Senate Economics Legislation Committee

ANSWERS TO QUESTIONS ON NOTICE

TREASURY

Australian Taxation Office

(Budget Estimates 2 June 2005)

Outcome 2

Topic: **Service Entities -rulings**

Hansard Page: **E117**

Senator Sherry asked:

Have there been any agreements or rulings in respect of this issue with taxpayers?

Mr Carmody—*I do not know if there have been any formal rulings. But if we go back into the early 1990s or whatever, there are a couple of advices that went out.*

Senator SHERRY—Are you able to produce them for the committee?

Mr Carmody—*I do not have them on me but we can have a look.*

Senator SHERRY—You believe you will be able to provide those for us?

Mr Carmody—*I should be able to.*

Answer:

Edited versions of the relevant rulings/advice are attached.

Whilst in some cases the mark-ups used in the Phillips case were accepted as being applicable, the ATO policy remained as set out in the Income Tax Ruling 276: that is, mark-ups were required to be commercial in the circumstances of each arrangement.

The need for commerciality has been identified as being reinforced in speeches and articles given by both ATO staff and members of the legal and accounting profession at least as far back as 1994. As one professional association speaker told their audience in 1998, 'The key message is: Check the mark-ups in the market place.'

It would therefore be erroneous to conclude that the individual letters contained here represented the general ATO view. However, when releasing the draft booklet providing guidance on service arrangements we advised that where" taxpayers have acted on specific advice from the Tax Office they would generally not fall into the high risk category for our current audit program, but should review their arrangements for the future. Of course in these cases we would need to consider the terms of the specific advice and whether there are material factors relevant to the operation of the service arrangements that were not disclosed in connection with the advice".

28 June 1991

Our reference: 6/ADV3/ETP/M15
Contact officer: [--------------------------]
[----------]
[----------------]
[---------------]

Dear Mr [------------],

INCOME TAX: ELIGIBLE TERMINATION PAYMENTS PAID BY THE SERVICE COMPANY TO RETIRING PARTNERS WHO ARE EMPLOYEES OF THE COMPANY

We refer to your letter dated 24 April 1991 in which you requested confirmation that the payments made by [-------------------------------------] Pty Limited ("the Service Company") to retiring partners who were also employees ("partner/employees") of the Service Company, will constitute eligible termination payments (ETPs) in accordance with the definition contained in sub-section 27A(1) of the Income Tax Assessment Act and that the payments would be deductible to the Service Company. You also sought confirmation that the basis for the Service Company charging the partnership for the costs of providing services should be in accordance with our ruling concerning Service Trusts dated 11 October 1990.

You will appreciate that an expression of opinion as to the application of the income tax law given in advance of an assessment cannot be binding on the Commissioner and when the time comes to make an assessment, the law as it then exists must be applied to the established facts. Subject to this necessary reservation and having regard to the information supplied in your letter, the following advice is provided.

1. Eligible Termination Payments Paid to Retiring Partner/Employees

We confirm that the payments made by the Service Company to the retiring partner/employees will be considered ETPs in accordance with paragraph (a) of the ETP definition. The Service Company will be entitled to claim a deduction for the amount of the ETPs paid to the retiring partner/employees under sub-section 51(1) of paragraph 78 (1)(c) where appropriate.

2. Charge Back By Service Company To Partnership

On the basis of the further information provided in your letter dated 18 June-1991, we confirm that the opinion expressed in our letter dated 11 October 1990 regarding the commercially realistic mark-ups on the costs of providing services by a trust to professional partnership practices, will be equally applicable to the Service Company. This confirmation is given on the provision that the Service Company would not charge the partnership for the ETPs or for future ETPs paid, to retiring or terminating partner/employees.

We trust that the above decision is satisfactory.

Yours faithfully

DJ Cortese

DEPUTY COMMISSIONER OF TAXATION

Our ref: [------------------------]

18 June 1991

The Deputy Commissioner of Taxation
Australian Taxation Office
8th Floor
299 Elizabeth Office
SYDNEY NSW 2000

Attention: [----------------------]

Dear Sir

SERVICE COMPANY

We refer to our letter of 24 April 1991 regarding Eligible Termination Payments and subsequent discussion including a meeting held on 14 June 1991 between your Mr [----------] and [-------------------] and our Mr [------------] and [--------------]. To ensure absolute clarity, we now expand upon the background information relating to the third matter on which your confirmation was sought to our letter dated 24 April 1991, being;

> Provided the service fee charged by the Service Company is within the limits of the basis agreed to in your ruling of 11 October 1990 the service fee will be deductible to [partnership] pursuant to Section 51(1) of the Income Tax Assessment Act.

During the current financial year, all partners who had been employed by [------------] Administration (NSW) Pty Limited (" the Service Company") were terminated and, in addition, nearly all of the non-professional staff employed by that company were also terminated, the non-professional staff being transferred and becoming employees of the firm's Service Trust. As you are aware, a ruling was obtained in October 1990 advising what would be the appropriate commercially realistic mark-ups on the cost of providing services by a trust to professional partnership practices. By the action of removing the partners from being employed by the Service Company, that company effectively ceased to be in " Administration" company and became a "Service" company.

That being the case, we wish to obtain confirmation that the opinion expressed in your letter of 11 October 1990 regarding service trusts would be equally applicable to a service company. We note that historically, as the Service Company has employed the partners and has been used to provide superannuation for the partners, fees charged by that company to the partnership have been set as a level such that the company achieved a "break even" result, such an arrangement being part of the overall agreement reached with the Australian Taxation Office at the time the company was established.

As this situation has changed and now the company is acting as a service company employing all the firm's professional staff and a small number of administrative staff,

it is important that we obtain confirmation as to the appropriate parameters for charging the partnership.

Please note that any charge would be based on salaries, on costs, etc and that the Service Company would not charge the partnership (that is it would not seek reimbursement from the partnership) for the Eligible Termination Payments referred to in our earlier letter.

We trust that this more detailed explanation removes any confusion regarding this third aspect of our 24 April 1991 letter and will, therefore, enable you to be able to respond quickly to the issue raised in the letter.

If you have any further queries on any of the issues raised, in either our 24 April letter or this letter, please contact our Mr[----------] on [--------].

Yours faithfully

[-------------]
Partner
[-----------------]

24 April 1991

Deputy Commissioner of Taxation
Australian Taxation Office
4th Floor Centrepoint
100 Market Street
SYDNEY NSW 2000

Attention: [-------------------]

Dear Sir,

PARTNER RETIREMENTS –
ELIGIBLE TERMINATION PAYMENTS

A small number of the partners of [--------------------] will be retiring as at 30 June 1991. It is intended that the service company for the partnership, being [partnership] Administration (NSW Pty. Limited ("the Service Company"), will make a termination payment to each of the retiring partners, the payment being in appreciation of the services provided by those partners in their varying capacities to {--------------] and its associated entities as well as to any predecessor firms (and their associated entities) with which the partners may have been involved.

We are writing to you to obtain confirmation that the payment will constitute eligible termination payments in accordance with the definition of that term within Section 27A of the Income Tax Assessment Act ('the Act') and that the payments will be deductible to the Service Company. We also seek confirmation that the basis for the Service Company charging the partnership should be in accordance with your ruling concerning Service Trusts addressed to [-------------------] dated 11 October 1990.

BACKGROUND

As I believe you are aware, our firm has a most complicated history as a result of a series of merges involving its predecessor firms. The partners who will be retiring have a variety of backgrounds as their careers originated from several different predecessor firms. The majority of the partners retiring were, prior to our most recent merger, with [partnership] [formerly partnership} and had been employed by the administration company of that firm. The other partners who are retiring were partners of the [partnership] practice prior to our most recent merger and they had been employed by the [---------] service company. In all instances the relevant partners retired from either the administration company or service company on 30 June, 1990.

The partners concerned will be retiring from the firm and therefore terminating their work/employment for the firm and any associated entities (including any predecessor firms and associated entities) on 30 June 1991.

The retirement of these partners has to be viewed in the wider context of the rationalisation of our partnership following our most recent merger between [partnership] and [partnership]. Since that time there has been a general restructuring of the partnership which has not only resulted in all partners retiring from the administration company or service company but has also led to a number of retirements from the practice as a whole, including the proposed retirements. As a result of the retirement of all the partners from the old administration company it has now become a service company for the firm employing professional staff and providing their services to the professional partnership.

The attitude of the partnership has been that whilst these rationalisations and restructurings are necessary and in this instance have necessarily led to the retirement of several partners, the firm is appreciative of the efforts of those partners over many years, their services having been of assistance to not only partnerships but of course the various entities associated with those partnerships including the old administration company and service company. With this in mind, the firm has, through the Service Company, decided that it is appropriate that the partners each receive a gratuity in consideration of those past services. It is in this context that the payments are proposed to be made when the partners retire from the wider practice on 30 June 1991.

In our view the proposed payments should fit within the definition of 'eligible termination payment' in Section 27A as they will be payments 'made in respect of the taxpayer in consequence of the termination of employment of that taxpayer".

In addition, we consider the Service Company should obtain a deduction for the eligible termination payments. In regard to the latter point we note that the payments range in amounts from $75,000 to $375,000, those payments being dependent upon a number of matters, in particular the years of service and the status of the individuals within the partnership. On the basis of the calculation we have done there should be no case where the payment of the eligible termination payment would result in any of the partners concerned receiving, together with any superannuation entitlements, an amount in excess of their maximum reasonable benefit limits.

Finally, we consider that the Service Company should be able to charge the partnership on the basis agreed to in your ruling of 11 October 1990 addressed to [partnership] (your reference 6/G/AF2058/13) and that provided the service fee falls within those limits the fee should be deductible in the partnership pursuant to Section 51(1) of the Act.

RULING SOUGHT

In this context we would appreciate your confirmation that:

1. The termination payments will be "eligible termination payments" within the definition in Section 27A and that accordingly they will be taxed in the hands of the retiring partners in accordance with Subdivision AA of Division 2 of Part III of the Act.

2. The termination payments will be deductible to the Service Company pursuant to either Section 51(1) of the Act of Section 78(1)(c) of the Act.

3. Provided the service fee charged by the Service Company is within the limits of the basis agreed to in your ruling of 11 October 1990 the service fee will be deductible to [partnership] pursuant to Section 51(1) of the Act.

As this matter is of some sensitivity and some urgency we would appreciate your contacting our Mr [------------] (phone -----) after you have had an opportunity to consider this issue.

Yours faithfully
[-------------------]

[------------]
Partner

Details for Case No: [-------]

Client #1
Type : IND

TFN : [---------]

ABN : 0

Name : [-------------------]

Subject
Use of related Phillips type service trust.

Facts
[A], Inc. carries on the business of management consulting in Australia through an Australian branch. The Service Trust agreement was executed on 21 June 1996 between [A], Inc. and [B] Pty Limited as trustee for the [B] Trust ("the Service Provider").

All [--------------------------------] ("[ABCs]") in Australia, or nominees of those persons, are given the opportunity to subscribe for units in the trust. The trust deed provides for the issue of new units as determined by the trustee from time to time and also provides that whenever an [ABC] ceases to be employed by the Australian branch of [A], the trustees will redeem the units issued for their issue price.

The [B] Trust leases certain office equipment and fittings and provides the services of various personnel to [A]. The methodologies for calculation of service fees for the provision of equipment and employees remains unchanged from those described in the previous ruling applications.

Broadly, the service fee comprises a charge for employee services. The charge takes into account direct employee cost, on-costs such as payroll taxes and workers compensation and a mark-up of 30%. [A], Inc. believes that this mark-up continues to reflect commercial rates for the provision of employees offered by consulting and temporary staff agencies.

The service fee also includes an equipment leasing charge. The [B] Trust leases the equipment to [A] at a rate equal to the amount to be provided for depreciation in respect of the relevant item plus an implicit return on capital of 20% p.a. (before costs of repairs etc., for which the [B] Trust is responsible for under the terms of the lease).

The terms of the lease, given the implicit return on capital of 20% in an operating lease where the lessor is responsible for repairs, maintenance and insurance etc. is unlikely to exceed current commercial market rates.

Other Relevant Comments

This case is related to Case Id [-------].

This PBR application seeks to confirm for a further six year period, the Commissioner of Taxation's views stated in a previous private ruling issued on 3 May 1996. Application of this previous ruling to [A], Inc. and one of the [------------------------] ("[ABCs]") expired on 31 December 2001.

This application is to confirm the above views of the Commissioner of Taxation for the income years ended 31 December 2002 (in lieu of the year ended 30 June 2003) to 31 December 2007 (in lieu of the year ended 30 June 2008) on behalf of [A] and the income years ended 30 June 2002 to 30 June 2007 on behalf of the Employee.

The previous Notices of Private Rulings confirmed that, in relation to [A], Inc.:

- fees payable by [A] to the service trust for the services of employees of the trust and for the use of the service trust's equipment would be deductible pursuant to section 51(1) of the 1936 Act; and

- that salaries and wages paid by [A] to [ABCs] would continue to be deductible under section 51(1) of the 1936 Act.

The previous Notices of Private Rulings confirmed that, in relation to [EFG]:

- salaries including any bonuses paid to Mr [EFG] would continue to be included in his assessable income under either section 25(1) or section 26(e) of the 1936 Act;

- distributions of net income from the service trust as calculated in terms of section 95 of the 1936 Act would be included in Mr [EFG]'s assessable income under section 97 of that Act;

- Mr [EFG] would not derive income under section 25(1) of the 1936 Act nor would he realise any capital gains in terms of Part IIIA of the 1936 Act on disposal of his units in the [A] service trust upon redemption of those units when he ceases to be employed by [A]; and

- Part IVA of the 1936 would not apply to include any amount in Mr [EFG]'s assessable income for any years covered by the ruling.

A Draft Public Ruling TR 2005/D5 issued on 4 May 2005.

Is Application Valid:

Application is Valid

Rulee's Opinion

The service trust arrangements have been implemented and operated as outlined in the previous private ruling applications. The service trust arrangement continues to reflect arm's length relationships that would exist if [A] and the Service Provider were independent parties.

Further, the commercial basis for the implementation of the service trust arrangement remain relevant in terms of support for the continuing of this arrangement. For example, in our view, recent developments in the area of industrial relations and employment law generally as well as the increasing administrative burden imposed on taxpayers to comply with the Australian taxation laws actually stregthen the commercial case.

In terms of the Australian taxation laws, although the general assessing provisions and deduction provisions have been rewritten and now appears as s. 6-5 of the Income Tax Assessment Act 1997 ("the 1997 Act") and s. 8-1 of the 1997 Act, the principles in these provisions remain unchanged from the date of the previous private ruling applications.

In relation to Part 3-1 of the 1997 Act (which now contains the capital gains tax provisions), we acknowledge that this component has been significantly redrafted particularly from a conceptual perspective as these provisions are now driven by "CGT Events". However, as with the general assessing provisions and deduction provision discussed earlier, the principles in these provisions remain unchanged from the date of the previous ruling applications.

Also, we are not aware of any case law since the time the applications for the previous private rulings were made that should influence the Commissioner of Taxation's views as expressed in those rulings. In other words, *FC of T v Phillips* 77 ATC 4169 continues to be the leading case on service trust arrangements.

Given that this application relates to arrangements that are already in place and have been accepted by the Commissioner of Taxation in the previous private rulings as not being arrangments to which Part IVA of the 1936 Act applies, we do not believe that any recent case law developments on Part IVA of the 1936 Act are relevant for the purposes of this submission. In addition, we acknowledge that the Commissioner of Taxation's public ruling on service trust arrangements, specifically IT 276 remains in force.

Assumptions

Nil.

Case Dates

Commencement Of Arrangement:

2001-07-01

Issue #1

Questions

1. Salaries including any bonuses paid to Mr. [HIJ] would continue to be included in his assessable income under s. 6-5 of the 1997 Act;

2. Distributions of net income from the service trust as calculated in terms of s. 95 of the 1936 Act would be included in Mr. [HIJ]' assessable income under section 97 of that Act;

3. Mr. [HIJ] would not derive income under section s. 6-5 of the 1997 Act nor would he realise any capital gain in terms of Part 3-1 of the 1997 Act on disposal of his units in the [A] service trust upon redemption of those units when he ceases to be employed by [A]; and

4. Part IVA of the 1936 Act would not apply to include any amount in Mr [HIJ]' assessable income for any years covered by the ruling.

Answers To Questions

1. Salaries including any bonuses paid to Mr [HIJ] would continue to be included in his assessable income under s. 6-5 of the 1997 Act;

2. Distributions of net income from the service trust as calculated in terms of s. 95 of the 1936 Act would be included in Mr [HIJ]' assessable income under section 97 of that Act;

3. Mr [HIJ] would not derive income under section s. 6-5 of the 1997 Act nor would he realise any capital gain in terms of Part 3-1 of the 1997 Act on disposal of his units in the [A] service trust upon redemption of those units when he ceases to be employed by [A]; and

4. The Commissioner is unable to provide a determination on the application or non-application of Part IVA of the 1936 Act.

Reasons For Decision

Mr [HIJ] has submitted an application for a private ruling. Mr [HIJ] is an employee of [A] and was paid a salary by [A] as a [----------------------] ('[ABC]').

All [ABC]'s subscribe for units in the [B] Trust, the service provider for [A]. Distributions from the [B] Trust depend on the size of the unit holding of each unit holder and the profitability of the [B] Trust. The profitability of the [B] Trust does not bear any relationship to the performance of [ABC]'s or the profitability of [A].

The [B] Trust is a unit trust, not a discretionary trust. Unit holders are presently and absolutely entitled to the income of the trust based on the number of units held in proportion to the total number of units on issue.

Payments of salaries and bonuses to individual [ABC]'s, as employees of [A] depends, inter alia, on the performance of individual [ABC]'s. Calculation of bonuses paid to [ABC]'s in each jurisdiction in which [A] Inc operate (including Australia) takes into consideration the individual [ABC]'s performance and in some cases, specific local conditions (such as local costs). The calculation in relation to Australian [ABC]'s does not take into account the existence of the [B] Trust.

[ABC]'s are not assisted in subscribing for units in the [B] Trust. As a matter of policy, units in the unit trust as issued at $150 per unit in accordance with clause 3.5 of the trust deed.

> Clause 3.5 states:
>
> Subject to sub-clause 3.6, all Units shall be issued as ordinary Units having a par value of $150.00

An [ABC] or entity nominated by an [ABC] may be offered units from time to time and the prospective unit holder is required to pay the issue price on subscription.

The redemption price is in accordance with clause 3.13 of the trust deed, which states:

> Unless otherwise provided in this Deed or so Determined all Units shall be redeemed for their issue price.

Aside from salaries and bonuses, [ABC]'s do not share in the profits of [A]. Additionally, there are no financing arrangements between [A] and the [B] Trust.

The ruling application requests confirmation that:

1. The salaries, including any bonuses paid to the rulee, would continue to be included in his assessable income under subsection 6-5 of the ITAA 1997.

2. Distributions of net income from the service trust as calculated in terms of subsection 95 of the ITAA 1936 would be included in the rulee's assessable income under subsection 97 of the ITAA 1936.

3. The rulee would not derive income under subsection 6-5 of the ITAA 1997 nor would he realise any capital gain in terms of Part 3-1 of the ITAA 1997 on disposal of his units in the [A] service trust upon redemption of those units when he ceases to be employed by [A].

4. Part IVA of the ITAA 1936 would not apply to include any amount in the rulee's assessable income for any years covered by the ruling.

In response to an ATO letter of 4 July 2003, [A] replied on 27 August 2003, providing answers to a number of questions regarding the service trust arrangement. The functions of the service trust were described as follows:

> "The primary function of the [B] Trust ("Service Provider") is to provide appropriate and adequate property, plant and equipment and human capital to meet the demands of [A]'s business.
>
> This involves acquiring or leasing property plant and equipment and providing such to [A] on appropriate commercial terms. This also involves recruiting and employing individuals with the requisite skills for [A]'s business needs and arranging for the provision of their services to [A] on appropriate commercial terms."

In the private ruling request, the applicant has stated that applicable Australian laws have not changed to the extent that the relevant provisions have to be re-considered:

> "In terms of the Australian taxation laws, although the general assessing provision and deduction provision have been rewritten and now appears as subsection 6-5 of the Income Tax Assessment Act 1997 ('ITAA 1997') and subsection 8-1 of the ITAA 1997, the principles in these provisions remain unchanged from the date of the previous private ruling applications.
>
> In relation to Part 3-1 of the ITAA 1997 (which now contains the capital gains tax provisions), we acknowledge that this component has been significantly redrafted particularly from a conceptual perspective as these provisions are now driven by "CGT Events". However, as with the general assessing provision and deduction provision discussed earlier, the principles in these provisions remain unchanged from the date of the previous ruling applications."

In respect of the rulee, Mr [HIJ], he would continue to include salaries and any bonuses paid in his assessable income under subsection 6-5 of the ITAA 1997. Additionally, distributions of net income from the service trust as calculated in terms of subsection 95 of the ITAA 1936 would be included in the rulee's assessable income under subsection 97 of the ITAA 1997.

CGT Determination Number 40 (1992) refers to:

> **Capital Gains: What is the treatment where units in a unit trust are issued or redeemed by the trustee?**
>
> 1. The treatment differs for the unitholders and the unit trust as follows:-
>
> UNITHOLDERS
>
> Issue of units - units issued to a unitholder are an acquisition by virtue of paragraph 160M(5)(aa).

Redemption of units - the redemption of units would constitute a disposal by virtue of paragraph 160M(3)(b). Any proprietary or equitable interest conferred by the units would be extinguished at the time of redemption, thereby effectively extinguishing the units.

Paragraph 160M(5)(aa) of the ITAA 1936 has been replaced by section 104-35(5)(c) of the ITAA 1997 and paragraph 160M(3)(b) of the ITAA 1936 has been replaced by section 104-25(1) of the ITAA 1997.

Section 104-25(1) of the ITAA 1997 refers to "Cancellation, surrender and similar endings: CGT event C2". CGT event C2 happens if the ownership of an intangible CGT asset ends by the happening of a number of events, including:

(a) being redeemed or cancelled;

In response to an ATO questionnaire, the following details about the units held and trust distribution policy were provided:

"In accordance with Clause 9.4 of the trust deed, unit holders are presently and absolutely entitled to the income of the trust based on the number of units held in proportion to the total number of units on issue."

An example was provided of a recent redemption of units:

"The most recent issue of (subscription for) units in the [B] Trust occurred on 17 June 2003. The acquiring unit holder was [XY1] Pty Ltd who acquired 10 units at $150 per unit.

The issue price was in accordance with clause 3.5 of the trust deed.

The most recent redemption of units in the [B] Trust occurred on 2 January 2003. The unit holder whose units were redeemed was [XY2] Pty Ltd whose 40 units were redeemed at $150 per unit.

The redemption price was in accordance with clause 3.13 of the trust deed."

It is proposed to treat the redemption of the rulee's units on the same basis as the previous ruling request, ie, Mr [HIJ] would not derive any income under subsection 6-5 of the ITAA 1997, nor would he realise any capital gain in terms of Part 3-1 of the ITAA 1997, on the disposal of his units in the service trust upon redemption when he ceases to be employed by [A].

Income Periods

Year ended 30 June 2002

Year ended 30 June 2003

Year ended 30 June 2004

Year ended 30 June 2005

Year ended 30 June 2006

Year ended 30 June 2007

Legislation

Income Tax Assessment Act 1997 Section 8-1.
Income Tax Assessment Act 1997 Section 6-5.

Rulings and Determinations

Taxation Ruling IT 276. **(ATO View)**

Relevant Cases

Taxation, Federal Commissioner of v. Phillips (1978) 20 ALR 607;(1978) 36 FLR 399;78 ATC 4361;8 ATR 783

Other References

IT 276 **(ATO View)**
Draft Taxation Ruling TR 2005/D5 **(ATO View)**

Keywords

Professional practice & service entities
Professional services sector
Service trusts

ATOID References

2001/4 **(ATO View)**
2001/87 **(ATO View)**

Received Date:
2002-10-03

Review Date:
2005-03-31

Due Date:
2005-06-22

Date Finalised:
2005-05-27

Date Closed:
2005-07-04

Last Date A T O View Checked:
2005-05-26

Last Date A T O View Checked:
2005-05-26

EDITED VERSION OF NOTICE OF PRIVATE RULING
Authorisation Number: 52430

This Ruling is a 'Private Ruling' for the purposes of Part IVAA of the Taxation Administration Act 1953.

YEAR(S) OF INCOME TO WHICH THIS RULING APPLIES:

Year ended 30 June 2002

TAX LAW:

Income Tax Assessment Act 1936 Section 95.
Income Tax Assessment Act 1936 Section 97.
Income Tax Assessment Act 1936 Part IVA.
Income Tax Assessment Act 1997 Section 6-5.
Income Tax Assessment Act 1997 Part 3-1.

WHAT THIS RULING IS ABOUT:

Application of the ordinary income provisions to the salaries, bonuses and distributions received

1. Would salaries including any bonuses paid to the taxpayer continue to be included in their assessable income under section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997)?

2. Whether distributions of net income from the service trust as calculated in terms of section 95 of the *Income Tax Assessment Act 1936* (ITAA 1936), would be included in the taxpayers' assessable income under section 97 of the ITAA 1936?

Application of the capital gains provisions to the disposal of units in the service trust

3. Whether the taxpayer would derive income under section 6-5 of the ITAA 1997, nor would they realise any capital gain in terms of Part 3-1 of the ITAA 1997 on disposal of their units in the service trust upon redemption of those units when they cease to be employed by the company?

Application of the general anti avoidance provisions under Part IVA of the ITAA 1936 to the service trust arrangement

4. Would Part IVA of the ITAA 1936 apply to include any amount in the taxpayers' assessable income for any years covered by the ruling?

THE SUBJECT OF THE RULING:

The company carries on the business of human resources in Australia through an Australian branch. The service trust agreement was executed between the company and services trust (the service provider).

The limited group of executives or nominees of those persons, are given the opportunity to subscribe for units in the trust. The trust deed provides for the issue of new units as determined by the trustee from time to time and also provides that whenever any of the limited group of executives ceases to be employed by the Australian branch of the company, the trustees will redeem the units issued for their issue price.

The taxpayer is a limited group executive.

COMMENCEMENT OF ARRANGEMENT:

1 July 2001

RULING:

Application of the ordinary income provisions to the salaries, bonuses and distributions received

1. Would salaries including any bonuses paid to the taxpayer continue to be included in their assessable income under section 6-5 of the ITAA 1997?

   Salaries including any bonuses paid to the taxpayer would continue to be included in their assessable income under section 6-5 of the ITAA 1997.

2. Whether distributions of net income from the service trust as calculated in terms of section 95 of the ITAA 1936, would be included in the taxpayers' assessable income under section 97 of the ITAA 1936?

   Distributions of net income from the service trust as calculated in terms of section 95 of the ITAA 1936 would be included in the taxpayers' assessable income under section 97 of the ITAA 1936.

Application of the capital gains provisions to the disposal of units in the service trust

3. Whether the taxpayer would derive income under section 6-5 of the ITAA 1997, nor would they realise any capital gain in terms of Part 3-1 of the ITAA 1997 on disposal of their units in the service trust upon redemption of those units when they cease to be employed by the company?

   The taxpayer would not derive income under section 6-5 of the ITAA 1997 nor would they realise any capital gain in terms of Part 3-1 of the

ITAA 1997 on disposal of their units in the service trust upon redemption of those units when they cease to be employed by the company.

Application of the general anti avoidance provisions under Part IVA of the ITAA 1936 to include any amount in the taxpayers' assessable income

4. Would Part IVA of the ITAA 1936 apply to include any amount in the taxpayers' assessable income for any years covered by the ruling?

   The Commissioner is not prepared to provide a determination on the application or non-application of Part IVA of the ITAA 1936 to the arrangement described in the private ruling.

Disclaimer

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Details for Case No: [-------]

Client #1
Type : COY

Name : [Z] PTY. LTD.

Trading Name :

Subject
Service entities, service trusts and agreements.

Facts

[Y] Pty Ltd as trustee for the [A] Service Trust (First Service Provider) and [B] Pty Ltd (First Principal Taxpayer) have entered into a service agreement with the other parties.

The First Principal Taxpayer conducts a specialist [----------] medical practice from a number of premise including, in particular, [---]. The parties named in the Service agreement as the Second Principal and the third principal conduct similar but independent practices from the same location.

The First Service Provider and the parties named in the service agreement as the Second and third provider have agreed to provide services to the First Principal Taxpayer, Second Principal and Third Principal respectively pursuant to the Service Agreement.

Generally, where principals conduct a practice in partnership the service agreements are between those parties on the one hand and their service providers on the other. The terms of the arrangements under the proposed Service Agreement are summarised as follows.

(a) Each principal appoints his, her or its respective service entity (ie its provider) to provide services to that Principal.

(b) Those services are normal services provided under professional service arrangements (ie premises, equipment, cleaning and maintenance , etc). A list of these services is set out in schedule B of the Service Agreement.

(c) A number of the services provided by the provider to the principals are for practical, efficiency and economic reasons better sourced by the providers jointly rather than each of them individually. For example, the [-------] premises are to be leased or licensed by the providers as tenants in common and subleased or licensed to each principal. However, the primary obligation for the provision of the services to each principal rests with their respective providers.

(d) The arrangement between the parties as evidenced by the terms of the Service agreement is for the providers to enter into an unincorporated joint venture for the purpose of, where appropriate, procuring services in order for each of them to meet their respective obligations to their principals.

(e) To the extent that the joint venture incurs debts each provider will be obligated to meet those debts in accordance with the rules set out in the Service Agreement. In some cases there are special arrangements regarding receipts and expenses and those arrangements are set out in schedule D in the agreement. For example, Part E of schedule D sets out how the costs in relation to the [-------] Surgery (the premises) are to be devised between the service providers.

The amount charged by each provider to each principal is to be no more than the -fair market price- for the provision of those services. In broad terms those changes will reflect the actual costs to each provider plus a mark a mark-up applying, as a guide, the guidelines and percentages set out in the decision of FCT v-Phillips 78 ATC 4361. Broadly speaking, the mark-ups set out in Phillips case were 50% for wages and 15% for other expenses.

The are currently three service entities providing services to the principals. Whilst the exact number of non-professional staff and what their actual duties will be, it is anticipated that some rationalisation will occur. The new entity has not been established at this stage.

Other Relevant Comments

Is Application Valid:

Application is Valid

Rulee's Opinion

It is now common practice for a professional practice to establish a service entity a service entity to provide non-professional services to the professional practice. The typical model was sanctioned by the decision in FCT v Phillips 78 ATC 4361.

It would be reasonable to conclude in light of Phillips case and the relevant rulings relating to the use of service arrangements (see IT 2531) that the proposed arrangement is acceptable. Provided the service providers and the Principals can demonstrate that the amount charged by the former to the latter for the provision of services is commercially acceptable, then the First principal taxpayer and the other Principals should be entitled to deductions for the amount paid to their respective service entities(the First Service Provider and the other Providers as described in the Service agreement).

We understand that Phillips' case may be used as a guide to determining what is

reasonable although the rates set out in that decision are not to be taken as representing in all cases an arms length commercially acceptable fee.

The fact that some of the services are sourced to the trust from the joint venture ought not to mean that the basic principles set out in Phillips case cannot be adopted in this particular case.

Assumptions

Case Dates

Issue #1

Questions

Will the agreements to be entered into by the taxpayers as evidenced by the terms of the Service Agreement annexed and marked with the letter -A- (-Service Agreement-) allow a deduction under section 8-1 of the Income Tax Assessment Act 1997 for payments for rental of equipment as provided for in Schedule A, services listed in Schedule B, and payment of staff as set out in Schedule C of the Service Agreement paid by the Taxpayers described as -Principals- in the Service Agreement to the taxpayers described as -Providers- in the Service Agreement?

Answers To Questions

Will the agreements to be entered into by the taxpayers as evidenced by the terms of the Service Agreement annexed and marked with the letter -A- (-Service Agreement-) allow a deduction under section 8-1 of the Income Tax Assessment Act 1997 for payments for rental of equipment as provided for in Schedule A, services listed in Schedule B, and payment of staff as set out in Schedule C of the Service Agreement paid by the Taxpayers described as -Principals- in the Service Agreement to the taxpayers described as -Providers- in the Service Agreement?

Yes, to the extent that the amounts are not capital, or capital, private and domestic, or incurred in gaining exempt income in accordance with section 8-1 of the Income Tax Assessment Act 1997, and to the extent that such deduction is not denied or modified by any other section of the Income Tax Assessment Act 1936 or the Income Tax Assessment Act 1997.

Reasons For Decision

To allow a deduction for the amounts paid by the Taxpayers described as -Principals- in the Service Agreement to the taxpayers described as -Providers- in the Service

Agreement the amounts paid must be necessarily incurred by the relevant -Principals- in carrying on their business for the purpose of gaining or producing assessable income (section 8-1 of the ITAA 1997).

An arrangement where a professional practice establishes a service entity to provide non-professional services to the professional practice has been considered in the decision in FCT v Phillips 78 ATC 4361. The Commissioner's views of the decision in this case were given in ruling IT 276.

The court in Phillips case allowed a deduction to a professional practice for payments made to a related service entity. There were two main factors in the Courts decision to allow the deductions:

1) The re-arrangement of business affairs was for commercial reasons. One of the reasons for the re-arrangement of the taxpayers (partners) affairs was to move assets away from partners to minimise consequences of successful litigation.

2) Charges for services were realistic and not in excess of commercial rates. Connected to this the court considered whether there was any collateral advantage gained by the taxpayer unconnected with business activity. To this end the court held that the only purpose of the expenditure was the acquiring of assessable income or the carrying on of business for that purpose.

Relating the factors in Phillips case to the relevant taxpayers (ie. the -Principals-):

1. A re-arrangement of business affairs for commercial reasons

It has been accepted that there may be commercial reasons apart from reducing the overall incidence of tax in having an arrangement where non professional services are supplied by a related service entity.

The arrangement proposed by the parties differs from Phillips case in that it involves service providers forming an unincorporated joint venture to source the supply of services etc. that are then provided to individual Principals. The taxpayers state that the reason for the joint venture sourcing the supply of services etc. is for reasons of practicality, efficiency and economics. This further supports the proposition of a real commercial reason for the arrangement.

2. A realistic charge not in excess of commercial rates.

The [----------------------] Service Agreement provides rates for provision of services, equipment and staff by a Service Provider to its related Principal in Schedule A (Equipment), Schedule B (Services) and Schedule C (Staff). Each of these schedules provides that the relevant fee or price charged to the -Principal- shall be as agreed between the parties but that the agreed price shall not be more than the price for which those services could reasonably be obtained in an arms length transaction between two non-related parties. Further, if the parties cannot agree upon a price the price shall be a fair market price as determined by the -Principal's- Accountant.

The agreement in effect dictates that a fair market price shall be charged between the -Principal- and its -Related Provider- for all equipment, services and premises. In this sense these rates comply with this second requirement.

In respect to the leasing of Premises by the Joint Venture to a Principal the [---------------------] Service Agreement provides (at clause 8.3) that the monthly license fee payable to the related service provider by the Principal shall be -an amount as agreed between the parties from time to time failing which shall be one hundred and fifteen percent of the rental and other expenses payable by the Joint Venture to the owner of the Licensed Premises-.

To the extent that any rental amounts payable for lease of premises that are in excess of fair market value the rental payments by any principal may not be fully deductible. (A question also arises as to the acceptability or not of 15% markup on leasing costs. Not quite on point but I am aware that property managers acting for the owner of a residential property generally charge the first weeks rent and then 7.5% of the rent to let and manage the property.) On the basis of the decision in Phillips case, it is apparent that a key issue is that any level of mark up be commercially realistic. If the 15% mark up is commercially realistic, then prima facie, it would be acceptable.

In respect to any advantage unconnected with business activity as referred to in Phillip's case there is not in the present situation any associated collateral advantage to the -Principals- that could be seen as a purpose for making the payments or incurring the liabilities to the service providers. All charges except for premises must be at a fair market value. The [---------------------] Service Agreement provides (at clause 4) that the agreement does not create an exclusive relationship between the parties and that each Principal may obtain services, staff and equipment from other parties other than the related Providers. Other provisions in the agreement are also consistent with dealings on a commercial basis.

In conclusion, as long as the rates charged by the service providers to the relevant Principals are commercially realistic the expenditure on these items will be necessarily incurred by the relevant principals in carrying on its business within the meaning of section 8-1 of the ITAA 1997. The fact that the service providers form an unincorporated joint venture to best provide the services etc. to their relevant principle does not distinguish the arrangement from that in Phillips case.

In the answer to questions at issue it is noted that the amounts paid would be deductible:

> -to the extent that the amounts are not capital, or capital, private and domestic, or incurred in gaining exempt income in accordance with section 8-1 of the Income Tax Assessment Act 1997, and to the extent that such deduction is not denied or modified by any other section of the Income Tax Assessment Act 1936 or the Income Tax Assessment Act 1997

Examples of sections that may modify or prevent deductibility under section 8-1 of the Income Tax Assessment Act 1997 may include, but are not limited to Section 65 of the Income Tax Assessment Act 1936 which relates to payments made to associated persons. A further example may relate to the luxury car leasing requirements as set out in Division 42A of Schedule E of the Income Tax Assessment Act 1936.

These examples are not intended to be exhaustive, but merely illustrative of the sections that may impact upon the deductibility, or level of deductibility of amounts paid between the principals and the providers under section 8-1 of the Income Tax Assessment Act 1997.

Income Periods

Year ended 30 June 1998

Legislation

Rulings and Determinations

Relevant Cases

Other References

Income Tax Assessment Act 1997 -8(1)
Income Tax Assessment Act 1997 -8(1)
Federal Commissioner of Taxation v. Phillips <casec>78 ATC 4361
IT 276_IT 2531_IT 2494_IT 2121_IT 2330_IT 2503

Keywords

Entities & taxpayer groups
Family entities
Family partnerships
Family trusts
Practice companies
Service companies
Partnerships
Partnership restructuring
Practice trusts
Service trusts
Professional practice & service entities
Joint ventures
Deductions & expenses
Services sector
Health sector
Health professionals
Medical practitioners
Brisbane ATO
Potential significant issues
Small business income case reports

ATOID References

Application Date:
1998-06-02

Received Date:
1998-07-24

Creation Date:
1998-07-24

Due Date:
1998-07-22

Date Finalised:
1998-07-22

Date Closed:
1998-07-22

Last Date A T O View Checked:
1998-07-22

11 October 1990

Our Reference: 6/G/AF 2058/13
Contact officer: [-------------]
Your reference: 212/Service90/0308

[-----------------]
[-----------]
[---------------]

Dear Sirs,

INCOME TAX: SERVICE TRUSTS

Reference is made to your letter dated 3 August 1990 regarding the amount of mark-up on cost for services provided by a service trust to a professional partnership practice.

You will appreciate that an expression of opinion as to the application of the income tax law given in advance of an assessment cannot be binding on the Commissioner and when the time comes to make an assessment, the law as it then exists must be applied to the established facts. Subject to this necessary reservation the following information is provided.

As you are aware service trust arrangements are only acceptable for income tax purposes provided that the activities of these trusts are considered commercially realistic and the mark-up on the cost of providing the services is reasonable. This view is supported by the decision in Phillips Case and is outlined in Taxation Ruling IT 276.

In view of the decision in Phillips Case and the information provided in your letter, you are advised that the mark-ups you have proposed are acceptable to this office.

Trusting that this information satisfies your enquiry.

Yours faithfully,

D J Cortese

DEPUTY COMMISSIONER OF TAXATION

3 August 1990

The Deputy Commissioner of Taxation
Australian Taxation Office,
QBE Building
12th Floor
80-82 Pitt Street
SYDNEY NSW 2000

Attention: [-------]
Advising Section

Dear Mr [------]

REQUEST FOR RULING: SERVICE TRUSTS

I refer to our recent telephone discussions concerning the amount of mark up on cost for services provided by a service trust to a professional partnership practice.

As I indicated to you, we have a number of law firms as clients whom we are advising (inter alia) as to appropriate mark ups on cost for services provided by their service trust to their professional partnerships. Over the years, it appears that there has been some conflict as to the level of appropriate mark up on certain types of costs. The purpose of this ruling request is to confirm our discussions as to acceptable make ups so that our client service trusts operate on a basis which is acceptable to the Commissioner.

As we discussed, the prima facie test as to the appropriate level of mark up is that enunciated by the High Court in Phillips Case 78 ATC 4361. In that case, the Court accepted various mark ups on the basis that they represented a commercial arm's length consideration for services provided. On behalf of our various clients, we would appreciate confirmation that, in order to avoid the need to conduct regular market research as to what the commercial arm's length rates for particular services are, the Commissioner will accept the following mark-ups:

Salaries and Wages of Support and Administration Staff (excluding debt collection staff salaries).	50%
Salary on costs (eg payroll tax, annual and long service leave, worker's compensation, sick pay, salary continuance insurance, superannuation and training), but excluding debt collection staff salary on costs.	15%
Expenses (eg equipment lenses, consumables, stationery, telephone, and other out of pocket expenses).	15%
Rent for premises used by the practice and lease costs for partitioning and fittings.	10%
Debt collection fee for debts collected after 56 days (being two 4-week accounting months).	5%

Tax Depreciation (this would apply where the service trust purchases equipment outright and makes it available for use by the professional practice)	15%

Where a service trust specifically changes a fee for debt collection , we have taken the view that the salaries and salary oncosts of the people specifically involved in debt collection should be excluded from the total salaries on which a 50% mark up is charged. In this way, the fee of 5% should absorb the salary costs of the debt collection staff. Indeed, our research suggests that commissions charged by debt collection agencies may vary from 5% to 15% depending on the amounts and types of debtors involved.

In relation to the mark up for depreciation, we note that, if the service trust had leased the particular equipment, it would have been able to charge cost plus 15% on the lease costs (which effectively includes depreciation and interest). A 15% mark up on tax depreciation effectively spreads a 15% mark up on total cost over the effective life of the particular item of plant. For example, if an item of plant costs $1,000 and is depreciable at 10% (prime cost), we would envisage that a fee equal to $115 per annum ($1,000 x 10% x 1.15) for the use of that plant is reasonable.

We note that the above outlined mark ups are to only apply to the cost of various services provided by the service trust to the professional partnership. We understand from your comments that these mark ups should not be applied to costs associated with activities not related to the provision of services to the professional partnership (eg investment activities): however, we note that, generally, our experience indicates that most service trusts of medium and large sized legal and accounting firms do not involve themselves in activities outside the provision of services to the professional partnerships.

We hereby request your confirmation that the above outlined mark ups are acceptable to the Commissioner. We note that we intend to use the ruling that you provide as the basis of advising legal and chartered accounting firms, as well as professional practices with service trust arrangements similar to that outlined in Phillips Case (eg specialist consulting practices, certain medical and dental practices).

We would appreciate an early response; should you have any queries, please contact the writer on [--------].

Yours faithfully

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