



Tax Working Group
Te Awheawhe Tāke

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This paper has been prepared by the independent advisor to the Tax Working Group for consideration by the whole Group.

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Taxation of Labour

I am very supportive of the work previously and currently being undertaken by Inland Revenue on the extension of withholding taxes and possible proposals for an increase in reporting on payments to contractors.

However for the purposes of the TWG I am of the view that this could go further. The TWG is charged with looking out over time to ensure the sustainability of the tax base.

What is clear from the increase in regulation around employment, the decline of unions and the increase in technology; is that traditional employment patterns are breaking down albeit slowly. This was the basis of David Parker's private members bill while in Opposition to get the minimum wage paid to contractors who no longer have employment rights.¹

Similarly the recent controversy over zero hour contracts has showed that even employees can have very uncertain employment outcomes. And the drive to improve secondary tax comes from issues faced by employees with multiple jobs – either concurrently or sequentially - and/or the interface with the benefit system.

As the employment base becomes more unstable so does the tax base from labour. For that reason the recent initiatives by Inland Revenue to expand withholding and potentially increase reporting for contractors have merit in terms of preventing tax evasion and reducing the compliance costs associated with provisional tax.

However those initiatives follow the legal form – rather than the substance - of the employment or contractual relationships and simply look to ensure compliance with the existing rules.

The effect would be that – even with full compliance – in the event that the employment tax base ultimately became a contractor tax base; there would be both a drop in revenue and an increase in compliance costs.

This is because employees are not entitled to claim employment related expenses or the associated GST input tax credits.²

This is not the case for any labour income earned outside employment. At the far end of this continuum is labour income earned by professional firms. They can employ or subcontract staff, use capital and can have multiple engagements at one time.

¹ https://www.parliament.nz/en/pb/hansard-debates/rhr/combined/HansDeb_20160810_20160810_16

² Employees are not entitled to deductions for employment related expenditure. This ability was removed in the 1980s. While unprincipled; it has compliance and administrative benefits for not having to deal with small claims and also removes the opportunity for fraudulent activity.

Similarly with GST. Employees are not permitted to register for GST. This stops the compliance costs of having to file GST returns and the risk of fraudulent claims. However it also means that the GST component of any work related expense is not claimable.

At the other end is a contractor to a government department or a vulnerable worker targeted by David Parker's bill. The contractor cannot employ or subcontract staff, uses no or negligible capital; is paid for their time not outputs and has a single engagement at a time. In the case of government departments such workers are reported to have cost \$500 million a year.³ Although that could be a mix of contractors and short term employees.

My concern is with the last case where it is pretty fungible whether a person is an employee or a contractor. These pseudo employees tend to be known as *dependent contractors*.

I accept that with correct compliance such additional loss of revenue is likely to be minimal on an individual basis: a phone, tablet and maybe some home office expenses. However spread across the current employment tax base; these costs are likely to be significant. I would also suggest that when this effect becomes obvious in the data it will be too late to change the treatment as the benefit of the deductions and input tax credits will have become the norm. That is if they haven't already.

In my view all the policy arguments for the current tax treatment of employees: reduction of compliance costs; certainty of revenue; reducing the opportunities for tax evasion apply equally to dependent contractors.

I note the secretariat's comments that such people could already meet the tests for an employee under the common law tests. I agree with the secretariat that this is entirely possible and would be a tidy solution for this issue. However in my view this would cause a great deal of upheaval for business as by definition all the current and past contracts would be subject to the tax treatment for employees with retrospective PAYE obligations; denial of deductions and deregistration from GST.

It would be good to seek more information from Inland Revenue on their approach with this issue.

If that proved to be the case, then my suggestion should take on a higher degree of urgency but on a prospective basis only.

I am proposing that the current tax treatment of employees become the tax treatment of (dependent) labour generally which would include employees and dependent contractors.

This would mean that all issues involving deductions etc could be considered in the round. That is if work related deductions are a policy issue for dependent contractors; they are equally an issue for employees.

It has been suggested to me that a better approach is that Inland Revenue monitors the situation and then recommends a change in approach if the issue escalates. That is one approach. I am not confident that a more uniform tax treatment will be possible if the

³ <http://nzh.tw/12075767>

practice escalates. My suggestion is that the TWG recommends that this approach be adopted/consulted on alongside Inland Revenue's existing work.

My comments on parts of the Secretariat note.

There are also a number of disadvantages:

- *Setting the standard for application of the rule by reference to capital employed or employees could result in taxpayers who are actually running a business being precluded from claiming deductions or registering for GST, this could create another inequity;*

If there are dependent contractors with similarities to employees that are actually running a business this is true. This would mean that the definition of dependent contractor had been drawn too widely. My view of a dependent contractor is a pseudo employee who is not in business.

This is not to say that I understate the issues involved in finding a definition. If the working group were sympathetic to a change in the taxation of dependent contractors I would be happy to work with officials on this.

- *It would introduce another fairly arbitrary border in attempting to define who is and who is not subject to the restriction with fairness and efficiency concerns around the border;*

There are always fairness and efficiency concerns around any border. This would be a case of shifting the border back to where it was arguably intended when the approach to deductions and GST was created in the 1980s.

- *It would mean that there are two boundaries, the current employee/contractor boundary and the new "dependent" contractor boundary which has the potential to increase compliance and administration costs;*

I don't see it that way. There would be a new definition that is true but this new group – dependent contractors - would join an existing classification of employees.

- *We also have concerns with such a rule that will at times go too far in denying deductions for expenses which are validly incurred in earning income;*

This is valid but must equally be an existing issue with employees. Perhaps then the response is to look that this issue broadly for both groups.

- *Although the rule would address a potential area of non-compliance by the self-employed (being the inflation of expenses) we do not have any evidence that this is a substantial contributor to non-compliance. The benefit of the work we are doing on information reporting and increased withholding taxes will ensure the self-employed*

are in the system and that will make our analytical investigation options for that group much more focused;

My suggestion is not based on the non-compliance of existing rules. My suggestion is based on compliance costs and sustainability of the labour tax base.

- *The removal of a small subgroup of contractors from the GST regime could also create a distortion in our GST framework by introducing unnecessary tax cascades in some cases.*

As with employees this is likely to be minimal and be far outweighed by the compliance cost benefits.

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The best way to illustrate the definitional issues is to look at some examples as to where such a rule might apply:

1. *Suppose that a government department is short of policy resource and obtains the services of a contractor on a 12 month contract. This is probably the clearest of the examples such a rule would be targeted at. The person is akin to an employee, they are doing the same tasks as those policy advisors who are employees and they use the resources of the payer.*

Say that contractor and the employee both are members of the same professional body. The contractor can claim a deduction for the membership fee yet the employee who does not have that reimbursed cannot claim that expense because of the prohibition on employee deductions.

A rule might be targeted at this type of unfairness. But this sort of extreme situation should be prevented by the current employee/contractor legislative boundary. The person is likely to be held to be an employee under those tests.

While strictly speaking such a person might indeed be an employee under the existing tests; I would argue that the practice is so widespread that Inland Revenue would not find enforcing this boundary sustainable without legislative change.

2. *A real estate agency contracts a sales person to join the team. The person is only paid by the commission they earn and are responsible for all their own expenses but pay a fee to the agency for some shared services. They don't have much capital employed in the business but might use a vehicle to travel to open homes etc.*

In this case the person is more akin to running their own business although they don't have a lot of capital employed in the business apart from a vehicle. This might be someone who might be described as a dependent contractor but it would seem that their expenses should be deductible.

This is a very good testing example as shows that a non-contingent payment for time is a key aspect of employment. That should be part of the definition of dependent contractor. As this person has their income at risk I would not see them as being a dependent contractor.

3. *An engineer sets up in business. She has a small number of clients and little capital invested apart from a small amount of office equipment. Should she be considered a “dependent” contractor and subject to the prohibition on expenses. In essence the only difference between her and a large engineering firm is scale but she is running a business.*

I agree she is running a professional services business and should not be a dependent contractor. While she is not employing staff, there is unlikely to be any contractual reason with any of her clients why she couldn't subcontract or have someone do the work that was under her supervision.

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