



**Professional
Contractors and Consultants
Australia**

THE RESULTS TEST

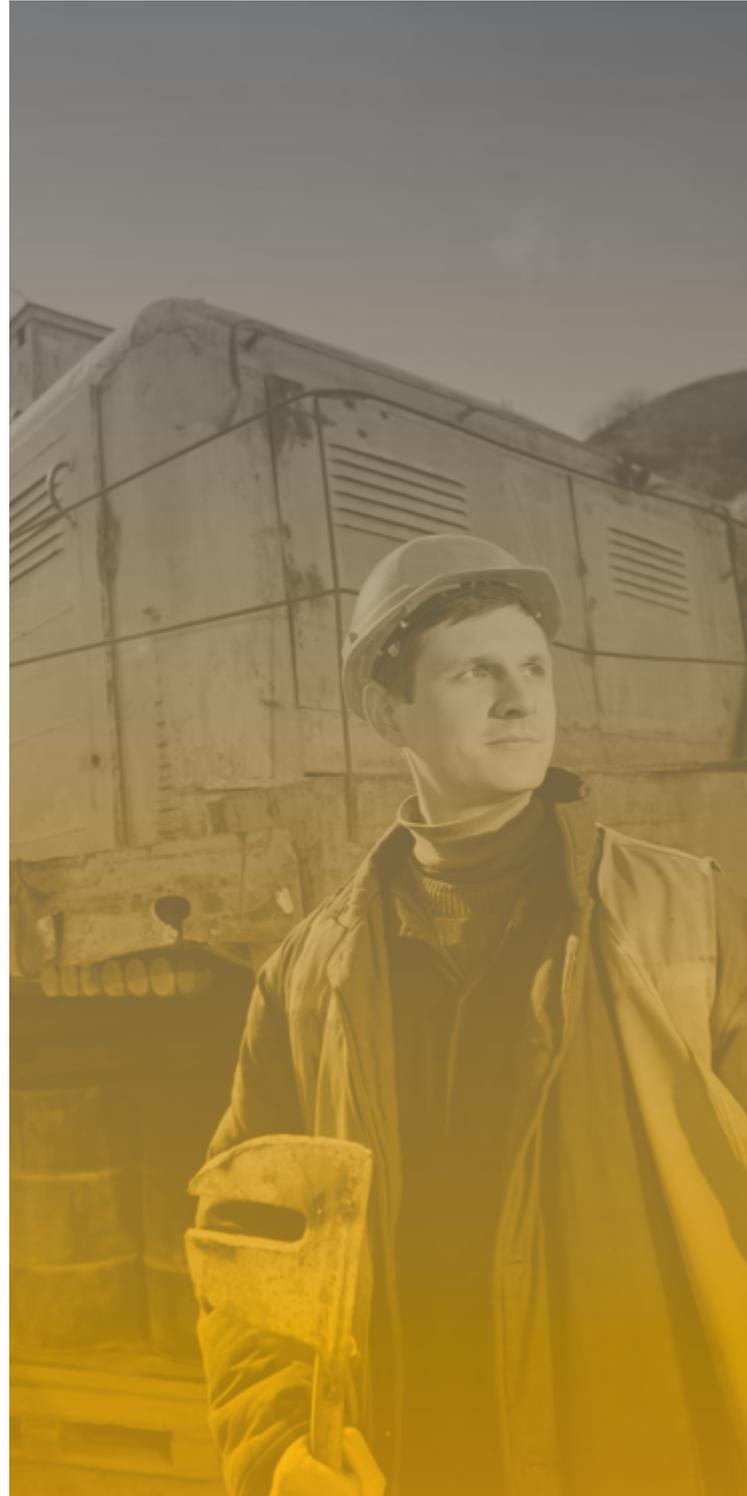


THE RESULTS TEST

The Alienation of Personal Services Income (PSI) legislation was enacted on 1 July 2000 in response to recommendations set out in the Ralph Report. The legislation was intended to prevent individuals who generate income from their personal services from reducing their liability to taxation by diverting that income through a company, partnership or trust, and to limit and clarify the work-related deductions available to the individual and the interposed entity. The ATO put in place Taxation Rulings TR2001/7 and 8 which detail how a range of personal services business tests to determine contractor status would be applied. Those who did not satisfy these tests would not be regarded as businesses, would fall within the scope of the PSI measure and be entitled to claim only those deductions and expenses to which an employee would otherwise be entitled.

While introduced as an anti-avoidance measure, Professionals Australia continues to hold the view that the Alienation of Personal Service Income legislation has imposed both uncertainty and financial penalties on a significant number of genuine independent contractors and consultants.

One of the major problems with the legislation for professional consultants continues to be the 80/20 Rule which effectively limits the type and duration of contracts genuine independent contractors and consultants can take on. The legislation presupposes a “normal” contract length of less than 12 months. However in many cases, this simply does not reflect the reality of commercial practice with many infrastructure projects and contract renewals meaning genuine contractors are contracted to one client for a period longer than 12 months in the one financial year. The PSI legislation forces them to effectively reduce the number of hours provided to a client in order to diversify their client base and sources of income, or potentially lose the capacity to claim a range of legitimate deductions.



In the revised ATO Rulings the Results Test was elevated as the first criteria against which contractor status was determined. Professionals Australia holds the view that a major problem with the Results Test is that it is largely inappropriate in the context of professionals delivering business services as it is framed in terms more appropriate to the manufacturing sector than the fast-growing service sector in the supposed knowledge-based Australian economy.

While Professionals Australia does not accept that it is desirable in terms of policy or application to require independent contractors to frame their contracts for service in a particular way to comply with poorly drafted legislation and Tax Rulings, it is within this framework that we provide a range of tips to consider when next drafting contractor terms of engagement.

The results test as specified in subsection 87-18(1) of the ITAA 97 provides: “An individual meets the results test in an income year if in relation to at least 75% of the individual’s personal services income:

- a. the income is for producing a result; and
- b. the individual is required to supply the plant and equipment, or tools of trade, needed to perform the work from which the individual produces the result; and
- c. the individual is, or would be, liable for the cost of rectifying any defect in the work performed.”

All three conditions must be met if a contractor is to satisfy the Results Test.

Tips for satisfying the Results Test

The terms of the contract under which a Consultant is engaged will be the determining factor in whether or not individuals satisfy the Results Test.

- Firstly you need to ensure you have in place contract documentation which describes the performance of services by the contractor to the acquirer of those business services. A verbal agreement, or a quotation and email exchange accepting the quotation, may not be a sound or sufficient record of what is an important business arrangement that should be appropriately documented (refer to Professionals Australia’s Standard Terms of Engagement document).
- In drafting terms of engagement, Professionals should differentiate between payment for producing a result and payment for performing work – evaluating whether the individual is **working for a result OR working to provide a service is a key area which will be considered by the ATO in assessing the character of a contract for service**. To satisfy the Results Test, the essence of a contract has to be to achieve a result and not to do work. Milestones, or results upon which progress payments are to be paid, can be included as an attachment to the terms of engagement.
- **To satisfy the first condition of the results test, it is necessary that not only is a result achieved but that the entitlement to receive income is dependent on that result. Contracts for service should therefore specify that payment for service is contingent and/or conditional upon achievement of a result and should specify this result.** That result can be a provision of expert advice in the form of a report, the conduct of a feasibility study whether or not the project goes ahead, or the achievement of specific milestones in a larger longer-term project. Terms such as “manage, coordinate, oversee, research, provide strategic input” are likely to be problematic in the context of the Results Test because they describe the work to be performed rather than the results to be achieved.

The terms of engagement should state:

The Contractor hereby agrees to achieve the following outcome [details of the outcome to be specified in sufficient detail so that the parties can determine whether the intention of the contract has been achieved] (“Services”) by the following date [insert proposed date of completion] subject to any extension agreed in writing between the parties.

- **Payment by hourly rates or progressive periodic payments DOES NOT NECESSARILY mean automatic failure of the Results Test.** However, whether or not these payments would be paid back if the final result was not achieved WOULD be seen as significant in these circumstances. The fact that repayment would be required should the result not be achieved should be specified in the contract for service.

This provision could be set out in the contract in the following terms:

The Contractor will provide the client with an invoice at the end of each week [or month if appropriate] indicating the progress made to achieving the performance of the Services and making a claim for a proportion of the contract sum based on the progress achieved.

The client will pay the Contractor the amount of the progress claim or such lesser amount as the client reasonably determines to reflect the progress to date within five days of the progress claim.

The Contractor agrees that this contract is for the obtaining of a result described above and unless that result is achieved, the Contractor will not be entitled to any of the contract sum and any amount of the contract sum that has been paid to date shall be refunded if the result is not achieved by completion.

- **The contract for service should specify a commitment to liability for rectification.** ATO officials confirmed that carrying own PI and PL insurance is important though not necessarily sufficient to satisfy this condition. Stated liability for the cost of rectification is sufficient – the contractor does not have to directly rectify the fault him/herself but the terms of engagement should specify liability for the cost of rectification. The key underlying consideration is whether the individual or entity is exposed to commercial risk in terms of a liability to cover the cost of rectifying defective work, consistent with the focus on “the chance of profit and the risk of loss” as a traditional indicator that an individual is an independent contractor conducting their own business.

A model clause would be:

“The Contractor will be liable for the cost of rectifying any defect in the work performed.”

This condition of the test would also be met by the following:

- the service acquirer pursuing a legal remedy for damages in circumstances where the defect is incapable of physical repair, or
- requirement for the consultant to perform additional work to complete a job which was defective without an entitlement to any additional payment.
- **The contract for service should specify a commitment to provide all tools and equipment necessary to achieve the result/s.** ATO officials have confirmed that a laptop computer is generally accepted as a tool of trade. If you use a client’s car, computer, phone, pen, etc., it is essential to satisfy this condition that they are **incidental** to the work and **not necessary** or required to complete the work. Temporary use of a client’s tools/equipment where it is more convenient to do so will not of itself disqualify the individual or cause this condition to be failed where they are not **required** to complete the work.

The terms of engagement should read:

“The Contractor will supply all equipment and tools of trade necessary for the provision of the Services.”

- **Termination**

The traditional criteria in relation to Termination set out in TR 200/14 states: “An independent contractor is contracted to complete a set task. The payer may only terminate the contract without penalty where the worker has not fulfilled the conditions of the contract.”

Indications are that the ATO in evaluating the character of contracts is considering these clauses very narrowly by concluding that where a termination option for both the independent contractor and service acquirer are provided for within the terms of the contract, that the contractor may not be bearing “the chance of profit and the risk of loss”.

APESMA Connect rejects the view that that a one month notice clause means there is ‘no risk’ - there is still the risk that the contractor will be out of work with only a month’s pay to show for it. Contractors - particularly those working to only one client - who include a mutual notice period in their terms of engagement should be aware that a Termination clause providing for termination by either party may be used as an indicator of the character of the relationship between the consultant and the Principal.

NB: A Termination clause in the context of defaults made by either party is specifically outside the scope of factors considered in determining the character of the contract in the Ruling.

- **Expenses**

Evidence suggests that the ATO may interpret the inclusion of an Expenses or Work-Outgoings clause in a contract as an indicator that the relationship between the contracting parties is not that of client and contractor. The ATO sees an Expenses clause as an indicator that the contractor is not being exposed to the commercial risk of making a loss under the performance of the contract. Allowances and expenses should be calculated into the total contract sum rather than being provided for in the contract as reimbursable items.

If you have concerns about how the PSI measure may affect you, Professionals Australia has a range of articles available that will help clarify its operation.

Professionals Australia will continue to lobby government for the 80/20 Rule to be considered over a 3-5 year period.

Traditional criteria for distinguishing independent contractors from employees as set out in TR 2000/14:

1. The contractual obligations	An independent contractor enters into a contract for a specific task or series of tasks.
2. How the work is performed	The independent contractor maintains a high level of discretion and flexibility as to how the work is to be performed. However, the contract may contain precise terms as to materials used and methods of performance and still be one for a result.
3. Risk	An independent contractor stands to make a profit or loss on the task. They bear the commercial risk. The independent contractor bears the responsibility and liability for any poor workmanship or injury sustained in performance of the task. Often an independent contractor would carry their own insurance and indemnity policies.
4. Tools and equipment	An independent contractor provides the assets, equipment and tools, if any, necessary for the work.
5. Hours of work and place of work	An independent contractor may set their own hours of work, or place of work, depending on the contract or the nature of the work.
6. Leave and entitlements	A contract for a result usually does not contain leave provisions, or allowances.
7. Payment	Payment to an independent contractor is often based upon performance of the contract rather than being paid an hourly rate, piece rates or award rates.
8. Expenses	An independent contractor usually incurs their own expenses.
9. Appointment	An independent contractor is likely to advertise their services to the public at large, and the contract for a result is often the direct result of this activity.
10. Termination	An independent contractor is contracted to complete a set task. The payer may only terminate the contract without penalty where the worker has not fulfilled the conditions of the contract. The contract usually contains terms dealing with defaults made by either party.
11. Delegation	An independent contractor may delegate all or some of the tasks to another person, and may employ other persons.



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