

## working as a contractor

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Contracting refers to an arrangement under which you render services to a company or organisation without becoming an employee. Contracts will generally be for a fixed period, usually weeks or months, although it is not uncommon for “back to back” contracts to be offered.

### why do companies and other organisations hire contractors instead of employees?

Some of the reasons companies and other organisations may hire contractors rather than employ someone on a permanent basis includes:

- ~ The need for temporary resources for specific projects. Contractors may be hired to work on a specific project.
- ~ Restrictions on employee numbers. Some companies and organisations may have restrictions on full/part time employee numbers; however, they may be able to offer contracting roles.
- ~ Outsourcing. Many companies and organisations may outsource particular functions eg, IT.
- ~ Flexibility. Contracting offers companies and other organisations flexibility to hire staff on a needs basis.

### why do individuals take contracting roles instead of becoming an employee?

Some of the reasons individuals may take contracting roles instead of becoming an employee include:

- ~ Lack of choice. In some situations, individuals may only be offered a contracting role.
- ~ Flexibility. Contracting may offer greater flexibility than employment, eg, the ability to set working hours.
- ~ Financial. In some situations, contracting may offer greater remuneration than employment.

### practical issues

There are a number of practical issues to consider when taking on contracting roles, including:

- ~ structure;
- ~ cash flow;
- ~ job security;
- ~ asset protection;
- ~ insurance; and
- ~ sick, annual, long service leave.

#### *structure*

There are three main ways contracting arrangements are structured:

##### **individual**

The simplest way to contract is to directly enter into a contract with a company or organisation.

##### **through an agency**

Another common way to contract is to offer your services through an agency. An advantage of this arrangement is that the agency may play an active role in seeking work for you and negotiating your hourly rate. This comes at a cost, as the agency will charge a commission, which may reduce the hourly rate you receive.

##### **through an entity such as a company or trust**

Offering your services through an entity such as a company or trust involves additional cost over contracting as an individual. In some situations, having a company is a necessity as some companies and other organisations will only offer contracts through a company, ie they will not offer contracts to individuals. In addition, there may be some advantages in using a company or trust which may offset the additional cost.

They may include:

- ~ Ability to take advantage of salary packaging options such as fringe benefits and salary sacrifice superannuation;
- ~ Income splitting opportunities, although these may be limited by the Personal Services Income (PSI) rules, which are discussed in more detail below; and
- ~ Asset protection.

#### ***cash flow***

One of the biggest issues, which you need to address in moving from employment to contract work, is cash flow. Things you need to consider include:

- ~ Your budget needs to be able to accommodate periods when you do not receive contracting work; and
- ~ You may be paid in arrears and there may be time lags between the time services are rendered and when you receive payment.

Part of your budgeting process should include a cash buffer or the ability to conveniently access funds by some other means to allow for peaks and troughs in your cash flow.

#### ***job security***

Contracts are generally for a fixed period; accordingly you have no “job security” beyond the end of a contract. You therefore need to plan in advance for new contracts/renewal of existing contracts. Your business plan needs to allow for “down” time, between contracts. In particular, you may encounter difficulty negotiating new contracts in December and January.

#### ***asset protection against litigation***

When you are an employee, your employer is liable for your actions. As a contractor you could find yourself liable for work you perform under your contract. Accordingly, you need to consider asset protection strategies such as use of a company or trust, transfer of ownership of assets and professional indemnity insurance.

#### ***insurance***

You need to review your insurance cover to ensure it is adequate. In particular, you should review the following:

- ~ Professional indemnity, as outlined above.
- ~ Workcover. Do you need to take out separate cover or are you covered by the policy held by the organisation you are contracting to?
- ~ Income protection. What definition of disability is used by the policy? As your income from contracting may be irregular, what definition of income is used by the policy?

#### ***sick, annual and long service leave***

As a contractor you are unlikely to be eligible for sick, annual and long service leave. Thus you need to ensure that the amount charged for your services incorporates an allowance for these.

## **Taxation**

### ***Pay as you go (PAYG)***

#### ***PAYG Withholding***

If you contract directly with the company or organisation or contract through an agency and the contract is primarily for your labour, the company, organisation or agency may deduct PAYG tax from payments in the same way as would happen with salary and wage income.

Alternatively, if you are employed by your own company, your company will be required to deduct PAYG tax from the salary it pays you.

### ***PAYG Instalments***

If the payments you receive for contracting are not subject to PAYG withholding, you may be liable to pay quarterly PAYG tax instalments. You will be required to lodge either an Instalment Activity Statement (IAS) or Business Activity Statement (BAS) with the Australian Taxation Office (ATO), which is due when you remit the quarterly PAYG tax instalments.

### ***Goods and Services Tax (GST)***

You may be required to register for and charge GST where you operate a contracting business or where you offer your services through a separate entity such as a company or trust. In this situation, you are required to register for GST if annual turnover exceeds \$50,000. You are required to charge GST on your invoices, accordingly, you need to take this into account when negotiating contracts. You are also able to claim an input tax credit for GST on items purchased for use in your contracting business.

GST is generally paid to the ATO quarterly.

### ***Business Activity Statement (BAS)***

Where you operate a contracting business or where you offer your services through a separate entity such as a company or trust, you will be required to lodge a BAS, usually on a quarterly basis. A BAS covers all payments to the ATO including GST, PAYG and FBT. It is usually lodged quarterly and is required in addition to annual tax and fringe benefits tax (FBT) returns.

### ***Personal Services Income (PSI)***

The PSI rules may apply where you receive income wholly or principally for your labour or services or where you receive income from exercise of personal expertise. This is an anti-avoidance measure designed to prevent income from personal services being diverted to a related person or company, which would result in less tax being paid than if you personally earned the income. The PSI rules may also restrict the tax deductions that can be claimed.

Factors, which indicate that the PSI rules may apply, are as follows:

- ~ most of your personal services income comes from a single source (normally 80% or more); and
- ~ you operate from premises supplied by the company or organisation you contract to.

Factors which suggest that the PSI rules may not apply are as follows:

- ~ you meet the “results test”
  - you are contracted to produce a specific result eg deliver a specific component of software
  - you provide your own plant and equipment or tools of trade
  - you are liable to rectify defects in the work performed
- ~ you contract to two or more unrelated entities
- ~ you employ one or more non- related parties who perform at least 20% of your personal services work.

If the PSI rules apply:

- ~ you cannot pay a salary or make superannuation contributions for a family member unless they perform “principal” work
- ~ you cannot split your personal services income with other related parties eg through the use of a company or trust
- ~ if you contract through a company, all the profit from personal services must be paid to you as salary

### ***Australian Business Number (ABN)***

If you are providing your services through a company or trust you will need to quote a valid ABN when invoicing for your services. If you don't, the company or organisation you contract to will be required to withhold tax at the top marginal tax rate (46.5%) on payments made to you

You do not need to quote an ABN if the amounts paid for your services are subject to PAYG withholding. In this situation, you would need to quote your Tax File Number (TFN).

## **Superannuation**

### ***Superannuation Guarantee (SG) Contributions***

Companies and other organisations are required to make SG contributions where they hire contractors and the contract is wholly or principally for labour. The required contribution is 9% of the gross amount payable under the contract, with a maximum contribution of \$3,171.60 per quarter (in 2006/07, based on quarterly income of \$35,240 or \$140,960 p.a.). You should also receive SG contributions where you contract through an agency. In most situations you will be able to choose the superannuation fund to which your SG contributions are paid.

Where you offer your services through your own company or trust, that company or trust has an obligation to make SG contributions on your behalf.

### ***Salary sacrifice***

You may be able to negotiate additional superannuation by way of salary sacrifice where you contract directly to a company or organisation, which is required to pay SGC superannuation contributions or where you contract through an agency. However, the company or organisation you contract to is not required to offer salary sacrifice.

Where you offer your services through your own company or trust, you can arrange for the company or trust to make salary sacrifice superannuation contributions on your behalf.

### ***Personal deductible superannuation contributions***

If you receive no or only minimal employer superannuation support (employer superannuation support includes SGC contributions) you may be eligible to claim a deduction for personal superannuation contributions. The deduction is the lesser of \$5,000 plus 75% of the excess above \$5,000 and the age based maximum deductible contribution (MDC) limit.

The MDC limits for 2006/07 and the contribution required to claim the MDC (if \$5,000 plus 75% of the excess is deductible) are:

Age	MDC	Contribution required to claim MDC
Under 35	\$15,260	\$17,804
35 to 49	\$42,385	\$52,414
50 and over	\$105,113	\$132,450

## **Where to seek help**

For additional assistance, contact you ipac adviser or your tax or legal adviser.