

SERVICE ENTITY ARRANGEMENTS IN THE FIRING LINE - ATTENTION ACCOUNTING, LEGAL, MEDICAL AND ALLIED HEALTH PRACTICES

“The Commissioner does not accept... that asset protection alone can explain service arrangements that use grossly excessive service charges to shift a part of a firm’s profit to another entity without the taxable income forming part of that profit having been subject to tax in the firm’s hands”¹

On **20 April 2006**, the ATO issued the final version of its service trust Ruling - TR 2006/2 - entitled *Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements*. It was previously released in draft form as TR 2005/D5. On the same day, the ATO released the accompanying Guide entitled *Your service entity arrangements*.

The content of the final Ruling is not materially different from the previous draft Ruling. The new Guide does contain significant variances to the previous Guide.

The final Ruling and Guide mark a significant shift by the ATO in its attitude to service arrangements. **Taxpayers that do not critically consider their service arrangements, and ensure that they comply with the ATO’s stated methodologies, run the real risk of a full blown tax audit, with respect to current and previous income years, with consequential income tax adjustments and penalties.**

In short, taxpayers using service arrangements must get their houses in order **now** to avoid a review by the ATO of **all historical** service arrangements.

Audit activity for existing arrangements

The ATO will allow a period of 12 months, to **30 April 2007**, for taxpayers (other than ‘highest risk cases’ – see below) to review their service arrangements.

Service arrangements should be reviewed (see ‘Review methods’ below) as soon as possible, as the implementation of changes will take some time.

If, at the end of that review period, a taxpayer’s service arrangements are generally in line with the information provided in the Guide, there is little risk of an audit of the arrangements occurring. If, however, a taxpayer’s service arrangements are not in line with the information in the Guide and an audit occurs, the ATO audit may include earlier income years (see ‘Retrospective effect’ below).

In light of the new Ruling and Guide, we anticipate significant audit activity by the ATO after 30 April 2007 for taxpayers that do not comply with the new methodologies.

The ATO will continue with its current audit program for what it classifies as the ‘highest risk cases’. These are cases that meet all of the following tests:

- service fee expenses are over \$1m;
- service fee expenses represent over 50% of the gross fees or business income earned;
- net profit of the service entity (or entities) represents over 50% of the combined net profit of the entities involved.

Retrospective effect

The Guide expressly states that the ATO’s review of taxpayers’ service arrangements may include earlier income years. The Ruling is expressed to apply to years of income commencing both before and after its date of issue. Accordingly, an audit by the ATO of current service arrangements will also be directed to previous years’ arrangements.

Will your arrangements withstand an audit?

The ATO in its Ruling states that a service arrangement may not pass scrutiny, and will therefore require an examination of the relationship between the taxpayer and the service entity, the manner in which the taxpayer and the service entity have dealt with each other and the taxpayer’s subjective purpose, motive or intention in incurring the service expenditure where:

- the service fees/ charges are disproportionate or grossly excessive in relation to the benefits conferred by the service arrangement;
- the service fees/ charges guarantee the service entity a certain profit outcome without reasonable commercial explanation; or
- the service fees/ charges generate profits in the service entity without any clear evidence that the service entity has added any value or performed any substantive functions.

If it is determined that service arrangement expenditure was in fact incurred partly or wholly in the pursuit of an **independent advantage** then, to that extent, based on a fair and reasonable apportionment, the expenditure will not be deductible. The Commissioner has also flagged the application of **Part IVA** to service arrangements in certain circumstances.

Alarm bells

Do any of the following circumstances apply to your or your client's service arrangements? If so, it is **critical** to review the service arrangements:

- **Illusory benefits.** Service arrangements with an associated entity have been entered into without fully considering whether the benefits passing to the business enterprise will assist the business or its income earning activities. In particular:
 - arbitrary or fixed mark-up service fees/ charges, with no discernible connection with the value or nature of the services provided, have been charged;
 - the business has effectively guaranteed the service entity a certain profit outcome without obvious explanation;
 - service fees/ charges are being paid by applying mark-ups to private/ domestic expenses incurred by the service entity for a taxpayer or its associates;
- **Disproportionate fees.** Disproportionate or excessive service fees/ charges have been paid in relation to the benefits conferred on the business by the service arrangements when one compares the high profit outcomes of the service entity with the profit outcomes of independent service providers and the relative risks assumed, and functions performed, by the service entity. Has the taxpayer inquired whether any independent businesses exist that could provide the services? Have steps been taken to be satisfied that the agreed service fees/ charges are not disproportionate or grossly excessive in relation to the benefits passing to the business under the service arrangements?
- **Insufficient or inadequate documentation.** Insufficient, un-commercial or non-arm's length documentation exists in respect of the service arrangements. Alternatively, there is doubt as to whether adequate records and documentation have been maintained in relation to the service arrangements and its perceived benefits. In circumstances where the business enterprise acts as agent for the service entity, is a commercial agency agreement in place?
- **Fiction over form.** There is no clear separation between the business activities of the business enterprise and the activities of the service entity. For example, is there evidence that the service entity has added any value to the business enterprise, that it has performed any substantive functions for the business enterprise or that the services were actually provided by the service entity? Other danger signs include where tax, superannuation and workers compensation matters applicable to the service entity are in fact handled by the same staff as are 'on-hired' to the business enterprise, where the service entity has no professional indemnity insurance of its own or where the service entity has no employees or assets of its own.

“Our attention will be drawn to arrangements with related parties that are not well documented and that do not have the elements usually associated with a commercial activity”²

Review methods

The Guide sets out 2 review methods for taxpayers to follow. The simplest method is to look at the Guide's **indicative rates** and case studies. If a taxpayer comes within the indicative rates and no more than 30% of the combined profits of the business enterprise and the service entity is earned by the service entity due to the service arrangement, the ATO considers there to be a low risk of audit. Alternatively, a more extensive review utilizing more sophisticated analyses may be undertaken to determine a market benchmark from which it can be determined whether service charges are correctly calculated. Such analyses include scrutiny of arrangements having regard to **comparable market prices** and/ or **comparable profits** to determine whether the service arrangements are objective, commercial and on arm's length terms having regard to prevailing market conditions.

How we can help you and your clients

You cannot perform an objective review of your own service arrangements. Similarly, where a client's service arrangements have existed for a number of years, your client and you may prefer to obtain independent advice. **Baggiolegal** can perform a **legal and technical tax review** of your/ your clients' service trust arrangements to determine their variance from the new methodologies. Thereafter, after consultation and recommendation, we can assist in the **implementation of complying service arrangements** and **appropriate service arrangement documentation**. We can also assist in all related issues, including winding up service trusts (if appropriate), stamp duty, GST and payroll tax implications, alternative structures, asset protection and transition strategies.

About Us

Baggiolegal is a boutique law firm, specialising in commercial, taxation and private client law. **We understand** our client's objectives and provide clear and independent advice. Service is paramount to us. **We deliver** technically sound, timely and commercially oriented solutions. **We know** and understand the South Australian landscape, but our international perspective is unique in Adelaide. Our people have excelled in the legal profession in private practice and industry all over the world. **We apply** international best practice to our local client's needs. **We work** with our clients. **We listen** to our clients. We are approachable, accessible and personable.

These materials are for general information purposes only and do not constitute legal advice. Before acting on any of our views expressed in this publication, careful consideration of the case specific facts should be undertaken by a qualified lawyer.

¹ Paragraph 43 of the Ruling

² Page 10 of the Guide