

TAXATION AND THE SEX INDUSTRY

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THE PURPOSE OF THIS PAPER IS TO GIVE A BRIEF OVERVIEW OF THE INTERACTION of the Australian Taxation Office with taxpayers engaged in business in what is termed 'the sex industries'. At the outset, it is necessary to stress that the Australian Taxation Office (ATO) is not a law enforcement agency in the sense of detecting, investigating and prosecuting illegal activities associated with prostitution, pornography or, for that matter, any criminal business activity. Rather, the ATO is the government's prime revenue collection agency.

The ATO does not perform a function relevant to the detection and control of criminal activity except to the extent that it may from time to time act in concert with other agencies, such as the National Crime Authority, the Australian Federal Police or other law enforcement agencies. Where the ATO chooses to participate with other law enforcement agencies its participation is limited to a purely 'revenue collection' role.

In more recent times, the ATO has also assumed responsibility for some social objectives of government such as the Child Support Agency, the Higher Education Contribution Scheme and the National Training Guarantee.

Background

The ATO administers the various taxation Acts. To carry out this function it employs approximately 18,000 officers. Its main office is located in Canberra and in 1991 there were sixteen branch offices and several small regional offices in the states and territories. The ATO's primary objective is to ensure that the budgeted revenue is collected and that government policies are implemented.

Enforcement Program

The primary enforcement program of the ATO is one based upon promotion of voluntary compliance concepts through a balanced program, directed toward all taxpayer groups. This program is carried out by the Taxpayer Audit Group, whose role in essence is to detect and bring to account those who do not pay their correct amount of tax.

The Audit Group, which comprises roughly one-quarter of the total staff, is organised around distinct business groups or market segments. These groups are identified as the Complex Business and Primary Audit Groups, and the individual streams of work range from the very largest corporate structures through to partnerships, trusts, private companies and salary and wage earners.

In addition to these primary business streams the ATO maintains within the Audit Group a relatively small number of staff dedicated to the audit of persons deriving income from illegal business activity which may cross all principle streams. These officers form part of the Special Audit Program. They also undertake those audits where the taxpayer, because of his or her high profile, merits specialist attention sometimes in a secure environment.

In 1991, the group of 165 officers located in ten branch offices represented a salary cost of approximately \$6 million. In 1989/90, their program generated additional tax and penalty of approximately \$65.3 million.

Targets

For the greater part, cases processed by the Special Audit teams include persons engaged in 'organised' criminal activity which might include the operation of brothels, escort agencies or any other activities with criminal connotations. These activities generally require extension of inquiry to subsidiary or spin-off cases such as employee activities—prostitutes (female and male) and, in the case of the video industry, actors, actresses and stage crews.

The Income Tax Assessment Act 1936

The *Income Tax Assessment Act 1936* makes no distinction between income from legal or illegal activities. Regardless of moralities, ethics, social stigmas and so on, tax is payable on a taxpayer's taxable income. Providing an amount falls within the definition of assessable income, as defined in the Act, that income, less any allowable deductions, is subject to tax.

It follows that where a person is deriving assessable income from illegal activities, such as drug dealing or prostitution, the taxpayer is obliged in terms of the law to disclose that income in his or her taxation return.

Persons engaged in business enterprises, whether they be brothels, escort agencies, pornographic production and dissemination outlets or whatever, are for taxation purposes carrying on business in the same fashion as any other business and consequently subject to appropriate federal taxation statutes. Similarly, persons employed by such enterprises are drawing wages in the same way as any other employee and are subject to the same rules applying under the 'Pay As You Earn' (PAYE) system.

The Sex Industry

Like any other industry, the sex industry can be divided for tax purposes into two components—the 'tax compliant' part of the industry and the 'non-compliant' part of the industry.

Tax compliant

Within this segment there is a further breakdown of case types—those involved in activities which fall within the law and those which do not.

Legal

There are many examples of legitimate businesses within the sex industry which clearly comply with taxation laws, lodging taxation returns for income generated from their business.

In the ACT, for example, businesses involved in the production and dissemination of videos operate quite legitimately and derive profits from their business activity. Those businesses are also subject to state taxes and presumably comply with those state taxation laws as well. At the same time the businesses are registered as Group Employers for the purposes of the (PAYE) Tax Instalment Deduction system and remit tax deducted from employee's wage packets. The employees of these businesses, of course, are salary and wage earners, like the greater bulk of the population, and lodge returns at the end of the financial year.

In those states where prostitution has been legalised, many persons engaged in that industry voluntarily comply with the law by lodging returns of income derived as either an employer or employee of the business. Special PAYE arrangements are in fact in place to assist these taxpayers comply more easily with the tax law. In addition, proprietors of the various industries and their employees, like the general public, contribute further to the revenue through the Sales Tax legislation which impacts on the products they buy and/or sell.

Illegal business

While the greater majority of persons engaged in illegal activities tend not to disclose income derived from their activities in their returns, some do, and claim quite legitimate deductions for expenditure incurred against income derived from, say, brothel earnings.

Other taxpayers—and the numbers involved are unknown—mask the source of their income by declaring the income as commission income for whatever type of employment they choose to nominate, claiming equivalent expenditures for appropriately related costs.

In Perth, for example, where prostitution is not legal, but subject to what is understood to be a tight containment program, compliance with taxation laws is thought to be high. In a number of other states similar compliance has been achieved after the conduct of audits into the affairs of certain brothel owners.

Non-compliant

Again, there are two components within this class of taxpayer—legal and illegal business activity.

Legal

Persons engaged in legitimate business activities are dealt with by the 'normal' procedures and staff within the office. Depending on the type of business, its size and structure, the matter will be the subject of action by the respective Audit Group program.

Illegal business

This noncompliant business activity is the sector of the market dealt with by the Special Audit area in conjunction, as necessary, with other areas of the ATO.

However, it is necessary to stress that persons engaged in the pornographic, prostitution or whatever other sex-related industry draw no greater or lesser degree of attention than other illegal business activity not complying with the taxation laws.

Case Selection

The ATO case selection process involves the systematic analysis of groups of taxpayers in order to choose a stream which will:

- maximise the impact of voluntary compliance through a visible presence in the 'market' across all areas;
- within any area chosen for audit, focus audit attention on those taxpayers who are identified as having the greatest probability of having substantially understated their tax obligations; and
- systematically build ATO knowledge and understanding of the degree of compliance in the community and the main areas requiring audit attention.

An ad hoc approach to the selection of cases for audit attention, whilst perhaps picking up worthwhile cases does not provide assurance that attention is being directed to the important areas, nor that we are obtaining the most effective results for our input.

In the non-compliant illegal sector, possible case targets are therefore:

- illegal businesses;
- unregistered employees;
- nonlodging commission/contract workers;
- pimps; and
- prostitutes.

Brothels

As Special Audit targets, brothel owners and escort service promoters provide better revenue incentives and more reliable recovery prospects than industry employees. Income may be evidenced by the business records of the organisation, if kept; if not, by virtue of asset accretion or by other methods developed by astute Special Audit staff familiar with the trade.

Several accepted techniques for measuring brothel/escort agency takings have gained acceptance in recent years and involve the measurement of turnover by reference to the ratio of credit to cash sales and the split of escort agency 'take' against the escort 'take'. The aggregate of these percentage figures equals the agency's taxable turnover.

It must be remembered, of course, that the turnover figure is not the assessable income on which tax is levied. Substantial running costs can be incurred for genuine business expenditure such as rent, rates, advertising and so on.

The prostitutes also incur their own business-related expenses and, in the case of escort employees, communication costs related to the use of beepers, mobile phones and so on are part of their overheads.

National figures of the number of persons involved in the prostitution industry are not held in the ATO. However some state figures have been reported following limited projects in the respective states. For example, the population in Victoria has been identified as approximately fifty-five legal brothels using at least 3,000 to 5,000 prostitutes with 1,000

current at any given time. In Sydney, on the other hand 150 establishments were identified in the inner city and suburban areas. On the other side of the nation in Western Australia, nine brothels are known to operate in Perth, while three conduct business in Kalgoorlie. Some 500 employees ply their trade in these houses while another 150 operate under three escort agencies in Perth. Another fifty persons have been identified as independent operatives.

The size of brothels varies considerably, with some owners operating chain-like operations in one city, across a state and even across borders. Some criticism by employees of differing taxation treatment in different states has arisen where employees rotated through different houses of a particular employer. Other smaller establishments operate on a much smaller scale. Ten brothels, the subject of a recent ATO project in the Sydney area, resulted in additional revenue of \$480,000.

The foregoing figures and others mentioned later in the paper have been collected during the course of state-based projects which do not necessarily reflect any true picture of the real industry size in the nation or even the state in question. Furthermore, figures of tax collected in one branch office or state need not necessarily be any benchmark for determining a national figure, given different population sizes, local client behaviour and differing service fees and costs.

Escort Agencies

Again, national average figures are not available for escort agency business. Nevertheless, monthly turnover of \$100,000 is not unusual for enterprises employing say 100 girls in 'escort' arrangements where the 'escort' collects a commensurate share. In the bigger markets the dollar value is even higher.

In the escort industry the employer/employee relationship is not so easily established, and difficulties arise in detecting the relationship between work identities (assumed names) and the real identities of taxpayers engaged in the industry. These persons are nonetheless liable to taxation and the onus is firmly placed upon employers to verify claims for wages paid to employees.

Prostitutes

Experience to date indicates that while many prostitutes enjoy a lifestyle commensurate with the healthy profits generated by their endeavours, there are many more at subsistence level because they are supporting young families as sole parents or supporting a drug habit of their own or that of a partner. At the end of the day in these cases, there is often little left for the revenue to collect. This is also why the audit of prostitutes does not always have a high priority in terms of the total 'illegal' market.

However, as a result of audits of brothels or escort agencies, the natural spin-off is the list of persons identified in the wages sheets of the brothel owner. The identification of these persons and their tax return lodgment status is not usually a function of Special Audit. That process is normally undertaken by auditors involved in the Source Deduction Program officers who are drilled in the administration of the PAYE provisions.

Because of special circumstances peculiar to employment in brothels, arrangements have been made in a number of states to alter the rate of tax deductible from wages paid. For example, the employer (brothel owner) may make application under section 221D of the Income Tax Assessment Act to vary the rate of tax instalments to a flat rate (say 20 per cent) on all payments made to prostitutes in the business.

In recognition of known costs that go with the profession, the seasonal work in some areas, the otherwise unlikely lodgment of tax returns and other factors, an adjusted rate is quite feasible. This, of course, does not represent a final tax liability for the person.

As a further inducement to facilitate PAYE compliance and in recognition of taxpayer's concern for privacy, special care and arrangements are taken to ensure that true identities remain, where appropriate, unknown to employers, and others.

When prostitution was legalised in Victoria a number of employees expressed concern that compliance with the tax laws might lead to their spouse's discovery of previously unknown income. For all taxpayers, the individual affairs of each taxpayer is protected by strict secrecy provisions contained in the various statutes and severe sanctions apply to breaches of these provisions. In 1991 no evidence of breaches in this regard have come to notice.

Unregistered Employees

In the sex industry the greater number of unregistered employees would be located in brothels, whether legal or illegal. However, in those states where the industry is legalised, unregistered agencies employing illegal immigrants, for example, are believed to represent a sizeable audit target. These employees and the people who control them are the hidden side of the industry.

Nonlodging Commission/Contract Workers

Possibly the best example of this type of taxpayer is the escort agency operative. Essentially there is no employer/employee relationship and often the agency might have no knowledge of the real identity of the escort.

From an audit point of view, regardless of payment records of the agency, the task of matching 'street names' to real names is often impossible.

The ATO and Other Agencies

As mentioned at the outset, the ATO does from time to time act in task forces with other agencies where revenue is at risk. The assistance of the Australian Federal Police is also sought, where necessary, for information or intelligence gathering purposes. Formal liaison arrangements are in place with other enforcement agencies, such as the Director of Public Prosecutions, Customs, and the National Crime Authority.

The Future

The Special Audit Program as a formally-structured program is a relatively new initiative of the ATO directed toward those business activities which generate income from illegal or criminal business activities. Any activities generating income have always been liable to taxation and we are now starting to develop better strategies to ensure that the more organised, more profitable and less compliant segments of the market are addressed.