. Personal Services Income Tax laws. Correct application of the results test.

The PSI laws are a critical piece of legislation that give practical effect to the right of self-employed people to be treated as a business for the purposes of tax. If a self-employed business person does not have that practical tax right, his or her activities as a 'business' fall into a strange 'neverland'. In other words, at commercial law they are operating as a business and have all the rights and obligations that go with that. Yet the way they are treated denies them the tax treatment afforded to all businesses. Where this occurs because of the actions of the ATO, the ATO becomes a powerful institutional force that suppresses innovation, entrepreneurship and economic development at the core base of the economy—the small business end.

The critical issue under PSI is the definitions required to be used by the ATO in assessing whether a self-employed person is otherwise an employee.

The ATO is required to follow the law in assessing PSI and is explained in Taxation Ruling TR 2001/8 http://law.ato.gov.au/atolaw/view.htm?DocID=TXR/TR20018/NAT/ATO/00001
In assessing whether a person passes the PSI tests, the ATO is required at first instance to assess against the 'results' test. This test is broadly based on the major common law indicia determining whether a person is an independent contractor or an employee.

A self-employed person's contract and business operations are required to be assessed against 11 subtests as detailed below.

1.The contractual obligations	An independent contractor enters into a contract for a specific task or series of tasks.
2. How the work is performed	The independent contractor maintains a high level of discretion and flexibility as to how the work is to be performed. However, the contract may contain precise terms as to materials used and methods of performance and still be one of result.
3. Risk	An independent contractor stands to make a profit or loss on the task. They bear the commercial risk. The independent contractor bears the responsibility and the liability for any poor workmanship or injury sustained in performance of the task. Often an independent contractor would carry their own insurance and indemnity policies.
4. Tools and Equipment	An independent contractor provides the assets, equipment and tools, if any, necessary for the work.
5. Hours of work and place of work	An independent contractor may set their own hours of work, or place of work, depending on the contract or the nature of the work.
6. Leave and other entitlements	A contract for a result usually does not contain leave provisions or allowances.
7. Payment	Payment to an independent contractor is often based upon performance of the contract rather than being paid a hourly rate, piece rates or award rates.
8. Expenses	An independent contractor usually incurs their own expenses.
9. Appointment	An independent contractor is likely to advertise their services to the public at large, and the contract for a result is often the direct result of this activity.
10. Termination	An independent contractor is contracted to complete a set task. The payer may only terminate the contract without penalty where the worker has not fulfilled the conditions of the contract. The contract usually contains terms dealing with defaults made by either party.
11. Delegation	An independent contractor may delegate all or some of the tasks to another person, and may employ other persons.

This table is reproduced from Taxation Ruling TR 2001/8
http://law.ato.gov.au/atolaw/view.htm?DocID=TXR/TR20018/NAT/ATO/00001

There is a standard practice for how this should occur. Our experience in assisting and reviewing cases is that the ATO does not even bother to apply the criteria above. Instead it applies its own 'smell test'. This has particularly been the case over the last few years. On our observations, the ATO seems to operate on the principle of 'Don't be trapped by the technicalities of the law'.

The extent of this is significant. Even where the self-employed person has provided substantial documentation and submissions on their circumstances in relation to the results test, the ATO chooses to treat such submissions as if they have not even been made and ignores them.

We explained and detailed in our submission to the Inspector-General of Taxation (See Attachment A: Submission to Inspector General of Taxation Review into the ATO's Employer Obligations Audits December 2015) that since 2006 at least, ICA has looked at around 40-or-so PSI cases brought to us by small/micro businesspeople. These are all cases where the ATO has claimed that the party has failed the 'results' test, but where the

ATO did not bother even to apply the results test. During 2015 alone, ICA has looked at around nine such cases.

ICA's observation is that the ATO routinely ignores the PSI laws and its own rulings in relation to the critical results test.

This is a situation that supports our submissions for enhanced independent scrutiny of the ATO.

8. Case study: Freelance

Freelance Global was a large 'white collar' labour hire business that supplied independent contractors as consultants under 'trust' arrangements to clients since around 1991. It claimed to have several thousand independent contractors on its books. The ATO long accepted the independent contractors to not be employees and processed and accepted tax returns on the basis of self-employment.

In February 2014, Freelance lost a case against the New South Wales State Revenue Office http://www.osr.nsw.gov.au/info/legislation/summaries/court-payroll/2014-nswsc-127 over payment of payroll tax. The multi-million dollar payroll tax liability resulted in Freelance closing its doors, with large numbers of independent contractors remaining unpaid.

Under the NSW payroll tax laws, payroll tax is payable on wages to employees and also remuneration paid to independent contractors under defined circumstances. The case against Freelance related to the remuneration paid to independent contractors.

Following the collapse of Freelance, the ATO launched a large number of cases (numbering in at least the many hundreds) against ex-Freelance contractors alleging that they were employees. The ATO is denying the contractors their previously accepted self-employed tax status, which includes denying them their superannuation contributions as tax deductions against their income as is allowed for every other taxpayer in Australia.

In taking its action against the ex-Freelance contractors, the ATO has imposed new additional tax liabilities and penalties in the many tens of thousands of dollars (and sometimes higher) against each contractor. In each case seen by ICA the ATO should—but has not sought to—apply the results test as required under the PSI laws.

ICA's observation is that the ATO has acted to prey upon vulnerable people who have, through no fault of their own, been caught up in the Freelance collapse.

The key issue for ICA is, again, the complete failure of the ATO to apply, almost to ignore, the results test and instead to apply its 'smell test' where they operate on the principle of 'Don't be trapped by the technicalities of the law'. We view the process the ATO has applied here as being illegitimate and arguably in breach of the law.

Again, this is a situation that supports our submissions for enhanced independent scrutiny of the ATO, both on the issue of process and on interpretation of the law.

9. Additional issues

In earlier submissions on the ATO's treatment of self-employed people ICA has highlighted that:

a) The ATO continues to reject Australian Business Number applications and cancel ABN numbers in a manner which, we argue, is in breach of the law.

- Application rejections and cancellations are neither explained nor consistent.
- The ATO arguably breaches the law relating to ABNs.

Our experience is that there can be no confidence in the ATO's approach to rejecting or cancelling ABNs. (See Attachment A Submission to Inspector General of Taxation Review into the ATO's Employer Obligations Audits December 2015)

b) The ATO's Contractor v Employee decision-making tool is misleading and fails to apply common law criteria as required. It should be closed down. On the basis of the 'decision-making tool' the ATO rejects/cancels ABNs.
We gave five specific case study examples.

Further, we pointed out cases of incompetent and illogical administration and rules application. We gave four specific case study examples.
(See Attachment B: Submission to the Board of Taxation. Review of the Tax System Impediments Facing Small Business. March 2014)

Again, these situations support our submissions for enhanced independent scrutiny of the ATO, both on the issue of process and interpretation of the law.

The missing link

[Note: This document has been sourced from a US website that takes archival 'snapshots' of important websites. After close scrutiny, we believe that the document is an accurate version of the Commissioner's article as it appeared on the ATO website in December 2005. If there are any material differences between this version and the 'official' one, we would be pleased to see the official version—preferably on the ATO website.]

Refocus of the income-splitting test case program

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Background

In March 2003 I announced a test case program on how Part IVA - the general anti-avoidance provision of the income tax law - applies to the alienation of personal services income ('income splitting'). The program was aimed at providing greater certainty for taxpayers in today's business environment.

Since the announcement, judicial guidance in the Ryan (*Ryan v FCT [2004] ATC 2181*) case has resolved one of the issues we undertook to test, namely the making of large superannuation contributions to an associate of the main service provider. Our views on this issue can be found in Taxation Determination TD 2005/29.

However, the broader issue remains. As I noted back in 2003, there has been considerable disagreement about the breadth of the conclusions that can be drawn from the alienation cases of the 1980s. At times, considerable emphasis has been placed on the nature of the income, that is, personal services income.

For example, the Administrative Appeals Tribunal (AAT) has in the past intimated that Part IVA operates to give effect to a 'general rule that income from personal exertions is assessable in the hands of the person who earned it by those personal exertions' (*Case X90 90 ATC 648 at 654*). This emphasis on the nature of the income has arguably been at the expense of an appropriate focus on the artificiality of the underlying arrangement.

With the benefit of the decision in Ryan, and other decisions on the operation of Part IVA more generally, our experience leads us to conclude that broad statements in this area are likely to fall short of the mark in relation to the variety of facts and circumstances that exist. Rather, as with all Part IVA cases, the issue needs to be approached by carefully applying the eight factors listed in section 177D to the particular facts of the case.

By approaching the issue in this way, contrived arrangements to which Part IVA applies can be distinguished from ordinary family or commercial dealings which are not subject to Part IVA.

Consequently, we are refocusing our test case program to concentrate on identifying those features that, under section 177D, would tend to stamp an arrangement as one entered into mainly for a tax avoidance purpose.

Personal services income where Part IVA is unlikely to apply - 'husband and wife' partnerships

A consideration of 'husband and wife' partnerships that derive personal services income provides a useful illustration of this approach. Suppose a husband and wife conduct a personal services business in partnership and, as the relevant Partnership Act provides, share equally in profits and losses, notwithstanding that only one of them performs the main bulk of the work.

This arrangement has the effect of dividing income equally notwithstanding that only one of the partners is the generator of the income of the partnership.

However, in the ordinary case, the arrangement also has the very real financial consequence of exposing each partner to full liability for the debts of the partnership. The equal division of profits and losses is not solely explicable on its face by the purpose of obtaining a tax benefit: it is what the Partnership Act prescribes as the normal consequence of forming a partnership. Moreover, entering into a partnership is an ordinary means for a husband and wife to conduct a business together.

Therefore, absent unusual features, it would be difficult to conclude that having regard to the section 177D factors that the dominant purpose of such a partnership arrangement was the obtaining of a tax benefit through the equal division of profits and losses.

Of course every case turns on its own facts. Different considerations could arise if, for example,

- the use of the partnership is prohibited by regulatory or other laws, or
- a contract with a partnership represented a disguised employment relationship, or
- losses of the partnership were allocated differently to profits having regard to the partners' respective tax positions.

However, where these different considerations do not apply, Part IVA is unlikely to apply in the ordinary case outlined above. We have therefore discontinued our husband and wife partnership test cases where the facts reflect the ordinary case contemplated above.

Other personal services income cases where Part IVA is unlikely to apply

The Tax Office's fact sheet, General anti-avoidance rules and how they may apply to a personal services business, issued in March 2003, provides guidance on the steps to take to avoid the potential operation of Part IVA.
Generally speaking, Part IVA will not apply if the individual providing the personal services is fairly remunerated for his or her services - having regard to the net personal services income earned by the individual's private company or trust.

Similarly, if the net profits of a company through which an individual provides his or her personal services to the ultimate service acquirer are substantially distributed to the individual as dividends in the year in which those profits are derived, Part IVA is unlikely to apply.

Retention of profits

However, the issue of retention of profits by companies conducting a personal services business, and the related issue of remuneration paid by an entity to a principal that is not commensurate with the value of the services provided, is more difficult.

On the one hand it might be argued that once the income is derived by the company then retention of a margin above costs is not in itself a manner of dealing by the company that necessarily points to a tax avoidance purpose. It may be argued that a company acting in the ordinary course of business 'will pay as little of it as possible to its employees consistently with being able to continue to carry on a profitable business' (*Ryan v FCT [2004] ATC 2181 at 2184*).

However, against this we must balance the apparent lack of commerciality in the main service provider taking a salary which is less than the worth of his or her exertions, the nature of the connection between the taxpayer and the company, and the substance as well as the form of the working relationship from which the company's income actually arises.

There may also be other Part IVA signs present. For example, there may be a contrived variation of salary from year to year depending on whether the main service provider has other taxable income, such that there may be no salary paid in certain years. Or the main service provider may obtain access to the retained profits in a tax-effective but contrived manner. Or the profits may be retained with a view to allowing them to be paid to an associate of the taxpayer who has a lower marginal tax rate.

These sorts of features would make the case more blatant, artificial and contrived.

We continue to hold the view that Part IVA may apply to a case involving profit retention by a personal services business where it is apparent from the scheme that the purpose of profit retention is to avoid or defer tax. There are potentially significant revenue implications that arise if personal services income can be retained and taxed at the corporate tax rate rather than the individual's marginal rate. It is therefore an important issue which is appropriate for us to continue to pursue through the courts.

In saying that, however, I acknowledge that the outcome is not free from doubt. Litigation may clarify the matter.

The future of the test case program

In seeking the courts' guidance on which of the spectrum of arrangements used in today's business world are acceptable, we will first be focusing on those cases which, in our view, are the more blatant – those cases which more strongly demonstrate features of artificiality and contrivance.

Without attempting to be exhaustive, cases which we consider to fall into this more blatant category and may therefore be litigated include -

- disguised employment cases not covered by Part 2-42 of the Income Tax Assessment Act 1997 where the individual is in substance an employee of the entity to which the individual's private company or trust, in form, agrees to provide his or her services, especially if the private company or trust has tax losses

- trusts splitting personal services income in a tax effective manner between beneficiaries who make no contribution to the derivation of the income. For example, distributions matching tax-threshold amounts to children of the main service provider: see Case W58 89 ATC 524 where a computer consultant provided his services by way of a company as required by the service acquirer, but made the company trustee of his family trust, which distributed its income at threshold rates 'for no reason apparent other than fiscal reasons'

- the use of more than one entity by the main service provider to facilitate the splitting of personal services income where a single entity would adequately serve the individual's commercial purpose, and

- profit retention cases involving features of the kind outlined above, where -
  - there is a contrived variation of salary from year to year depending on whether the main service provider has other taxable income, such that there may be no salary paid in certain years
  - the main service provider obtains access to the retained profits in a tax-effective but contrived manner. For example, by complicated loan arrangements involving other entities controlled by the main service provider where Division 7A of the Income Tax Assessment Act 1936 does not apply, or
  - profits are retained with a view to allowing them to be paid to an associate of the taxpayer who has a lower marginal tax rate or to be used to acquire personal assets unrelated to the business activities of the company. For example, in Egan v FCT [2001] ATC 2185 the AAT found that Part IVA applied to a scheme involving the payment of a modest salary to the main service provider, a salary to his wife, superannuation contributions for both and retaining excess income in

the company to be taxed at corporate rates.

We will apply the judgment of the courts in these cases to determine what further action may be required.

To repeat what I said when I originally announced the test case program, while the program is under way we will not be running a specific audit program in this area other than to support the test case program. However, cases arising from our ongoing audit operations will, as is currently the case, be progressed as necessary.

Michael Carmody
Commissioner of Taxation
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