

# Employees vs Contractors: Key Insights to Avoid Common Errors



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## The Current Tax Landscape for Employers

The Australian Taxation Office (ATO) and State Revenue authorities are getting more sophisticated at identifying and investigating non-compliant employers, with improved data-matching capabilities and increased audit activity.

From a tax perspective, the question of whether an employee or contractor relationship exists is not always clear. In these cases, a careful analysis of various factors by a tax professional is strongly recommended to determine whether an employee or contractor classification applies. Knowing the difference is important because it impacts:

- Pay-As-You-Go Withholding (PAYGW)
- Worker's Compensation Insurance
- Fringe Benefits Tax
- Superannuation Guarantee (SG) Contributions
- Payroll Tax.

Employers that fail to comply with their employer obligations could potentially find themselves with significant unfunded tax liabilities and penalties. It is therefore critical for employers to understand their employment tax risks and obligations and take steps to manage them.

## Key Differences Between Employees and Independent Contractors

If you are looking to engage an independent contractor, it is important to first become familiar with some of the key factors and risks involved in implementing such a relationship. No single factor is determinative or exhaustive of the relationship and the totality of the arrangement needs to be considered as a whole. You must also look beyond any contractual descriptions to the real substance of the relationship. A few of the main factors are outlined below:

**Control:** In an employment relationship, the employer generally dictates when and how the employee works, while an independent contractor has the necessary experience, expertise and autonomy to be able to run their 'business' the way they deem fit. This also includes having the ability to subcontract or engage their own employees to perform work for them.

**Method of payment:** Employees are usually paid a fixed rate such as a salary, or an hourly/weekly rate, while independent contractors generally submit invoices for specific work performed or projects under a negotiated contract price. Employees may be paid for the time worked or even a fixed price per item/activity (including commission arrangements) while independent contractors are often only remunerated when a specified result is produced or achieved.

**Independence:** A worker that is considered as forming part of or 'integrated' into the business of the payer is indicative of an employment relationship. In contrast, a genuine independent contractor provides services in the course of carrying on their own business and could be expected to generate goodwill in their own right. Further, independent contractors should not be locked into an arrangement where they are prevented from providing services to other businesses. They should also have the flexibility to decide when they are available or not available to perform work.

**Risk:** Employees generally bear little or no risk for services they provide under their contract, while an independent contractor is usually liable for any defects or damages that may arise from their work. The higher the degree to which a worker is exposed to the risk of commercial loss or profit, the higher the likelihood they would be considered independent contractors.

**Equipment:** Contractors usually provide all or most of the equipment, tools and other assets required to complete the work while employees are provided with or reimbursed for the cost of these items by the business engaging their services.

### Common Errors and Misconceptions

- Arguably the most common misconception around classifying workers is the belief that if one has an ABN then they are automatically an independent contractor.
- Similarly, simply classifying your worker as an independent contractor, and providing a written independent contractor agreement, will not suffice.
- Just because your worker wants to be engaged as an independent contractor, does not completely remove you from any potential financial or legal liability should the arrangement be deemed illegitimate by the relevant authorities.
- Industry convention, i.e. "everyone else is doing it", is not reason enough to classify your worker as an independent contractor.
- The definitions of employee and contractor are not necessarily the same for different tax purposes. These discrepancies can sometimes lead to inconsistent tax obligations for employers between PAYGW, SG contributions and payroll tax.

### The Ramifications of Getting it Wrong

If a contractor is found to be an employee, the employer may be liable to back pay leave and other employee entitlements such as superannuation. Importantly, there is no statute of limitations for an employer's SG obligations. Employers may also be liable to potential shortfalls of PAYGW, payroll tax and associated penalties that may be imposed by the relevant authorities. Directors can be held personally liable for unpaid PAYGW and superannuation under the Director Penalty Regime.

Unpaid superannuation has been a key ATO audit risk area for the last few years. This means the ATO will continue to target arrangements with workers that are incorrectly treated as contractors by their employers and should be entitled to SG support. The minimum level of SG contributions for employees is currently 9.5% (for 2020/21) but this is due to increase to 12% by 2025/26.

Businesses also need to be mindful of the inherent risk of disgruntled contractors (both present and former) raising claims for employee entitlements with the ATO or Fair Work Ombudsman.

The Fair Work Act 2009 provides protections for workers who are incorrectly classified as an independent contractor when they are not, which is commonly referred to as "sham contracting". This protection includes dismissing an employee for the purposes of re-engaging them as a contractor and making false or misleading statements to an employee to persuade them to enter a contract for services when the role will remain similar or the same to that of an employee. Employers who are found to have intentionally established a sham contracting arrangement can face penalties of up to \$63,000 per contravention.

### How to Get it Right

It is never too late to check your arrangements with workers to ensure they are legally compliant and valid. The ATO website contains useful general information as well as an online tool to help determine whether your worker is a contractor or an employee.



For further information regarding your tax and super obligations, speak to your Nexia advisor.

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