

Employee or Contractor – understanding the issues and potential pitfalls.

Contracting is growing rapidly in Australia – it provides the contractor with an independence they can't get as an employee, and it allows the "employer" (the business receiving the services) to minimise their exposure to the administrative and legal issues associated with employees. However, there are many traps and pitfalls to navigate to avoid a contracting disaster.

The difference between an employee and an independent contractor has been an issue of confusion for some time. It has been an area of focus for the States and Territories as it potentially impacts both Payroll Tax and Workers Compensation. More recently the Australian Taxation Office (ATO) has increased their focus in this area due to the potential issues with the Superannuation Guarantee scheme and Pay As You Go (PAYG) Withholding.

The key factors that distinguish an employee from a contractor

Contracting has become a common alternative to the traditional employment relationship. A contractor can be engaged directly (as an individual/sole trader), or through an entity (a trust, partnership or company).

The first key factor to understand is the type of entity that is contracting to you.

If the entity contracting to you is either a trust, partnership or company, is quoting a valid ABN and the contracting arrangement is not a sham, then in most cases the contracting relationship will not be caught for the purposes of superannuation, PAYG withholding, or workers compensation.

Payroll tax may still apply (excluding Not for Profit organisations that have been granted appropriate exemptions), as in most States and Territories, there are

now specific contractor provisions which deem payments to contractors to be part of 'taxable wages' regardless of the type of contracting entity.

If the entity contracting to you is an individual / sole trader, then there are various indicators that will be considered at law in determining whether that person is an independent contractor or an employee.

It is always best practice to record the terms of any engagement in a written contract before the engagement commences, and have both parties sign it. This ensures that the terms of the contracting relationship are clearly defined.

It is not uncommon to engage an individual to perform work and, due to time or other pressures for the work to be performed, fail to record the terms of the engagement in a written contract. Even if you have already engaged the individual, it is not too late to enter a written contract, and acknowledge that the contract has already commenced.

The table below includes some of the most common indicators considered when evaluating whether an individual is an employee or an independent contractor:

Indicator	Employee	Independent Contractor
Degree of control over how work is performed	Performs work, under the direction and control of their employer, on an ongoing basis.	Has a high level of control in how the work is done.
Hours of work	Generally works standard or set hours (note: a casual employee's hours may vary from week to week).	Under agreement, decides what hours to work to complete the specific task.
Expectation of work	Usually has an ongoing expectation of work. (note: some employees may be engaged for a specific task or specific period).	Usually engaged for a specific task.
Risk	Bears no financial risk (this is the responsibility of their employer).	Bears the risk for making a profit or loss on each task. Usually bears responsibility and liability for poor work or injury sustained while performing the task. As such, contractors generally have their own insurance policy.
Superannuation	Entitled to have superannuation contributions paid into a nominated superannuation fund by their employer.	Pays their own superannuation (note: in some circumstances independent contractors may be entitled to be paid superannuation contributions).
Tools and equipment	Tools and equipment are generally provided by the employer, or a tool allowance is provided.	Uses their own tools and equipment
Tax	Has income tax deducted by their employer.	Pays their own tax and GST to the Australian Taxation Office.
Method of payment	Paid regularly (for example, weekly/fortnightly/monthly).	Has obtained an ABN and submits an invoice for work completed or is paid at the end of the contract or project.
Leave	Entitled to receive paid leave (for example, annual leave, personal/carers' leave, long service leave) or receive a loading in lieu of leave entitlements in the case of casual employees.	Does not receive paid leave.

Source: Fair Work Ombudsman

The ATO also provides an online tool to assist with understanding whether an individual will be an employee or an independent contractor. This can be found at www.ato.gov.au/Business/Employee-or-contractor/

Ultimately, the issues surrounding employees and contractors can be complex. Even after taking into consideration all of the resources available, such as the ATO online tool and the information and fact sheets provided by the Fair Work Ombudsman, it is still prudent to consult with a tax specialist or advisor as they are in the best position to apply the law and provide you with the appropriate advice for your situation.

What are the potential penalties if you treat an employee as a contractor?

Where an employee is incorrectly treated as a contractor, there can be serious penalties.

If you consider the way a typical employee is paid, they receive an amount each pay period which is net of Pay As You Go Withholding tax (that the employer remits directly to the ATO) and Superannuation Guarantee (which the employer remits directly to the employee's super fund at least quarterly).

A contractor, on the other hand, is paid the full amount for their services on any engagement – i.e. no withholding of tax or allowance for superannuation.

If, through a review or audit, the ATO determines that a contractor was actually an employee, they may assess amounts against the employer for the PAYG

withholding that should have been withheld from the employee's wages and superannuation that should have been paid on the employee's wages. They may then add other penalty and interest amounts to these liabilities.

These amounts of PAYG withholding, superannuation, penalties and interest can double and in extreme cases even triple the original cost of the contractor.

For this reason, it is vital to take every action available to you to minimise the chance of incorrectly treating an employee as being an independent contractor.

What to do if your contractor is probably an employee ?

Where you have a contractor who would more likely be considered to be an employee, then it is important to address the following issues :-

1. Superannuation – they may be entitled to superannuation. Superannuation is currently calculated at a rate of 9.5% on “ordinary times earnings”
2. PAYG withholding – you may need to withhold tax from their payments and report to the ATO
3. Payroll Tax – ensure that you are including the contractor in your calculation of “taxable wages” for payroll tax purposes
4. Workers compensation – include the contractor in your workers compensation calculations and reporting.

“Contracting is becoming increasingly common as it can provide desirable outcomes for both the contractor and the employer. However, getting it wrong can have severe, even business-ending, financial consequences. Take the steps to get it right so that you actually enjoy the benefits of contracting.”



JULIAN NICHOLS