PCG 2022/D5 (Finalised) - Classifying workers as employees or independent contractors - ATO compliance approach

This document has been finalised by PCG 2023/2.

Status: **draft only – for comment**

Draft Practical Compliance Guideline

Classifying workers as employees or independent contractors – ATO compliance approach

Relying on this draft Guideline

This Practical Compliance Guideline is a draft for consultation purposes only. When the final Guideline issues, it will have the following preamble:

This Practical Compliance Guideline sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow this Guideline in good faith, the Commissioner will administer the law in accordance with this approach.

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Status: **draft only – for comment**

What this draft Guideline is about

1. This draft Guideline[1] outlines the Commissioner's compliance approach for businesses that engage workers and classify them as employees or independent contractors. It sets out how we allocate our compliance resources, based on the risk associated with the classification.

2. The Commissioner is also the Registrar of the Australian Business Register. To the extent that this Guideline discusses matters of Australian business number (ABN) registration, the Registrar's approach aligns with the Commissioner's.

Background

3. When a business engages a worker, the arrangement will generally be one of:

- employment, where the worker is an employee and the engaging business is their employer, or
- independent contracting, where the worker performs the work in the course of carrying on their own business.

4. Determining which kind of arrangement is entered into is known as 'worker classification'. A business' tax and superannuation obligations, and a worker's tax obligations and entitlement to an ABN, can vary greatly depending on how the worker is classified.

5. Correctly determining whether a worker is an employee or independent contractor is important to ensure that both the business and the worker get their tax, superannuation, ABN registration and reporting obligations right.

6. It is not always easy to identify a worker's classification. The classification is determined by the totality of the contractual arrangement between the parties (including any implied or oral terms). The characterisation of the parties' relationship will generally be guided by the question of whether a worker is serving in the business of the engaging entity, as distinct from conducting an independent business of their own.[2]

7. It is the substance of a contractual arrangement that will dictate a worker's classification, rather than the labels used in it. Sometimes an entity that is carrying on a business will engage a worker with a written contract that describes the worker as an independent contractor, but when all rights and obligations in the totality of the contractual arrangement are considered, the arrangement is actually one of employment, or vice versa. A label in a contract, written or otherwise, cannot deem the relationship to be something it is not.[3]

8. Many arrangements will clearly be one of employment or of independent contracting. However, sometimes the totality of a contractual arrangement may have some indicators that point to an employment relationship and others that point towards independent contracting. This can make the correct classification difficult to ascertain.

9. The Commissioner's preliminary view of who is an employee is outlined in Draft Taxation Ruling TR 2022/D3 *Income tax: pay as you go withholding – who is an employee?*, which explains when an individual is an employee of an entity for the purposes of section 12-35 of Schedule 1 to the *Taxation Administration Act 1953*.

[1] All further references to 'this Guideline' refer to the Guideline as it will read when finalised. Note that this Guideline will not take effect until finalised.
[2] *Construction, Forestry, Maritime, Mining and Energy Union v Personnel Contracting Pty Ltd* [2022] HCA 1 (*Personnel Contracting*) at [39].
[3] *Personnel Contracting* at [58] and [66].

10. Further to the common law definition of employee, the *Superannuation Guarantee (Administration) Act 1992* (SGAA) contains an extended definition of employee for superannuation guarantee purposes. This extends beyond traditional employment relationships to take into account some independent contractors. Subsection 12(3) of the SGAA provides that if a person works under a contract that is wholly or principally for the labour of the person, the person is an employee for superannuation purposes.

11. The Commissioner's view of who is an employee under the extended definition is outlined in Superannuation Guarantee Ruling SGR 2005/1 *Superannuation guarantee: who is an employee?*. While SGR 2005/1 is being reviewed in light of the decisions of the High Court in *Personnel Contracting* and *ZG Operations Australia Pty Ltd v Jamsek* [2022] HCA 2, until it is updated, SGR 2005/1 is the Commissioner's published view on the extended definition of employee.

Who this Guideline applies to

12. This Guideline applies in situations where an entity that carries on a business (engaging entity) engages a worker and describes how and when we will allocate compliance resources to cases investigating the worker's classification.

13. This Guideline is relevant for a variety of tax and superannuation obligations for both the engaging entity and the worker, where the worker contracts directly with the engaging entity. Table 1 of this Guideline summarises the tax, superannuation and reporting consequences for the engaging entity and the worker depending on the worker's classification.

Table 1: Consequences of a worker's classification

Where the worker is an employee of the engaging entity	
Consequences for the engaging entity	**Consequences for the worker**
• Report via Single Touch Payroll • Withhold amounts under the pay as you go (PAYG) withholding regime • Make superannuation contributions or be liable for the superannuation guarantee charge • Meet fringe benefits tax obligations for benefits provided • Not entitled to claim input tax credits for wages paid	• Not entitled to an ABN in relation to that employment • Not entitled to register for goods and services tax (GST) and no GST reporting obligations in relation to that employment
Where the worker is an independent contractor	
Consequences for the engaging entity	**Consequences for the worker**
• Report via Taxable Payments Annual Reporting (TPAR) as legislated or on a voluntary basis if they satisfy the turnover-threshold test • If the worker satisfies the extended definition of employee, make superannuation contributions or be liable for the superannuation guarantee charge	• Make provision for income tax through PAYG instalments, if required • Entitled to apply for an ABN • Register for and paying GST, if required • Consider the personal services income implications

• If the engaging entity and worker are both registered for GST, claim eligible input tax credits • If the worker does not quote an ABN when required, or the parties enter into a voluntary agreement, withhold amounts under the PAYG withholding regime	

14. This Guideline does not replace, alter or affect our interpretation of the law in any way. It does not relieve the parties of their obligation to comply with all relevant tax or superannuation laws but is designed to give confidence that we will allocate compliance resources in line with the risk approach detailed in paragraph 22 of this Guideline.

15. The Guideline will be most relevant for situations where a worker's correct classification is less obvious and the business or worker (or both) want to understand how the ATO will allocate its compliance resources in such circumstances. If the arrangement is clearly one of employment or independent contracting, the parties may choose not to rely on this Guideline and self-assess based on their confidence that they have correctly classified their workers.

16. This Guideline does not extend to the income tax affairs of a worker, including whether they are entitled to claim deductions or concessions associated with carrying on a business or whether the personal services income rules apply to their arrangement.[4]

17. This Guideline does not apply to matters that are not tax and superannuation related and are outside the scope of the laws administered by the Commissioner. This includes matters concerning:

- the *Fair Work Act 2009*
- State revenue issues, including payroll tax
- Comcare and other worker insurance-related matters, and
- obligations under a contract or an applicable award or enterprise agreement (including where those obligations concern payment of superannuation).

Date of effect

18. When finalised, this Guideline is proposed to apply in respect of the application of the Commissioner's compliance resources from its date of issue.

Our compliance approach

19. Paragraphs 20 to 30 of this Guideline outline our risk framework for worker classification arrangements, based on the actions taken by the parties when entering into the arrangement. Parties can self-assess against this risk framework to understand the likelihood of the ATO applying compliance resources to review their arrangement.

20. The review of an arrangement may be the result of proactive case selection where particular risk factors and information known to the ATO warrants a review.

[4] See Part 2-42 of the *Income Tax Assessment Act 1997*.

21. A review may also be the result of an unpaid superannuation query received from a worker where they believe that they were entitled to superannuation because:

- they should have been classified as an employee and not an independent contractor, or
- they satisfy the extended definition of employee for superannuation purposes.

22. The risk framework is made up of 4 zones. When we review an arrangement on either of the occasions referred to in paragraph 21 of this Guideline, we will apply compliance resources initially to determine which risk zone the arrangement falls into. Once the risk zone has been confirmed, our application of compliance resources will depend on the zone in line with Table 2 of this Guideline.

Table 1: Risk zones

ATO approach		
Risk zone	**Unpaid superannuation query**	**Proactive case selection**
Very low	No further compliance resources will be applied.	
Low	Compliance resources will be applied to test whether the worker meets the extended definition of employee under the SGAA.	No further compliance resources will be applied.
Medium	Compliance resources will be applied to test the correct worker classification[5] for the arrangement but will be given lower priority than arrangements that are rated high risk.	
High	Compliance resources will be applied to test the correct worker classification for the arrangement and will be given the highest priority resourcing. Businesses may be subject to higher penalties if it is found they failed to correctly classify their workers.	

23. The following paragraphs of this Guideline outline the criteria that must be satisfied for an arrangement to fall into each of the risk zones. These criteria should not be taken to indicate whether an arrangement is in fact one of employment or independent contracting and should not be taken as guidance on how the ATO will apply the law to determine a classification if compliance resources are applied. If the ATO does apply compliance resources, it will be in line with the principles described in paragraphs 3 to 11 of this Guideline.

Very low-risk arrangements

24. An arrangement will fall into the very low-risk zone if all of the following are met:

- there is evidence to show that both parties agreed for the arrangement to have a given worker classification

[5] Reference to 'the correct worker classification' in this Guideline includes reference to the extended definition of 'employee', as well as 'common law employee'.

- there is evidence[6] the parties both understood the tax and superannuation consequences of that classification and intended for that to be the classification
- the performance of the arrangement has not deviated significantly from the contractual rights and obligations agreed to by the parties (including the actions outlined in Table 1 of this Guideline)
- the party relying on this Guideline obtained specific advice confirming that their classification was correct under both the common law definition of employee and the extended definition; the advice must be professional advice from the engaging entity's in-house counsel or an appropriately-qualified third party, such as a solicitor or tax professional, an administrative body or client-specific written advice from the ATO[7], and
- the party relying on this Guideline is meeting the correct tax, superannuation and reporting obligations that arise for that classification[8], including voluntarily reporting under TPAR where a business satisfies the turnover threshold test.

25. For an engaging entity relying on this Guideline, the arrangement will only fall into the very low-risk zone if the entity can demonstrate they have also satisfied the criteria in paragraph 24 of this Guideline for the extended definition of 'employee' for superannuation purposes. That is:

- they took steps to ensure the worker understood that they would not be an employee under the extended definition, and
- the advice obtained addressed the extended definition as well as the broader worker classification issue.

26. An arrangement can also fall into the very low-risk category if the engaging entity voluntarily decides to meet employer obligations regardless of their view of the classification. This includes voluntarily engaging in PAYG withholding for the worker, reporting via Single Touch Payroll or the taxable payments reporting system, and making superannuation contributions on behalf of the worker.

Low-risk arrangements

27. An arrangement will fall into the low-risk zone if all of the following are met:

- there is evidence to show that both parties agreed for the arrangement to have a given worker classification
- the performance of the arrangement has not deviated significantly from the contractual rights and obligations agreed to by the parties (including the actions outlined in Table 1 of this Guideline)
- the party relying on this Guideline obtained specific advice confirming that their classification was correct under both the common law definition of

[6] Evidence could include but is not limited to documentation such as an accepted record of discussion between the worker and engaging entity and any correspondence between parties on the intention and consequences of the classification.

[7] Where multiple workers are engaged under the same kind of arrangement, a single piece of advice that addresses that kind of arrangement will be sufficient to cover all relevant workers, provided the rights and obligations between the parties have not been altered in any meaningful way from the arrangement for which the advice was sought.

[8] In determining the correct tax, superannuation and reporting obligations for the purposes of this requirement, it is assumed that the classification adopted by the parties is correct.

employee and the extended definition; the advice must be professional advice from the engaging entity's in-house counsel or an appropriately-qualified third party, such as a solicitor or tax professional, an administrative body or client-specific written advice from the ATO[9], and

- the party relying on this Guideline is meeting the correct tax, superannuation and reporting obligations that arise for that classification[10], including voluntarily reporting under TPAR where a business satisfies the turnover threshold.

Medium-risk arrangements

28. An arrangement will fall into the medium-risk zone if all of the following are met:

- there is evidence to show that both parties agreed for the arrangement to have a given worker classification, and
- the party relying on this Guideline obtained specific advice confirming that their classification was correct under both the common law definition of employee and the extended definition; the advice must be professional advice from the engaging entity's in-house counsel or an appropriately-qualified third party, such as a solicitor or tax professional, an administrative body or client-specific written advice from the ATO.[11]

High-risk arrangements

29. An arrangement will fall into the high-risk zone if it does not fall in the very low, low or medium-risk categories.

30. Indicators of high risk include, but are not limited to, arrangements where there is evidence that:

- the party looking to rely on this Guideline did not turn any attention to the manner in which the worker in the arrangement was classified
- the parties did not agree on a classification
- the performance of the arrangement has deviated significantly from the contractual rights and obligations agreed to by the parties
- one party coerced the other to accept the arrangement as being a particular classification, or
- one party made false or misleading representations to the other or deceived them into believing the arrangement had a particular classification.

[9] Where multiple workers are engaged under the same kind of arrangement, a single piece of advice that addresses that kind of arrangement will be sufficient to cover all relevant workers, provided the rights and obligations between the parties have not been altered in any meaningful way from the arrangement for which the advice was sought.

[10] In determining the correct tax, superannuation and reporting obligations for the purposes of this requirement, it is assumed that the classification adopted by the parties is correct.

[11] Where multiple workers are engaged under the same kind of arrangement, a single piece of advice that addresses that kind of arrangement will be sufficient to cover all relevant workers, provided the rights and obligations between the parties have not been altered in any meaningful way from the arrangement for which the advice was sought.

What if the circumstances of an arrangement change?

31. It is common for arrangements between engaging entities and workers to change over time, as the relationship between the parties evolves and their circumstances change. A material change in the operation of an arrangement may amount to a variation of the contractual rights and obligations between the parties, which could impact the worker's classification.

32. Where a party to an arrangement self-assessed into one of the risk categories in this Guideline when an arrangement was entered into, and circumstances have materially changed, the party will need to reassess to ensure their risk rating has not increased. This may include:

- ensuring that both parties understand the impact of the changes on their working arrangement and classification
- ensuring the contractual rights and obligations agreed by the parties reflect the changes in the working arrangement
- ensuring that, if the classification has changed, all parties understand the tax, superannuation and reporting consequences of the new classification, and
- ensuring that new professional advice (whether from the ATO, the engaging entities' in-house counsel or an appropriately-qualified third-party) has been obtained to confirm the classification in light of the new circumstances.

Example 1 – very low risk – business and worker acting consistently with an agreed and understood relationship

33. *A manufacturing business entered into a contract with a software engineer, Brett, to design, develop, test and install a new software program. The business engaged Brett as an independent contractor and the agreement between the business and Brett indicated this classification.*

34. *In seeking to rely on this Guideline, the business identified the following facts that show it satisfied the criteria listed in paragraph 21 of the Guideline in determining the risk zone of the arrangement:*

- *the business had a record of discussions with Brett in which it highlighted that he was being engaged differently from the business' employees and why he was a contractor and not entitled to superannuation*
- *the business had procedures in place to ensure the terms of contracts and the tax and superannuation implications for Brett were explained, understood and acknowledged*
- *neither Brett's nor the business' subsequent actions suggested any significant deviation from the contracted arrangement; Brett acted consistently with that arrangement by applying for an ABN and through the way in which he reported his income, claimed business deductions and dealt with GST*
- *the business had obtained professional advice from an employment lawyer regarding their arrangement with Brett and their resulting tax and superannuation obligations, which indicated that the classification was correct and Brett did not satisfy the extended definition of employee for superannuation purposes, and*

- *the business complied with all of the taxation and reporting obligations arising from its engagement of Brett as a contractor, including voluntarily reporting the payments made to Brett through TPAR.*

35. *The arrangement is rated in the very low-risk zone. No further compliance resources will be applied to scrutinise whether Brett should instead have been classified as an employee of the business.*

Example 2 – very low risk – business engages both contractors and employees – relationships are agreed and understood

36. *Aussie Building Cleaners Pty Ltd (ABC) operates a cleaning business. The business does not have established premises; rather, cleaners attend a client's premises to undertake their duties. Some of the cleaners were employed by ABC under conventional contracts of employment, while other cleaners were engaged as independent contractors. While similar duties were undertaken by both kinds of cleaners, the terms and conditions differed significantly between the 2 kinds of arrangements.*

37. *Maria was one of ABC's window cleaners who was engaged as an independent contractor. After working for ABC for several years, Maria ceased her engagement with them. Subsequently, she lodged an unpaid superannuation query with the ATO claiming she should actually have been classified as an employee of ABC.*

38. *When Maria was engaged, ABC gave Maria the choice of entering into either kind of arrangement, noting that she would not be required to do the work herself if she was engaged as an independent contractor. Maria chose the independent contractor arrangement. The actions of Maria and ABC demonstrate they understood the differences between hiring someone as an independent contractor and hiring someone as an employee.*

39. *ABC also identifies the following facts that show it satisfied the criteria in paragraphs 24 to 25 of this Guideline in determining the risk zone of the arrangement:*

- *a written contract of engagement was provided to Maria which outlined the role, responsibilities and remuneration*
- *records of discussions between ABC and Maria demonstrate that both parties understood and acknowledged the tax and superannuation implications of engagement as an independent contractor rather than an employee*
- *Maria's subsequent actions did not suggest any significant deviation from the contracted arrangement; she acted consistently with the arrangement by applying for an ABN, invoicing ABC for her work using this ABN, reporting her income as business income and claiming business deductions*
- *ABC had obtained administratively binding advice from the ATO indicating that the appropriate worker classification had been reached for both kinds of arrangements and that workers in Maria's circumstances would not be employees under the extended definition for superannuation purposes; they shared a copy of both pieces of advice with Maria in explaining to her their position that she was not entitled to superannuation, and*
- *ABC complied with all of the taxation and reporting obligations arising from its engagement of Maria as a contractor, including reporting payments made to Maria through TPAR.*

40. *The arrangement is rated in the very low-risk zone. While the ATO investigates Maria's unpaid superannuation query to determine the risk zone, no further compliance resources will be applied to scrutinise whether Maria should instead have been classified as an employee of the business. The ATO will notify Maria of this outcome in response to her unpaid superannuation query.*

Example 3 – low risk – no evidence that the employee understood the tax or superannuation consequences of the classification

41. *CCC Pty Ltd engages workers to deliver pamphlets of their products to encourage local sales. Frank was offered a job and signed a written contract stating he was an independent contractor. CCC Pty Ltd did not pay Frank superannuation and complied with all relevant tax and reporting obligations regarding Frank as an independent contractor.*

42. *CCC Pty Ltd had previously obtained professional advice regarding the classification of workers in Frank's role as being independent contractors and discussed Frank's classification based on this advice with him.*

43. *However, CCC Pty Ltd did not discuss the impact of the classification as an independent contractor with Frank or what it meant for Frank's tax and superannuation obligations.*

44. *Although he follows the duties outlined in the contract, given the nature of the role, Frank considered he might be entitled to superannuation and lodged an unpaid superannuation query with the ATO.*

45. *As CCC Pty Ltd has not taken action to ensure an understanding with Frank regarding the tax and superannuation impacts of the independent contractor classification, the arrangement cannot be rated in the very low-risk zone. The arrangement is instead rated in the low-risk zone and compliance resources will be applied to test if Frank satisfied the extended definition.*

Example 4 – medium risk – business and worker agreed to relationship

46. *Truck Takers Pty Ltd (Truck Takers) operates a courier service for parcels. It engages some workers as employees while others that are engaged for 'overflow' delivery services during busy periods are classified as independent contractors.*

47. *After these overflow arrangements had been running for some time, the ATO identified Truck Takers' arrangements with their workers for review, based on risk factors and known information.*

48. *The following facts show that Truck Takers satisfied the criteria in paragraph 28 of this Guideline in determining the risk zone of the arrangement:*

- *the overflow workers signed written contracts with Truck Takers which described them as independent contractors; however, there is no evidence that Truck Takers engaged further with the workers to help them understand the reasons for the classification and the tax and superannuation implications of this classification, and*
- *the business had obtained independent advice from an employment lawyer regarding arrangements for workers providing their overflow delivery services, which indicated that the classification was correct under both the common law and extended definition of employee.*

49. *The arrangement is rated in the medium-risk zone, as there is a lack of evidence to demonstrate that Truck Takers took action to ensure the workers understood the reasons for, and consequences of, their classification.*

50. *Compliance resources will be applied to scrutinise whether the overflow workers should instead have been classified as employees of Truck Takers.*

Example 5 – high risk – changing circumstances not considered

51. *Sasha entered into a fixed-term contract with a mining company to undertake a safety audit. Sasha was engaged as an independent contractor and the written contract between Sasha and the company reflected this relationship.*

52. *At the time, the arrangement was rated in the very low-risk zone as the actions of Sasha and the company demonstrated they intended to enter into an independent contracting relationship and that all parties fully understood the consequences of this classification. The mining company had also obtained professional advice from an employment lawyer regarding their arrangement with Sasha and their resulting tax and superannuation obligations, which indicated that the classification was correct and Sasha did not satisfy the extended definition of employee for superannuation purposes.*

53. *When the project concluded, the company decided to engage Sasha on a permanent basis. Her role and responsibilities changed; however, this was not reflected in a new or updated written contract between the parties. At no time did the company obtain professional advice regarding how the changed circumstances may impact their classification of Sasha as a worker. Nor did they discuss with Sasha whether the new arrangement might mean that she became their employee.*

54. *When Sasha ultimately left the company, she was concerned that the company may owe her superannuation. She lodged an unpaid superannuation query with the ATO.*

55. *While the arrangement may have previously been rated in the very low-risk zone, given the events that occurred when Sasha's engagement with the company changed, the arrangement is now rated in the high-risk zone as the company cannot demonstrate any agreement, professional advice or understanding about the classification of the new engagement. Compliance resources will be given the highest priority to scrutinise whether Sasha should instead have been classified as an employee from the time her role changed.*

Example 6 – high risk – no evidence of an agreed relationship

56. *A restaurant hires Sam; however, no formal agreement is entered into. Sam is unsure if he is an employee or contractor. The restaurant simply asserts to Sam that he is working as an independent contractor and will require an ABN. Sam is told to accept the arrangement if he wants to be hired.*

57. *Sam becomes concerned his remuneration does not include superannuation. After reading guidance on the ATO website, he reflects on the nature of his work and suspects he is actually an employee of the restaurant.*

58. *Sam lodges an unpaid superannuation query with the ATO.*

59. *Given the lack of a written contract and lack of evidence of the characteristics of the arrangement that were agreed to, the restaurant is unable to demonstrate that the contractual rights and obligations of the parties resulted in an independent contractor relationship.*

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60. *Furthermore, the restaurant could not demonstrate they obtained professional advice from an appropriately-qualified third party about the classification or that they worked with Sam to ensure he understood the classification and consequences.*

61. *The working arrangement is rated in the high-risk zone and compliance resources will be given the highest priority to scrutinise whether Sam should instead have been classified as an employee of the restaurant.*

Commissioner of Taxation
15 December 2022

Your comments

62. You are invited to comment on this draft Guideline, including the proposed date of effect. Please forward your comments to the contact officer by the due date.

63. A compendium of comments is prepared when finalising this Guideline and an edited version (with names and identifying information removed) may be published on ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: 17 February 2023

Contact officer details have been removed following publication of the final guideline

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References

Related Rulings/Determinations:

SGR 2005/1; TR 2005/16; TR 2022/D3

Legislative references:

- ITAA 1997 Pt 2-42
- TAA 1953 12-35
- SGAA 1992 12(3)
- Fair Work Act 2009

Cases relied on:

- Construction, Forestry, Maritime, Mining and Energy Union v Personnel Contracting Pty Ltd [2022] HCA 1; 279 FCR 631
- ZG Operations Australia Pty Ltd v Jamsek [2022] HCA 2

ATO references

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