



*Tax Working Group*  
*Te Awheawhe Tāke*

**Tax Working Group Information Release**

**Release Document**

**September 2018**

**[taxworkinggroup.govt.nz/key-documents](http://taxworkinggroup.govt.nz/key-documents)**

*This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.*

*The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.*

# Dependent Contractors

---

## *Discussion Paper for the Tax Working Group*

### Purpose of paper

---

The independent advisor has suggested the Group should consider rules targeted at a subset of the self-employed. Specifically where the self-employed person has minimal capital invested in the business or has no employees. Where those criteria are met then:

- No deductions would be permitted against income; and
- The contractor would not be able to register for GST.

This rule would apply whether the self-employed person contracts through a company or on their own account.

There is a three-fold objective in such a rule:

- Partially address the issue identified in the VUW and Inland Revenue research into the underreporting of income by the self-employed by removing the ability for the self-employed to inflate their expenses;
- More closely align those self-employed who are in “dependent” type contractual relationship with employees – treating these self-employees as pseudo-employees – on equity grounds; and
- Reduce compliance costs of some self-employed by eliminating the need for them to register for GST.

### Officials’ comments

---

There are a number of advantages to such a rule including:

- Equalising the tax position between employees and those contractors who are pseudo-employees and have very few expenses in earning that income;
- Removing the ability for dependent contractors to inflate the claiming of expenses through not permitting them to claim expenses thus reducing the compliance gap of this group; and
- Reducing the compliance costs of the dependent contractors by removing them from the GST regime (again equalising the treatment of them with a similar employee).

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;

- 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;
- 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;
- 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;
- 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;
- 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.

### *Discussion*

To date there has been no material growth in the self-employed workforce in recent years. There is an expectation that the proportion of those who are self-employed will increase over time as more flexible ways of working are adopted. However, it is unlikely that increase will be in the long-term dependent contractor area but rather in those who are performing short-term assignments for multiple clients as those who choose to work within the gig economy increase. This has been the trend evidenced offshore in recent years.

In general, it is desirable to allow deductions for expenses incurred in producing income. Not doing so can be unfair and inefficient. People who earn expenses to produce income end up being taxed on more than their true income and have too little incentive to incur reasonable expenses to increase their income.

We deny deductions for most expenses for employees. This has costs and benefits. At times it will mean that deductions are denied for valid expenses incurred in producing income and employees have little incentive to incur these expenses. But allowing deductions here would add to compliance and administration costs and open up the possibility of a large number of expenditure claims many of which may be largely spurious.

While there is a logic in extending the rules to those who are dependent contractors who are close enough to employees, there is a danger of overreach and bringing in a new unclear borderline. Defining who is a dependent contractor and who is not and confining any restriction appropriately is not an easy task. Any new borderline is likely to be reasonably arbitrary and there will be boundary issues that may create more uncertainty and create new equity and efficiency issues. It would create a second boundary as the existing employee/contractor boundary would remain.

By way of background the current employee/contractor boundary essentially applies five tests to determine whether a person is an employee or contractor. Those tests are:

- Intention – what was the intention of the parties to the agreement – this is not necessarily what the contract says the relationship is but how it operates;
- Control – what is the degree of control the employer or principal exerts over the work the employee or contractor is to do and the manner in which it is done;
- Independence – The inverse of the control test – how independent is the worker from the employer or principal;
- Fundamental or business – Is the person who has engaged to perform the services performing them as a person in business or on their own account ? If yes, they are more likely to be a contractor;
- Integration test – whether the person is part and parcel of the organisation and not whether the work is necessary for the running of the business – for example is the type of work being done usually undertaken by employees.

The UK is currently looking at these same issues and we are keeping a watching brief on how their work on attempting to define the self-employed progresses but their inclination is not to define a group who is “self-employed” but rather continue to rely on an employee/contractor boundary (with the exception of service companies who contract to the UK government).

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.

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.

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.

We are not convinced that we can come up with a better boundary for when to allow deductions than the current employee/contractor boundary. Any new boundary we might insert seems likely to create new fairness and efficiency concerns close to the boundary. If contractors are incurring valid expenses associated with earning income it seem reasonable for them to be able to register for GST and claim input credits.

The work we are considering around the increased provision of information to Inland Revenue and the expansion of withholding taxes, as previously outlined in our *Future of Work* paper (summary attached as appendix one), should bring more people into compliance and this should enable our analytical work in this area to be more appropriately targeted. That should result in the issue of expense inflation (as well as underreporting) being addressed as well as providing better information to assess employee/contractor boundary issues.

# Appendix One - The Future of Work

---

## *Summary Paper for the Tax Working Group*

### Purpose of paper

---

The future of work paper outlined various issues in relation to the changing nature of work in New Zealand. Predominately, it addressed the expected increase in the number of people who will become self-employed in the future.

### Key points

---

- Since the 1950's, New Zealand has seen a change in the way in which workers have engaged with “employers”. This has moved from a more formal employee/employer relationship to a less formal contractual relationship in a number of cases.
- Evidence suggest that the number of self-employed workers have been relatively stable over the last ten years but experience offshore would suggest that the rise of the contractor and the gig economy in the future may put pressure on tax systems.
- There are various components to the future of work including:
  - Automation – mainly affecting the less skilled and those who cannot retrain;
  - Loss of tax revenue from labour – requiring replacement funding;
  - Outsourcing to other countries – moving jobs/tasks to low cost jurisdictions;
  - Rise of the gig economy – more self-employed workers.
- This shift in the labour model can create challenges for the future tax system by:
  - Reducing compliance – the self-employed are generally less compliant than those in an employee/employer relationship due to the increased ability to underreport/evade income or inflate expenses;
  - Increased administration costs – dealing with larger employers is low in administrative costs, as more become single workers those administration costs can rise;
  - Increased compliance costs – similar to administrative costs being higher an employee is relatively simple but becoming self-employed brings with it increased compliance costs for the person.
- Officials are working on a number of potential ideas to address the increase in the self-employed:
  - Increased information reporting to Inland Revenue from payers and platforms.
    - Information reporting to tax authorities generally leads to increased compliance;
  - Potential extension of withholding taxes by payers and platforms.
    - Both targeted to problem areas and potentially more generally to dependent contractors; and
  - Providing third parties opportunity to support compliance.
    - Allowing third parties to meet the tax obligations for the individual contractor reducing both administrative and compliance costs.