

## MID MARKET FOCUS

# Employee or contractor? Know your payer's obligations

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An overview of the indicators used to determine whether a worker is an employee or a contractor, and the payer's differing obligations in respect of each.



In the current economic market, there is an increasing preference for the usage of contractors, particularly in the sectors of building and construction, and mining and engineering. As the number of workers operating as contractors has increased significantly, so has the audit activity around it. The Australian Taxation Office (ATO) has advised that there will be increased audit activity in the coming year targeting contractor arrangements.

Although a worker may be engaged as a contractor, this does not eliminate all employer obligations if they are actually an employee by nature. Payers have differing obligations in respect of employees and contractors and it is therefore critically important to determine whether a worker is an employee or a contractor. This month's Mid Market Focus will seek to explore the various indicators used to determine whether a worker is an employee or a contractor, and the differing obligations of the payer in respect of each.

## Employee or contractor?

There is no single definition of "employee". The definition of an employee is different for the purposes of pay as you go (PAYG) withholding, superannuation, payroll tax, WorkCover and fringe benefits tax (FBT) obligations. The definition of an employee is very similar for each, but each must be assessed separately.

An employer–employee relationship is commonly referred to as a "contract of service" as the employee provides their services exclusively to an employer and at the employer's discretion, while a principal–contractor relationship is commonly referred to as a "contract for service" as the contractor works to produce a specific result for the benefit of the principal.

The definition of an employee and the associated differing employee obligations are discussed below.

## Key indicators of relationship

An employee is not defined in the Income Tax Assessment Acts. To determine the nature of a relationship, the common law and ordinary meaning of an employee are applied. Whether a person is an employee or a contractor is a question of fact; to be determined by examining the substance rather than the form of the relationship between the payer and the payee. The courts regularly refer to the "totality of a relationship", meaning that all factors need to be considered when establishing the relationship. The key indicators from case law and as outlined by the ATO must be applied to the relationship. TR 2005/16 also provides guidance on the indicators of the relationship. The ATO provides an online employee/contractor decision tool to assist in complying with PAYG withholding obligations. The following indicators can be assessed to determine the relationship for PAYG withholding purposes.

## Control

Control is considered to be one of the most important factors. It refers to the degree of control that the payer has over the worker. In an employee relationship, the employer will direct and control how an employee performs their duties. An employer–employee relationship is referred to as a master–servant relationship. In a contractor relationship, a contractor is engaged to perform a specific task and the contractor will ultimately decide the manner in which the task is performed. Case law indicates that the control test focuses on not whether the control is being exercised, but rather if it is able to be exercised. In an employee relationship, there is

generally the right to exercise control. In a contractor relationship, the fact that there may be a degree of control as to how they perform the specific services will not necessarily mean that there is an employee relationship. Another evidence of control is that employees are paid to work within the business that is directed by the employer. Contractors operate their own business and are paid for a specific result.

## Integration

The extent to which the activities of the payee are considered to be a part of the business activities of the payer is another important factor. A contractor should be building up their own business and not simply integrated into the payer's business. An employee will be employed as part of the payer's business and their duties will be an integral part of the business, whereas a contractor is not integrated into the business and is only an accessory to it. Indicators of a contractor operating their own business include having their own premises, advertising, clients, using their own tools, and owning their own plant and equipment.

## Results

If a worker is engaged to produce a specific result or complete a specific task, this is usually a strong indicator of a contractor relationship. Furthermore, if remuneration is payable on completion of a specific task, as opposed to being paid at an hourly rate, this is also usually a strong indicator of a contractor relationship.

## Delegation

A contractor generally will have the power to delegate by employing other people within their business or subcontracting to a third party. If an individual is personally required to perform the work, it is an indicator that the person is an employee. Employees may

delegate their workload to other employees, but this is not true delegation as they are not paying the other employee. It is also important to consider the frequency of delegation. Consistent delegation is likely to indicate a contractor relationship.

### Liability

A contractor will be required to hold their own licences and insurances, and will be liable for any costs associated with rectifying defects in their work. A contractor will bear the risk of making a profit or loss from each engagement. An employee, however, is not required to personally hold their own licences and insurances, and will not be personally liable for any costs associated with rectifying defects in their work.

### Assets and expenses

An indicator of a contractor relationship is where the worker provides the tools and equipment necessary to perform the specific tasks. A large capital outlay on tools and equipment, and incurring overheads and expenses, will support a contractor relationship. The fact that specific tasks may not require a large amount of tools and equipment does not mean that it is an employee relationship. Employees will generally be provided with the necessary tools and equipment to perform their tasks and are more likely to be reimbursed for any expenses incurred in the performance of their work.

### Termination

An employee can only be terminated within the constraints of their contract and with consideration of any relevant industrial relations law. It is generally more difficult to terminate an employee. A contractor can generally be dismissed within the constraints of their contract and without consideration of any relevant industrial relations law.

### Exclusive services

An employee will generally provide their services exclusively for an employer, whereas a contractor will generally work for numerous other payers.

### Employment benefits

Employees are entitled to annual leave, sick leave and long service leave benefits. Contractors are not entitled to these benefits and it will generally be stipulated in the contract that they are responsible for these on-costs. It is not sufficient to simply stipulate

in the contract that they are responsible for these on-costs if, having regard to the other indicators, they are deemed to be operating in an employer–employee relationship.

### Uniform

If applicable, an employee is required to wear a uniform. However, a contractor is generally not required to wear a uniform.

### Payer's obligations

#### PAYG withholding

Where a worker is deemed an employee, PAYG withholding tax must be withheld from their earnings at the correct rate. If a worker is an independent contractor, a payer is required to withhold an amount from payments only where the contractor:

- has entered into a voluntary agreement with the payer to have amounts withheld;
- provides their work or services for a client of the payer under a labour hire arrangement; or
- has not quoted their Australian business number to the payer.

### Superannuation

As discussed above, the indicators in SGR 2005/1 are used to consider who is an employee for the purposes of s 12 of the *Superannuation Guarantee (Administration) Act 1992* (Cth). SGR 2005/1 uses the common law and ordinary definitions to determine the nature of a relationship. However, the Superannuation Guarantee Act expands the meaning of those terms to expressly cover other persons, including a person who works under a contract wholly or principally for labour. The ATO provides an online employee/contractor decision tool to assist in complying with superannuation obligations.

It should be noted that a contractor cannot be deemed to be an employee where a contractor operates through an entity such as a trust or company. This is because an individual did not personally enter into a contract; the contract was entered into by an entity. This same principle also applies to a partner of a partnership. However, if the partner entered into the contract in their own personal capacity, they can be deemed an employee.



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Where a worker is deemed an employee, the employer must make superannuation guarantee contributions at the required percentage (currently 9%) on the worker's earnings. The correct amount of superannuation guarantee must be contributed within the required time frames. Contractors are responsible for their own superannuation obligations.

### Payroll tax

Each state/territory of Australia has its own legislation governing payroll tax obligations. Payroll tax is levied on wages, generally known as "taxable wages". The definition of taxable wages is included in the relevant payroll tax legislation of each state/territory.

Wages do not have to be paid to employees to be taxable. Payments to contractors can be taxable if they are deemed an employee. Contained within the payroll tax legislation of each state/territory are factors identifying when a contractor is deemed an employee. Interpretations of the legislation are generally issued by each state/territory to provide guidance on the indicators taken into account when determining whether a contractor is deemed an employee. The Revenue Offices of New South Wales, Victoria, South Australia, Tasmania and the Australian Capital Territory have released PTA.038 (which applies from 1 July 2011) to assist employers and principals to determine whether a worker is a common law employee. The Western Australian Office of State Revenue has issued PT 6.1, which provides guidance as to how the Commissioner of State Revenue will consider certain subcontracting arrangements. It should also be noted that there are generally state-specific exemptions that can apply to payments to contractors to remove the obligation to remit payroll tax.

Where a worker is deemed an employee, the employer is required to have payroll tax paid on their taxable wages (only if exceeding the relevant payroll tax registration thresholds) at the applicable rate pertaining to each state or territory.

### WorkCover

Each state/territory of Australia has its own legislation governing WorkCover obligations. Payers are liable for WorkCover for workers who are deemed employees. Deemed employees can include contractors. Similar to common law, WorkCover uses the concepts of a "contract of service" (ie an employee) and "contract for service" (ie a contractor). The

key indicators that are used to determine whether a worker is an employee or a contractor are similar to that for PAYG withholding and superannuation. Contained within the WorkCover legislation of each state/territory are factors identifying when a contractor is deemed an employee. Interpretation of the legislation is generally issued by each state/territory to provide guidance on the indicators taken into account when determining whether a contractor is a deemed employee. It should be noted that, if a contractor operates through an entity such as a company or trust, they will generally not satisfy the relevant definition of an employee and, as such, no WorkCover will be payable.

Where workers are deemed employees, the employer is required to have WorkCover for those employees. WorkCover premiums will be dependent on various factors, including the amount of payments to deemed employees, the industry classification of the business, and the risk factors associated with the business operations. Payers are not liable for contractors under WorkCover and contractors will provide their own insurances.

### Fringe benefits tax

The definition of an employee under the *Fringe Benefits Tax Assessment Act 1986* (Cth) includes any current, past or future employee who receives or has a right to receive salary and wages. Salary and wages are defined to mean an amount which an amount must be withheld under s 12-35 of Sch 1 of the *Taxation Administration Act 1953* (Cth). As previously mentioned, there is no definition of employee in the Income Tax Assessment Acts. Therefore, to determine the nature of a relationship, the common law and ordinary definitions of an employee are applied.

Where a worker is deemed an employee, the employer will be required to calculate and remit the correct amounts of FBT at the current rate of 46.5% on the grossed-up taxable value of non-cash benefits provided to employees, subject to any concessions and exemptions under the FBT Act.

### Penalties

There is a range of substantial penalties that a payer may be liable for associated with the misclassification of a relationship. Potential penalties are specific to each of the abovementioned payer's obligations and include the imposition of interest

charges and fines that are in addition to the required payment of any shortfall amounts.

### Conclusion

As discussed, a payer has differing obligations with respect to an employee as opposed to that of a contractor, and there are significant implications under various legislative provisions (including associated penalties) if a worker is incorrectly classified as a contractor when, in fact, the worker is an employee.

It is important that tax advisers of SME clients assist their clients to correctly classify the relationship that their clients have with the workers that they engage in the course of operating their business. When determining the relationship between a payer and a worker, it is necessary to consider the totality of the relationship between the parties and, ultimately, the substance rather than the form of the relationship must be carefully assessed and reviewed.

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