

Rorts & loopholes

Tax evasion, avoidance & tax breaks

ACTU Working Australia Tax Paper No. 3



Working for a better life.

ACTU
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September 2011

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The ACTU

The Australian Council of Trade Unions is the nation's peak body for organised labour, representing Australian workers and their families.

Any inquiries about this report should be directed to the ACTU on (03) 9664 7333, or help@actu.org.au

The Working Australia Papers

The Working Australia Papers are an initiative of the ACTU to give working people a stronger voice about social and economic policy. Although low and middle income Australians ultimately bear the costs of poor policy decisions made in relation to tax, infrastructure, retirement incomes, welfare, and services, their voice is too often absent from national debates about these issues.

This paper has been researched and written by Director Industrial & Policy, Joel Fetter.

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The ACTU Tax Papers

Tax is always a hot political topic, but the Government's announcement that it will hold a Tax Forum has helped put the tax debate on the front pages. The tax debate in Australia tends to be one-sided. Well-funded business groups make a self-interested case for cuts to business tax, or regressive personal income tax changes, and are given extensive coverage by the media. Such proposals for "reform" are treated as self-evidently good things, with little evaluation of competing ideas. False or misleading claims about the tax system are sometimes presented as facts.

There is a need to push back against the misleading claims and self-interested demands of the typical participants in the tax debate. As the peak council for working Australians and their unions, the ACTU is in a strong position to provide such balance, by advocating for tax reform in the interests of low- and middle-income people and for Australian society more broadly. After all, around half of all federal tax revenue is raised directly from individuals, with workers also paying GST and other indirect taxes. The tax system affects and belongs to all of us, so it's important that working Australians have a voice on this important topic.

This series of discussion papers represents one part of the ACTU's participation in the tax debate. The papers will examine:

- The facts about the Australian tax system, drawing comparisons over time and with other countries;
- Australians' preferences for their tax system and society;
- The appropriateness of the current cap on taxes as a proportion of GDP, and the challenges that will be encountered by Australian society as the population ages;
- The need for further progressive reform of the personal income tax system that supports and encourages workforce participation;
- The truth about business taxation, and the need to ensure that the tax system supports jobs while requiring corporations to pay their fair share; and
- The ways that loopholes in the tax system mean that ordinary working Australians pay higher taxes than those who can disguise their income through arrangements like sham contracting.

This is the third paper in the series.

JEFF LAWRENCE
Secretary, Australian Council of Trade Unions
September 2011

Executive summary

This Working Australia tax paper examines the extent to which tax evasion, tax avoidance and tax breaks are used by certain groups to minimise their taxes (legally or illegally). Our findings are as follows:

Wealthy Australians

- Wealthy people use various devices and tax breaks to reduce their marginal tax rate from 46.5% to 30%, 15% or even a negative tax. This costs \$22 billion per year.
- Wealthy people avoid \$1 billion in taxes each year. A further \$3 billion has been found in offshore tax havens under Project Wickenby.
- Many wealthy people abuse self-managed superannuation funds to evade or avoid tax.

Large corporations

- Companies use deductions and tax breaks to lower their effective tax rates from 30%. The mining industry receives up to \$10 billion in tax breaks each year and so only pays 19% of profits in company tax.
- Many large companies artificially shift profits between companies within Australia, or offshore, to legally avoid paying taxes. This costs the government billions of dollars each year.

Small business

- Many small businesses fail to declare income, fail to pass on GST collections, or claim false tax deductions. This costs the government more than \$10 billion each year.
- Each year, around 30,000 small businesses are caught failing to make \$300 million in superannuation contributions on behalf of their employees.

Contractors

- Most contractors fail to declare their income properly or at all, avoiding almost \$20,000 in tax on average. This costs the government up to \$17 billion per annum.
- Ninety-one percent of contractors who fill in a tax return declare they are genuine contractors, even though ABS data shows that at least 40% are sham contractors.
- Contractors who declare they are genuine are allowed to use companies and trusts to minimise their tax legally. This costs the government billions of dollars each year.

In light of these findings, the ACTU calls on the government to consider a range of measures to crack down on tax evasion and avoidance, including a 'Buffett rule' to ensure that high-income earners pay at least the same average rates of tax as middle-income earners.

1. Introduction

The first Working Australia Tax Paper examined the myths and realities of the Australian tax system. It demonstrated that, contrary to much rhetoric, Australia is actually a low-tax country. Other papers in the series deal specifically with corporate and personal income taxes.

In this paper, we look at who *doesn't* pay tax, because of tax evasion, tax avoidance, or tax breaks.

Tax evasion is the failure to pay the tax that one is legally obliged to pay – for example, by not reporting income. It is illegal. The crime of 'obtaining a financial advantage by deception' carries a maximum penalty of 10 years' imprisonment.¹

Tax avoidance is the deliberate structuring of lawful transactions so as to minimise the amount of tax which one will become legally obliged to pay. Tax avoidance is not technically unlawful,² although where the 'sole or dominant purpose' of the scheme is to obtain a tax benefit, the ATO can recover any tax avoided, plus interest, and can impose an amount of penalty tax. This penalty ranges from 5% of the tax shortfall (in cases of failure to take reasonable care in applying the tax laws, and where the taxpayer admits the avoidance before an audit commences) to 90% of the unpaid tax amount (in cases of intentional disregard of the law, and where the taxpayer fails to cooperate with the ATO).

Tax breaks are tax exemptions or concessions that are granted by Parliament to certain groups, for economic, social or — more commonly — political reasons. Since they reduce the tax that would otherwise be payable by the group, and the revenue the government would otherwise receive, these 'tax expenditures' are economically equivalent to direct subsidies provided by government out of general revenue, even though they do not appear as such in the government's budget.

There is significant overlap between these categories. Lawful tax minimisation strategies (including taking advantage of tax breaks) can shade into impermissible tax avoidance, which shades into tax evasion.

In any event, it is not appropriate to simply assert that any conduct that is not illegal is legitimate. There is a strong public interest in ensuring that all taxpayers not only pay their lawful share of tax (in the sense of what they are legally obliged to pay), but also that they pay their *proper* share of tax too — in the sense that the actual rates of tax paid should match the rates intended by the Parliament. In other words, taxpayers should not be able to access tax breaks, deductions, and

¹ *Commonwealth Criminal Code*, section 134.2.

² Except for 'bottom of the harbour' schemes: *Crimes (Taxation Offences) Act 1980* (Cth).

artificial business structures to reduce their effective levels of taxation far below the levels intended by Parliament: 30% for companies, 30.5% for high-income earners, and so forth.³

The reasons why everybody needs to pay their share of tax include:

- **Sustainability** – both tax evasion and minimisation (including tax avoidance and tax breaks) reduce the revenue available to government. As this increases, the tax base becomes more fragile, and government activities become less sustainable in the long term;
- **Equity** – if some taxpayers can evade or minimise their taxes, but others cannot, this distorts the equity of the tax system. Those who do not evade or minimise tax end up paying more than they would need to if everybody paid their proper share;
- **Efficiency** – wealthy taxpayers and companies can afford to hire lawyers, accountants and tax agents simply to avoid or minimise taxes. This diverts investment away from productive activities, towards unproductive rent-seeking, thereby reducing economic efficiency;
- **Public confidence** – tax rorts undermine faith in the system and are more likely to “normalise” avoidance. Once tax cheating becomes entrenched, it becomes difficult to stop; it can also spread to other areas where people interact with government, or with each other.

In this paper we will focus on the activity of a number of groups where tax evasion, avoidance, and/or tax breaks are problematic: wealthy individuals; large corporations; small businesses and contractors. These groups have access to a range of tax minimising devices (including the use of companies and trusts) that ordinary employees do not.

We argue that there is a strong public interest in ensuring that these groups pay both their lawful share as well as their ‘proper’ share of tax. To this end, the ACTU believes that the government should consider:

- Cracking down on criminal tax evasion by wealthy Australians, small businesses and contractors, and increase jail terms;
- Closing loopholes and concessions that allow big companies to minimise their taxes legally, particularly multi-national companies;
- Introducing a ‘Buffett rule’ (or Alternative Minimum Tax rule) to ensure that very high-income earners pay at least the same average rates of tax as middle-income earners;
- Making deliberate tax avoidance a civil wrong (punishable by a fine), with public disclosure of the names of those prosecuted, and with court decisions published;

³ Average tax rates for a person earning \$150,000, including the Medicare levy.

-
- Changing the rules so that wealthy Australians, small businesses, and contractors are not able to use companies and trusts to minimise their taxes;
 - Tightening the definition of who is a 'genuine' contractor under tax laws, and require contractors' clients to report fees paid to the tax office; and
 - Providing additional resources to the tax office to ensure that tax cheats are caught.

After all, if the government were able to stop tax evasion and avoidance, and collect the intended amount of tax from wealthy Australians, large companies, small business and contractors, it would be able to provide greater investment in the high-quality public services that the general community demands. It would also deliver a more equitable and progressive tax system.

2. Wealthy Australians' attitudes towards tax

In the first Working Australia Tax Series paper, we showed that Australia is a relatively lowly taxed country and that our tax system is only weakly progressive. As a result, we are a much more unequal country than most people think. Despite this, most people want a fairer society. They support giving tax cuts to lower and middle income earners, and increasing tax on the rich, in order to fund better government services.

However, these surveys were of the general population. It is clear that some people want to pay less tax, even if this means fewer services and a more unequal society. Wealthy people are more likely to hold such views than the general population.

A 2007 survey conducted for the ATO shows that:⁴

- only 65% of high earners (earning over \$200,000 per annum) strongly agreed that it was their duty to the wider community to meet their tax obligations, compared to 78% of those earning under \$100,000;
- 43% of high earners look for ways to pay 'less tax than they should', compared to 35% of the general population;
- 28% of people earning more than \$200,000 per annum know 'a lot' about how to reduce their taxes, compared to 11% of all people; and
- 34% of high earners have been recommended schemes to avoid tax, compared to 18% of the general population.

The ATO also commissioned qualitative research into the attitudes of high earners (earning more than \$80,000 per annum) and high net wealth holders, as well as the accountants, lawyers and others that advise them, towards tax and tax evasion.⁵ The results are very interesting.

⁴ DBM Consultants, *Project Wickenby General Community Survey: Final Report* (2008) 49.

⁵ DBM Consultants, *Project Wickenby: Initial Qualitative Exploratory Research* (2007).

Firstly, there was a widespread view that wealthy individuals and companies were avoiding or evading tax. Many people in the focus groups had personal experience of this:

“A lot of the business people who I’ve dealt with and the big CEOs, etc, they automatically just bring out their Visa, Amex or whatever card and pay \$40K because they can and because that bank account is actually overseas. And so they haven’t paid any tax on it, and it makes it a lot easier for them to manipulate the system ... the trouble is that the banking system makes it so easy to do it” (High income)

“One of the companies I worked at, they had one (off-shore scheme). They legislated against that ... so it became useless. We used to run certain services through it, because the tax was something like 15% ...” (High income)

“Anyone who is a senior person with their own company will make sure that they don’t pay themselves much... so they pay themselves lesser amounts and shift the money into their company and take the money via dividends through their company” (High net worth)

Secondly, there was a view that much of the evasion or avoidance was achieved by the use of networks of lawyers or accountants who exploited tax rules and loopholes:

“Tax minimisation is a topic of conversation around the BBQ and they would have full access to the sort of people that can facilitate that sort of thing ... to make that work that stuff worthwhile you have to be extraordinarily wealthy and have off-shore income” (High net worth)

Thirdly, people suggested a range of motivations for why wealthy people would seek to avoid or evade tax, ranging from greed and a sense of entitlement, to unthinking peer group behaviour, to calculated risk-taking:

“These people that earn a million or two million dollars a year are perfectly convinced that they earn that because they’re so much more able and entitled to that than those who don’t, so they honestly do feel ‘well that’s alright for everyone else, but we’re pretty special’ (High income)

“A lot of people with a lot of money - entertainers... sportsmen often move in similar circles to each other and you only need one to say oh I have got a great solicitor or I have got a great accountant who can save me a bucket load in tax and they say oh really how do they do that... oh well they may do this or may do that and ok well maybe I better talk to them ... the same way that people obtain drugs” (Financial planner)

“They’ve got so much, 10 or 20 million. You can lose 4 and still have 16. Spend half a million for 20 years and you’re not going to go broke ... they are able to recover. They are risk takers” (High income)

The ATO’s quantitative research validates these views. The general community view is that greed motivates tax evasion (given by 69% of all respondents, including 79% of professionals, not necessarily all high-paid). However, respondents in managerial roles were more likely to give other excuses, such as: ‘a perception that they are paying more than their fair share of tax’ (13%, versus 5% of professionals); ‘saving money’ (8%, versus 2% of professionals); and ‘it’s human nature; nobody wants to pay tax’ (5%, compared to 1% of the general community).⁶

Finally, many wealthy tax evaders are not scared of getting caught. One accountant interviewed in the qualitative study said:

“I don’t know what the penalties are and I don’t think anyone would know ... they aren’t a serious deterrent if you don’t know about them ... If someone got 10 years jail for tax avoidance I think people would file that away in the memory bank for future reference. I’m not aware of any cases where the ATO has actually prosecuted anyone for serious avoidance or evasions.” (Accountant)

What this research shows is that many wealthy people do, indeed, seek to evade or avoid paying tax. This fact is appreciated by the rest of the community. In a recent survey, 57% of ordinary taxpayers strongly agreed with the statement that the tax system ‘allows a substantial number of people to legally avoid paying their fair share of tax due to the availability of sophisticated, artificial tax schemes’, and only 4% of people strongly disagreed with it.⁷

This is very dangerous. There is a real risk that if wealthy people are seen to evade or avoid taxes, the fairness of the whole tax system will be called into question, and non-compliance will become widespread, crippling the government’s ability to raise revenue, and increasing inequality in society.

Unfortunately, the attitude of wealthy Australians towards tax is best summed up by the well-known views of the late Kerry Packer, once Australia’s richest man. He famously said: ‘[O]f course I am minimising my tax, and if anybody in this country doesn’t minimise their tax, they want their heads read.’⁸ The irony is, of course, that most Australians citizens (and most businesses) do not have

⁶ DBM Consultants, above n 4, 59.

⁷ Ken Devos, ‘Tax Evasion Behaviour and Demographic Factors: An Exploratory Study in Australia’ (2008) 18 *Revenue Law Journal* 1.

⁸ Said to the House of Representatives Select Committee on the Print Media, Inquiry into the Australian Print Media Industry (4 Nov 1991).

access to the expensive advice and legal structures (such as companies and trusts) that enable the apparently 'legal' tax minimisation that Mr Packer was advocating.

In contrast with Mr Packer's views on tax, many super-wealthy people overseas (including Warren Buffett in the USA, and L'Oréal heiress Liliane Bettencourt in France) have recently expressed their public support for rich people to pay more tax.⁹ In contrast, Australian billionaires have not just been conspicuously silent in their response, but have been vocal in opposing taxation.

⁹ 'L'Oréal heiress Liliane Bettencourt and French high earners call for more tax' (23 Aug 11) *The Telegraph* (UK); Graeme Weardon, 'Warren Buffett calls for higher taxes for US super-rich' (15 Aug 11) *The Guardian* (UK)

3. Wealthy individuals

Introduction

In this section we show how many wealthy Australians minimise their tax through dubious means: some legal, some illegal, some of uncertain legal status.

Favourite strategies include: using companies and trusts to minimise tax; shifting assets to offshore tax havens; and abuse of self-managed superannuation funds.

The size of the leakage from the tax system in this area amounts to tens of billions of dollars each year.

We also show that the vast majority of wealthy tax cheats avoid being publicly identified, let alone prosecuted. They are let off with a modest 'tax penalty', with no further consequences.

Tax breaks

The tax laws do not treat all forms of income and all expenses in the same way. Wealthy individuals have the incentive and the means to reduce their taxation liabilities, by taking advantage of this phenomenon. There are a number of strategies used. Assets can be placed in companies or family trusts, allowing for income splitting and income deferral, which leads to favourable tax treatment. Executives can take their salaries in shares, rather than as wages, and enjoy concessional capital gains tax treatment. Obscure tax loopholes can be found by expensive tax lawyers and accountants, and generous tax concessions (for certain categories of investments) can be exploited.

All of these strategies lower the average rate of tax paid by the wealthy. This is most obvious in America. In 2010, American billionaire Warren Buffett admitted he paid an average tax rate of 17.4 percent on his personal income of US\$40 million, while his office staff, earning around US\$60,000 per annum, faced tax rates of 33 to 41 percent.¹⁰ The main reason why Mr Buffett was able to minimise his taxes was concessional treatment of capital gains; this is a problem in Australia too, as we discuss below. The Obama administration has now responded by proposing an 'Alternative Minimum Tax — or as he calls it, the 'Buffett rule' — which will ensure that high income earners pay at least the rates of tax faced by middle income earners.¹¹

ACOSS has analysed the different tax breaks that wealthy Australians are able to access. They estimate that these cost the government \$22.3 billion each year in revenue foregone. The table

¹⁰ Warren Buffett, 'Stop Coddling the Super-Rich' (14 Aug 2011) *New York Times*.

¹¹ Jackie Calmes, 'Obama Tax Plan Would Ask More of Millionaires' (17 Sept 2011) *New York Times*.

below sets out some of the common tax breaks and deductions, with the amount of revenue lost for each item. The table shows that wealthy Australians can ensure that the income they receive is taxed at 23% or 30% instead of their marginal tax rate, which might be as high as 45%.¹²

	Tax rate ¹³	Tax revenue foregone
Income		
Capital gains	23%	\$8.6 billion
Capital gains – small business	0% (if proceeds used for retirement); 11% otherwise	\$1.0 billion
Termination payments	Usually 15% (if over 55); otherwise 30%	\$1.5 billion
Income received through a company	30%	\$1.3 billion
Income received through a trust	Depends on the structure and beneficiaries. May be as low as 0%.	\$1.0 billion
Expenses		
Deduction for investment expenses (eg loans)	–45%	\$4.0 billion
Rebate for private health insurance premiums	–30%	\$4.9 billion

While these tax breaks may be legal, and the result of deliberate policy choices made by governments, it needs to be realised that they disproportionately benefit the wealthy and mean that they do not pay their fair share of tax. The net effect is that wealthy people can avoid paying tax at their ordinary marginal tax rate, the same advantages are not available to low and middle income earners.

Economist Saul Eslake of the Grattan Institute has said this of the Australian tax system:¹⁴

[If] you hired a consultant to advise you how to create a taxation system that encouraged the accumulation of wealth through borrowing and speculating, whilst penalizing the accumulation of wealth through working and saving, the consultant would hand you a copy

¹² Adapted from P Davidson, 'Tax Reform Agenda 1: Personal Income Tax' (2011) 4 *In Sight* [Victorian Council of Social Services magazine] 9, Table 1.

¹³ Assuming a marginal tax rate of 45%.

¹⁴ 'Australia's Tax Reform Challenge' (21 Sept 2011) Australian Parliamentary Library Lecture, 3.

of the Australian Income Tax Assessment Act – because that’s precisely what Australia’s income tax system (in particular) does.

Tax avoidance

As well as taking advantage of tax breaks, it is clear that wealthy Australians also engage in widespread tax avoidance. Some hints of the scale of this activity come from the ATO’s compliance activities.

Each year, the ATO plans to recover:¹⁵

- around \$800 million in unpaid taxes from audits of 650 ‘highly wealthy’ Australians (with over \$30 million in assets), or \$1.2 million per person on average;
- around \$25 million from audits of 600 merely ‘wealthy’ Australians (with \$5-30 million in assets), or \$40,000 per person; and
- around \$117 million from 983 audits of highly-paid directors and executives earning more than \$1 million per annum, or \$120,000 per person.

Indeed, in 2009 a senior ATO official let slip in a speech that Project Wickenby (see below) had identified one high wealth individual who had avoided \$242 million in taxes. The ATO refused to identify the individual, ‘citing privacy and tax secrecy concerns’.¹⁶

This is tax avoidance on an enormous scale. And yet provided the perpetrators repay the tax, plus a penalty (as little as 5% of the shortfall – equivalent to bank interest) they will face no consequences.

Enforcement efforts are expensive. For example, Project Wickenby (see below) has cost \$431 million over seven years.¹⁷ Keeping an eye on the 2,700 ‘highly wealthy’ Australians requires 356 ATO staff.¹⁸ Obviously, if all wealthy people paid their taxes properly, the public would not have to incur these expenses.

Offshore tax havens

One area of particular recent interest is offshore tax havens. In 2005-06, about \$5.3 billion in capital was shifted from Australia to tax havens.¹⁹ Project Wickenby was launched in 2006 to

¹⁵ ATO, *Annual Report 2009-10*, 61-2.

¹⁶ ‘Tax Office Won’t Prosecute Australia’s Worst Tax Cheat’ (20 Oct 09) *Crikey.com.au*

¹⁷ ATO webpage, Project Wickenby > What do we do? > Funding the fight.

¹⁸ ATO, *Annual Report 2009-10*, 61.

¹⁹ ATO webpage, Compliance issues > Tax evasion and crime > Report tax evasion > Tax havens in context > Extent of tax haven use.

investigate these flows. About 1,000 high wealth individuals came under particular attention for suspected involvement in tax evasion and tax avoidance schemes.²⁰

Since Project Wickenby commenced, the ATO has investigated more than 3,400 entities and has conducted 800 audits. This has discovered almost \$2 billion in avoided taxes. In addition, the 'Offshore Voluntary Disclosure Initiative' led to almost 8,000 people coming forward and disclosing \$836 million in income hidden in offshore havens, and about \$175 million in avoided or evaded taxes. As a result of these investigations, there has been a 20-30% reduction in the flow of funds from Australia to the tax havens that the ATO has focussed on: Vanuatu, Lichtenstein and Switzerland.²¹

Despite the apparently widespread nature of offshore tax avoidance and evasion, only fifty seven people have been charged with criminal offences, and 20 convicted. However, sentences are often low. For example, Sydney lawyer Paul John Gregory was convicted for helping entertainment manager Glenn Wheatley shift money offshore in order to avoid paying almost \$200,000 in tax. He was convicted of one offence and was sentenced to 2 years' jail (with a minimum of 12 months). Mr Wheatley was convicted of three offences and sentenced to 2 and a half years' jail (with a minimum of 15 months).

The DPP appealed Mr Gregory's sentence on the grounds that it was 'manifestly inadequate'. The Victorian Court of Appeal concurred, and said that a four to six year sentence (with a non-parole period of 3 to 4 years) would have been appropriate. However, since the prosecution never asked for this sentence at trial, and because Mr Gregory had already been released by the time of the appeal, the court declined to re-incarcerate him. The court also noted that Mr Wheatley's sentence was 'inappropriately low'. However, he too had already been released by then, and so could not be re-tried.²²

Superannuation

Superannuation is another area where wealthy people can avoid tax, either lawfully or otherwise.

At present all those who make superannuation contributions (up to a capped amount) to a regulated fund have those contributions taxed at a flat rate of 15%. Those earning over \$180,000 face marginal rates of 47.5% on their income. So while the highest earners receive an income tax concession of 32.5%, around 3.5 million of the lowest paid receive no concession at all. Some even pay more tax on their super contributions than they pay on their income. While the government's new Low Income Earners Contribution will effectively return the tax paid on

²⁰ Australian Federal Police, 'Dirty Sexy Money: The Wickenby net widens' (July 2008) 99 *Platypus* 14.

²¹ ATO, 'Wickenby Gathers Momentum' (Aug 2010) 3 *Targeting Tax Crime: A Whole of Government Approach* 4.

²² *DPP (Cth) v Gregory* [2011] VSCA 145 (17 May 2011)

contributions for those who earn \$37,000 and less, it will remain the case that the highest paid in Australia benefit disproportionately from how their contributions are taxed.

Furthermore, the investment returns to an individual's superannuation account are only taxed at a 15% rate, whereas returns to a directly owned investment portfolio can be taxed as high as the person's marginal income tax rate. Accordingly there are significant tax benefits in directing income into superannuation rather than taking income as wages, dividends or capital gains.

Under the Howard government, contribution caps were high – peaking at \$1 million in 2006-07. As a result, many high-earners (particularly those nearing retirement) salary sacrificed large amounts into superannuation, and/or sold investments to put the proceeds into their superannuation accounts.

Labor has now reduced the concessional cap to \$25,000 per year (or \$50,000 for those over age 50). Contributions above this amount (up to \$150,000 per year) are taxed at 31.5%. However, this still allows high-earners to reduce their tax rates by 7 to 16% by directing income into superannuation. They can also continue to take advantage of the concessional treatment of investment returns earned by their fund.

Of course, some high earners continue to evade or avoid the caps, perhaps hoping that won't get caught. In 2009-10 alone, the ATO detected 41,000 individuals who exceeded the contribution caps, raising \$285 million in tax.²³

A further area of concern is the use of self-managed superannuation funds ('SMSFs'). These are expensive to establish and maintain, and so are particularly used by wealthy individuals. There are 422,000 SMSFs in Australia. On average, each fund has \$888,000 million in assets, to be split between 1.9 beneficiaries, giving an average balance of \$467,000 per person.²⁴ In contrast, the typical Australian has a superannuation balance of just \$24,000.²⁵ This comparison confirms that SMSFs are predominantly used by wealthy Australians.

Given the high costs involved with SMSFs, why do wealthy people use them? The benign answer is that many wealthy people simply want to control how their assets are invested. However, the ATO has concerns that many wealthy people are using SMSFs for improper purposes, in one of three ways.

First, there is suspicion that some funds improperly claim tax deductions. In 2008-09, 97% of SMSFs claimed tax deductions. By far the biggest source of deductions (\$10 billion, or 83% of total

²³ ATO, *Compliance Program 2010-11*, 44.

²⁴ ATO, *Self-Managed Super Fund Statistical Report* (June 2011); ATO, *Taxation Statistics 2008-09*, 141.

²⁵ ABS cat 6361.0 (2007). Median figure.

deductions) was for 'exempt current pension income' ('ECPI') – that is, fund income that is specifically earmarked to pay an income stream (such as an annuity) to a beneficiary. However, in cases where not all of the beneficiaries are drawing down their superannuation, the fund must declare what proportion of fund earnings are 'earmarked' for ECPI payments.

The ATO is concerned that many such declarations are false. It says it is 'aware [that] many tax agents and trustees have difficulties with ECPI reporting' and cites one case where:²⁶

... the tax agent was asked to show how they calculated the ECPI. We requested the relevant documents demonstrating the segregation of the fund's assets or the actuary certificate.

As the tax agent was unable to supply the documents, the fund's claim for ECPI was disallowed. This resulted in:

- *a decreasing adjustment of over \$780,000 being made at the ECPI label*
- *a \$117,000 tax shortfall being raised*
- *penalties of over \$21,000 being imposed*

These penalties only amount to 17% of the shortfall amount. It is not clear why they are so low. This seems to be more a case of reckless, if not intentional, tax avoidance or evasion – after all, a tax advantage of \$117,000 was sought by the taxpayer (through their agent) with absolutely no documentation to substantiate the claim for the deduction.

Since the ATO have not released any further data, it is impossible to know how widespread the practice of making false claims for ECPI deductions may be.

A second rort is where wealthy individuals transfer personal assets ('in specie contributions') to their SMSF. Generally, a SMSF is not permitted to acquire assets from related parties, including beneficiaries. However, there are some exceptions, including business real property and listed securities, or any other asset so long as it will constitute less than 5% of the SMSF's total assets. These exceptions give rise to two abuses. First, wealthy individuals are able to circumvent the contribution caps, by making large 'gifts' to their SMSF. Second, since SMSFs enjoy concessional CGT tax treatment, gifts of assets that have appreciated in value mean that the beneficiary can avoid paying CGT.²⁷

A third (and related) rort is where the SMSF hides income from related parties. SMSFs are supposed to declare income from related parties, and (subject to the exceptions above) this

²⁶ Stuart Forsyth (ATO), 'Self-Managed Superannuation Funds: Common Mistakes and Other Compliance Issues' (14 September 2009) Speech.

²⁷ Ibid, 'In specie contributions'.

income is taxed at a rate of 45%. However, the ATO says that ‘many’ SMSFs fail to declare income from related parties. It only gives one example: a SMSF that failed to declare \$500,000 in distributions from a two related trusts, leading to \$167,500 a tax shortfall and penalties of \$40,000. Once again, it is hard to see why such low penalties were imposed in a case that clearly breached the rules, with no reasonable excuse.²⁸

A fourth rort is where the SMSF provides a benefit to a related party. An SMSF is not permitted to make a loan or investment of more than 5% of the fund in a related party. It is also not permitted to give any direct or indirect financial assistance to a beneficiary or their ‘relative’ (as defined). However, these rules are often breached. The ATO gives one example where a SMSF blatantly lent 95% of its assets to a related company.²⁹ There are anecdotal stories of SMSFs making loans to cousins (who do not meet the definition of a ‘relative’), who then forward the loan to the beneficiary. There are also stories of SMSFs that buy expensive artworks, which are then hung in the house of beneficiaries; and SMSFs that invest in residential property, and then rent the premises at undervalued rates to beneficiaries or their associates. Another apparently common situation is a SMSF that ‘invests’ all of its capital in a business operated by a beneficiary, at uncommercial rates of return.

These practices also raise the problem of the ‘early release’ of superannuation, which is unlawful. In 2009-10, the ATO audited 920 SMSFs that had released superannuation funds to beneficiaries before retirement, raising \$14 million in tax liabilities; four cases were referred for prosecution, with two civil penalties (totalling \$27,500) were imposed on SMSF trustees; and 440 suspect funds were prevented from operating.³⁰

Other rorts identified by the ATO include:

- **False residency claims:** the ATO is currently investigating 330 SMSFs that claim to be Australian-based but are suspected of being managed by trustees located overseas;
- **Evasion of capital gains tax (‘CGT’):** the ATO gives the example of one SMSF that sold a \$1.1 million property but declared no capital gains. The ATO notified the SMSF that it would be audited, at which point the tax agent admitted that he had omitted to declare a \$78,000 capital gain (triggering an \$11,700 CGT liability). The ATO imposed no tax penalty because of the voluntary disclosure before audit;³¹

²⁸ Ibid, ‘Non-arm’s length income’.

²⁹ Ibid, ‘A growing self-managed super fund market means an increase in compliance’.

³⁰ ATO, *Compliance Program 2011-12*, 48.

³¹ ATO, above n 26, ‘Capital gains tax (CGT)’.

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- **False investment expense claims:** investment expenses of \$478 million were claimed by SMSFs in 2008-09. The ATO is concerned about ‘overstatement’ of expenses. It gives the example of an SMSF that claimed a deduction for \$300,000 for investment related expenses. In fact, the moneys were not expenses associated with investments (such as brokerage fees) – they were *actual* investments by the fund in two companies. No deductions are permitted for capital investments such as these. A \$45,000 tax shortfall was raised, and \$11,250 in penalties imposed;³²

Overall, in 2009-10, the ATO reviewed 11,000 SMSFs and audited 900 funds, finding \$15 million in unpaid taxes. However, it only prosecuted 138 SMSFs, resulting in 101 civil breaches; it removed the complying status of 70 funds; wound up 10 funds; disqualified 312 trustees (and nine auditors). The vast majority of breaches detected were given an administrative tax penalty by the ATO, with no further action taken. No criminal charges of tax evasion were laid.

Conclusion

In this section, we have shown how wealthy Australians regularly minimise their tax by exploiting tax breaks (such as the concessional tax treatment of companies and trusts), but also through tax evasion and avoidance.

As we argued in the Introduction, not only is it inherently unfair that wealthy people get away with paying less than their fair share of tax (which increases the tax burden on everybody else), but this phenomenon threatens to undermine public confidence in the tax system, which is a key pre-requisite for a well-functioning democracy,

The government needs to take stronger measures to ensure the rich pay their fair share. The government should ask the ATO to crack down on wealthy tax cheats and avoiders. They should make deliberate tax avoidance a civil wrong, and ensure that wealthy tax cheats are publicly named and shamed, through open justice rather than through the secretive tax penalty regime administered by the ATO.

The government should also review the entire range of tax breaks that wealthy people access. Loopholes should be closed. Companies, trusts and other vehicles should not be permitted to be used solely for tax minimisation purposes.

The government should also follow the lead of the USA and introduce the equivalent of the ‘Buffett rule’, to ensure that wealthy Australians do not pay less, in average tax rates, than ordinary Australians.

³² Ibid, ‘Investment expenses’.

4. Large corporations

Introduction

Large corporations also have the incentive and means to minimise their tax. The late Kerry Packer's company, Consolidated Press Holdings, infamously paid just \$6 million in tax on \$600 million profits in 1992.

The second Working Australia tax paper examined the tax treatment of companies. It showed that taxes paid by corporations were low — well below the OECD average. It also showed that despite a headline company tax rate of 30%, the effective tax rate paid by companies (after deductions, tax credits, etc) was only 22 percent. Indeed, a recent paper by Treasury officials suggests the average effective tax rate is as low as 18 percent in the utilities sector, and 19 percent in the mining industry.³³

To give just one example, Andrew 'Twiggy' Forest's Fortescue Metals Group made \$579 million profit in 2010. However, it was able to deduct \$176 million against its \$174 million prima facie tax bill, meaning that it paid no tax in 2010 and will receive a \$2 million tax credit to use next year.³⁴

This section examines how large companies are able to minimise their tax by exploiting tax breaks offered by our tax laws, and through a range of tax avoidance practices that shade into outright tax evasion.

The culprits are both Australian-owned and foreign-owned companies, but the latter generally have better access to certain devices, such as offshore profit-shifting.

The loss to revenue from tax breaks and avoidance/evasion runs into tens of billions of dollars each year.

³³ John Clark, Peter Greagg and Amy Leaver, 'Average rates of company tax across industries revisited' (2011) *Economic Roundup* 157, 162.

³⁴ Fortescue Metals Group, *Annual Report 2010*, 75.

Tax breaks

One source of concern is the ability of large businesses to extract tax breaks from government. The mining industry is a particularly conspicuous beneficiary of these concessions. These concessions to large companies include:

- **Fuel tax breaks:** \$5 billion in fuel tax credits. The mining industry receives \$1.9 billion of these credits;³⁵ producers of crude oil condensate receive an additional \$600 million fuel excise exemption;
- **Depreciation concessions:** \$805 million in tax concessions allowing accelerated depreciation of planes, trucks and oil and gas infrastructure.³⁶ The mining industry accounts for a large share of these concessions: in 2010-11, BHP alone claimed US\$851 million in depreciation for its Australian oil and gas assets, giving it a tax deduction of around A\$260 million.³⁷ If the normal depreciation rules applied, they would have only been able to claim perhaps half that amount.
- **Research and development concessions:** \$1.1 billion in research and development (R&D) concessions. Unions support R&D concessions for genuine innovation, especially in the manufacturing sector. However, the mining sector is not a particularly innovative industry, and yet it claims 30% of the R&D spending in Australia (more than manufacturing), giving it access to \$330 million in R&D tax concessions. Some mining sector R&D claims are highly dubious:³⁸ the sector has a history of making claims for production rather than research activities (for example, building roads³⁹ or mines⁴⁰); its R&D expenditure claims do not match ABS statistics on the level of R&D investment in the sector; increases in claimed R&D spending outpaces growth in mining investment generally; and R&D claims showed a curious spike during the global financial crisis, when one would have expected the opposite result. For example, Rio Tinto increased its R&D spending from just US\$69 million in 2006-07, to US\$307 million in 2007-08 — a fourfold increase. This allowed it to claim tax credits (in the UK and Australia) of US\$72 million.⁴¹ Since then, Rio Tinto's R&D expenditure has declined by 77%, to US\$187 million in 2009-10.

³⁵ ATO Taxation Statistics, above n 24, 133.

³⁶ Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 4) 2002 (Cth), Table 4.2.

³⁷ BHP Billiton, *Annual Report: Form 20-F* (2010-11) F-108.

³⁸ See Nicholas Gruen, 'The BERD in the hand: Supporting Business Investment in Research and Development' (April 2011).

³⁹ *Re Coal and Allied Operations Pty Ltd v Industry Research and Development Board* [1992] FCA 548.

⁴⁰ *Industry Research & Development Board v Coal & Allied Operations Pty Ltd* [2000] FCA 979.

⁴¹ David Richardson and Richard Denniss, 'Mining the truth: The rhetoric and reality of the commodities boom' (2011) Australia Institute, Paper No. 7.

Overall, the Australia Institute estimates that the mining industry enjoys up to \$10 billion in tax breaks and subsidies annually. This is a sector that only pays \$13.3 billion in company tax, or about \$60 for every Australian citizen. On the Australia Institute's figures, the government is essentially waiving 43% of the mining sector's corporate tax bill.

This very low company tax contribution from the mining sector is just one of the reasons why it is legitimate to increase other payments that the mining industry provides to government (particularly resource taxes and royalties) so that the industry pays a fair price for exploiting non-renewable Australian resources.

Domestic profit shifting

Our tax laws generally treat companies within corporate groups as separate legal entities. This allows large businesses to reduce their tax by structuring transactions between related entities, generating tax deductions that would not have been available if the business operated through a single legal entity.

For example, if a company builds a mine it is not entitled to any tax deductions. However, if subsidiary A lends \$1 billion to subsidiary B in order to build the mine, subsidiary A can claim a \$1 billion deduction for the loan (generating a \$300 million tax credit). If subsidiary B fails to repay the loan, there is no further tax to be paid by either company.

Much of these transactions occur in the 'grey zone' between 'legal' tax minimisation and impermissible tax avoidance. Under our law, it all depends on the motive of the company concerned. The ATO sometimes challenges these arrangements, but has a poor record of success. For example, in April 2011 it lost a 20 year battle to recover \$850 million in deductions that the Foster's group created through making loans between 10 subsidiaries.⁴² In June 2011, it lost a 10 year fight in the High Court against BHP Billiton over \$550 million in capital allowance deductions, generated by loans between subsidiaries.⁴³ In September, it lost a 7 year case against Macquarie Bank over \$95 million in tax avoided through the purchase of shares in a mining company, via a subsidiary.⁴⁴ In each case that the ATO lost, it was ordered to pay the legal costs of the winning companies.

The ATO was clearly of the view that all of these transactions constituted tax avoidance. The fact that it lost shows the limitations of anti-avoidance rules that depend on the ATO having to prove an improper motive on the part of companies and their directors. These cases also show the problem of treating related companies within corporate groups as if they operate at arm's length.

⁴² *Commissioner of Taxation v Ashwick (Qld) No 127 Pty Ltd* [2011] FCAFC 49.

⁴³ *Commissioner of Taxation v BHP Billiton Ltd* [2011] HCA 17.

⁴⁴ *Macquarie Bank Ltd v Commissioner of Taxation* [2011] FCA 1076.

International profit shifting

The practice of international profit shifting is particularly problematic now that transactions within multi-national corporate groups accounts for 70% of global trade. A common form is ‘transfer mispricing’ – that is, selling goods to a related company overseas for less than their market value, thereby reducing taxable income in Australia. Under Australian tax laws, the ATO can go behind mispriced transactions and can levy tax based on what the ‘arm’s length’ value of the transaction would have been.⁴⁵ If the transaction was engaged in for the sole or dominant purpose was to obtain a tax benefit, it constitutes tax avoidance, and the ATO can impose additional penalty taxes.

One form of profit shifting is ‘thin capitalisation’. This occurs, say, where an Australian company takes a large loan from a related foreign company (so that it is ‘thinly’ capitalised, and highly geared). Under Australian law, the interest on the loan can be claimed as a tax deduction (up to a \$250,000 threshold),⁴⁶ while the loan repayments are taxed in the foreign country (which is often a low-tax jurisdiction). In contrast to this generous treatment, many other countries have much stricter rules: the UK disallows all interest deductions where loans are not at arm’s length;⁴⁷ the USA disallows all interest deductions where the recipient company’s debt to equity ratio is greater than 1.5:1;⁴⁸ and Hong Kong generally forbids interest deductions for loans from related companies.⁴⁹

Despite these provisions, international profit shifting appears widespread. A former Senior Fellow of the Brookings Institution has stated that “transfer pricing is used by virtually every multinational corporation to shift profits at will around the globe. ... I have never known a multinational, multibillion-dollar, multiproduct corporation that did not use fictitious transfer pricing in some part of its business to shift money between some of its entities”.⁵⁰

These practices certainly occur in Australia. For example, during the 1980s and 1990s, Nestlé Australia, with sales of \$2 billion per annum, managed to reduce its taxes from \$68 million to as little as \$2 million by paying enormous royalties to its Swiss parent company (up to \$50 million per year) for the right to use Nestlé trademarks, and by invoicing sales through a related company incorporated in the Bahamas. The ATO discovered this and issued a \$20 million tax bill in 1985;

⁴⁵ *Income Tax Assessment Act 1997* (Cth) Pt 3 Div 13.

⁴⁶ *Income Tax Assessment Act 1997* (Cth) Div 820. Deductions beyond this threshold are only permitted if the Australian company is adequately capitalised.

⁴⁷ *Taxation (International and Other Provisions) Act 2010* (UK) Pt 4.

⁴⁸ *Internal Revenue Code* (US) s 163(j).

⁴⁹ *Inland Revenue Ordinance* (HK) s 16

⁵⁰ R W Baker, *Capitalism’s Achilles Heel* (2005) 170. See also Prem Sikka & Hugh Willmott, ‘The Dark Side of Transfer Pricing: Its Role in Tax Avoidance and Wealth Retentiveness’ (2010) 21 *Critical Perspectives on Accounting* 342.

however, this was successfully challenged in court by Nestlé.⁵¹ Nestlé Australia is no longer a public company and does not produce public financial reports, so it is not possible to tell if Nestlé continues to avoid taxes in these ways. However, in 2010 the parent company disclosed that the Nestlé group only paid worldwide taxes of \$3 billion on sales of \$103 billion.⁵²

Overall, researchers calculate that in the mid-2000s, \$2 billion in capital was shifted from Australia to Europe through transfer pricing each year, and \$2.8 billion to the US, leading to tax losses to the Australian government of \$1.1 billion annually.⁵³ This is a very significant loss to revenue.

The ATO says it is 'concerned' about profit shifting, and will conduct 50 audits of large companies this year, examining transfer pricing and thin capitalisation.⁵⁴ However, if any breaches are detected, they are unlikely to be made public. We will never know just how widespread these practices are.

Other concerns

The ATO has serious concerns about other tax evasion and avoidance on the part of large Australian businesses with turnover of more than \$250 million per annum.⁵⁵

- 'Black-hole expenditure': this is a polite term for false claims of capital expenditure. The ATO will examine thirty-two claims, totalling \$210 million, in the coming year; and
- Private equity exiting Australia: the ATO is concerned about foreign firms pulling capital out of Australia without paying tax. Most notoriously, when TPG Holdings sold Myer in 2009 for \$1.5 billion, no tax was paid in Australia. The profits were channelled within days to the Netherlands, then to Luxembourg, then to the Cayman Islands, despite a court injunction. The ATO is now suing TPG for \$739 million in unpaid taxes.⁵⁶

It is not known how widespread these activities are, or how much they cost the public.

⁵¹ B Pritchard, 'Transnationality Matters: Related Party Transactions and Corporate Finance in the Australian Food Industry' (2001) 48 *Journal of Australian Political Economy* 23.

⁵² Nestlé, *Annual Report 2010*, 44.

⁵³ Christian Aid, *False Profits: Robbing the Poor to Keep the Rich Tax-Free* (2009). Figures converted using average annual exchange rates.

⁵⁴ ATO, *Compliance Manual 2011-12*, 28.

⁵⁵ *Ibid.*

⁵⁶ Richard Gluyas, 'Tax Office wins legal backing to pursue TPG over Myer float millions' (24 Aug 2011) *The Australian*.

Conclusion

It is disappointing that some of Australia's biggest companies engage in tax avoidance strategies, shading into tax evasion, with the intention of paying less than their fair share of tax. These are some of our most profitable companies, and they can certainly afford to pay our low rates of company tax.

The government should ask the ATO to crack down on avoidance and evasion behaviour. The ATO should be empowered to publicly identify the companies involved, and the amounts sought to be avoided. The public has a right to know what some of our biggest businesses are up to, especially given the significant influence these companies have in national debates on economic and social issues.

Directors and executive that are responsible for companies' tax evasion or avoidance should also be personally held to account.

Furthermore, the government should review the tax breaks offered to certain industries, particularly the mining industry. The mining industry is extremely profitable, and certainly does not need to be subsidised by the taxpayer. It can, and should, pay its fair share.

At the very least, the government should ensure that the new Mineral Resource Rent Tax does not allow the big mining companies to abuse loopholes and deductions; the headline rate of tax should be the level of tax paid, as far as possible.

5. Small businesses

Introduction

There are perhaps 1 million small businesses in Australia that sell goods and services (rather than their labour) to the public.⁵⁷ These businesses are usually operated by an individual, couple or friends (whether through an incorporated entity or not), with few or no employees (apart from the owners), turnover of less than one or two million dollars per annum, and a typical reported operating profit (before tax and payments to owners) of around \$50,000 per owner per year.⁵⁸

Although many small business owners are honest and pay their taxes, these businesses are undercut by other small businesses that cheat on tax. These businesses pocket cash income, steal their employees' superannuation, rort the GST system and, when everything fails, simply 'phoenix' the business in order to avoid liability. The result is tens of billions of dollars lost to the public purse. This lost revenue must be made up by the rest of us (including the honest small business operators) paying higher taxes than we otherwise would need to.

We shall examine some of the main abuses below.

The cash economy

The most significant problem with small businesses is tax evasion through non-reporting of cash income. The ABS estimates that 9% of all income earned by unincorporated businesses is not reported (totalling \$11 billion per annum), but admits that it could be as high as 27% (\$33 billion per annum).⁵⁹ Assuming a 30% marginal tax rate, that represents a loss of revenue of \$3-10 billion per annum.

In 2011-12, the ATO will target 46,000 businesses, in 30 industries, suspected of under-reporting their cash income,⁶⁰ as well as 1,900 registered tax agents suspected of being complicit in tax evasion.⁶¹ Last year, the ATO recovered \$151 million in evaded taxes from small business.⁶² However, as the figures above suggest, this is merely the tip of the iceberg – perhaps as little as 1.5% of the small business cash economy.

⁵⁷ ABS cat 6359.0 (2010).

⁵⁸ ABS cat 1321.0 (2001); ABS cat 6225.0.55.001 (2005-06).

⁵⁹ ABS cat 1350.0 (2003).

⁶⁰ ATO, *Compliance program 2011-12*, 13.

⁶¹ *Ibid* 37.

⁶² *Ibid* 45.

Despite evidence of widespread tax evasion on the part of small business, there were only six criminal prosecutions of small business owners in 2010-11.⁶³ It seems that most people are let off with a tax penalty and a warning.

GST fraud

Another area of widespread abuse amongst small business is Goods and Services Tax ('GST') fraud. Many small businesses fail to register for GST; intentionally under-report GST collections; collude with others to avoid GST; or intentionally avoid GST through 'phoenix' activity (liquidating one company and starting another).⁶⁴

This activity is prevalent among small businesses in the retail, hospitality and construction sectors (although it is also engaged in by larger businesses in finance and mining).⁶⁵

In 2010-11, the ATO undertook over 40,000 reviews and audits of small businesses,⁶⁶ GST non-compliance was found in three quarters of cases, with \$435 million in GST recovered (or about \$14,500 for each non-complying business). Once again, this is probably only the tip of the iceberg. If this pattern of non-compliance is found across the whole small business sector, then there could be as much as \$11 billion in 'missing' GST payments each year.⁶⁷

Despite the apparently widespread nature of GST fraud, small business owners are hardly ever prosecuted for GST-related tax evasion. In 2010-11, only 14 small business owners were prosecuted.⁶⁸ Among those convicted were small retailers, cartage contractors, a lawyer, a dentist and an insurance broker. This wide range of businesses shows that tax fraud is not confined to small, fly-by-night operators, but extends to high-earning professional sectors too.

Unpaid superannuation

Although compulsory superannuation guarantee ('SG') contributions are, in substance, wages foregone by employees, they are treated by Australian law as tax obligations due from the employer to the Commonwealth. Small business operators are notorious for failing in these obligations and, in effect, stealing from employees' retirement savings.

Last year, the ATO received 16,300 complaints from employees that their employers had not been making SG contributions on their behalf.⁶⁹ The ATO says these were 'mainly' small business

⁶³ Ibid 47.

⁶⁴ Ibid 22.

⁶⁵ Ibid.

⁶⁶ The ATO includes contractors in its definition of micro businesses.

⁶⁷ Assuming that 75% of the 1 million small businesses owe \$14,500 each.

⁶⁸ ATO quarterly prosecutions media releases, 2010-11.

⁶⁹ Compliance program, 7.

employers. The tax office recovered \$152 million from 10,000 businesses as a result of these complaints; raised a further \$45 million from 16,000 small businesses that ‘voluntarily’ disclosed breaches after receiving letters from the ATO; and found another \$109 million from 4,600 reviews of small employers in targeted industries (road freight transport, automotive repair and electrical services).

Altogether, more than \$300 million was recovered from around 30,000 small businesses. Over the last five years, the ATO has recovered \$1.3 *billion* in unpaid superannuation, mostly from the small business sector. This is not tax avoidance, but is outright tax *evasion* on a monumental scale. Despite this fact, there are only rare criminal prosecutions by the ATO; the government and public seem to accept that it is acceptable for a small business, say, to hold onto SG amounts as working capital in the business for a few quarters to ride out tough trading conditions.

The ACTU welcomes the government’s announcement of the *Securing Super* changes, as part of the *MySuper* reforms, that employers will be obliged to inform employees (via payslips) if they have forwarded SG contributions to the ATO. This is an important step along the road to stamping out SG tax evasion in the small business sector, and protecting employees’ superannuation entitlements.

False deductions

In order to supplement their incomes, many small business owners make illegitimate claims for tax deductions, including claims for expenses never incurred, or claims deliberately overestimating the ‘business’ content of mixed business and private expenditure.

The examples are legion. They include the business owner who claims their house is their office, and deducts most or all of the rent; the owner who takes a holiday and claims it as a business trip; the owner who puts their car ‘on tax’; the owner who always buys lunches for their friends ... but who always collects the receipt to give to their accountant.

Good quality data on the extent of these false claims does not exist. However, one clue is to look at the nature of deductions claimed by small business. Two patterns stand out. The first is that the smaller the business, the higher the proportion of income that is offset by deductions. Large businesses deduct as little as 60-70% of income, whereas small businesses tend to deduct 80-90% of income.⁷⁰ Second, certain items (motor vehicle expenses, repairs, depreciation and ‘other’ expenses) form a greater share of the total deductions of small business than they do for large business.⁷¹

⁷⁰ ATO, *Tax Statistics 2008-09*.

⁷¹ Ibid: ACTU analysis of detailed tables.

The innocent explanation is that large businesses are more profitable than small ones, and that certain business expenses (such as motor vehicle expenses) are fixed costs that cannot be avoided and do not vary much with business size. However, the alternative explanation is that small businesses tend to inflate their deductible expenses, particularly for items (like 'other') that are easy to inflate and disguise (compared, for example, to the cost of stock).

In 2010, the ATO rejected \$129 million in 'fraudulent' deductions, found in 28,000 tax returns;⁷² already in the first month after the end of the 2011 tax year, it has rejected \$150 million in fraudulent claims.⁷³ Given the limited ability of employees to obtain tax deductions, it would appear that most of these claims were from businesses.

If that is the case, then there is evidence that deductions fraud is widespread amongst business. Despite this, the ATO hardly ever prosecutes businesspeople for tax evasion. As far as we have been able to ascertain, the ATO only launched two prosecutions for deductions fraud last year.⁷⁴ Much more needs to be done in future.

Phoenix activity

Another well-known rort is 'phoenix' activity. This occurs when a company runs up debts (including tax debts, as well as debts to employees); the directors put the company into liquidation, leaving the creditors unpaid; they then incorporate a new company that continues operating the old business, but without the former debts.

The ATO estimates that phoenix activity costs the taxpayer \$600 million per annum in avoided taxes. Other creditors, including employees, are also left out of pocket by millions, if not billions of dollars. Phoenix activity is 'most prevalent' amongst small business, but often involves 'individuals who already have significant levels of wealth'.⁷⁵

The ACTU welcomes the government's recent legislative changes, to make directors personally liable for unpaid SG entitlements (as well as PAYG income tax withheld from employees' wages) when they 'phoenix' a company.⁷⁶ However, the government should consider going further and making directors of phoenix companies personally liable for *all* outstanding debts of the old company.

⁷² ATO, 'Income Tax Return Update' (15 Feb 2011).

⁷³ Philip Hudson, 'Tax cheats put on notice by ATO' (5 August 2011) *Courier Mail* (Brisbane).

⁷⁴ ATO, 'Worst Tax Offender Hit with Eight Year Jail Sentence' (28 Feb 2011) Media release; ATO, 'Over 600 Individuals and Companies Prosecuted for Offences Totalling Over \$9.5 million' (15 Aug 2011) Media release.

⁷⁵ Treasury, *Action against Fraudulent Phoenix Activity: Proposals Paper* (November 2009).

⁷⁶ Tax Laws Amendment (2011 Measures No. 7) Bill 2011 (Cth).

Conclusion

There is considerable evidence that outright tax evasion is rife amongst some sections of small business. The government should crack down on these abuses. Although rorts that harm workers — such as theft of superannuation, or phoenix activity — should be the first priority, the government needs to take broader and tougher enforcement measures in the small business sector as a whole, in order to prevent ongoing revenue losses, to improve the efficiency and equity of our tax system, to restore public confidence in the integrity of the tax system, and to ensure that honest small business operators are not put at a competitive disadvantage.

Moreover, the government should make sure that tax cheats are disqualified from receiving government grants, awards, or other forms of assistance. This should be reserved for small businesses that do the right thing.

6. Contractors

Introduction

Colloquially, the term 'contractors' covers genuine contractors (who operate their own businesses), but also 'sham' contractors (who are employees misclassified as contractors).

Increasingly, employees are being told 'no ABN, no job'. Employers (wrongly) believe that if the worker has an Australian Business Number (ABN) then they are a contractor, and so are not entitled to award wages and conditions, sick leave, annual leave, superannuation, worker's compensation or severance pay.

A contractor bears all of the risks of the job, including unemployment, illness, injury, and failure to save for retirement. If these contingencies arise and the contractor cannot cover the costs, the government does, through Medicare and the welfare system. In other words, sham contracting represents an effort by employers to shift risks to workers and the taxpayer.

Despite the economic principle that greater risks demand greater returns, many employees receive little or no additional compensation from their employer for becoming contractors (whether genuine or sham). They continue to earn low wages. They then face significant temptation to make up for these low incomes by cheating the tax system.

This is possible because there are very few record-keeping requirements for contractors, and because our self-assessment system depends on the honesty of the taxpayer in declaring whether or not they are a 'genuine' contractor. As a result, many contractors fail to declare their income, and many sham contractors falsely claim business deductions.

In addition, many contractors (whether sham or genuine) use interposed entities (such as companies and trusts) to minimise their taxes. This is unfair to regular employees, who perform the same work but have no equivalent access to these devices. The government should make sure that all income from labour is treated the same, whether it is earned as a contractor or as an employee.

Who is a 'contractor'?

As law, an independent contractor is a person who runs a genuine business providing their labour to the public. The key distinction between an employee and a contractor is control: a contractor is generally free to decide how and when to perform their work, whereas an employee must take instructions from an employer. In addition, contractors are generally free to take on

multiple jobs, and subcontract work others. They generally supply their own tools and materials, and are personally liable for the cost of fixing any mistakes made.

The ABS reports that 1.1 million workers claim to be 'independent contractors'. They are most commonly found in construction (341,000), professional services (160,000), administrative services (97,000) and transport/postal/warehousing (83,000). However, despite these figures, we know that not all of these workers meet the legal definition of a contractor. Forty percent say they have no authority over their own work; 32% say they cannot subcontract their work; and 23% say they are not allowed to take on work from a second client.⁷⁷

As such, there are probably only about 650,000 genuine contractors in Australia, at most. The rest are generally described as 'sham' contractors. In some of these cases the worker has initiated the sham (usually to obtain tax benefits); in other cases the employer has initiated the sham, usually to avoid labour law obligations.

Contractors may work under a variety of legal forms: as sole traders, partners in an unincorporated business, or shareholder/directors in a company. As we shall see below, the tax laws try to make a distinction between genuine and sham contractors. Genuine contractors are treated as small businesses, and can deduct the full range of business expenses against their contracting income. Sham contractors are treated as employees, in terms of the expenses that they can deduct. Furthermore, if they earn contracting income through an interposed entity (such as a company, trust or partnership), the income will be attributed to the contractor, and the entity will have to withhold and remit the contractor's share of tax to the ATO on a periodic basis.

Non-reporting of income

It is widely known that many contractors work 'for cash', and fail to report some or all of their income to the ATO. This is blatant tax evasion.

It is difficult to accurately establish the scale of this evasion. As mentioned previously, the ABS estimates that 9-27% of income earned by unincorporated businesses (including contractors) is not reported, or up to \$33 billion per annum. This is likely to be an underestimate.

Other clues come from tax return data. Last year, only 98,835 people declared income from working as a contractor (personal services income) – less than 9% of the total number of people treated as contractors by the ABS. In the construction sector, only 12,820 people declared contracting income, out of a workforce of 510,000 people (ie 2.5%). It is inconceivable that the proportion of contractors is that low. While it is possible that some construction contractors mistakenly declare their income under another item on their tax return (say, as wages), or failed to

⁷⁷ ABS cat 6359.0 (2010) Table 10.

correctly identify the industry in which they work, another possibility is that they simply failed to declare any income at all.

This suspicion is borne out by ATO compliance data. The ATO recently tracked down 22,000 contractors. It found that 31% had not lodged a tax return, while a further 20% of contractors had lodged a return but had failed to declare any of their contract income. In other words, 51% of contractors engage in outright tax evasion.⁷⁸

In another exercise, in 2008, the ATO followed up 11,000 contractors placed through labour hire agencies. They found that 73% failed to declare that their income was contract income. It is not clear how many declared their income under another category (such as 'wages'), and how many did not declare the income at all. It is also not known what proportion of cases involved deliberate misclassification of income (tax evasion) rather than a mistake.

How much tax is evaded by these contractors? In 2008-09, the ATO undertook targeted compliance activity against 231 contractors suspected of evading at least \$5,000 in tax. What the ATO found was much worse. Of the 231 contractors, 193 (or 84%) were found to be 'non-compliant', with an average unpaid tax bill of \$18,800,⁷⁹ implying average unreported income of approximately \$80,000 per annum.⁸⁰

If this incidence of evasion were found across the 1.1 million people who identify as contractors, then there could be up to \$74 billion in undeclared contractor income, and up to \$17 billion in evaded tax, each year.

Remarkably, despite widespread evidence of tax evasion, the ATO rarely prosecutes contractors. For example, the sanction applied to each of the contractors caught in the ATO's targeted audit, described above, was 'penalties and interest of \$6,000' per person. That is hardly a deterrent, either to the individuals concerned or to other contractors.

Fuelling much tax evasion are lax income reporting requirements. Although contractors generally report their Australian Business Number (ABN) to clients, the client is not obliged to report the ABN (and the contract fee) to the ATO, which means that the ATO cannot undertake any data-matching against the income declared on the contractor's tax return. This contrasts with the position of employees: generally, every dollar in wages earned is reported by the employer to the ATO, allowing the tax office to undertake a reconciliation at the end of the tax year.

⁷⁸ ATO, *Annual Report (2009-10)*, 15.

⁷⁹ Board of Taxation, *Post Implementation Review into the Alienation of Personal Services Income Rules (2009)* 21.

⁸⁰ ACTU calculation.

If the ATO does wish to investigate a contractor's income, they must ask the contractor to reveal all of his or her clients, and (assuming an honest answer) must then contact each client and seek copies of invoices. This is a resource-intensive process, and so is rarely undertaken. However, we note that when the ATO *does* perform these inquiries, it finds that 10% of invoices are missing ABNs or else contain a false ABN.⁸¹

The ATO also finds that many contractors who fail to report income also fail to withhold and remit GST. For example, the ATO expects to collect \$17 million in unpaid GST from contractors in the building and construction industry in 2011-12.⁸²

Deductions

One of the main reasons why so many sham contractors claim to be genuine is that the tax laws treat 'genuine' contractors as small businesses,⁸³ allowing them to claim the full range of business deductions. We have seen above, in our discussion of small business, how these deductions can be inflated or falsely claimed in order to evade tax. Contractors who are not 'genuine' are treated as employees for tax purposes, and cannot access these deductions.

The tax laws treat a contractor as a genuine small business if they pass the 'results test'. This test requires that, for at least 75% of their contract income:

- (a) the income was earned for producing a specified result;
- (b) the worker is required to provide their own equipment; and
- (c) the worker is liable to rectify any defects in the work.

This test has a number of flaws. First, it is much weaker test than the common law test, which requires a contractor to have 'control' over their work, not just work 'for results'. Second, it gives ambiguous results for many types of workers, such as white-collar 'knowledge' workers or commission-based salespeople. Third, it encourages avoidance, by focussing on the formal legal requirements of the contract, rather than on the practical reality of work relationships. Employees (or employers) can structure work relationships in an artificial way in order to attempt to satisfy the results test. So long as this is not done for the 'sole or dominant' purpose of obtaining a tax benefit, it does not count as tax avoidance.

⁸¹ ATO, *Annual Report 2009-10*, 15.

⁸² Australian Government, *Budget Measures: Budget Paper No 2 (2011-12)* 47.

⁸³ Strictly, operators of a 'personal services business'.

Even if a contractor fails the results test, they may still qualify as a genuine contractor for tax purposes if less than 80% of their contract income comes from a single client, and they pass one of the following tests:

- (a) the 'unrelated clients' test: they advertise publicly (but not through a labour hire firm) and receive work from two or more unrelated clients;
- (b) the 'employment test': they have employees or subcontractors (who are not relatives or associates) performing at least 20% of the value of the work, or they employ an apprentice for at least 6 months;
- (c) the 'business premises test': they own or rent premises that are physically separate from residences or client premises, and which are used mainly to operate the PSI business.

If a contractor is in doubt about whether they meet the results test, or any of the other tests, they can apply for a Personal Services Business Determination from the Tax Office to resolve their position. Despite the ambiguity of the results test, it seems that contractors generally do not seek these determinations: in 2009-10, the ATO only made 75 tax determinations of any sort.⁸⁴

The suspicion that the tax laws do not provide an appropriate filter of 'genuine' contractors is borne out by ATO data. Remember that ABS figures suggest that only 60% of 'contractors' would meet the common law test of contracting, because they control their own work. However, ATO data shows that 91% of contractors self-assessed as genuine contractors, under the tax law tests! This suggests that at least 30% of all 'contractors' are misclassifying themselves as contractors.

The Board of Taxation examined this problem in 2009.⁸⁵ They considered that much of this misclassification was accidental, due to the complexity of the tax laws. We agree that the rules are complex. However, we suspect that deliberate tax evasion explains a large portion of the misclassification, particularly in certain industries like construction where (anecdotally) employees are told 'get an ABN and then put your car/rent/tools on tax'.

Of the small number of contractors that declared labour income on their tax return, 59% claimed deductions, averaging around \$5,000 per contractor, and totalling \$291 million (or 14% of the gross labour income). In contrast, the average employee only deducts \$2,256 in work-related expenses each year.

As was the case for small businesses, the less a contractor earned, the greater their deductions (as a share of gross income). Once again, this may either reflect fixed operating costs, or else inflation of expenses.

⁸⁴ ATO, *Annual Report 2009-10*, 73.

⁸⁵ Board of Taxation, above n 79.

Use of interposed entities

Another way that contractors (who self-assess as genuine contractors) can obtain a tax benefit is by creating a legal structure (such as a partnership, company or trust) which is 'interposed' between themselves and their clients: the clients transact with the entity, which then distributes income to the contractor and/or their family.

This can be used to minimise tax in a number of ways. First, contractors can 'smooth' their income patterns, gaining tax advantages. For example, a contractor who earns \$50,000 in one year and \$150,000 in the next will pay a total of \$64,375 in tax. However, if the interposed entity earns those fees but distributes it to the contractor in two annual payments of \$100,000, the contractor will only have to pay \$54,900 in tax, saving almost \$10,000 and bringing their average tax rate down from 32% to just 27%.

Second, contractors can also split income with family members on low marginal tax rates, thereby obtaining tax benefits. This can be done in one of two ways. Family members can be put on the payroll (either as employees or as sub-contractors). For example, instead of earning \$100,000 as a contractor and paying \$27,450 tax, the contractor can employ their spouse as a book-keeper, earning but \$50,000 per annum (including superannuation). The family now only pays \$14,296 in tax, saving thousands of dollars every year and reducing their average tax rates from 27% to just 14%. This does not constitute tax avoidance – unless the wage paid to the spouse is uncommercial.⁸⁶

As an alternative to employing family members, the contractor can use the interposed entity to make payments (as company dividends, trust distributions, partnership income, etc). For example, a contractor earning \$100,000 per annum with a child attending University can direct \$50,000 per annum to the child. Once again, this reduces tax payable by more than \$13,000, and reduces average tax rates to just 14%.

These schemes are lawful, and the ATO does not consider them to constitute tax avoidance. However, it is clearly unfair that some workers (contractors) are able to use interposed entities to reduce their tax bill, while other workers (employees) — often performing the same or similar work — cannot do so.

Non-labour income

Recall that sham contractors (ie who do not meet the results test) are supposed to be limited in the deductions that they can claim.

⁸⁶ ATO, 'Income Tax: Income Splitting' (1986) Taxation Ruling IT2330.

However, many sham contractors can avoid this rule by structuring their affairs so that they earn 'business' income, rather than labour income (strictly, 'personal services income').

Labour is income earned as a reward for personal efforts or skills. However, ordinary business income is income generated by:

- selling goods;
- using an asset;
- giving somebody a right to use property (including intellectual property); or
- use of a business structure (eg a large firm).

This distinction is very fine. A truck owner-operator's income is considered to be earned from the use of the truck, not from their personal exertion, so is not treated as labour income. An author who does a deal with a publisher before they write their book earns labour income, but one who does a deal after the book is written is regarded as earning income from the sale of copyright.

If a payment from a client is *mostly* for non-labour items, then the tax laws will treat *all* of the income as ordinary business income (against which expenses can be deducted). In other words, if a contract is 49% for labour, but 51% for the supply of parts, all of the income from that job will be considered to be ordinary business income.

Many contractors seek to structure their affairs to earn ordinary business income, rather than labour income, in order to obtain tax benefits. For example, they may inflate the costs of capital items, and understate labour inputs: instead of charging \$50 for parts and \$150 for labour, they will charge \$150 for parts and \$50 for labour. This change allows them to treat all of the income as business income against which all business expenses can be deducted; and triples their GST input tax credit from \$5 to \$15 (which can ultimately be recovered from the ATO).

Alternatively, they may use sophisticated (and somewhat artificial) contracts that formally structure transactions as asset sales, even though the substance of the exchange is an agreement that that one person will work for another.


It is difficult to know how widespread these practices are. However, the fact that they remain open as tax loopholes remains cause for concern.

Conclusion

Sham contracting is a cancer in our system. It allows employers to shift risks and costs to workers and the taxpayer. It erodes our tax base. It puts workers in invidious positions, with almost no rights. All of this is being driven by the tax system.

The government should move immediately to close the tax loopholes that drive sham contracting. First, it should tighten the test of who is a 'genuine' contractor. Second, it should require clients of contractors to remit information to the ATO, to allow data-matching to occur. Third, it should resource the ATO to conduct a public crackdown against sham contractors.

The government should also examine the various tricks and loopholes that allow even genuine contractors to minimise their taxes, such as the use of interposed entities. At the end of the day, the principle must be that all labour income should be taxed in the same way; nobody should be disadvantaged because they earn their income as an employee, rather than as a contractor. Artificial vehicles (such as companies and trusts) should not be used to hide labour income from the tax collector.



Rorts and loopholes
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