



**Australian Government**

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**The Treasury**

# Contractor Compliance Improvement Proposal

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Regulation Impact Statement

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## Background

1. In total there are more than one million independent contractors currently operating throughout Australia.<sup>1</sup> These contractors operate as self-employed businesses across an array of industries, with high concentrations in building and construction, financial and insurance services, agriculture and other professional services industries.
2. One issue that all of these contractors have in common is the taxation obligations that correspond with running a self-owned and operated business. Compliance with these obligations is often a difficult task for most taxpayers, but for some contractors the difficulty can be compounded by the volume of obligations and a general lack of understanding of them, or poor administrative practices.
3. Unlike most individual (non-business) taxpayers, contractors often deal with more complex taxation arrangements and requirements. For example, most contractors have to deal with the more complex aspects of income tax including capital gains tax, business deductions and additional reporting and record keeping requirements.
4. Some contractors may also be liable to remit and account for Goods and Services Tax (GST)<sup>2</sup>. Although exact numbers are not available, it is estimated that about half of the individual contractors in the building and construction industry have an active GST status.
5. Given these difficulties, the ATO has made a considerable effort over the years to educate and support contractors in respect of their taxation obligations. However, despite these efforts, the ATO believes that compliance with taxation obligations by contractors remains an issue and presents a systemic risk to revenue collection. In response to this risk, the ATO have suggested a number of ways to address non-compliance with taxation obligations by contractors.
6. In October 2009, the Board of Taxation also considered contractors in the context of the alienation of personal services income rules as part of their report entitled "*Post implementation review into alienation of personal services income rules*". In this report, the Board identified an increase in the number of contractors, the use of contractors and the problems associated with non-compliance.
7. This Regulation Impact Statement (RIS) examines this issue and some possible solutions in order to understand the foreseeable impacts on contractors and industry as well as the costs and benefits of the proposed approach.

## Problem

8. The core problem that this RIS examines is the high level of non-compliance with taxation obligations by certain contractors, particularly in relation to lodgment, correct reporting and payment. There are also the associated problems with contractors not complying with GST requirements, record keeping requirements and the personal services income rules.

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<sup>1</sup> Australian Bureau of Statistics (2010) "Forms of Employment" Release 6359.0, November 2009, p.32.

<sup>2</sup> Contractors with a turnover that is under the GST threshold (of \$75,000) are not required to register for GST.

9. Non-compliance with taxation obligations is not a problem that is unique to contractors. However, the ATO has identified a high level of non-compliance by contractors working in certain industries. This view is also supported by some industry representatives who have identified systemic non-compliance in the building and construction industry, which is a risk to fair and balanced competition. Other industry representatives consider that there are pockets of non-compliance in the industry similar to those that exist in other industries.

### *Why is non-compliance a problem?*

10. Non-compliance with taxation obligations is a problem that affects everyone in society. The obvious problem is the loss of revenue collections, which can restrict and reduce the ability for the Government to administer projects, policies and services to the benefit of the community.
11. However, non-compliance is also a key problem for business. In an industry with high levels of non-compliance, compliant taxpayers are often undercut by their non-compliant competitors who pay less or no tax and are therefore able to charge less for their goods or services and undercut competitors. This creates an uneven playing field and can lead to compliant businesses failing or becoming non-compliant themselves. It can also lead to a higher barrier to entry for new businesses.

### *Understanding the problem*

12. The ATO recently undertook compliance analysis on data from the 2006 and 2009 income years in relation to the top six industries in the micro market<sup>3</sup> (based on population size). These included the following broad industry groups:
  - Financial and insurance services;
  - Building and construction;
  - Professional, scientific and technical services;
  - Rental, hiring and real estate services;
  - Agriculture, forestry and fishing; and
  - Retail trade.
13. The analysis revealed that the building and construction industry was the least compliant out of the six largest industries in the micro market. The ATO data indicated that for the building and construction industry, 41 per cent of those entities with an active Australian Business Number (ABN) had not lodged a tax return. Of those that had lodged a tax return, 40 percent did not lodge their activity statements on time, with 10 per cent having not lodged at all.
14. Furthermore, ATO analysis also showed that the construction industry accounts for \$1.58 billion (or 20.73 per cent) of all debt owed to the ATO in the micro market and 60 per cent of all debt cases held by the ATO in the micro market (146,084 cases).
15. The ATO's current audit program, under the *Level Playing Field - Strategic Budget Initiative*, was initially established to target businesses engaging contractors that may be employees (otherwise known as 'sham contracting'). The ATO also used the audit program to check whether contractors were properly reporting their income, by matching the details of income paid to contractors for the 2008, 2009 and 2010 income years with ATO records.

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<sup>3</sup> The ATO defines the micro market as businesses that have an annual turnover of less than \$2 million.

16. The audit program revealed significant compliance problems with contractors in the building and construction industry who had not correctly reported payments received in tax returns or activity statements.
17. From this program, it was found that approximately 10 per cent of all tax invoices had been unable to be matched to a payee on ATO systems due to non-quotation or invalid quotation of an ABN. Of the approximately 11,500 matched entities in the initial analysis, 34 per cent were contractors in the building and construction industry. It was found that 31 per cent of those contractors that were matched to ATO records had not lodged a tax return, with a further 20 per cent having lodged but omitting all or part of their income (see Figure 1).

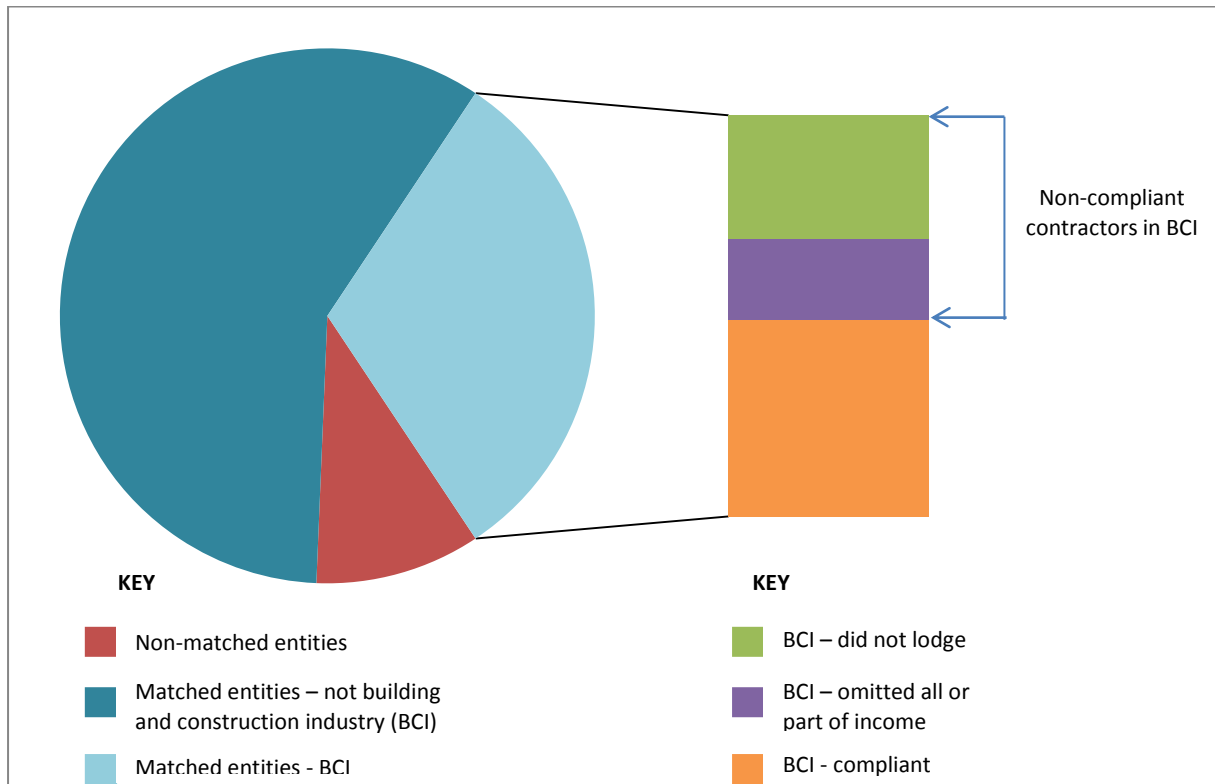


Figure 1: Audit program results - compliance of contractors in building and construction industry

18. The ATO has also produced some key compliance statistics<sup>4</sup> comparing the non-compliance levels of individual contractors in the building and construction industry with other individual businesses in the micro market.

<sup>4</sup> These compliance statistics are based on 2008 analysis from the ATO.

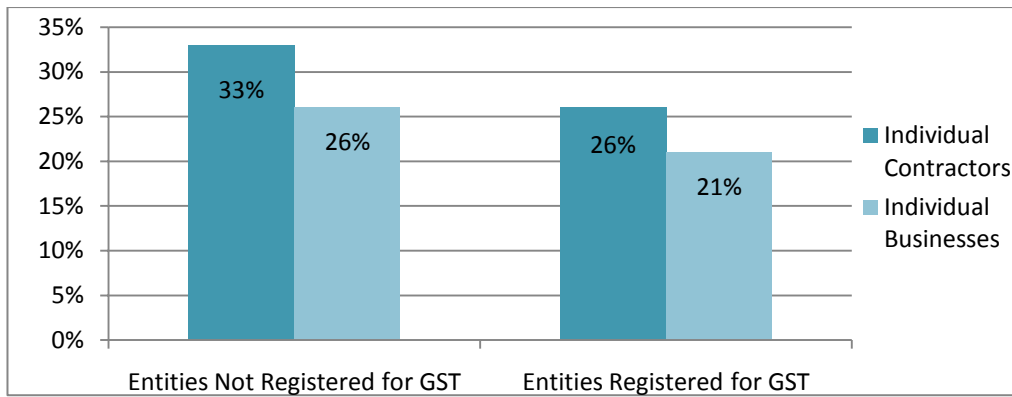


Figure 2: Income tax return non-lodgment rates in the micro market

19. Figure 2 shows a comparison between individual contractors in the building and construction industry and other individual businesses with respect to non-lodgment rates for income tax returns in the micro market.
20. The figure indicates the higher levels of non-compliance from individual contractors compared to other individual businesses irrespective of whether the entity is registered for GST. On average, the level of non-compliance with income tax obligations by contractors is approximately 6 per cent higher than the non-compliance level of comparable individual businesses.

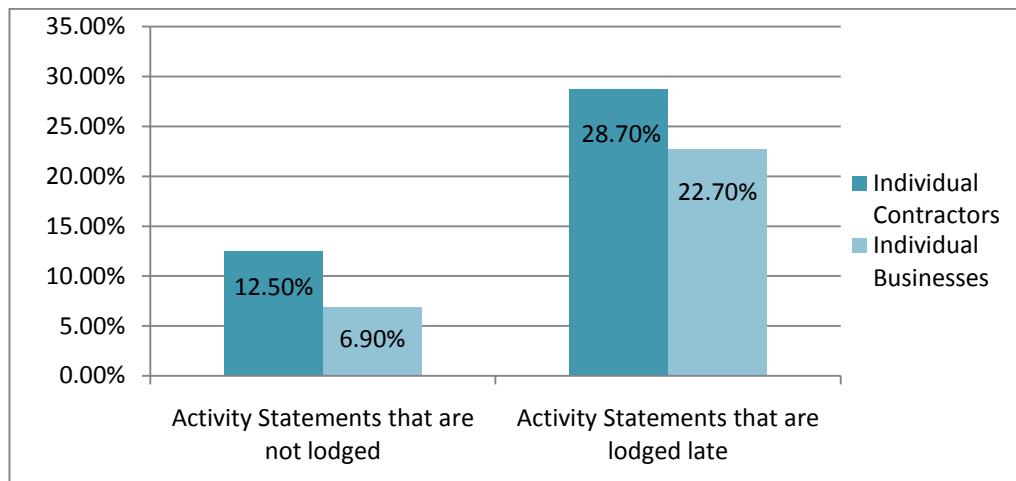


Figure 3: Activity statement lodgment rates in the micro market

21. Figure 3 shows a comparison between individual contractors in the building and construction industry and other individual businesses with respect to lodgment rates for activity statements in the micro market.
22. As with Figure 2, this chart shows a higher level of non-compliance from individual contractors than other individual businesses in a similar market base who have activity statement obligations.
23. The higher non-compliance level of contractors in the building and construction industry represents an unacceptable risk to revenue. Left unresolved, it could continue to build up and have broader adverse impacts on voluntary compliance in the micro market base.

### *What caused the problem?*

24. Many factors have contributed to the high levels of non-compliance with taxation obligations by contractors in the building and construction industry.
25. For instance, some contractors operating in the building and construction industry lack the capacity to comply with their taxation obligations due to the complex nature of the business tax system and pressures on time and resources (coupled with a lack of tax knowledge). This view is supported by many industry representatives who note that a lack of knowledge or awareness and the complexity of the system is a major contributing cause to non-compliance in the industry.
26. However, the entrenched non-compliance by contractors in the building and construction industry indicates that it is often the contractors' unwillingness to comply that contributes to the higher rates of non-compliance. This leads to the existence of the 'cash economy' and, (in the words of some industry representatives), a 'black market for labour'.
27. Where non-compliance is systemic or entrenched within an industry, it acts as a disincentive for new entrants in the industry to comply with their taxation obligations. This is especially the case where non-compliant contractors are able constantly undercut or outbid compliant rivals.
28. A related, but nevertheless separate issue is that, in practice, many contractors appear to approach their work as if they were employees rather than contractors, either unaware of, or disregarding, their broader business tax obligations. As a result, some contractors who are unable to manage their business tax obligations can find themselves with a considerable tax debt, which often results in business failure and the consequential social issues that follow.
29. Non-compliance with taxation obligations can also arise from factors external to the contractor or industry. Legislative amendments to existing taxation obligations can often lead to additional responsibilities. Inadequate notification or education of these changes may reduce the contractors' ability to comply with these new obligations. This can occur where the ATO changes their administrative treatment or applies the law in a way that has adverse ramifications for contractors in particular industries.
30. Additionally, non-tax issues associated with employment law and immigration can also have an effect on a contractor's ability/willingness to comply with their taxation obligations. For example, consultation with industry has revealed compliance issues associated with contractors engaging in 'sham contracting' arrangements and businesses contracting work to foreigners holding non-457 visas. Although the exact extent of this interaction is unclear, industry representatives have indicated that breach of 457 visa restrictions, allowing unqualified labour to work in the industry, is a significant problem in the building and construction industry.
31. It is hard to identify one set of specific factors that has caused the non-compliance problem. However, any solution proposed must consider both the contractors' *willingness* to comply as well as their *ability* to comply.

### *Efforts already made to solve the problem*

32. Since identifying the high levels of non-compliance with tax obligations by contractors in the building and construction industry, the ATO has made increased efforts to address the

problem. This included increasing resources for audit activities and education programs for contractors in this industry.

33. These activities have been met with limited success, with many contractors still failing to show a willingness or ability to comply. The ATO has evaluated these efforts and concluded that longer-term improvement in voluntary compliance in the building and construction industry is unlikely to come from these approaches. Short-term improvements following compliance intervention are generally not sustained, and this approach is costly to apply on a wide scale.

## Objectives of possible solutions

34. There are two main objectives for any possible solution.
35. The first is to improve compliance with taxation obligations by contractors in the building and construction industry. The second is to develop a model to improve compliance that could be applied to contractors in other industries — particularly those with high-levels of contractors or of non-compliance.
36. The reason for this two-tiered approach is that ATO compliance analysis has indicated that contractors in the building and construction industry have particularly high levels of non-compliance compared to contractors in most other industries.
37. As a result, the options in this RIS are developed with the primary objective of compliance improvement in the building and construction industry. Depending on the success of these options, they could then be considered for extension to other industries with similar problems.

## Implementation options

38. This section considers the different types of implementation options, both regulatory and non-regulatory, and assesses why these alternatives might be used to achieve the proposal objectives. The options include both explicit government regulation and non-regulatory options. Although each option can be viewed as a stand-alone option, it is also possible to combine a regulatory option with the non-regulatory option to better improve the chances of satisfying the proposal objectives.
39. This section also assesses how effectively these options would achieve the proposal objectives.

## Regulatory

40. The first three implementation options are forms of 'explicit government regulation'. The Office of Best Practice Regulation handbook explains that explicit government regulation can be an effective way of regulating where the regulation needs to apply to an entire industry or more than one industry sector, or where there is a significant history of a systemic compliance problem. As stated above, both of these elements are relevant for this proposal. Accordingly, explicit government regulation is justified.
41. Recent academic research supports the hypothesis that 'compliance is likely to be higher when taxpayers perceive there to be a higher probability of being caught along with anticipated



adverse consequences'.<sup>5</sup> Additionally, research has found that compliance with taxation obligations often becomes a casualty of business pressures for small businesses where there is no third party reporting of income and the chances of detection are low.<sup>6</sup>

42. For that reason, systemic non-compliance in the building and construction industry is likely to continue and may in fact worsen as industry perception of compliance integrity degrades. To combat this attitude and ensure that the perception of compliance integrity in the building and construction industry is high, explicit government regulation is required.
43. The use of explicit government regulation would also facilitate expansion of a regulatory model to contractors in other industries, should it prove effective.
44. The parameters of each option proposed below (who would have an obligation, which contractors would be subject to the regime and what types of contracts would be covered) would require further development following consultation with industry.

### Option 1 — Reporting

45. Option 1 involves the introduction of an income reporting regime which would require businesses to report annually to the ATO amounts paid to contractors in the building and construction industry as well as each contractor's ABN. The information that businesses are required to provide in these annual reports is information that they should already commonly collect and/or record under existing business record keeping requirements.
46. The reporting regime would operate through the existing Payment, ABN and identification verification system (PAIVS) in Part 5-30 in Schedule 1 to the *Taxation Administration Act 1953* (TAA). The PAIVS allows for reporting of payments such as those targeted by this option. It was introduced in 2000 as part of the *A New Tax System* changes and would provide a suitable legislative platform to deliver a reporting regime as intended by this option.
47. The explanatory memorandum (EM) to the *A New Tax System (Tax Administration) Act 1999* (ANTS Act) details the policy intent underlining the creation of PAIVS. Paragraph 4.1 of the EM states that:

*"The system [PAIVS] is intended to be used in areas where non-compliance with the taxation laws is entrenched. The main objective of the new system is to ensure that business participants meet their tax obligations and that any current or future competitive advantage resulting from non-compliance is minimised."*
48. The PAIVS has not been activated yet, however, as foreshadowed in the EM at paragraph 4.3, *"components of the new compliance system will only be used in areas where there is entrenched non-compliance and when the Government is convinced that it is necessary."*
49. To apply the PAIVS to contractors in the building and construction industry, a regulation would be inserted into the *Taxation Administration Regulations 1976*. The regime would operate to require a 'purchaser' to report details to the ATO of 'suppliers' who they have paid for a

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<sup>5</sup> Ahmed, E. & Braithwaite, V (2005) 'Understanding small business taxpayers: Issues of deterrence, tax morale, fairness and work practice', *International Small Business Journal*, Vol 23, Issue 5, pp. 539-568 at p. 540.

<sup>6</sup> Ahmed, E. & Braithwaite, V (2005) at p. 543.

'supply'. The incentive for purchasers to meet their reporting obligations would be provided by the penalty provisions within the existing PAIVS system (currently 20 penalty units).

50. The regulations would set the parameters of this option by defining these key terms.

#### *Parameters – who would report and how*

51. The responsibility to report payments to the ATO would fall on the 'purchaser' as defined by the regulations. It is expected that the purchaser would be any business, including a sole trader or a contractor, engaged in the building and construction industry.
52. Consultation with industry will help to determine whether it is appropriate to extend the definition of 'purchaser' any further, such as to 'connected businesses'. Such an extension would bring into scope those businesses that are not necessarily engaged in the building and construction industry, but are sufficiently connected to it to warrant inclusion in the scheme. For example, it may bring in retailers of building and construction products, such as a hardware store, that regularly contracts tradespeople to install their products, such as kitchens, tiles and paving, security screens and doors, and air conditioners. Consultation on the appropriateness of this extension would also be necessary for Option 2 and Option 3.
53. A 'purchaser' would not include an individual in a domestic capacity, such as a householder.
54. The reporting regime would require the 'purchaser' to fill out an annual report providing details of any payments to suppliers for a supply of services (including labour and materials) under a contract. These reports may be lodged electronically or manually, depending which is most compatible with businesses' natural systems as determined through post-announcement consultation between industry and the ATO. Administratively, the ATO has a number of manual and online lodgment channels that could be utilised for this reporting function.
55. To implement this reporting regime it may be possible to use the Standard Business Reporting (SBR) Program to automate some of the requirements. This would allow SBR compatible businesses to avoid manual reporting of payments. As is currently the case, use of the SBR Program would not be mandatory, allowing those who wish to report manually to do so.
56. Currently, only those businesses that use SBR compatible software and use, or are willing to use, electronic record keeping practices are likely to be able to use automated reporting. It is expected that the SBR may be most useful at the business or 'principal' contractor reporting level, as smaller contractor businesses and sub-contractors may not have made arrangements to make use of the SBR platform. The degree of effectiveness of the SBR program in minimising compliance costs under this proposal should be revealed during consultation.

#### *Parameters – who would be reported on*

57. The 'supplier' would be any contractor (individual and non-individual) in the building and construction industry with an ABN, regardless of their GST status.

#### *Parameters – what payments would be subject to reporting*

58. A payment for a 'supply' would be covered by the reporting regime where the payment is made to a contractor in connection with building or construction activities.

59. Combining these definitions, the reporting regime would operate to require a business that is engaged in the building and construction industry to report any payments made to contractors in the building and construction industry (see Figure 4).

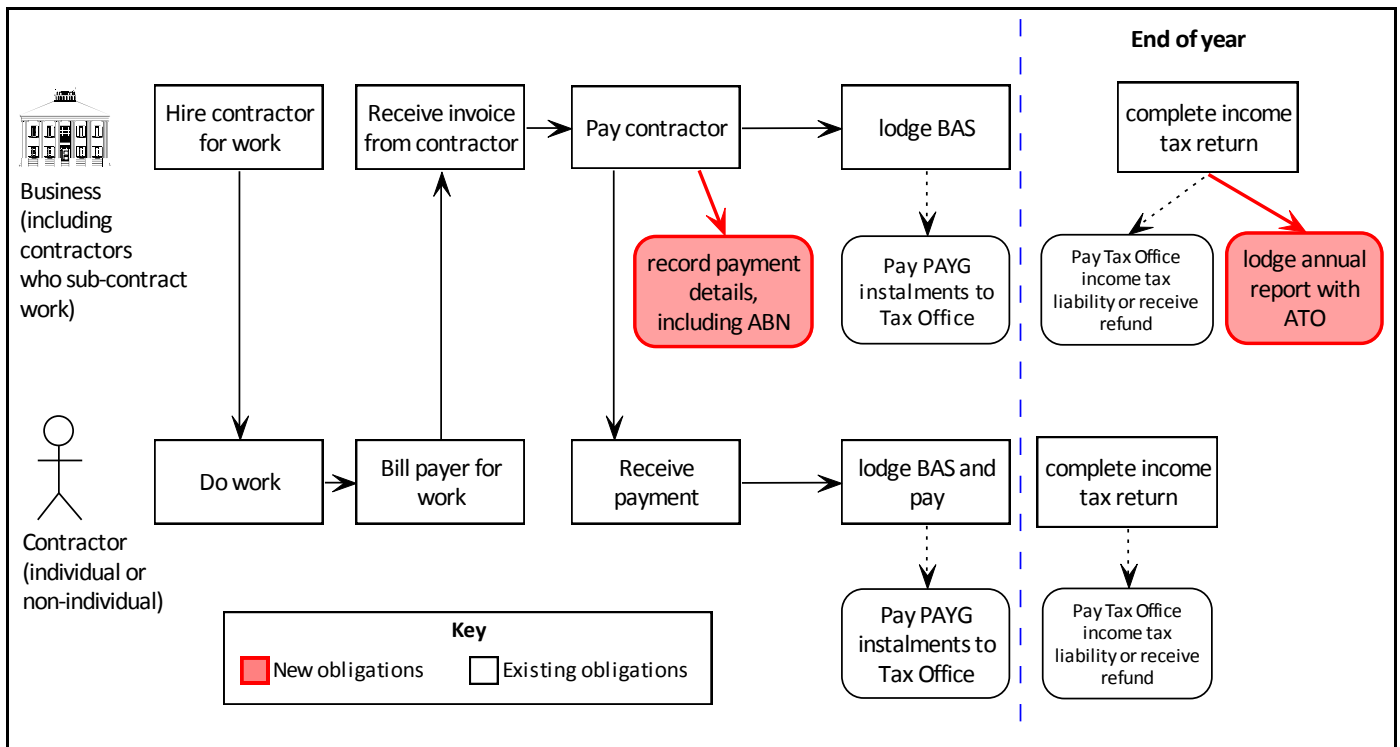


Figure 4: Example of the proposed reporting regime — Option 1

### Achieving the proposal objectives

60. For contractors in the building and construction industry who were *unwilling* to comply, the establishment of such a reporting regime would be likely to change their behaviour towards voluntary compliance. This is because they would be aware that the details of their income have been provided to the ATO and that failure to properly fulfil their tax obligations would be much more likely to lead to audit and penalties. The reporting requirement is also likely to send a clear message to those acting in the cash economy that their payment details and ABN will be captured and they may be pursued for their tax evasion.
61. For contractors who are not *capable* of complying, the reporting regime would also assist them indirectly, as the ATO would be able to more efficiently target their existing education and assistance products and subsequently monitor their behaviour.
62. Once established and proving its effectiveness, the reporting regime could be extended to other industries with high levels of contractor non-compliance by adding regulations to bring those payments under the PAIVS.

### Option 2 — Withholding

63. Option 2 would involve the introduction of an income withholding regime, which would require businesses to withhold amounts from payments to individual contractors in the building and construction industry and pay those amounts to the ATO.

64. The withholding regime would operate in accordance with the existing pay as you go withholding (PAYGW) regime. The PAYGW regime can be applied to any type of payment by specifying the details of the payment in the legislation. These are known as specified payments. The withholding regime for contractors in the building and construction industry would be implemented by introducing a new specified payment into the existing provisions under the PAYGW legislation. The legislation would also be amended to allow businesses to quote their ABN, as opposed to their TFN, for withholding purposes.
65. The amounts remitted to the ATO under the withholding regime would be available as credits that may be claimed by the individual contractors when they lodge their income tax return.

#### *Parameters – who would withhold and how*

66. It would be the responsibility of the ‘payer’ to withhold from payments they make to individual contractors and pay those amounts to the ATO. In this instance, the payer would be defined in the same terms as the purchaser under the reporting regime: any business, including a contractor or a sole trader, engaged in the building and construction industry (or, if appropriate, sufficiently connected to it — see paragraph 44).
67. Under the withholding regime the payer would be required to withhold a specified percentage from a payment made to an individual contractor prior to making the payment. The specified percentage would need to be determined in consultation with the industry as it has the potential to significantly impact on the cash flow of the business.
68. Currently, a withholding regime applies where an entity makes a payment under a contract for construction and associated activities to a foreign resident. Under that regime, the withholding rate is 5 per cent. This withholding rate covers a broad range of construction and related activities. Although the context is slightly different, this withholding rate may provide a platform to assess what an appropriate rate for all contractors in the building and construction industry would be.
69. The payer would then be required to pay the amount withheld to the ATO (see Figure 5).

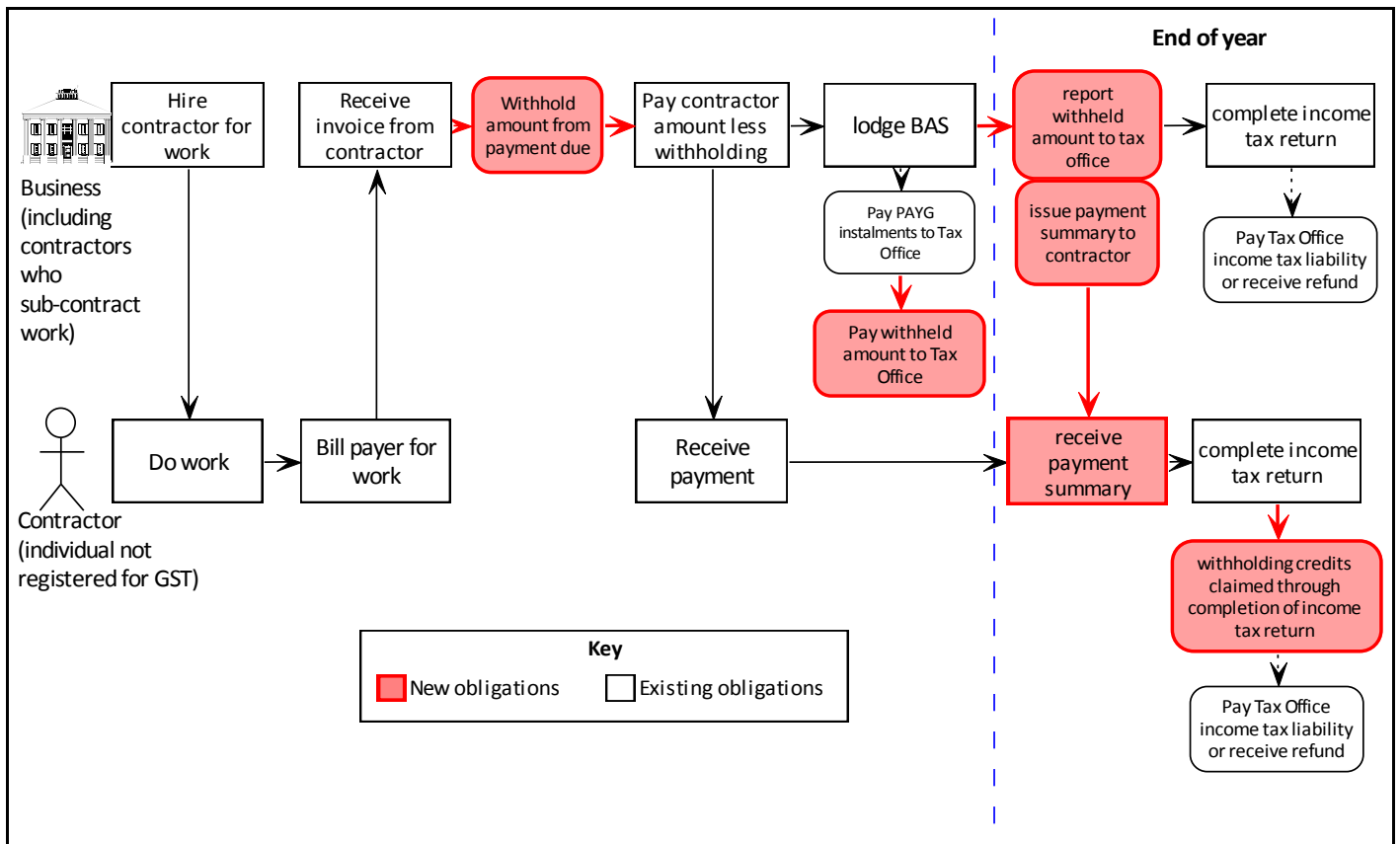


Figure 5: Example of proposed withholding regime — Option 2

### Parameters – who would be subject to withholding

70. The payees that would be subject to withholding would be a subset of those subject to reporting (Option 1). In the case of withholding, the payee would need to:
  - be an individual contractor;
  - be engaged in the building and construction industry;
  - hold an ABN; and
  - not be registered for GST.
71. Those contractors who are not registered for GST are viewed as being more likely to be non-compliant than their GST-registered counterparts. Part of the reason for this may be that those contractors who are not registered for GST have no real need to interact with the ATO. Those not registered for GST are also more likely to be vulnerable or less informed taxpayers who would benefit more from the assistance a withholding regime offers. Accordingly, a more targeted application would be adopted for this option.
72. Additionally, imposing a withholding regime onto a GST system would be very complex for taxpayers and would pose significant administrative costs and complexities. It would also pose problems for contractors' cash flow in terms of the interaction between the withholding and the GST credits/remittance. The potential payer would commonly be aware of the payees' GST status by checking the tax invoice that is required from the payee. If they wish to claim an input tax credit they will need the tax invoice from the payee which would provide the

necessary information for the payer. Additionally, the payer could also use the 'ABN lookup' website to determine whether the payee is GST registered and therefore, whether a withholding obligation has arisen.

*Parameters – what payments would withholding apply to*

- 73. The requirement to withhold would apply to all payments to individual contractors in the building and construction industry.
- 74. Where contractors further sub-contract the work, then payments to other individual contractors would also be subject to withholding (see Figure 6).
- 75. Consultation would be necessary to determine an appropriate withholding rate to avoid unnecessary restrictions on cash flow of these businesses.

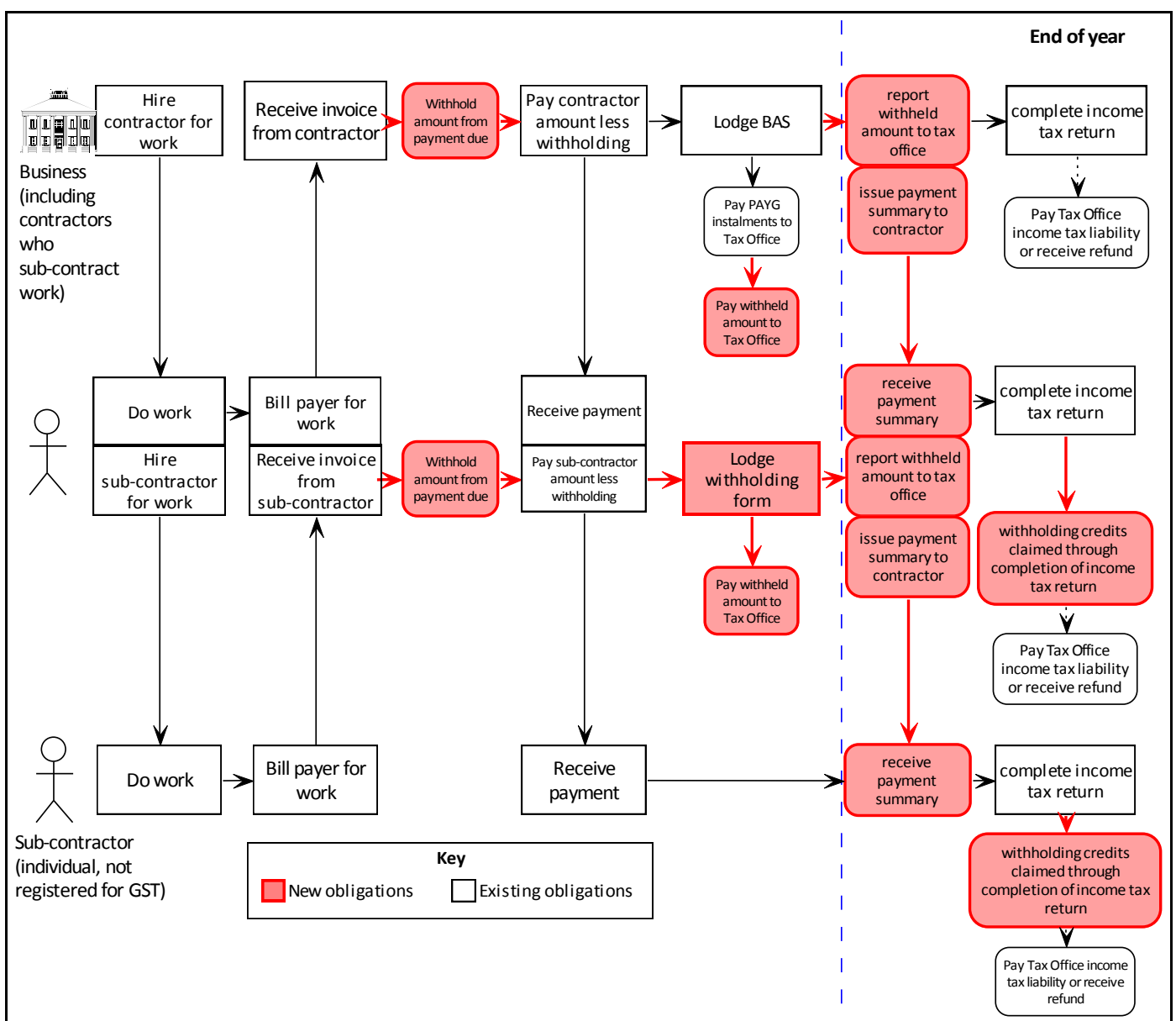


Figure 6: Example of proposed withholding regime with multi-level withholding — Option 2

*Achieving the proposal objectives*

76. A withholding regime could be an effective way of achieving the first proposal objective of improving compliance rates for contractors in the building and construction industry. The withholding regime would encourage contractors to submit income tax returns or face losing their tax credits.
77. However, the definition of key parameters would largely determine the success of this option in achieving the proposal objectives. In the proposed approach, the incentive to improve compliance would only be felt by individual contractors in the building and construction industry who are not registered for GST. Accordingly, this option is unable to fully satisfy the proposal objectives.
78. In a technical sense, the withholding regime would achieve the second proposal objective as other specified payments could be introduced into the existing PAYGW framework to encompass other industries with high levels of contractor participation or contractor non-compliance, or all industries. The required change to allow for the quotation of the ABN would facilitate the expansion of the regime to these other industries.
79. Although it is theoretically possible to transfer this regime to all industries, it would prove very difficult in practice. Extending a withholding regime to all contractors would essentially apply a withholding regime to any business in Australia who hires a contractor. This would both be impractical and cause significant compliance costs and cash flow issues across the economy.

### **Option 3 — Withholding and Reporting**

80. This option would entail a combination of both the first and second options. Those businesses who are engaging contractors in the building and construction industry would need to determine the contractor's GST status and their business structure to determine whether they have a reporting obligation or a withholding obligation. As explained in Option 2, this would be commonly done by using the tax invoice provided by the payee or by using the 'ABN lookup' website which lists the contractor's GST status with their ABN details.
81. The establishment of the legislative framework would be the same as under the first two options. However the parameters for determining which obligations apply are different under this option than under the separate frameworks. The obligations under this combined framework would be determined primarily on a contractor's GST status (see Figure 7).

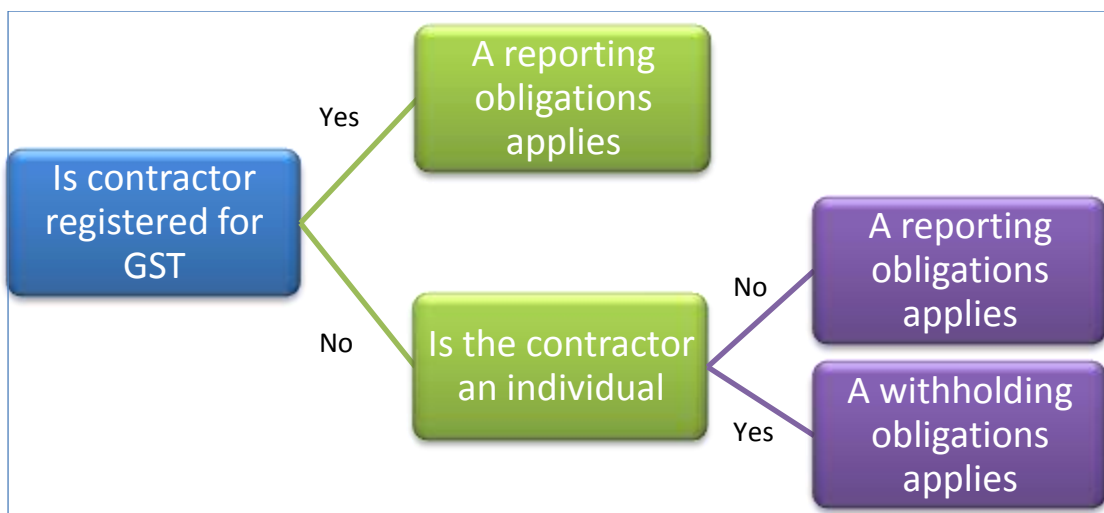


Figure 7: Application diagram of the proposed reporting/withholding regime — Option 3

### Reporting parameters

82. Under this combined framework, the parameters for defining the purchaser and the supply would be the same as the reporting framework (Option 1). However, the definition of the supplier would be different, requiring businesses to report on payments made to all contractors in the building and construction industry who are registered for GST. This change in the definition of suppliers would be designed to complement the fact that the withholding regime would not apply to those individual and non-individual contractors registered for GST. Accordingly, the introduction of a reporting regime for GST-registered contractors would ensure that more contractors are within some type of compliance framework.

### Withholding parameters

83. The withholding framework under the combined approach would be consistent with the parameters of the withholding regime (Option 2). That is, payments made:
- by businesses engaged in the building and construction industry;
  - under a contract in relation to a building or construction activity; and
  - to an individual contractor who is not registered for GST.

### Achieving the proposal objectives

84. This option would be the most complex as it would require businesses and contractors who sub-contract work to be familiar with and engaged in both the reporting and withholding regimes, as well as the difference between the parameters of the regimes. In practice, this would mean that businesses would potentially have annual (reporting) and quarterly (withholding) obligations depending on the GST status of the contractors they use.
85. Like Option 1 and Option 2, it would be possible to expand the combined regime to apply it to other industries with high concentrations of contractors, or to all contractors, satisfying the second proposal objective. However, like with Option 2, Option 3 would pose the same practical difficulties surrounding the application of a withholding regime to all contractors in all industries.



86. In addition to those difficulties, Option 3 would be expected to be even more challenging to expand to contractors in all industries given the complexity of this framework. As mentioned above, the inconsistency in the parameters and timing of obligations between the reporting regime and the withholding regime would require all businesses to be familiar with and engage in both regimes, making it particularly complex for those responsible for withholding and reporting to understand and meet their obligations.

## Non-regulatory

87. The fourth option is an alternative instrument, or non-regulatory option, which can be considered independently or as an option to accompany Options 1 – 3.

### Option 4 — Increased education and assistance by the ATO

88. This option would involve increasing funding for the ATO to provide a targeted package of information and assistance to contractors and apprentices in the building and construction industry. The educational program would be accompanied by a high profile activity, such as an ‘audit blitz’, to encourage greater initial engagement with the program.
89. This non-regulatory option stems from the understanding that contractors generally have a complex compliance framework as they are responsible for almost all of the regulation surrounding their work. On top of taxation obligations, contractors also have superannuation obligations, workers compensation obligations and other regulatory burdens stemming from both the State and Federal Governments. Unlike employees, who benefit from their employer taking care of these obligations, contractors are responsible for meeting each of these obligations themselves.
90. The education and assistance program would also be targeted towards apprentices as it would better equip them to be business-ready by helping them to understand their taxation obligations when they do enter the industry as contractors.
91. By improving the understanding of those most likely to become contractors in the building and construction industry, there is an increased chance that they would be more confident to meet their obligations immediately on entering the contracting workforce.

### *Achieving the proposal objectives*

92. The ATO has indicated that this approach would have short term benefits but is unlikely to achieve any long term increase in voluntary compliance. If it were coupled with any of Options 1 to 3 it may improve the effectiveness of the compliance aspects by improving contractors’ *ability* to comply. However, it does not effectively deal with contractors who are *unwilling* to comply.
93. This option could be expanded to other industries with high concentrations of contractors or non-compliance, or to all industries. However, it would require the educational programs to be adapted to the circumstances and conditions of the specific industry. This is particularly the case as some industries with high levels of contractors would not have a formal educational process for entry. Accordingly, it would be necessary to develop an alternative method of disseminating the educational information which does not rely on the ‘training’ process.

## Assessment of impacts

94. The intention of this section is to assess the expected impacts and the costs and benefits of each of the options in this proposal. This process involves identifying which groups in the community are likely to be affected by the proposal, which assists in quantifying the estimated impacts of each option.
95. The second part of the process involves an evaluation of the purported costs and benefits of the proposal using the status quo as the benchmark for assessing the estimated impact of each option. This assessment provides a clear explanation of how the actions, obligations and circumstances of different stakeholder groups are likely to change if the option is implemented.

## Impact group identification

96. The following groups have been identified as likely to be impacted by this proposal.

### *Contractors and sub-contractors (individual and non-individual)*

97. At a simplistic level, a contractor or sub-contractor is normally a sole trader (but can be any entity type) who engages in contracted work to perform a specialised job as part of a bigger project. The key difference between a contractor and a sub-contractor is that some contractors may engage other contractors (who would typically be known as a sub-contractor) to undertake work on their behalf.
98. Under this proposal, the contractors and sub-contractors that would be impacted are those that are engaged in the building and construction industry. The work engaged by contractors in the building construction industry includes, but is not limited to:

- |                                      |                                       |
|--------------------------------------|---------------------------------------|
| – Bathroom &/or Kitchen Manufacturer | – Door, Window Frame & Screen Fitting |
| – Alarm Installer & Home Security    | – Brick Layer &/or Masonry            |
| – Carpenter & Joiner                 | – Builder and Building Contractor     |
| – Electrician & Plumber              | – Cabinet Maker &/or Furniture        |
| – Fencer, Erector & Installer        | – Concrete Supply & Formwork          |
| – Landscaping & Paving               | – Demolition &/or Renovation          |
| – Painter & Decorator                | – Swimming Pool Construction          |
| – Pest Control & Termite Inspection  | – Excavation & Earthmoving            |
| – Air Conditioning/Heating           | – Hardware & Builders Supplies        |
|                                      | – Roofing & Roof Construction         |

- Tradesman – Insulation Supply & Installer
- Glazier – Scaffold Supply & Erection
- Tiler, Plasterer & Concreter

99. Based on ATO estimates, in total there are currently 451,000 contractors and sub-contractors in the building and construction industry that would be affected by the compliance proposal.

### *Businesses*

100. The use of the term ‘businesses’ in this proposal is intended to cover any business in the building and construction industry that engages contractors. As mentioned earlier in the paper, this would include contractors where they sub-contract their work to other contractors.

101. It is impossible to estimate how many of the 451,000 contractors would be included in this definition as it would be unclear how many sub-contract their work on a regular basis and this number could change from year to year.

102. However, there are a number of businesses that are not contractors that would have obligations under this proposal. Based on ATO estimates, in total there would be approximately 150,000 businesses that would be impacted by the compliance proposal. However, most of those businesses would not be new to the withholding system (in respect to Options 2 and 3).

103. Further consultation would inform whether it would be appropriate to expand the definition of ‘businesses’ to include ‘connected businesses’ which, as discussed earlier, would cover those businesses that are not necessarily engaged in the building and construction industry, but are sufficiently connected to it.

### *Tax advisors and intermediaries*

104. The use of the terms ‘tax advisors and intermediaries’ covers the professionals who provide businesses and contractors with tax advice and assistance. Whilst it is unknown exactly how many tax advisors and tax intermediaries would be affected by this proposal, based on current figures approximately 95 per cent of businesses use tax agents to prepare and lodge their annual returns. Consultation with industry representatives in this sector has confirmed that this level of tax agent usage is common in the building and construction industry.

105. For this reason, we would expect that a number of businesses and contractors that have new obligations under this proposal would engage with a tax intermediary for advice and assistance.

106. The affect on tax intermediaries’ knowledge base is expected to be minimal as most if not all agents and advisors in the industry would already understand the new obligations, as they are a key area of taxation law.

### *Software developers*

107. The large commercial/tax software developers may be involved in changing or developing new products for the proposal and will be engaged with the ATO in the development of the administrative arrangements for the reporting requirements.
108. For options that involve reporting regimes, there is scope to use the SBR to lessen the compliance burden. This may require some software developers to create or adapt programs to allow for SBR compatible reporting of payments to contractors. The extent of the take up of SBR as a consequence of this proposal is expected to be revealed during industry consultation.

## *ATO*

109. The ATO would be responsible for the administration of the proposal. The ATO would be affected in respect of lodgment, collection, system processing, registrations, client contact and general operations. They would also be required to develop education and assistance products for the industry.
110. As well as revenue collection, the ATO may also be required to provide tax rulings, practice statements and interpretive decisions to interested taxpayers.

## **Analysis of costs and benefits**

111. Understanding the groups impacted by the proposal, this section then seeks to examine the costs and benefits of each option.

### **Option 1 — Reporting**

#### *Costs*

112. Assessing the costs of the reporting only option requires analysis of the costs on three fronts. These include the costs to business, consumers and to government. This option is expected to result in a medium overall compliance cost impact, comprised of a medium implementation impact and a low increase in ongoing compliance costs relative to the affected group.

#### **Costs to Business**

113. Option 1 would introduce a new regulatory framework that would impact on businesses and contractors who are required to report. As businesses and contractors are already required to collect and/or record the necessary information under existing record keeping requirements, the compliance costs are expected to be relatively low.
114. Additionally, the use of accounting software by businesses in the target market is high and as a result, the ability to automate parts of the reporting process will help to reduce compliance costs. In a 2008 report commissioned by the ATO entitled *'Profiling the micro business segment communication and information needs'* it was found that 85 per cent of micro businesses used accounting and reporting software (14 per cent did not use any, and 1 per cent did not know). Consultation with industry representatives has indicated that the figure could be even higher for those who would commonly have a reporting obligation.
115. For those businesses and contractors without an accounting software package there is likely to be a cost associated with establishing record keeping and reporting systems. As mentioned earlier, the various manual and online lodgment channels available through the ATO will

provide businesses and contractors with different options for fulfilling their reporting obligations under this option.

116. To the extent that it is possible to use the SBR Program and that there is sufficient use of SBR by businesses and contractors in the building and construction industry, these costs may be lower, particularly over the long term. Using electronic reporting through the SBR Program would require eligible businesses to obtain SBR compatible software. However, once a business has that software, the compliance costs associated with the reporting obligation would be reduced as the software would generate reports on request. Accordingly, this reporting regime would be an ideal project for incorporation into the SBR with benefits for both the businesses and the SBR Program. Further consultation with industry is required on the effectiveness of the SBR program under this option.
117. Under Option 1, the immediate cost per business is estimated to be just over \$300, and the total potential immediate cost of regulation is approximately \$45 million. The ongoing cost per business (per annum) is estimated to be \$90, with the total potential ongoing cost of regulation being approximately \$15 million.
118. These costs reflect an estimate of the potential direct compliance costs that this option may have on businesses in the building and construction industry, including expenditure relating to learning and education, record keeping (upgrading systems and procedures) and the time and costs related to the lodgment and preparation of forms and payments. However, these estimates represent a theoretical average across the industry and do not account for administrative efficiencies or the usage and uptake of accounting software in the time between announcement and implementation, should the option go ahead.

#### *Tax advisors and intermediaries*

119. Tax advisors are likely to be required to provide advice to contractors and businesses to assist them in understanding their new regulatory requirements and the costs of specialist advice could be expected to be passed onto contractors. Although the reporting regime would not provide a 'cost' to tax advisors, accountants or tax agents in terms of diminishing their business, they could be expected to argue that costs of familiarising themselves with the new system cannot be passed on fully. Consultation with industry representatives of tax practitioners has shown that Option 1 would not impose any direct costs on them.
120. Bookkeepers would need to adjust to new systems of record keeping in order to facilitate the reporting obligations. This may include updating or purchasing record keeping software and engaging in the appropriate training. Use of SBR software (where available and where possible) could assist in reducing this requirement.

#### *Software developers*

121. Depending on the implementation of this reporting regime, it may be necessary for software developers to invest resources in developing programs that facilitate the reporting of contractor payments to the ATO. This may be the case regardless of whether the SBR Program is used. However, as all the underlying information required to be reported is kept in the current accounting packages these investments are not expected to be high.

#### **Costs to consumers**

122. There is a general risk that businesses or contractors may seek to recoup any real or perceived compliance costs by increasing the price to final consumers. For example, a hairdresser hires a project management business to build a new salon. Where the project management business

engages, for example, a painter under a contract to paint the new salon the project management business would have increased administration costs as a result of the reporting regime and may pass those costs on to the hairdresser. As contractors would also have to report on sub-contractors, this increase in administrative costs may flow throughout the entire transaction processes.

123. This risk is expected to be extremely small and could quite easily be managed by ensuring that the administrative requirements of the reporting obligation are kept to a minimum.

### **Costs to government**

124. This option would cost the ATO in terms of implementation and administration as well as to educate and inform businesses and contractors about their new responsibilities.
125. This would require resources in the systems and operations areas to facilitate the reporting mechanisms and ensure that the forms processes can be automated electronically. Resources would also need to be apportioned to compliance areas to ensure that businesses are fulfilling their reporting obligations.
126. These additional costs should be offset to some extent by savings made through better targeting of education and audit activities.

### **Benefits**

#### **Benefits to business**

127. A reporting regime would create an incentive for contractors to account for their tax liabilities in a more reliable, accurate and timely manner. This would reduce the risk of an unaffordable tax liability at the end of the income year or as a result of ATO audit activity.
128. This option would not affect the cash flow of businesses that are currently complying. Cash flow management is a significant element in the success of businesses, particularly small businesses. Accordingly, an option that does not impact on the cash flow of compliant businesses would be preferred over an option that restricts cash flow, such as one that includes a general withholding. To the extent that the option is successful in increasing compliance in businesses that are currently non-compliant, resulting in additional costs (such as the payment of income tax) and that the costs cannot be recovered in prices, cash flow will be affected, even under a reporting option.
129. By requiring a business to report on payments made to contractors, there is a likelihood that contractors would be discouraged from operating in the cash economy. This would increase fairness across the industry as more contractors who move out of the cash economy are more likely to be forced to meet any income tax and GST obligations that may arise. This would restrict the ability for non-compliant businesses to undercut the prices of compliant businesses when tendering for work.

#### **Benefits to consumers**

130. By increasing compliance in the building and construction industry and reducing the ability for non-compliant contractors to undercut compliant contractors this would have a flow on benefit for consumers by making the compliant market more competitive.
131. Without the ability to undercut prices to the amount of the tax avoided, previously non-compliant contractors would move into the compliant market and would need to make themselves more efficient by introducing more competitive pricing or improving their quality

and service. Whilst not a quantifiable benefit, consumers are likely to benefit by receiving better prices and services, but not at the expense of the taxpayer dollar.

### **Revenue implications**

132. This option would be expected to lead to a significant increase in the Commonwealth's revenue collection from its second year of operation. The magnitude of these collections is estimated to be in the vicinity of \$200 million per annum in the 2013-14 and subsequent financial years.
133. Further, by discouraging involvement in the cash economy and therefore encouraging contractors to meet their GST obligations, this option also has the potential to benefit State Government revenue through increased GST collections.

## **Option 2 — Withholding**

### **Costs**

134. Assessing the costs of the withholding only option (Option 2) requires analysis of the costs on three fronts. These include the costs to business, consumers and to government. This option is expected to result in a medium overall compliance cost impact, comprised of a medium implementation impact and a low increase in ongoing compliance costs relative to the affected group.

### **Cost to business**

135. There is a significant risk that this option would increase compliance and administrative costs for the businesses that are responsible for withholding (whether currently compliant or not), including contractors and sub-contractors, depending on how the work relationships are structured. Consultation with industry representatives has confirmed this view.
136. The costs to business in terms of administration would involve adopting appropriate administrative practices to allow for withholding and payment of withheld amounts as well as related record keeping. Where the business required to withhold has employees, it is likely that they would already use appropriate administrative systems.
137. The withholding option poses a risk to the cash flow of businesses, particularly contractors who sub-contract work. Consultation with industry representatives has shown that there is concern amongst many within the industry that a withholding regime would restrict cash flow for businesses, whether or not they are currently compliant, and may have a disruptive effect for payments down the contractor chain.
138. The impact on cash flow to business was not able to be quantified as part of the business impact calculations. However, it is expected that the introduction of a withholding regime would have a cash flow impact and this would pose compliance costs on businesses that comply and prefer to manage their affairs and cash flow under the PAYGI system.
139. For contractors who sub-contract work, the impact of withholding at the point of payment may be felt more strongly as they require sufficient cash flow to pay their sub-contractors in a timely fashion. Contractors may have to adapt their business management processes to facilitate having sufficient funds to pay sub-contractors as well as other creditors and suppliers.
140. It is also possible, given that the application of the withholding regime would be specific, that the measure could reduce fairness across the contracting industry as it could only apply to

individual contractors that are not registered for GST (without creating inordinate complexity and churn of payments).

141. This narrow application may also affect taxpayer behaviour in terms of restructuring their businesses to avoid the withholding regime. As the withholding regime would only apply to contractors structured as a sole trader, these contractors may seek to create a business structure for the purpose of operating their contracting services, which would be outside of the withholding regime.
142. Under Option 2, the immediate cost per business is estimated to be around \$400 and the total potential immediate cost of regulation is approximately \$85 million. This cost reflects an estimation of the potential direct compliance cost that this option would have on businesses in the building and construction industry. The immediate costs include business expenditure relating to:
  - learning and education;
  - evaluation and tax planning; and
  - purchases (including equipment/software/supplies).
143. The ongoing cost per business (per annum) is estimated to be -\$22, with the total potential ongoing cost of regulation being approximately -\$5 million. The negative ongoing cost for business reflects the net outcome for both PAYGW payers (those businesses/contractors that withhold) and payees (those contractors that have amounts withheld).
144. This is because payees are taken out of the PAYGI system and are no longer required to lodge the required forms and pay instalments. Instead, this cost is shifted to the payer who is required to report and remit the withheld amounts on the payee's behalf. The ongoing costs for businesses who are payers under this option are estimated to be \$40 per annum with the total potential ongoing cost of regulation being approximately \$2.8 million. The ongoing costs include business expenditure relating to:
  - record keeping (upgrading systems and procedures); and
  - time and costs related to the preparation and lodgment of forms and payments.

#### *Tax advisors*

145. Tax advisors would need to ensure that they are informed of their client's responsibilities under the withholding regime (both for payers and payees). This is likely to have a cost for tax advisors.

#### **Cost to consumers**

146. Like Option 1, there is a risk that businesses or contractors may seek to recoup unmitigated compliance costs by increasing the price payable by final consumers. It is possible that the ability of businesses to mitigate compliance costs would be lower for Option 2 than Option 1.

#### **Cost to government**

147. The ATO would require additional resources for the processing of PAYGW collections. Additional resources for systems and compliance activity would also be necessary to achieve appropriate compliance rates.



148. As with Option 1, by discouraging involvement in the cash economy and therefore encouraging contractors to meet their GST obligations, this option also has the potential to benefit State Government revenue through increased GST collections.

## **Benefits**

### **Benefits to business**

149. One benefit for some contractors from a withholding regime would be that the burden of making regular payments to meet their end of year tax liability would be shifted from them (under the PAYGI system) to the business paying for their services (through a PAYGW system). Accordingly, contractors (who do not sub-contract work) would have reduced compliance costs in terms of making ongoing contributions to their tax liability. Consultation with industry representatives has shown that there are some within the industry who support the introduction of a withholding regime for this reason.
150. Shifting the burden of making ongoing contributions to a separate business would also reduce the likelihood that contractors would face significant tax debts at the end of the income year as a result of failing to make ongoing contributions through the instalment system. Consultation with representatives of tax practitioners confirmed that this was a particular problem for small-scale sub-contractors in their first year of operation when no PAYG instalments are payable.

### **Benefits to consumers**

151. Similar to Option 1, Option 2 has the ability to increase competitiveness in the industry through a more even playing field that could result from increased compliance. However, as Option 2 would apply to fewer contractors, the benefits would likely be less than for Option 1.
152. Also in line with the benefits provided by Option 1, Option 2 would also force some contractors to become more efficient. This improved efficiency may result in consumers receiving better prices and services, but not at the expense of the taxpayer dollar.

### **Revenue implications**

153. Option 2 would be expected to lead to a significant increase in the Commonwealth's revenue collection from its second year of operation. The magnitude of these collections is uncertain but is estimated to be slightly higher than the estimated figure detailed in Option 1.
154. Given that the responsibility for withholding would lie with a separate business, it is more likely that the ATO would be able to collect the revenue without having to undertake the extensive audit work currently required. This would not only increase the revenue collection but would also reduce the costs to Government associated with that collection. However, there are risks that the withholding option would drive taxpayer behaviour into greater incorporation of entities in order to avoid the regime. This could significantly diminish the potential revenue gains.
155. Further, by discouraging involvement in the cash economy and therefore encouraging contractors to meet their GST obligations, this option also has the potential to benefit State Government revenue through increased GST collections.

## Option 3 — Withholding and Reporting

### Costs

156. The combined withholding/reporting option (Option 3) is expected to result in a significant overall compliance cost impact, comprised of a significant implementation impact and a medium increase in ongoing compliance costs relative to the affected group.

### Costs to Business

157. The combined withholding and reporting regime (Option 3) would cause the greatest compliance costs for businesses. Businesses would need to change their business systems to enable them to operate in both the reporting and withholding systems as their responsibilities would change depending on the characteristics of each contractor.
158. Accordingly, under Option 3 businesses hiring contractors would be faced with all of the compliance costs associated with Option 1 and all of the compliance costs associated with Option 2. In addition, they would face further compliance costs associated with determining the characteristics of each contractor and ensuring that they deal with each contractor under the appropriate regime, fulfilling different obligations depending on the regime.
159. As with Option 2, there is likely to be a cost associated with the cash flow impacts of the withholding component. These costs have not been factored into the business impact assessment, as they are unquantifiable.
160. Like Option 1, there may be scope to lessen the compliance burden by enabling businesses to satisfy their reporting obligations through the SBR Program. However, these record keeping adaptations would be expected to result in significant compliance costs.
161. Although there is still a risk that this option would provide an incentive for contractors to restructure their businesses to avoid withholding or reporting, the broader application makes the risk lower than it is under Option 2.
162. Costs to businesses and tax advisors would also arise from the changes to bookkeeping requirements and business management systems.
163. Under Option 3, the immediate cost per business is estimated to be \$540 and the total potential immediate cost of regulation is approximately \$140 million. This cost reflects an estimation of the potential direct compliance cost impact that this option would have on businesses in the building and construction industry. The immediate costs include business expenditure relating to:
- learning and education;
  - evaluation and tax planning; and
  - purchases (including equipment/software/supplies).
164. The ongoing cost per business (per annum) is estimated to be \$45, with the total potential ongoing cost of regulation being approximately \$12 million. The low ongoing costs for business under this option are due to the same factors as explained for Option 2.
165. For this reason, the ongoing costs for businesses who are payers or who have reporting obligations under this option are estimated to be \$140 per annum with the total potential

ongoing cost of regulation being approximately \$20 million. The ongoing costs include business expenditure relating to:

- record keeping (upgrading systems and procedures); and
- time and costs related to the lodgment and preparation of forms and payments.

#### *Tax advisors and intermediaries*

166. It is likely that this option would increase the need for tax advisors and bookkeepers to educate themselves on the new requirements that their clients would face.

#### **Costs to consumers**

167. Like Options 1 and 2 there is a risk that if compliance costs are not mitigated then businesses or contractors may seek to recoup these amounts by increasing the cost payable by final consumers. This option is likely to prove the most difficult in terms of businesses being capable of mitigating compliance costs. Accordingly, it is the most likely option to have the effect of increasing the cost of services to consumers.

#### **Costs to government**

168. Like Options 1 and 2, resources in the systems and operations areas would be required to facilitate the reporting mechanisms, collection of the withheld amounts and to ensure that the forms processes can be automated electronically. Again, compliance areas would also require resources to ensure businesses meet their obligations.

169. Further, by discouraging involvement in the cash economy and therefore encouraging contractors to meet their GST obligations, this option also has the potential to benefit State Government revenue through increased GST collections.

#### **Benefits**

##### **Benefits to business**

170. This option, like Options 1 and 2 would be expected to improve competition by levelling the playing field between those contractors who currently comply with their taxation obligations and those who do not. As it has a broader application than Option 2 it would be expected to provide a greater improvement to competition and fairness within the industry than Option 2.

171. The other benefits experienced by businesses (in this case the contractors) would depend on the regime they fall within. Those that were subject to reporting would experience benefits consistent with those outlined in Option 1. Those that were within the withholding regime would be likely to experience benefits consistent with those outlined in Option 2.

##### **Benefits to consumers**

172. Like with Option 1 and Option 2, consumers would be likely to benefit from the increased competition associated with a more level playing field.

##### **Revenue implications**

171. Governments would benefit from this option in terms of increased rates of compliance amongst contractors in the building and construction industry. This, like Options 1 and 2, would provide a significant increase to revenue. The magnitude of these collections is uncertain but could be up to \$400 million per annum in the 2013-14 and subsequent financial years.

172. Further, by discouraging involvement in the cash economy and therefore encouraging contractors to meet their GST obligations, this option also has the potential to benefit State Government revenue through increased GST collections.

## **Option 4 — Increased education and assistance by the ATO**

### **Costs**

#### **Costs to Business**

173. Although the compliance costs are expected to be very low, this option may create a cost to business in terms of failing to adequately address the unfairness associated with some contractors failing to meet their taxation obligations. The contractors who are currently unwilling to comply with their taxation obligations would have little incentive to comply under Option 4 and accordingly, those who are complying would continue to face disadvantage.
174. Additionally, businesses may see this option as a cost in terms of 'lost time' spent gaining education and training on taxation obligations that could otherwise be spent working. However, this 'lost time' would probably provide an overall benefit to the businesses as they would then be more aware of their obligations and require less time in the future to meet those obligations.

#### **Costs to consumers**

175. A cost to consumers would be unlikely for Option 4.

#### **Costs to government**

176. The cost of implementing Option 4, although low relative to the other options, must be weighed against the likelihood of achieving systemic change in compliance activity. Although short term improvement in compliance may occur, if this option were implemented independently, the likelihood of long term or sustained improvements in compliance would be very low.
177. To gain improved compliance by only using this option, the ATO would have to rely on increased audit activity or some other method to provide an incentive for contractors to comply with their taxation obligations. This would create a system that is resource intensive and that has narrow application (in terms of audit or compliance activity).

### **Benefits**

#### **Benefits to Business**

178. Given the extensive number of obligations that contractors face, the availability of additional educational and assistance resources would allow them to better understand their taxation obligations. It would not, however, change the number of obligations or the compliance costs associated with those obligations.

#### **Benefits to Government**

179. The Government may see a short term increase in compliance based on the implementation of Option 4. However, the expectation of Option 4 resulting in a sustained increase in compliance is low.

## Revenue implications

180. Governments would benefit from this option in terms of a small increase in the rates of compliance amongst contractors in the building and construction industry. Unlike the other options detailed in this RIS, Option 4 would provide only a very slight increase to revenue.

## Consultation

### Consultation undertaken

181. Confidential consultation was undertaken in the development of this RIS with key industry representatives and key stakeholders with views on tax compliance in the building and construction industry. This consultation was conducted to get an understanding of the compliance costs that may be imposed on business should one of the options in this RIS be accepted as Government policy.
182. The consultation was undertaken in person or through phone hook ups with ten organisations between 28 March 2011 and 4 April 2011.

### *Industry views on whether there is a non-compliance problem in the building and construction industry*

183. All of the organisations that were consulted agreed that there was a level of non-compliance with taxation obligations in the building and construction industry. Some organisations argued that the level of non-compliance was no higher than any other industry and other organisations argued the non-compliance was rife within the industry. A small minority even spoke of an 'entrenched' culture of non-compliance. The consultation views overall supported the ATO data which suggests that there is at the very least a medium to high level of non-compliance in the building and construction industry.
184. When asked about the cause of the problem the majority of the organisations argued that the complexity of the business tax obligations and the difficulty associated with complying with multiple (tax and non-tax) obligations was a major cause of the non-compliance. There was also a general acceptance that some operators in the industry would be non-compliant as a business strategy to undercut competitors.
185. The consultation views show that some smaller contractors' ability or capacity to comply is problematic due to their lack of knowledge and awareness. This supports the assessment in the RIS that capacity is a major cause of non-compliance. However, it is unlikely that many, larger businesses are non-compliant for this reason. When non-compliant, those contractors are more likely to be operating within what some industry representatives labelled the 'black market of labour' or the cash economy.

### *Industry views on how to address the non-compliance problem*

186. When asked about what options would best address the non-compliance problem, the majority of the industry representatives preferred increased education and assistance programs and/or more targeted audits by the ATO. However, some of those organisations conceded that the lift in compliance would be likely to be in the short to medium term.
187. When asked about whether regulatory options such as the withholding or reporting option would be suitable in addressing the problem, a few of the industry representatives were

supportive of a withholding option akin to the old Prescribed Payment System (PPS) that was repealed with the *A New Tax System* changes in 2000. Those industry representatives argued that many of the small-scale sub-contractors that operate in the building and construction industry are not capable of running a business and therefore struggle to meet their PAYGI obligations. By introducing a withholding regime, they saw that as a way to ensure that those contractors would be compliant and would be less burdened by the business tax system.

188. The industry representatives supportive of the withholding option explained that views on withholding/bringing back the PPS were split fairly evenly in the industry. Some operators within the industry support moving back to PPS as it was simpler than having to organise paying their own tax, whereas others in the industry supported the current system, as they would rather manage their own cash flow and business affairs.
189. Those who supported a withholding/PPS system tended to be contractors who have experienced that system before 2000 (albeit in the absence of the GST and prior to the introduction of the ABN). Many contractors have entered the industry since 2000 and have no experience of a withholding regime for contractors.
190. Some key industry representatives supported the option to introduce a reporting regime in the industry. The main argument in support of the reporting option was that non-compliance was a problem in the industry from a competition perspective and currently, there is no single mechanism that connects the entities within a contracting chain. Those supporting the option explained that reporting regime would provide such a mechanism to enable the ATO to identify the non-compliant operators and audit effectively without needlessly auditing compliant businesses. However, supporters of the reporting option stressed that any reporting regime introduced would have to be sufficiently targeted and well designed to reduce compliance costs and be effective.

#### *Industry views on the compliance costs associated with each option*

191. When asked about estimated compliance costs, industry representatives responded that each option would impose costs on business and for that reason, efforts would be required to minimise those costs. For the education and assistance option, some organisations explained that there were likely to be costs associated with having to take time off from work and go through the training or engage with the ATO. However, most organisations agreed that the compliance costs for this option were minimal.
192. For the withholding option, industry representatives felt that the cost to business in having to organise withholding and pay amounts to the ATO on behalf of contractors would be costly. They were also concerned about the interaction with the GST system and the cost that would have on businesses in having to deal with input tax credits and identify whether the contractor was registered in the first place. Some representatives also explained that the withholding option would have an effect on the timing of payments and cash flow of businesses and that it would impose costs on businesses in managing their affairs and paying staff.
193. Some industry representatives commented that the withholding rate utilised under the old PPS system (20 per cent) was generally about right to cover most contractors' end of year obligations.
194. For the reporting option, most of the industry representatives' main concern was about how complex and detailed the reporting form would be. Some industry representatives explained

that many contractors in the industry disliked dealing with ATO forms and had difficulty understanding them. They also argued that the time spent filling out the form would be a cost to business. However, for many this option would not be a big problem for them as they already collect the required information and have established administrative systems that would allow them to report the information to the ATO easily.

195. When asked about whether small-scale sub-contractors would have accounting software or systems that would facilitate efficient reporting without or with a low cost, the views of the industry representatives were varied. Some believed that up to 90% of contractors would have accounting software and packages that would enable easy reporting. Others argued that very small-scale sub-contractors, especially those that are labourers, tilers and plasterers would be unlikely to have any system in place.
196. However, the representatives broadly agreed that very small-scale sub-contractors were unlikely to be further sub-contracting and would therefore most likely not be required to report. Furthermore, those contractors who sub-contract to these small-scale sub-contractors were likely to have business systems in place and use accounting software. The feedback on these business impacts and costs for all options have been reflected in the development of the 'Analysis of costs and benefits' section of this RIS.

#### *Other issues or insights arising out of consultation*

197. Most of the industry representatives when asked about the issue of tax compliance explained that the problem was multi faceted and the issue was broader than just the tax sphere. Many of the representatives spoke about the issue of 'sham contracting' and whether very small – scale sub-contractors should really be employees instead of contractors.
198. Those organisations also explained that there was an issue with some businesses in the industry using employer-sponsored 457 visa workers and temporary visa-holders<sup>7</sup> who, in their view, have a relatively high propensity to engage in 'sham contracting' and other tax avoidance activities.
199. This intersection between tax compliance, employment law and immigration issues indicates that there is also a need to consider the compliance of contractors in the building and construction industry from a whole-of-government perspective. Should a tax-related proposal be followed by Government as detailed in this RIS, further consultation should be undertaken with industry representatives to see if there is a way to integrate other Government departments in employment and/or immigration to facilitate information sharing and address the broader non-tax related issues.
200. Another important issue that was raised during consultation was the integrity of the ABN system. Many of the industry representatives expressed concern over the ease of which contractors could receive an ABN and lack of scrutiny of whether they should be entitled to continue to hold one. Similarly, industry representatives expressed concern over the illegitimate quoting of invalid ABNs by contractors who are operating in the cash economy or seeking to avoid their taxation obligations more generally. Whilst ATO data has reflected an issue with the invalid quoting of ABNs and this can be addressed somewhat through the reporting option with ATO assistance, the broader issue of ABN integrity will not be directly addressed by these proposals.

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<sup>7</sup> Including foreign students, working holidaymakers and graduate skills 485 visa-holders.

## Proposed consultation on recommended proposal

201. If a decision is taken by Government to proceed with the regulatory option recommended in this RIS, extensive public consultation should be undertaken following the announcement. The detailed policy development would require input from affected industry groups, tax professional bodies, legal firms and the general public.
202. Consultation would include engaging industry expertise and knowledge to properly target the proposal and determine which contractors and businesses would be subject to the regime and precisely what payments would be covered. It is expected that consultation will be undertaken by the ATO on administrative aspects of the proposal including form design and lodgment requirements.
203. The consultation process would be undertaken in two broad stages. The first stage would involve consultation on the policy aspects of the proposal, seeking specific comment on the detailed design of the particular features of the option proposed. The second stage would involve consultation on the wording of legislation/regulations and whether it achieves the intended policy of the option proposed.

## Recommendation and conclusion

204. After evaluating each of the options proposed and their anticipated impacts and consulting with key industry representatives and stakeholders, Option 1, the introduction of a reporting regime for contractors in the building and construction industry, is recommended.
205. Option 1 would significantly reduce non-compliance with taxation obligations by ensuring that amounts received for services are detected by the ATO in a timely and coherent manner. This establishment of this regime would send a strong message to non-compliant businesses and would therefore be likely to increase voluntary compliance as contractors would be aware that payments they receive are being reported to the ATO and that the ATO would be better equipped to target certain businesses/contractors through audit activity. This approach is consistent with the existing academic research that 'compliance is likely to be higher when taxpayers perceive there to be a higher probability of being caught along with anticipated adverse consequences'.<sup>8</sup>
206. For those contractors who are willing to comply but do not have the capacity or are erroneously underreporting their income, the reporting option would provide the ATO with data that would alert them to this situation. ATO resources could then be directed towards assisting the contractor to comply and ensuring that they are able to meet their taxation obligations in the future.
207. Option 1 has also been assessed through ATO costings as having the lowest compliance costs on businesses and contractors. There is also a greater possibility for reducing these compliance costs under the reporting option by using the SBR technology and automating the reporting requirements. Further consultation with industry is required to determine how effective the SBR would be for the reporting requirements under this option.
208. Whilst the withholding models could yield a higher compliance dividend, on balance the drawbacks from additional compliance costs and the difficulties with administration (as well as

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<sup>8</sup> Ahmed, E. & Braithwaite, V (2005) at p. 540.



the risk of possible behavioural responses) make Option 1 the preferred approach to resolving the problem of non-compliance by contractors with taxation obligations.

209. Option 1 provides a solid framework from which to achieve the objective of improving contractor compliance in the building and construction industry and, due to its design and lower compliance costs, would constitute an effective model that could be transferred to contractors in other industries with high-levels of non-compliance.

## **Strategy for implementation and review**

### **Implementation approach**

210. Assuming the recommended approach is adopted, we expect that the reporting regime could be implemented with a 1 July 2012 start date. Following the start of the regime, the ATO would be responsible for administration and enforcing compliance with the reporting obligations using existing systems and processes.
211. During the 2011-12 income year, administrative systems would be put in place to ensure that there are adequate resources to provide for efficient and effective reporting through the existing ATO channels. This process would involve consultation with industry and software providers as well as investigating the usage of the SBR platform to automate reporting obligations. This transition time will also minimise compliance costs for industry and administrative costs to Government.
212. The ATO would also undertake an education and awareness process in the lead up to the start date of the reporting regime. This would target the affected businesses and contractors in the building and construction industry and provide support surrounding the requirements of the new obligations.
213. Any additional arrangements required to provide for a smooth transition are expected to be raised and considered as part of the broad consultation process with industry.

### **Post-implementation review**

214. It is envisaged that a formal post-implementation review would be undertaken within three to four years after implementation. The time between the implementation and the review would allow for the industry affected to learn, accept and undertake their new obligations. This period would also allow for the ATO to introduce and improve their administration mechanisms and investigate the proposal to integrate obligations through the existing SBR platform.
215. This post-implementation review is expected to look at the effectiveness of the option proposed in achieving the primary objective of improved compliance. This would involve extensive consultation with the building and construction industry, contractor associations, the ATO and other affected groups. This review would also involve an evidence-based evaluation of the compliance improvement based on the data collected by the ATO and the industry views put forth as part of the consultation.
216. One of the additional objectives of the review would also be to canvass whether the option proposed would be a suitable model to adopt and expand to contractors across other industries. This would again involve extensive consultation and would require additional policy approval and consultation.