



ATO FINALISES SERVICE ARRANGEMENT GUIDELINES

Following extensive consultation with professional firms and representative bodies, the ATO has now finalised the ruling (TR 2006/2) and guide (NAT 13086-04.2006) for service arrangements. Each of these must be read in conjunction with IT276.

What is clear from the Commissioner's comments and media reporting of them is that "Phillips" service trust arrangements are acceptable as asset protection measures if they are implemented for commercially justifiable reasons and if the fees charged under them are not grossly excessive.

The ATO has softened its stance on such arrangements from the initial announcement in 2005 and has announced some indicative rates on common services which are more generous than those foreshadowed last year. The Commissioner will also allow firms until 30 April 2007 to review and bring their arrangements into line. During that time only "high risk" cases are likely to be audited.

The "high risk" cases which the ATO will concentrate on are arrangements where:

- service fee expenses are over \$1 million
- service fee expenses represent over 50% of gross fees or business income earned; and
- net profit of the service entity (or service entities) represents over 50% of the combined net profit of the entities involved; and
- those which raise serious questions as to whether the services were in fact provided by the service entity.

It is still possible for firms to charge fees which exceed the indicative rates set by the ATO. However, it will be necessary to undertake an extensive (and expensive) pricing review in order to justify the higher charges being made. Each case will be considered on a case by case basis.

The practical effect of the ruling is that many firms will be stuck with the limits set by the ATO as the cost of review to justify higher charges may be unsustainable. It is also probably fair to say that the ATO will take a greater interest in such firms even though they may well justify higher charges.

For further information (or to order our updated service agreement package) please call us on 1800 773 477 or refer to our information memorandum below.



AUSTRALIAN COMPANY INCORPORATION SERVICES

EXPLANATORY MEMORANDUM SERVICE ARRANGEMENTS

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INTRODUCTION

The whole area of “service trusts” has been the subject of a large amount of commentary and speculation since the decision of the Federal Court in Phillips – v – FC of T 8 ATR 783. The ATO issued taxation ruling IT 276 in 1978 after the Phillips case to clarify some of the issues contained in it. The ATO’s current position is now also supplemented by TR 2006/2 and the guide booklet issued by the ATO which must be read in conjunction with the original decision and IT 276.

The new ruling and guide indicate:

1. an increased compliance burden on taxpayers;
2. a ‘broader examination’ by the ATO of deductions for service fees where the fees are not considered (objectively) commercially realistic or are considered grossly excessive; and
3. an emphasis on the commerciality of establishing the service arrangement and not only the level of the relevant fees.

ATO APPROACH

The ATO has indicated on many occasions that it considers the proliferation of service arrangements since the Phillips decision to be generally indicative of an unwarranted extension of the Phillips principles. While the ATO accepts the correctness of the Phillips principles, it considers that many service arrangements do not come within the intent of that decision.

When issuing the ruling and guide in draft form in 2005, the ATO stated that “The draft ruling reflects our long standing view that service arrangements are acceptable provided they are entered into for commercial reasons – and at commercially realistic rates”.

The final ruling confirms the ATO’s view of the law that service fees will be deductible if the service arrangements are entered into for commercial reasons and the service fees are not grossly excessive. The guide will help firms self-assess their own situation and provide them with greater practical certainty.

The ATO will allow a period of review ending 30 April 2007, during which all affected firms should bring their arrangements into line with the guide. If at the end of the review period an arrangement is generally in line with the guide, there is little risk they will audit the arrangement. If at the end of the review period an arrangement is not in line with the guide and the arrangements are audited, then the ATO may include previous years.

The new ruling and guide have as a recurring theme, the need for these arrangements to be commercial. In particular, firms must consider:

1. the need for the arrangements to be connected to the conduct of the taxpayer’s business. In other words there must be a real and substantial reason for the establishment of the service arrangements. It seems that without other substantial reasons, the diversion of income and asset protection are not considered to be sufficient commercial reasons for the establishment of these arrangements. There must be other commercial reasons why the taxpayer would decide not to perform the services for itself. You must be able to identify commercial benefits from the arrangements. For example:
 - (a) the improvements in the projected profits expected to become available to the taxpayer by virtue of the delegation of the services to the service entity;
 - (b) the improvements in productivity expected to flow from the separation of the administrative functions of the taxpayer’s business from the revenue producing functions of the business;
 - (c) the elimination of staff and employment risks associated with the direct engagement of staff;
 - (d) the elimination of Occupational Health and Safety risks associated with the direct engagement of staff; and

- (e) the improvements in cost controls expected to become available to the taxpayer by the engagement of experienced financial controllers engaged by the service entity.

If you nominate these as reasons, then you should ensure your arrangements support this. That is, the ATO would not consider any commercial benefit was being gained by the professional practice if the business owner performed all these tasks even if they were notionally performed (and then charged) by the service entity;

2. the need for the service charges being imposed under them to be not grossly excessive. The commerciality of any service charge must be considered on a case by case basis having regard to the business and the prevailing conditions. The guide provides a list of indicative rates for various services to be provided.

DOCUMENTATION

Formal documentation must be in place to support the service arrangements. The guide provides a fairly complete list of the documents which the ATO considers necessary. Largely, they conform to what would be expected in an arm's length transaction for the provision of the services. The guide provides the following list:

- (a) Service agreement.
- (b) Evidence of how the pricing structures were agreed.
- (c) Tax invoices for service fees charges, as well as evidence of payment.
- (d) Calculations showing how the fee was calculated (i.e., not just a fixed amount each month).
- (e) Partnership agreements of the professional practice (if applicable).
- (f) Constituent documents establishing the service entity (e.g., trust deed).List of service entity employees and their employment contracts and job descriptions.
- (g) resolutions of the service entity regarding the distribution of profits.
- (h) a list of personnel employed with job descriptions.
- (i) employment contracts, timesheets, personnel records and guidelines for employees for the service entity.
- (j) relevant insurance contracts.
- (k) Relevant lease/rental agreements held by the service entity.

COMMERCIALITY

The ATO will look at features indicating a lack of commerciality. These might include:

1. Service charges being grossly excessive or out of proportion to the benefits supposedly conferred on the service recipient;
2. a lack of separation between the day to day operations of the service trust and the taxpayer. The reality of the practice must be consistent with the stated position as reflected in the available documentation. The service entity should employ people to perform the tasks performed rather than utilising the staff supposedly supplied to the business to do them or if this is common practice keep separate records of the work performed on behalf of each of the taxpayer and the service entity;
3. services charges calculated by reference to fixed mark ups without regard to the value of the services rendered;
4. service charges that are set at levels which would be grossly excessive or not commercially realistic or available to the taxpayer in the open market. Comparable price/profit data should be collected as well as sound commercial reasons why service entity

fees/profitability might be higher than industry standards (e.g. some taxpayers may not have access to some services at standard rates or at all in some cases); and

5. service charges that lock in a set return without commercial explanation.

HIGH RISK CASES

During the review period “high risk” cases will continue to be audited. In such cases no 12 month review period is available since the ATO considers that firms which would fall within the “high risk” category should comply with the law without the need to rely on the information in the ruling or the guide.

The ATO will concentrate on arrangements where:

- service fee expenses are over \$1 million
- service fee expenses represent over 50% of gross fees or business income earned, and
- net profit of the service entity (or service entities) represents over 50% of the combined net profit of the entities involved; and
- those which raise serious questions as to whether the services were in fact provided by the service entity.

On an ongoing basis, if the fees charged by the service entity are no more than the indicative rates and the profits of the service entity are no more than 30 percent of the combined profits of the professional firm and the service entity, there is little risk of being audited due to the deduction claimed. If charging in excess of the indicative rates, you should keep adequate evidence and comprehensive records for the justification of those higher fees and of the commercial reasons for the higher fees charged. The greater the fees charged differ from the indicative rates, the greater will be the likelihood of an audit.

If the arrangement does not deliver the firm any commercial benefit over and above that which could be provided by using an independent supplier but the fees are grossly excessive compared to the market price, then the arrangement is at high risk of audit.

DEADLINE

The ATO has announced that there will be a transitional period of 12 months (ending on 30 April 2007) for service arrangements to be brought onto a commercial footing. The Commissioner has suggested that all affected entities should immediately review their arrangements and bring them into line with the ruling and to put in place the appropriate documentation to satisfy the commercial terms conditions.

SUMMARY

We strongly recommend that, as a starting point, you read carefully the ruling and the guide booklet and particularly, the case studies.

ACIS has, in conjunction with its lawyers, reviewed and amended its service agreement in light of the new rulings. The issues raised by the rulings are addressed in our new agreement, however, each situation must be examined individually. You must satisfy yourself that the particular arrangement satisfies the proposed criteria and does so on an ongoing basis.

THE ACIS SERVICE AGREEMENT

ACIS provides with the standard Service Agreement package:

1. The Service Agreement;
2. Minutes for the execution of the Service Agreement for both Service Recipient and Service Provider;
3. Minutes for the reasons for the establishment of the Service Agreement for the Service Recipient and for the adoption of the initial fees;
4. Blank minutes for the annual review of the arrangements and the fees payable;
5. Blank Check Lists and Fees Schedules; and
6. Floppy disk containing copies of the blanks listed in 4 and 5 above.

NOTE: ALL OF THE ADDITIONAL FORMS AND MINUTES INCLUDED IN OUR SERVICE AGREEMENT ARE SUGGESTIONS ONLY. THEY MUST ONLY BE USED AFTER CAREFUL CONSIDERATION OF THE CIRCUMSTANCES OF EACH CASE ON ITS MERITS.

We strongly recommend that the arrangements be formally reviewed at least annually and proper documentation be put in place each year which satisfies the new guidelines. Remember, these guidelines will focus on the substance of the arrangements in question rather than the legal form so you must be in a position to provide evidence of the reality of the service arrangements.

It is important that each affected business review its current practice and take steps to put service arrangements on a commercial footing now.

You should immediately examine the ruling and the guide and review whether payments made under your service arrangement are commercially realistic and reasonably connected to your business.

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This memorandum was prepared by redchip lawyers. For more information on redchip lawyers and the services we offer please visit our web site www.redchip.com.au

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