Tax Consequences of Employment Court Rulings in Employee-Contractor Cases

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Tax Consequences of Employment Court Rulings in Employee-Contractor Cases

(2007) 13 NZBLQ 115

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1 Tax Implications of Employment Status

The Employment Court is the primary authority for determining a worker's legal status. Problems arise when the Court's determination of the worker's status as an employee is inconsistent with his or her income tax and GST treatment. In effect, workers may be declared retrospectively to have been employees for employment law purposes but have been filing returns as independent contractors for tax purposes.

There is settled authority that a person must have a consistent employment law and tax status. A statement to that effect was made by Casey J in *TNT*:

> "The problem with [an inconsistent employment law and tax status] lies in the indivisible and consistent nature of whatever relationship is found to exist between the employer and the employee. It cannot be a contract *for* services for some purposes and a contract *of* service for others. …[E]ach party was deliberately trading off benefits under one type of relationship for perceived benefits under the other."

Likewise, in its policy statements on the issue, Inland Revenue has stated:

> "Tax law relies upon the terms 'contract of service' and 'contract for services' but does not define them. Therefore their meanings depend upon the contract law developed by the Courts and any statute that applies to a particular kind of work. A person will have the same employment status for tax purposes as he does under the general law."

Accordingly, once the Employment Court has declared the worker to be an employee, any inconsistency in that worker's tax treatment must be addressed. Having been determined to be in an employment relationship, the parties must likewise treat the worker as an employee for income tax and GST purposes. This treatment will necessarily have retrospective effect for tax purposes. **[(2007) 13 NZBLQ 115, 116]**

2 Inland Revenue Department's Powers of Investigation

The Inland Revenue Department ("IRD") has a statutory period of 4 years within which it may reconsider a taxpayer's affairs with a view to reassessing them. While tax returns honestly or innocently filed by the parties may have been considered correct at the time they were filed, the IRD is entitled to reconsider that tax treatment for previous years in light of the Employment Court ruling. Even if the IRD has previously accepted the tax treatment of the worker, this will not prevent it from going back and reassessing those returns in order to give effect to the employee-employer relationship.

As was noted by the Supreme Court in *Bryson*, the tax treatment of the worker is a consequence of their employment law status, and is not indicative or determinative of that status. Accordingly, there is nothing to stop the IRD from re-examining its previous tax treatment of the worker in light of the Employment Court's determination.

This obligation on the IRD to correct past returns is enshrined in the Revenue Acts and rigorously endorsed by the courts. For instance, in *Brierley Investments Ltd v C of IR* the taxpayer disputed the IRD's decision to abandon a previously agreed tax treatment and reassess the taxpayer in a different way. In dismissing the taxpayer's claim, Richardson J in the Court of Appeal stated:

> "Taxpayers must be taken to know that while the 4-year period still operates they cannot safely rely on the general practice of the Commissioner or on any indication to them as to how particular matters will be dealt with by the Department or on the way their returns have been processed in the past."

This allows the IRD to re-examine previous years' returns in light of current facts. Accordingly, the IRD is able to reassess all returns previously filed by both parties to ensure they comply with the (newly determined) employment status. This reassessment will necessarily involve a reconsideration of all income tax and GST returns filed by the parties.

3 Income Tax Consequences

Income derived by self-employed contractors falls under the definition of "business income" and is taxed accordingly. However, income derived by employees is defined as "salary and wages". Consequently, the employer is liable to make "source deductions" (ie withhold PAYE) from an employee's income. The primary liability to deduct PAYE from salary and wages at the applicable marginal tax rate falls upon the employer. The employer's failure to deduct (and then account for) PAYE from wages constitutes a breach of the Income Tax Act 2004. **[(2007) 13 NZBLQ 115, 117]**

PAYE is treated as having been deducted by the employer (whether in fact it was) where an employee receives a "net" payment of wages. In effect, the payment of an employee's "net income" is sufficient proof that the tax on that amount has been (or is deemed to have been) withheld. Thus, when a net payment is received by an employee, it is deemed to be the result of a deduction by the employer. The effect is that the employer cannot argue that PAYE was not deducted. Rather, the employer is liable to account for the full amount of the deduction whether or not funds were deducted or set aside for that purpose. A sum equivalent to this deemed PAYE deduction is then granted trust status and gives the Commissioner a priority for its recovery against the employer's other creditors. The IRD can also automatically register a charge over the employer's assets.

If PAYE is deducted (or deemed to have been deducted) and the employee therefore has received (or is deemed to have received) a net payment, he or she cannot be required to pay a further amount of tax. The Act contains no provision making the employee liable to make good PAYE that was deducted and misappropriated by a dishonest or insolvent employer. To require otherwise would effectively result in double taxation of the employee.

3.1 Liability where PAYE not deducted

The situation is different when PAYE was required to be deducted but was not. This will most commonly occur because the employer has paid the person (who is now determined to be an employee) their full fee without deducting PAYE on the mistaken belief that he or she was an independent contractor. The result is that the worker has effectively received his or her gross salary. In that instance, the deeming provision in the Tax Administration Act 1994 does not apply because the individual has been paid the full gross income rather than the net amount.

The Income Tax Act 2004 specifically states that where, for any reason, a tax deduction is not made in full at the time of making the payment, the employee must make the deduction him or herself and pay it to the IRD on the 20th of the following month. Strictly speaking, an employee must pay Inland Revenue the amount of PAYE that the employer should have (but did not) deduct from their gross income. However, it can be presumed that the employee also did not make these payments, again on the mistaken belief that he or she was an independent contractor.

Likewise, the Tax Administration Act 1994 provides that, if an employer fails to deduct PAYE, it remains liable for the tax wrongfully not withheld. However, the Act also stipulates that Inland Revenue may alternatively recover the PAYE from the employee, thus allowing the IRD to pursue either the employer or employee (or both) for unpaid PAYE. **[(2007) 13 NZBLQ 115, 118]**

Despite a common misconception, there is no statutory presumption that the amount received by an employee is their net income. Accordingly, there is no requirement for the employer to "gross up" the payments and calculate tax on top of the total sum. Rather, the employer must simply account for the amount of PAYE that it should properly have deducted from the employee's salary. Importantly, once PAYE is paid by the employer, the Act gives the employer the right to recover from the employee "any amount,

including a penalty" imposed on the employer for its default. This provision effectively passes the full liability — for the employer's failure to make the deduction — on to the employee.

The policy of the Act seems to be that, just as it would be unfair to require an employee to pay PAYE again if it was previously deducted by a now dishonest or insolvent employer, it would be equally unfair to allow the employee to keep the full gross payment free of tax.

This policy was made clear in *Case P44*, where Barber DJ stated:

> "It would be quite reasonable to require the employee to pay a tax content which was never deducted by the employer in the first place … If the deduction has been made, then an employee would, in effect, be taxed twice if required to remedy the employer's default. However, if there has been no deduction, so that the employee received gross salary, then it seems fair that there be recovery from the employee."

3.2 Conclusion on PAYE

Where no deduction of PAYE was made by the employer, the IRD may recover the unpaid tax from either the employer or the employee. But in either instance, the ultimate liability for the PAYE remains with the employee. Presumably on the basis of the (mistaken) belief that he or she was self-employed, the employee should have returned his or her income and paid provisional tax upon it for the relevant years. As such, the question of who must pay the outstanding tax should (but often does not) become academic.

3.3 Deductions no longer permitted

One of the consequences of being deemed to be an employee is that the worker may no longer claim deductions. As was noted by the Court of Appeal in *TNT*, one of the trade-offs of being an employee rather than an independent contractor is the inability of employees to claim income tax deductions for expenses incurred in deriving salary and wages. As a result, whatever net income calculations the employee made in previous years will have allowed for deductions that were not permitted.

For workers who are deemed to be employees, all deductions claimed in previous years must be added back. The newly-deemed employee's tax liability must be recalculated on the full gross salary without deduction for any expenses incurred in deriving that income. The result of this recalculation is that the worker is likely to owe additional income tax for the relevant years. Workers seeking to be declared employees would therefore be wise to balance this increased tax liability against the quantum of damages and compensation they stand to win by bringing their personal grievance. **[(2007) 13 NZBLQ 115, 119]**

3.4 Employee expense allowances

Some partial mitigation for the inability to deduct expenses for those deemed to be employees exists. Any allowance paid to reimburse the employee for expenses incurred as part of his or her employment would now qualify as exempt income. When recalculating their tax, employees would be able to reverse out those amounts from their gross income on the grounds that, as an employee, they are exempt from tax.

4 GST Consequences

Invariably, because the worker had the mistaken impression that he or she was self-employed, GST will have been charged. But, their newly-determined employment status would preclude the individual from being registered for GST. The employee will have wrongly charged GST output tax on exempt employment services and the employer will wrongly have claimed input tax credits on that supply.

Surprisingly, this incorrect treatment is not an issue under the Goods & Services Tax Act 1985 ("GST Act"). Presumably in recognition of the tax neutral result that was achieved, the GST Act deems any person who has charged GST on a supply of goods or services to be registered for the purposes of that supply. Persons deemed to be employees must therefore pay the IRD all GST charged by them in the usual way. Employees cannot contend that, as they were wrongly registered, they should be entitled to a refund of GST paid. Nor can employees contend that they should be able to retain the GST component incorrectly charged.

As for the employers, it appears they are likewise able to retain the GST input tax previously claimed in respect of the employee's supplies. The definition of "input tax" is sufficiently wide to include GST wrongfully charged by an employee, provided that GST was actually paid and the person's services were acquired for the principal purpose of making taxable supplies.

As a result, unlike the recalculations required for income tax, there is no reassessment required by either party for GST.

5 Shortfall Penalties or Criminal Liability?

In addition to being liable for the full amount of the PAYE deducted, the employer may also be liable for shortfall penalties and/or a criminal offence. In some instances the criminal penalty for evasion may be imposed. **[(2007) 13 NZBLQ 115, 120]**

In practice, without evidence that the parties' original treatment of the individual as an independent contractor was a sham, seldom will the employer face shortfall penalties and almost never will criminal penalties result. Even if the relevant monetary shortfall thresholds are reached, where the question of the individual's employment status was finely balanced and vigorously contested between the parties, only rarely will the IRD be able to show that the parties took a lack of reasonable care or adopted an unacceptable tax position.

The contrary decisions delivered by the different courts at each level in the leading cases of *Bryson*and *TNT* show how finely balanced the employment status of a worker can be. The IRD's own policy recognises that "[s]ometimes it is not easy to tell if a taxpayer is an employee or an independent contractor". Accordingly, it is suggested that (absent evidence of recklessness or sham) seldom will the parties' mistaken treatment of the worker as an independent contractor be either careless or legally groundless.

Even less commonly will it be possible to prove "knowledge" by the employer that the PAYE deductions were required to be made but deliberately were not. An employer who took reasonable steps to satisfy itself that the individual was a contractor and complied with all the tax requirements commensurate with that status would therefore seldom be exposed to shortfall or criminal penalties.

There is however a sting in the tail for both parties. The reasonableness of the error will not alleviate the imposition of Use of Money Interest on the underpayment of tax. Interest is charged on the full amount outstanding from the original due date when the PAYE should have been paid until it is finally accounted for. At the current rate of 14.25 per cent per annum, interest can quickly turn the error over the worker's tax treatment into an expensive mistake.

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FOOTNOTES

1 Employment Relations Act 2000, s 187(1)(f).

2 *TNT Worldwide Couriers (NZ) Ltd v Cunningham*(1993) 15 NZTC 10,235, at p 10,247.

3 See *Tax Information Bulletin*, vol 11, no 2, February 1999, at p 6.

4 Tax Administration Act 1994, s 108. The 4-year time bar in s 108 does not apply where the return was fraudulent or wilfully misleading, or if it omitted amounts of income, or to reassessments that reduce the amount of tax payable. The 4-year time bar in s 108 does not apply where the return was fraudulent or wilfully misleading, or if it omitted amounts of income, or to reassessments that reduce the amount of tax payable.

5 (2005) 22 NZTC 19,242, at para 37.

6 See Tax Administration Act 1994, ss 6, 6A and 113.

7 (1993) 15 NZTC 10,212.

8 Ibid, at p 10,217.

9 Income Tax Act 2004, s CB 1.

10 Income Tax Act 2004, s CE 1.

11 Income Tax Act 2004, s NC 2. The GST amount charged by the employee is exempt from income tax, by virtue of s CX 1.

Likewise, that amount is excluded from the calculation of any PAYE deduction under reg 6(2) of the Withholding Payment Regulations 1979.

12 Income Tax Act 2004, s NC 15.

13 Tax Administration Act 1994, s 4A(2)(b). The Tax Administration Act applies "when payment is made of the net amount." The Act deems a deduction to have been made by an employer who pays an employee their net salary, regardless of whether sufficient funds existed to pay the PAYE or were set aside to satisfy the tax liability.

14 Tax Administration Act 1994, s 167.

15 *CIR v Smith*(2000) 19 NZTC 15,541 (CA).

16 Tax Administration Act 1994, s 169.

17 *Case N45*(1991) 13 NZTC 3,375.

18 Tax Administration Act 1994, s 4A(2)(b).

19 Income Tax Act 2004, s NC 16.

20 Tax Administration Act 1994, s 168(1).

21 Tax Administration Act 1994, s 168(2).

22 Tax Administration Act 1994, s 168(1).

23 Tax Administration Act 1994, s 168(3).

24 (1992) 14 NZTC 4,308, at p 4,313.

25 *TNT Worldwide Couriers (NZ) Ltd v Cunningham*[1993] 3 NZLR 681 (CA), at p 695.

26 Income Tax Act 2004, s DA 2(4).

27 Income Tax Act 2004, s CW 13. So payments received by the employee to compensate for vehicle, telephone or home office expenses would now be free of tax. These kinds of payments are not exempt to contractors but must be included by them within business income under Income Tax Act 2004, s CB1. Thus presumably these payments were included in the employee's gross income and tax was paid on them accordingly.

28 Goods & Services Tax Act 1985, s 6(3)(b).

29 Goods & Services Tax Act 1985, s 51B(1)(a).

30 Goods & Services Tax Act 1985, s 3A.

31 The employer may face a shortfall penalty under ss 141A-141E of the Tax Administration Act 1994 calculated as a percentage of between from 20 to 150 per cent of the PAYE not deducted. The employer may also face a possible criminal offence for knowingly failing to make a tax deduction when required, under s 143A(1)(e) of the Tax Administration Act 1994. This carries a penalty of a $25,000 fine for the first offence and a $50,000 fine for subsequent offences.

32 Under s 143B of the Tax Administration Act 1994, which carries with it a potential penalty of up to 5 years' imprisonment, a $15,000 fine, or both.

33 The threshold for imposition of the shortfall penalty for adopting an Unacceptable Tax Position under s 141BTax Administration Act 1994 is a tax shortfall of either $20,000 or 1 per cent of the taxpayer's total tax position.

34 Ibid, note 4.

35 Ibid, note 5.

36 *Tax Information Bulletin*, vol 11, no 2, February 1999.

37 Use of money interest is imposed under Part VIITax Administration Act 1994.