The Tax Institute

10 March 2023

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By email: PAGSEO@ato.gov.au

Dear Mr Murphy

Draft guidance on the meaning of an employee

We refer to our meeting with the Australian Taxation Office (**ATO**) on 27 February 2023 and thank the ATO for the frank discussion and the opportunity to provide a further written submission in relation to Draft Taxation Ruling TR 2022/D3: *Income tax: pay as you go withholding – who is an employee?* (**draft TR**) and Draft Practical Compliance Guideline PCG 2022/D5: *Classifying workers as employees or independent contractors – ATO compliance approach* (**draft PCG**)**,** and together, the **draft guidance**. Our submission reiterates the key issues that were discussed during this meeting.

The recent decisions of the High Court in *Construction, Forestry, Maritime, Mining and Energy Union v Personnel Contacting Pty Ltd* [2022] HCA 1 (***Personnel Contracting***) and *ZG Operations Australia Pty Ltd v Jamsek* [2022] HCA 2 (***Jamsek***), have signalled a major shift away from the approach the courts have historically adopted to characterise a worker as either an employee or independent contractor at general law. The judgment of Wigney J in *JMC Pty Ltd v Commissioner of Taxation* [2022] FCA 750 (***JMC***) is an example of how the courts have applied the principles in *Personnel Contracting* and *Jamsek*, with the analysis centred around the terms of the relevant employment contract.

It is important for the guidance to be consistent with, and accurately reflect the reasoning of the High Court, including, in particular, the emphasis that the High Court has placed on legal rights and obligations being determined by reference only to the terms of the contract between the worker and the principal.

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Draft Taxation Ruling TR 2022/D3

We consider that the draft TR requires certain amendments in this regard, to be clear that when the task of characterising the relationship is undertaken, it is done only by reference to the legal rights and obligations established by the contract. The Tax Institute is of the view that the draft TR does not currently state this principle as clearly or prominently as it could. The reference to a comprehensive written contract being determinative of the legal rights and obligations does not appear until paragraph 9 of the draft TR, and may be misunderstood by taxpayers as not being central to the analysis.

Further, the draft TR would benefit from clarification about how certain factors may demonstrate an employee or a contractor relationship as expressed by the terms of the contract. This includes further guidance on the emphasis to be given to matters such as how the worker presents themselves to the public, banks and regulators (such as the ATO), the principal's right to terminate the worker, the worker's right to delegate, and the impact of reimbursement agreements (to the extent these matters are addressed in the contract). In doing so, the Tax Institute considers it would be appropriate for the ATO to accurately adopt the language of the High Court in *Personnel Contracting* and *Jamsek,* which has been helpfully set out by Wigney J in *JMC* at paragraphs 17 to 27.

Draft Practical Compliance Guideline PCG 2022/D5

The Tax Institute considers that an effective PCG can assist taxpayers to better allocate their limited resources to assess their current risk rating and determine what actions, if any, could be taken to achieve a lower risk rating, and identify the relevant evidence that should be retained to support their position in the event of an ATO engagement activity.

The risk zones in the draft PCG may be difficult for taxpayers to demonstrate and the delineation between them may also be difficult for the ATO without undertaking comprehensive engagement activity. In practice, a taxpayer's self-determination that they fall into the 'very low risk' category, and therefore should not be subject to the allocation of ATO compliance resources, may not be demonstrated without some level of ATO compliance resources being dedicated towards verifying that determination. We consider that the risk zones would benefit from further clarification and amendments that introduce certainty and allow taxpayers to more readily evidence the risk zone into which they fall. The draft PCG would also benefit from updates that incorporate recent case law developments that focus on the centrality of the written contract.

Our detailed response is contained in **Appendix A**. We have also included with our submission the following for your consideration:

- Attachment 1 – a marked-up version of the draft TR highlighting how the suggested changes in our submission may be implemented; and
- Attachment 2 – a marked-up version of the draft PCG highlighting how the suggested changes in our submission may be implemented.

These attachments have been provided for the sole information of the ATO and will not be included in the published version of our submission.

We would be pleased to meet with the ATO again to provide any further clarification on the points raised in our submission.

The Tax Institute is committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all. Please refer to **Appendix B** for more information about The Tax Institute.

If you would like to discuss any of the above, please contact our Senior Tax Counsel, Julie Abdalla, on (02) 8223 0058.

Yours faithfully,

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APPENDIX A

Draft Taxation Ruling TR 2022/D3

Greater emphasis on terms of the contract

The Tax Institute is of the view that the draft TR requires amendments, such as at paragraph 10, to ensure consistency with the High Court's decisions in *Jamsek* and *Personnel Contracting*. Greater emphasis should be placed on the terms of the contract when determining the appropriate characterisation under the employee–contractor distinction. We note that in situations where the contract is a sham or is otherwise ineffective at general law or under statute, the employee–contractor distinction may need to be made with reference to the surrounding circumstances and actual behaviours of the parties.

By way of example, paragraph 19 of the draft TR states:

> '…the majority of the High Court [in *Personnel Contracting*] confirmed that in determining whether a relationship between a worker and putative employer is one of employment, an examination of the totality of the relationship must be undertaken…'

This extract is from the decision of Gordon J,[1] with Steward J agreeing.[2] However, Gordon and Steward JJ were not part of the majority in that case. The majority judgment of Kiefel CJ, and Keane and Edelman JJ did not state that an examination of the 'totality of the relationship must be undertaken.' Rather, their Honours held that:

> '**Where the parties have comprehensively committed the terms of their relationship to a written contract the validity of which is not in dispute, the characterisation of their relationship as one of employment or otherwise proceeds by reference to the rights and obligations of the parties under that contract.** Where no party seeks to challenge the efficacy of the contract as the charter of the parties' rights and duties, on the basis that it is either a sham or otherwise ineffective under the general law or statute, **there is no occasion to seek to determine the character of the parties' relationship by a wide-ranging review of the entire history of the parties' dealings**. Such a review is neither necessary nor appropriate because the task of the court is to enforce the parties' rights and obligations, not to form a view as to what a fair adjustment of the parties' rights might require.'[3]
>
> (emphasis added)

Their Honours cautioned against the use of the phrase 'totality of the relationship', noting that:[4]

> '…this statement was made in the context of a discussion the point of which was to emphasise that the right of one party to control the work of another was "not ... the only relevant factor".'

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1 *Personnel Contracting*, at 162.

2 Ibid, at 203.

3 Ibid, at 59.

4 Ibid, at 56.

Their Honours also stated that:[5]

> 'The foregoing should not be taken to suggest that it is not appropriate, in the characterisation of a relationship as one of employment or of principal and independent contractor, to consider "the totality of the relationship between the parties" by reference to the various indicia of employment that have been identified in the authorities. What must be appreciated, however, is that in a case such as the present, for a matter to bear upon the ultimate characterisation of a relationship, **it must be concerned with the rights and duties established by the parties' contract**, and not simply an aspect of how the parties' relationship has come to play out in practice but bearing no necessary connection to the contractual obligations of the parties.'
>
> (emphasis added)

The majority in *Personnel Contracting*[6] held that the characterisation of the relationship between the parties is not affected by circumstances, facts or occurrences arising between the parties that have no bearing on their legal rights.[7] If there is a comprehensive written contract, then the contract will be decisive of the characterisation of the worker as an employee or independent contractor.[8] In these circumstances, the High Court has made it clear that it would generally be inappropriate to have regard to any post-contractual conduct of the parties.[9] Further, the fact that a particular contractual right may have never been exercised or utilised, will generally be irrelevant.[10]

We note that paragraph 7 of the draft TR, when describing the appropriate approach to use in determining the employee–contractor distinction, uses the language of Gordon J in *Personnel Contracting* where her Honour states:

> 'The resolution of the central question requires consideration of the totality of the relationship between Construct and Mr McCourt, which must be determined by reference to the legal rights and obligations that constitute that relationship.'
>
> (emphasis added)

We agree that the totality of the relationship must be considered when determining the employee–contractor distinction. However, as set out in the majority judgement in *Personnel Contracting,* this is with regard to the legal rights and obligations of the parties established by the contract between them, and not by other matters. Without this clarification, this extract from the reasons of Gordon J is likely to mislead. As such, we recommend that the draft TR instead adopt the language of the majority in *Personnel Contracting*. This can be achieved by replacing the current use of the phrase 'the legal rights and obligations which constitute that relationship' with the phrase 'the rights and duties established by the parties' contract'.[11]

Please refer to Attachment 1 which incorporates our suggested changes throughout the draft TR.

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5 Ibid, at 61.

6 Ibid, at 44.

7 See also *Jamsek*, at 109;

8 For example, refer to *JMC*, at 17.

9 *Personnel Contracting*, at 176.

10 *JMC*, at 20.

11 *Personnel Contracting*, at 61.

We also consider that the explanation section of the draft TR would benefit from a clearer distinction between the application of the law when a contract is or is not comprehensive. Paragraph 9 of the draft TR states that:

> 'Where the worker and the engaging entity have comprehensively committed the terms of their relationship to a written contract and the validity of that contract has not been challenged as a sham nor have the terms of the contract otherwise been varied, waived, discharged or the subject of an estoppel or any equitable, legal or statutory right or remedy, it is the legal rights and obligations in the contract alone that are relevant in determining whether the worker is an employee of an engaging entity.'

However, the explanation section of the draft TR may lead to confusion for taxpayers and tax practitioners as the requirement set out by paragraph 9 above is intermingled within that explanation section with a separate requirement to examine all the circumstances surrounding the contract. Clarity may be achieved by splitting the explanation section into different parts that compares the ATO's view of the law when there is or is not a comprehensive contract.

Paragraph 11

Paragraph 11 of the draft TR states:

> 'The central question is whether the worker is working in the business of the putative employer, based on the construction of the terms of the contract, having regard to the indicia of employment identified in case law…'

However, we consider that the central question, as determined by the High Court, is simply whether the person is an employee.[12] The High Court has also noted that the appropriate characterisation may be aided by an examination of whether the person is running their own business or serving the business of their employer.[13]

We recommend that paragraph 11 of the draft TR be amended to better reflect the High Court's views. Please see our proposed amendments to paragraph 11 in the marked-up version of the draft TR enclosed in Attachment 1.

Representative of a business

The two dot points in paragraph 35 of the draft TR state that the core distinction between an employee and an independent contractor is that:

- an employee serves *in* the business of an employer, **performing their work as a representative of that business**
- an independent contractor provides services *to* a principal's business, but the contractor does so in furthering their own business enterprise; **they carry out the work as principal of their own business, not a representative of another**

[emphasis added]

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[12] Ibid, at 39.

[13] Ibid, at 35.

We consider that the requirement for an employee to be performing their work as a 'representative' of that business may not accurately reflect common employment scenarios, potentially resulting in misunderstandings for taxpayers and tax practitioners. Further, it is common practice in certain industries for a person who is engaged in their own business to be authorised to represent another without altering their status as an independent contractor. As such, it may be an enquiry which is of limited assistance for the purposes of characterising the relationship.

We do not consider that the cases cited in footnote 38 support or require a determination of whether the worker is a 'representative' of a business. *Colonial Mutual Life Assurance Society Limited v Producers and Citizens Co-operative Assurance Company of Australia Limited* [1931] HCA 53 involved a slander action between two insurance companies, where a person employed as a canvasser and agent by one company made slanderous comments. Although the comments were within the scope of the person's authority when dealing with the other company in the course of trying to win business for their employer, they were contrary to the terms of the person's contractual agreement. That is, the issue at question was not whether the canvasser was an employee. Rather, the court examined whether the employer was liable for the person's slanderous comments. As such, it was a case where the central concern was one of whether the principal was vicariously liable, similar to *Hollis v Vabu* [2001] HCA 44 (***Hollis***), rather than a case about characterisation of the relationship alone. The distinction between such cases and the facts before the court in *Personnel Contracting* was emphasised by the High Court.

We therefore consider that both dot points in paragraph 35 of the draft TR should be amended to remove references to the individuals acting as a representative of any party. Noting common arrangements and the ordinary understanding of the term 'representative', the use of this term is likely to confuse taxpayers, tax practitioners and workers. The deletion of the relevant phrases will still convey the intended question of whether the work was undertaken as part of the employer's business. We have marked-up the proposed deletions in Attachment 1.

Paragraph 41

We consider that the first sentence in paragraph 41 of the draft TR should be amended as suggested below (our suggested changes are in red below and marked-up in Attachment 1):

> 'Whether a worker is required under the contract to present~~ed~~ to the public as part the engaging entity's business is a key consideration in determining whose business they are serving in.'

As currently worded, this factor incorrectly emphasises consideration of how the contract is performed in practice and more closely aligns with the kinds of considerations that are important in the context of determining vicarious liability of the principal per *Hollis*.[14] Our recommended amendment shifts the focus to the examination of the rights and obligations established in the contract.

[14] Ibid, at 83.

Paragraph 46

Feedback from our committee members suggests that the example given in paragraph 46 of the draft TR in practice, reflects only limited circumstances though it appears to suggest a standard that is more common. A core feature of the employer–employee relationship is that the employer retains a right of control no matter the extent of the practical area for operation of the right.[15] We are of the view that removing this paragraph will better align with the position at general law as confirmed in *Personnel Contracting*.

Alternatively, we consider that the paragraph should be amended to clarify that it covers an exceptional circumstance and will not apply in all situations. Below we have recommended alternate wording that we consider will achieve this (our suggested changes are in red):

> Generally, a~~A~~n employer ~~may not always~~ retains a right to control how, when and where work is performed; however, different kinds of control may be contractually available depending on the nature of the arrangement. For example, in ~~the nature of~~ a casual employment arrangement, in its ordinary sense, ~~means that it is likely that~~ the employee retains control over when or for how long they work for an employer, because the employee may refuse a particular offer of work under their casual employment arrangement.

Paragraph 65

Paragraph 65 suggests that only an employee (and not a contractor) can be reimbursed for expenses. This is not correct. A contractor can be reimbursed for their expenses. The examination of a reimbursement can, in some instances, assist in characterising the overall contract. For example, a reimbursement under the terms of the contract may highlight that the worker is not being engaged as part of the worker's own business. However, if all other factors provided in the contract point towards a contractor relationship, the mere reimbursement of certain expenses of itself should not alter that characterisation. We consider that paragraph 65 of the draft ruling should be amended as suggested below (and marked-up in Attachment 1) to better reflect this position (our suggestions are in red):

> Further, an employee~~, unlike an independent contractor,~~ can be reimbursed (or receive an allowance) for expenses incurred in the course of employment, including for the use of their own assets such as a car. In the examination of the contract as a whole, reimbursement of expenses of a putative contractor may support a characterisation of the relationship as one of employment, if other factors pointing to that characterisation are also present in the contract.

Draft Practical Compliance Guideline

Delineation of risk zones

Feedback from our committee members indicates that the difference between the risk zones is difficult to apply in practice. In particular, concerns have been raised that taxpayers will not be able to readily distinguish their arrangements between the 'very low risk' and 'low risk' zones. This may require an ATO engagement activity in order for a taxpayer to understand which risk zone their arrangement falls under, which to some extent defeats the purpose of a PCG.

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[15] *Zuijs v Wirth Brothers* (1955) 93 CLR 561, at 571.

We consider that the delineations between the various risk zones need to be clearer and provide taxpayers with greater certainty. It would be beneficial if the requirements of the risk zones could be based on demonstrable factors that taxpayers can readily evidence. Further, and similar to the points raised above with respect to the draft TR, in our view, there should be greater emphasis placed on the High Court's recent decisions regarding the importance of the existence of a contract (particularly if it is a comprehensive written contract).

Practically, the ATO's assessment of 'very low risk' to 'high risk' arrangements appears to focus compliance resources towards confirming requirements that may not be driving factors of the employee–contractor distinction following the decision in *Personnel Contracting*. These include the focus on how an arrangement is classified, and the post-contractual performance of the work. These and other factors are discussed under the subheadings below. If the ATO does not strictly follow the precedent set by *Personnel Contracting*, this could result in significant ATO compliance resources focusing on post-contractual conduct that taxpayers and their advisors may argue is largely irrelevant.

As an alternative approach, we recommend the following framework for determining whether an arrangement falls into the 'very low risk' category:

- there is evidence of a comprehensive written agreement that was properly executed;
- the contract was not a sham, or otherwise ineffective at general law or under statute;
- a consideration of the legal rights and duties in the contract makes it clear that the worker is either an employee or a contractor; and
- in the case of a contractor, the worker has an ABN and carries on their own separate business.

We consider that this approach would provide greater certainty to taxpayers, allowing them to evidence their position with the contract and accompanying analysis. This approach is also consistent with the views of the majority in *Personnel Contracting*.

Role of labels

The first dot point in paragraph 24 of the draft PCG states that an arrangement will fall into the 'very low risk' zone if 'there is evidence to show that both parties agreed for the arrangement to have a given worker classification'. The High Court in *Personnel Contracting* has confirmed that labels used to describe the relevant relationships are rarely a relevant factor for consideration, even in instances where the analysis can reasonably lead to either conclusion. The current wording in the draft PCG may be misunderstood by taxpayers and tax practitioners as indicating that the label itself can be determinative. Accordingly, we recommend that the dot point be updated to focus on the mutual understanding of the roles and requirements under the contract indicating an employee or contractor relationship. Refer to our mark-ups at paragraph 24 of the draft PCG in Attachment 2.

We note the role of the parties' agreement of the classification of the worker is not limited to paragraph 24 of the PCG and occurs throughout. For the reasons above, we consider that examples and references to this phrase should be similarly removed or updated to reflect the High Court's position.

Deviation from contractual rights

The third dot point in paragraph 24 of the draft PCG states that an arrangement will fall into the 'very low risk' zone if:

> the performance of the arrangement has not deviated significantly from the contractual rights and obligations agreed to by the parties (including the actions outlined in Table 1 of this Guideline)

We consider that in light of the High Court's decision in *Personnel Contracting*, the focus on post-contractual performance should not be a relevant factor when determining whether ATO compliance action should be undertaken.[16] In practice, this requirement will likely require ATO staff to ask a multitude of questions to establish how the contract was actually performed to determine whether it deviated from the written contract. This type of analysis is inconsistent with the High Court's approach to how these matters should be determined.[17] Accordingly, we recommend that this requirement be removed.

Employer responsibility for monitoring contractor's personal tax arrangements

In addition to emphasising the need for no deviation of the contract, paragraph 34 of the draft PCG, dot point 3 also implies that the business is responsible for ensuring that a contractor is complying with their Australian Business Number registration and tax obligations. We consider this to be an unreasonable burden on business that engage contractors. Moreover, under confidentiality and privacy laws, this would not be practically feasible to do in any event.

A business engaging a contractor should not be responsible for monitoring the contractor's compliance with their tax obligations. Those steps are beyond the expertise or general legislative obligations for parties. Non-compliance by the contractor should not impact the business' risk rating, unless the business was complicit in the non-compliance. We therefore recommend that Example 1 be amended to remove this aspect (refer our mark-up at paragraph 34 of Attachment 2).

Seeking advice

The very low, low and medium-risk zones all require the employer to seek qualifying advice on the nature of the worker's engagement. Feedback from our members indicates that this requirement will be financially onerous for many smaller businesses that may find their arrangements categorised as high-risk, even where all other evidence otherwise indicates a lower risk arrangement. We consider that this requirement should be removed from the medium risk zone to more appropriately categorise arrangements by risk.

Alternatively, there may be other avenues to provide greater assurance for taxpayers through other ATO guidance and tools. For example, designing a stronger, more reliable employee/contractor decision-making tool that requires taxpayers or tax practitioners to provide all of the necessary information upfront may encourage more accurate record keeping and reduce occasions for potential disputes.

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[16] Ibid, at 176.

[17] Ibid, at 33 and 176.

Leveraging bargaining power

The fourth dot point of paragraph 30 of the draft PCG states that one party being coerced into accepting the arrangement as being a particular classification is indicative of a high-risk scenario. Feedback from our committee members suggests that in practice it may be difficult to distinguish between coercion and an instance where one party merely has a bargaining advantage. Bargaining advantage or disadvantage is not a relevant factor as confirmed by the High Court in *Personnel Contracting.* It is not uncommon for parties to lawfully leverage their bargaining advantage in the negotiation of contracts with the intention that the terms of the contract will be followed.

We consider that an approach which places the leverage of bargaining power in a high-risk category is not indicative of commercial realties. It is also inconsistent with recent case law, which holds that unfair bargaining power is not generally relevant to an analysis of legal rights in the contract.[18] For these reasons we consider that this dot point should be removed as an indicator of a high-risk transaction. See our mark-up in Attachment 2.

[18] See *Jamsek,* at 6, 8 and 62; and *Personnel Contracting,* at 58.

APPENDIX B

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge and learning.

We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.