



# The Practice Managers' Guide to Service Trusts

McMasters' Medical Practice Management



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### **Introduction**

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The Practice Managers' Guide to Service Trusts has been developed to assist both doctors and practice managers with understanding the impact that taxation rulings may have on the use of service entities by professional practices. It contains numerous practical tips and advice, and identifies the main issues connected to setting up and successfully running service trusts within the practice entity. It has been identified as an area where practice managers and doctors alike have a keen interest, and a lot of important information is contained in the guide.

On 20 April 2006 the Australian Taxation Office (ATO) released Income Tax Ruling TR 2006/2 dated 20 September 2006 "Income Tax: deductibility of service fees paid to associated service entities: Phillips arrangements" (The Ruling) and the related "Your Service Entity Arrangements" Guide (The Guide).

The Ruling and the Guide set out the ATO's views of how the income tax law applies to service entity arrangements. The Ruling and the Guide are not the law. They are just the ATO's view of the law. However, professionals using service entity arrangements, or considering using service entity arrangements are well advised to observe the Ruling and the Guide, and how it impacts their arrangements, and to only depart from its benchmark rates on specific legal advice, ideally supported by a private ruling from the ATO.

The Guide stated that the ATO generally allowed professionals 12 months to 30 April 2007 to review their existing service entity arrangements, and to ensure that they complied with the law.

This guide contains many citations of actual circumstances in which service entities have been misused. It also contains guidance as to alternative structures and processes that might be put in place, that actually lead to more efficient and more remunerative professional practices.

Topics included in this guide include:

- A brief history of service entities;
- The law;
- Changes that arose from the Ruling;
- The benefits of practice trusts; and
- Practical issues to consider.

Further reading is encouraged on the topics and these will be identified throughout the guide.

## 6.1 THE HISTORY OF SERVICE ENTITIES

Before considering the specific content and importance of the Ruling and the Guide, it pays to briefly explain the history of service entities. This includes what a service entity is, the law of service entities and the ATO's views of service entities, as well as the reasons for the ATO releasing the Ruling and the Guide in 20 April 2006.

### **What is a "service entity"?**

A "service entity" is usually a trust that provides administrative services to a professional practice. A service trust can either be a discretionary trust (i.e. a family trust), a unit trust or a hybrid trust. The service trust of a solo practitioner will normally be a discretionary trust (i.e. the practitioner's family trust), and the service trust of a partnership or an associateship will normally be a unit trust, or a hybrid trust, with the units owned by the practitioners' family trusts, in accordance with their partnership percentages.

In a small number of cases a company or a partnership of trusts or companies provides the administrative services to the professional practice. These are relatively rare because they tend to have either less efficient income tax results, or higher set up and running costs. However, they are sometimes encountered, and therefore, the Ruling and the Guide deliberately use the phrase "service entity" rather than the narrower, but more common, phrase "service trust".

The service entity provides the services to the professional practice, whether it is a solo practitioner, a partnership, a practice company or an associateship. These services are provided for a fee, and the fee will include a profit component. It is this profit component that has caused the concerns: is it a reasonable reward for the work actually done, and the risk actually borne, by the service trust? Or is it just a tax device, a ruse designed to shift taxable income away from the hands of the high income practitioner, to the hands of lower taxed family members?

### **A brief look at the law**

The leading case in this area came before the Full Federal Court in 1978. The decision in *FCT v Phillips* 78 ATC 4361 is commonly known as "Phillips case", and involved a service trust set up some seven years earlier to provide non-professional services to a firm of accountants.

Previously, the accountants performed these tasks. In Phillips' case the service entity was a unit trust and the units were owned by the partners' family trusts. But there is nothing in Phillips case suggesting the decision is limited to unit trusts and the draft ruling, and the ATO's earlier pronouncements, show that the Commissioner accepts that Phillips case has general application to all service entity arrangements.

The particular services provided by the service entity in Phillips case were:

- (i) secretarial services and general clerical services;
- (ii) share registry services;
- (iii) insurance agency;
- (iv) internal training;
- (v) office furniture and plant and equipment; and

(vi) finance.

The partnership claimed a tax deduction for the amount of the management fees invoiced to it by the service entity. This management fee was calculated on a costs plus basis (for example, labour was charged at cost plus fifty per cent). This, in effect, resulted in an amount of taxable income equal to the mark-up amount being shifted out of the partners' hands into the hands of their family trusts.

Generally the partner's family trusts had better tax profiles than the partners. This meant overall less tax was paid, than would have been had the service entity not been set up, and these management fees not been paid to it.

The Commissioner of Taxation rejected the arrangement. He disallowed the deduction for management fees claimed by the partnership. The partnership objected and, eventually, the matter ended up in court. Once there, Phillips, one of the partners, stated the setting up of the service entity was intended to:

- (i) protect valuable assets from litigation;
- (ii) increase the amount of valuable assets owned by the partners' families;
- (iii) reduce the risk of death duties eroding partnership wealth; and
- (iv) reduce income tax.

#### **The Full Federal Court's view**

The Full Federal Court accepted the re-structure for income tax purposes and allowed the partnership a deduction for the management fees paid. The court thought the amounts paid to the service entity by the partnership were commercially realistic and were not excessive. It found the main reason the partnership incurred the management fee was to secure the management services provided to it by the service entity. This meant that the management fees were deductible losses and outgoings under general principles and that the anti-tax avoidance rules of the day (i.e. the old section 260) did not apply to the arrangement.

#### **The ATO's view**

The ATO accepted the Full Federal Court's decision in Phillips case. In paragraphs 4 and 5 of Income Tax Ruling IT 276 the ATO writes:

*"...Given the view of the facts which the court adopted...that is, a re-arrangement of business affairs for commercial reasons and realistic charges not in excess of commercial rates, the decision to allow the deduction must be accepted as reasonable..."*

*The decision indicates the need for a close examination of all relevant facts before deductions are allowed in cases of this kind..."*

There are numerous other examples of the ATO accepting the general concept of a service trust. And of course the Ruling and the Guide accept the general concept of a service trust. The area of contention is, and always has been, what is a commercial rate?

Newspaper reports indicate that around 1999 a number of very large accounting practices and legal practices set up service entity arrangements involving grossly excessive charges and that were otherwise not commercially justified. The ATO detected these arrangements during other audit activity (which, interestingly, involved aggressive tax schemes) and this led to a general review of service entities by the ATO. The review raised a lot of concerns, particularly about what the 'big end of town' was up to with its service trust arrangements. These concerns were raised publicly in the Commissioner of Taxation's Annual Report to Parliament for 2000 and 2001 and subsequent speeches by the Commissioner and other senior ATO staff.

These concerns were raised in a number of other forums. For example, in 2002 speaking at the American Chamber of Commerce presentation, the then Commissioner of Taxation, Mr Michael Carmody, said that the ATO accepted Phillips Case but was concerned about a number of specific cases where:

- (i) the service entity was not a fixed unit trust;
- (ii) the service entity did not have substantial assets;
- (iii) there were substantial profits in the service trust that were a large proportion of the total profit of the practice.

The general review culminated in the release of a draft ruling and related booklet on 4 May 2005. At the time of the draft ruling's release, we made the following comments:

*"The ATO's bottom line is quite clear: service entities are OK. They are not dead. And solo practitioners can use them still. The ATO accepts service trusts. But, like most ATO acceptances, there are provisos, and the ATO says here the provisos boil down to the service entity arrangements being real, the service fees being commercial and the whole arrangement not being something done just to get a tax benefit. This is actually nothing new. It's what the ATO has been saying for years and the court cases are pretty much on their side.*

More specifically, on 4 May 2005 the, Tax Commissioner Michael Carmody said:

*"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."*

And as Anne Lampe wrote in the Sydney Morning Herald on 5 May 2005:

*"The draft sets out the features of such arrangements which involve a primary business or partnership, a separate trust entity owned or controlled by the taxpayer or associates, and an agreement entered into between the parties, whereby the business pays certain fees and charges to the service entity in return for the provision of services. Typically the fees and charges are calculated on a cost-plus basis, giving rise to profits for the service company.*

*“The draft ruling makes it clear that the Tax Office will not attack genuine arrangements, but will come down on cases where the service company overcharges, where fees set are arbitrary and bear no relation to the value of the services provided, where the service fees are disproportionate to the benefits conferred, and where there is no clear separation between the service entity's business activities and those of the business which is paying for those services.”*

The release of the draft ruling and associated booklet was followed by a consultative process with both the general tax profession industry groups, such as the Taxation Institute of Australia, and the major professional representative bodies. It is fair to say that this consultative process accepted the ATO's position on service entities in principal, but did not accept some of the detail, particularly its conservative view of what comprises an arms-length charge and a reasonable mark up on costs.

### **Income Tax Ruling TR 2006/2 dated 20 September 2006 “Income Tax: deductibility of service fees paid to associated service entities: Phillips arrangements” and the “Your Service Entity Arrangements” Guide**

The consultative process culminated with the release of Income Tax Ruling TR 2006/2 dated 20 September 2006 “Income Tax: deductibility of service fees paid to associated service entities: Phillips arrangements” (i.e. “the Ruling”) and the “Your Service Entity Arrangements” Guide on 20 April 2006 (i.e. “the Guide”). The Ruling and the Guide can be downloaded at the ATO's website [www.ato.gov.au](http://www.ato.gov.au) and can be accessed at the following direct links:

<http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR20062/NAT/ATO/00001>

<http://www.ato.gov.au/content/downloads/N13086-04-2006.pdf>

## **6.2 CHANGES ARISING FROM THE RULING AND THE GUIDE**

The ATO's current view of service entities is best summed up in the introductory pages of the Guide, where it states:

*“If you have a conventional service arrangement where your payments are correctly calculated and the services are reasonably connected to the conduct of your business, then the presumption will be that your service fees and charges are a real and genuine cost of your business and are deductible in full.*

*If your payments are grossly excessive or the services are not reasonably connected to the conduct of your business, then the purpose, and the deductibility, of some or all of your service fees is open to question. We may ask you to explain your entitlement to the deduction claimed. If we are not satisfied with your explanation we may disallow some or all of your deduction.”*

Most tax commentators would accept these two paragraphs as a fair and reasonable summary of the law relating to service trusts and a reasonable position for the person responsible for administering the law, (i.e. the Commissioner of Taxation, and the Australian Taxation Office), to adopt. We certainly have no problem with this summary and position.

The difficulty, as usual, is in the detail. In the Guide the ATO sets out its views of what is and what is not a commercial service entity arrangement. Numerous examples are provided of what is acceptable to the ATO and what is not acceptable to the ATO. Unfortunately, as with any list of examples, the specific situations addressed are limited both in number and in scope. The question then becomes: what if a reader's individual situation is not specifically addressed by one of the examples?

### **Should a service entity be used?**

We believe the Ruling and the Guide will significantly reduce the incidence of service entities within most types of professional practices.

The incidence of service entities was in fact decreasing even before the draft ruling and booklet were released in May 2005. This is because the cost of setting up and running a service trust, compared to the asset protection and tax planning advantages it creates, was often not comparable with the cost of setting up and running alternative structures and strategies. Many practices are concluding that they do not need a service entity and alternative legal structures and strategies are cheaper and easier to set up and run and may produce a better tax result. Examples of more preferred strategies include:

- (i) practice trusts, practice companies and partnerships of trusts to run practices where the practice is a business;
- (ii) large deductible superannuation strategies;
- (iii) gearing strategies;
- (iv) employment of related persons; and
- (v) various other structures and strategies depending on the particular profile and circumstances of the individual practice.

The following sections contain some thoughts about how each of these strategies might be enacted in a particular practice.

### **Practice trust or company**

Many practices currently using service trusts do, or within a reasonable period of time, can, satisfy the ATO's rule of thumb for determining whether a practice is a business. This rule of thumb is set out in sub-paragraph 10(a) of Income Tax Ruling IT 2639 and, says that the ATO will accept that a professional practice is a business if it has as many or more material fee earners who are not owners as it has owners, on an equivalent full time basis. "Material fee earners" is not exhaustively defined. In the case of medical practices, for example, it is thought to include other doctors, practice nurses, counsellors, dietitians and various other medical technicians who are involved in fee generating work.

The issue of fee-generation is pivotal. Administrative staff will not allow the practice to satisfy the benchmark. The staff must generate fees that would not be available were the staff not employed.

Practices that satisfy the ATO's rule of thumb, i.e. which have as many or more material fee generating material fee earners who are not owners as it has owners, on an equivalent full time basis, can use a practice trust or a practice company to run their practice. They do not need to

obtain a private ruling from the ATO before they do this. IT 2639 is a public ruling and it applies generally to all professional practices.

Using a practice company or trust means it has a number of serious advantages over a traditional service entity arrangement and these include:

- (i) they are cheap to set up and to run each year;
- (ii) they take up less scarce time and are less likely to distract professionals from more value adding activities;
- (iii) they decrease external accountants' fees relative to service entity arrangements;
- (iv) they make GST compliance easier as there are fewer BASs and complicated and self-cancelling GST calculations each quarter;
- (v) they do not have the inherent uncertainty implicit in using service trusts after the Ruling;
- (vi) their equivalents are used every day in other businesses, ranging from the local milk bar to BHP Billiton. Companies and trusts are conventional ways of owning businesses and have been in use for more than one hundred years; and
- (vii) the ATO recognises them, and the income tax law contains literally thousands of different provisions, dealing specifically with companies and trusts.

In addition, it is possible that a practice company or a practice trust will lead to less income tax being paid. This is because the practice company or trust may not have to be owned by one individual practitioner and can be owned, for example, by a family trust. This means the whole profit of the practice can be distributed to the beneficiaries of the trust including the professional's spouse, children, other family members and any other company that a beneficiary owns a share in. This typically leads to a lot less tax being paid than otherwise would have been the case.

The capacity for non-professionals to own practices varies according to the profession. In some states, for example, only qualified solicitors can own a solicitor's practice.

### **Large deductible superannuation contributions**

The 12.5% superannuation surcharge was abolished in the May 2005 Federal Budget, with effect from 1 July 2005. This means the only tax charge applying to superannuation contributions is the 15% tax applying to the fund's net income, which includes its taxable contributions. Superannuation is now a very powerful tax planning tool. The amount of deductible superannuation contributions is determined by the recipient's age, and the limits for the year ending 30 June 2006 are:

Under age 35 at 30 June	\$14,603
Between age 35 and age 50	\$40,560
Over age 50	\$100,587

As a general comment, practitioner's spouses can be superannuated by the practice, provided they are either a director of the payer company or a general law (i.e. genuine) employee. The only limit on the amount of the contribution is the spouse's age based deductible superannuation contribution limit. This means, that as a practical matter, the real deductible contribution superannuation limits faced by a married professional can be as much as double those shown above. For example, if a 51 year old accountant has a 49 year old spouse, their combined deductible superannuation contribution limits will be \$141,147 (i.e. \$40,560 plus \$100,587) and if a 51 year old accountant has a

52 year old spouse their combined deductible superannuation contribution limits will be \$201,174 (i.e. \$100,587 plus \$100,587).

In some cases these limits can be increased further by, for example:

- (i) superannuating adult children; and/or
- (ii) arranging one or more separate employments with an arms-length employer to achieve a further and additional deductible superannuation contribution limit. (We know of one situation in which there were five such employments and the professional could choose to be superannuated up to his age based limit five times if he wished to be.)

Assuming the professional pays income tax at a rate of 48%, and the fund pays tax at 15%, superannuation contributions generate a tax benefit equal to 33% of the amount contributed. This is a very significant saving which has to be seriously considered by all practitioners and particularly those closer to age 55, where superannuation benefits can be accessed if need be.

### **Changing from an employment situation to a non-employment situation**

Professionals who are employed by their practice company may consider changing to a practice trust structure using a special deed that complies with the ATO's rules for incorporating practices even where the practice income is personal services income and is not business income.

An advantage of the change is that the professional may jump from the Pay As You Go (i.e. "PAYG") Withholdings system to the PAYG Instalments system. This means the professional will in effect get a tax holiday on his or her practice income from the date of the change say 1 July 2006 to, say, April 2008, being the expected time for lodgement of the income tax return for the year ended 30 June 2007. This does not of itself decrease the amount of tax payable, but it does defer the due date for payment and this is of some benefit

In some cases the professional can use the enhanced cash flow created by changing from being an employee to running his or her own practice to pay off a non-deductible home loan as fast as possible. The interest on this loan is effectively costing 14% pa before tax and the early retirement of this loan is usually the best available investment opportunity.

When the tax bill does finally come in, the trustee of the practice will borrow to pay the tax bill (technically a borrowing to pay out a distribution to a beneficiary) and the interest on the amount borrowed will be tax deductible in the hands of the trustee. The trustee can speed up this process by using debt to pay its practice costs (for example, the professional's insurance premiums, training costs, car costs and other outgoings) while streaming the cash out to the professional to be used to retire debt.

## **6.3 PERSISTING WITH SERVICE ENTITIES**

### **How To increase the likelihood that Your Service Entity Arrangements Satisfy The ATO's Rules**

Assuming that you have still determined that you should use a service entity to provide administrative services to your practice, what should you do next? That is, what should you be doing

to make sure your service arrangements satisfy the ATO's rules as set out in the Ruling and the Guide?

The general answer to these two questions is "read the Ruling and read the Guide". The Guide in particular sets out what needs to be done to make sure that your service entity arrangements pass muster with the ATO. The difficulty with the Ruling and the Guide is that, apart from limited examples, no specific guidance might be available for your individual situation.

The purpose of this section of the article is to provide readers with general guidance on what should be done to maximise the likelihood that service entity arrangements satisfy the ATO's rules as set out in the Ruling and the Guide.

### **Practical issue one: actually provide the services**

Practices need to ensure the services are actually provided by the service entity to the practice. This may sound obvious, but it is surprising how often this is not the case. More than once, a service entity has been set up, and a client advised in detail as to how to run a service entity, only to turn around a year or two later to find nothing ever happened and the exercise has been a waste of time. But more commonly one of the following errors is made:

- (i) the lease should be in the name of the service entity, and not in the name of the practice, and the service entity should then sub-lease the premises to the practitioner. This may require a lease to be transferred to the service entity, or the old lease surrendered and a new lease taken up by the service entity. The risk of something going wrong under the lease should lie with the service entity, not the practitioner, or some other benefit should arise for the practitioner, or else it is hard to see why the service entity is there, and why the lease is not directly between the landlord and the practitioner;
- (ii) non-professional staff should be paid by the service entity. This may mean employments need to be terminated and new employments started as the service entity is introduced into the practice's structure. Letters of appointment, termination letters, and all other relevant correspondence should be on the service entity's letterhead, and the facts should generally be consistent with the service entity employing the staff, and directing them in their day to day duties, rather than the professional whose practice is being served;
- (iii) all third party suppliers' tax invoices should be in the name of the service entity. Records for gas, electricity, seminars, conferences, consumables, insurances, printing etc should all show the service entity as the customer, and the service entity should in fact pay for these services;
- (iv) the service entity should own all plant and equipment and furniture and fittings and the monthly tax invoices rendered by the service entity to the professional should include a charge for the use of these assets.

It also means employment related amounts, such as superannuation, pay as you go withholdings and Work Cover premiums should be paid by the service entity. Where employees are transferred at the start of the arrangement, the service entity will need to assume liability for all accrued annual leave and long service leave entitlements.

Making sure that the service entity actually does the work, and that you can prove that it actually does the work is critical. Without this proof there would be no commercial advantage to the practice and the service entity will be ineffective at law. This means the purported service fees and charges

will not be deductible, and there is a risk of interest and penalties being charged by the ATO on the resulting under-paid tax.

#### **Practical issue two: get the name right**

The service entity should conduct its affairs in its own name (or, in the case of a trust, in the name of the trustee company). This means, for example, stationery invoices received should be in the name of the service entity and the service entity should pay the account using its own funds, preferably by cheque.

The Ruling is sceptical of situations where the professional engages a service entity to provide services to the practice, and the professional acts as the sole director of the service entity's trustee company. It makes sense to heed the ATO's concerns and change the directorships as appropriate. It is also a good idea to make sure the practical things are done properly. For example, if the service entity employs the professional's spouse as an administrator, the spouse should then actually do the work. The professional's (i.e. not the spouse's) handwriting all over the financial records, such as cheque counterfoils and similar documents, will not look good if an ATO audit team arrives.

#### **Practical issue three: keep an eye on things**

The relationship between the service entity and the trust should be constantly monitored and be adjusted for changing commercial conditions. Ideally the practice will prepare written instructions to be followed by all relevant personnel, and compliance with these instructions will be periodically reviewed.

There is a natural tendency for office procedures to evolve over time as staff and principals (consciously and sub-consciously) search for easier ways to do things. Short cuts should not be taken with the service entity. The service entity should do everything that needs to be done to run the practice, except the things that must be done by a practitioner, and the practice does the things that need to be done by a practitioner. Short cuts are hard to explain to a tax auditor and cast doubts on the whole arrangement.

Make sure there are systems in place to prevent evolutionary short cuts.

#### **Practical issue four: monthly tax invoices**

It is critical that monthly tax invoices including GST be raised by the service entity, and that these be paid for by the practice on a timely basis. If this is not done the whole arrangement will be thrown open to question. And no payments should be made to the service entity by the practice, unless they are supported by a tax invoice prepared in line with the written agreement between the parties. We have seen cases where management fees were purportedly paid to the service entity, but the real reason was to get extra cash in to the trust to fund its quarterly principal repayments on its building loan. These extra management fees cast doubts on the efficacy of the whole arrangement.

We have also seen cases where a year's management fees were charged each year by the practitioner's accountant, some months after the end of the year. The amount of the charge was set to bring a practice to a nil profit position each year, and had nothing to do with the services actually provided (or claimed to be provided) by the service entity. If this practitioner were selected for audit

it would have been a picnic: the management fees just weren't deductible. The practitioner would have been up for tens of thousands of dollars income tax and penalties, and there would not have been much that could have been done about it.

Tax invoices must show the name of the supplier, the supplier's ABN, the pre-GST amount, the GST and the post GST amount.

#### **Practical issue five: get the documents right**

The most important document is a service agreement. This document will set out the services to be provided and the method of charging for them. Without such a contract the ATO is likely to challenge the payments made by the practice to the service entity. The service agreement should be up-dated on a regular basis, say once every three years, and the service fees reviewed at least annually.

Regular tax invoices should be rendered by the service entity to the practice. These invoices should set out in detail the basis for the monthly fee, whether it is on a "costs plus" basis or a fixed monthly fee basis. These invoices should be paid on a timely basis.

Minutes of a meeting of the directors of the practice and the directors of the trustee of the service entity should be prepared authorising each company to enter into the service agreement and do all things required to give effect to that agreement. Care should be taken to make sure that the minutes of the meetings of the service entity only relate to the service entity's business, and do not relate to clinical matters. We have seen cases where the matters were mixed, blurring the lines between the practice and the service entity and suggesting that the service entity was not separate to the practice.

Where the service entity is providing finance to the practice, a loan agreement and, if appropriate, security documents giving the trust a charge over the assets of the incorporated practice should be executed.

Working files and normal accounting records to substantiate all payments made by the practice to the service entity, should it be called upon to do so by the ATO, should be kept. These records have to be kept for five years under the income tax law, but they should be kept for at least seven years to comply with the Corporations Law.

#### **Practical issue six: separate the personnel**

A theme of the Guide is the need for the arrangements to be real and commercially based. One aspect of this is separating the personnel in the practice from the personnel in the service entity. It is a good idea for the director(s) of the service entity's trustee company to not be the professionals, and to instead be someone else, probably the professional's spouses. If this is not feasible then, at the very least, document when and what 'hat' the professional is wearing when a particular task is completed.

The main aim is to get the facts right. And just as importantly, to make sure you can prove the facts are right. The document trail should be long and wide, including accountant's letters describing the

purpose of the arrangements, third party quotes for similar services or other evidence of what is being charged, an up-to-date service agreement (anything more than 3 years old is a problem), detailed tax invoices and timely payment histories in accordance with those tax invoices.

Ideally the director of the service entity will not be the professional, and the professional will not be doing the work supposed to be done by the service entity. For smaller practices this can be problematic, and virtually demands that the spouse should be the director and the spouse's handwriting should appear on all documents, such as cheque counterfoils and bank deposit forms.

#### **Practical issue seven: all payments strictly by tax invoice**

All payments by the practice to the service entity should be supported by a tax invoice and should be in line with the service agreement. There should be no payments by the practice to the service entity other than payments supported by tax invoices and in line with the service agreement.

One of the most fundamental errors with service entity arrangements is to move cash between the practice and the service trust at will, (or perhaps more commonly, and descriptively, at need) in a way that is not consistent with the service entity arrangement.

This fundamental error raises serious doubts as to whether the service entity arrangement is effective.

#### **Practical issue eight: identify the commercial benefits of the arrangement**

You should be able to adequately explain how the use of a service entity helps your business and advantages your practice. These advantages need to be real and substantial and the focus is on substance rather than form. Bear in mind that the major costs of running a practice are staff costs and occupancy costs. This means that:

- (i) the risk of employing administration staff should lie with the service entity. This includes the risk of an unfair dismissal claim, and financial obligations such as long service leave, annual leave and sick leave, as well as vicarious liability for an error or omission on the part of an employee; and
- (ii) the risk of occupancy should lie with the service entity (for example, the practice should only have a weak proprietary interest in the premises, say a licence or a month to month tenancy, whereas the service entity has a long term lease to an independent third party, i.e. the landlord).

#### **Practical issue nine: make sure you can prove everything**

It is critical that you are able to prove your case with the ATO, and perhaps the courts after the ATO. In tax matters the burden of proof is on the tax payer. Here, paper proves purpose. So make sure you have lots of paper to show why you are using a service entity and how you are using the service entity. The paper trail should include:

- (i) an up-to-date service agreement;
- (ii) pricing structure information;
- (iii) tax invoices and evidence of timely payment of all tax invoices;
- (iv) minutes of meetings of the directors/trustees/partners et al, recording decisions taken in relation to the service entity;

- (v) constituent documents for the service entity, including the (trustee) company's constitution and any trust deed;
- (vi) budgets and business plans and organisational charts;
- (vii) employment contracts, timesheets etc;
- (viii) insurance contracts; and
- (ix) leases.

### **In summary**

If you comply with each of the above practical issues you will be able to explain to the ATO how the service entity arrangement helps run the business. It does this by:

- (i) giving the professional access to staff, skills and know-how needed to run the practice efficiently;
- (ii) relieving the professional of responsibility for certain tasks, such as recruiting and supervising administrative staff, or liaising with a difficult landlord;
- (iii) relieving the professional from certain risks, such as the risk of an unfair dismissal action, a negligence act towards a licensee using the building and so on.

Once you have done this the only remaining question is whether the service charges are correctly calculated. It is unlikely that there will be a problem if you have complied with the ATO's indicative rates (given in the ruling guide), and have otherwise complied with the Ruling and the Guide.

### **What happens if the ATO does not accept your service entity arrangements?**

It is unlikely that the ATO will completely reject a service entity arrangement. This would require a fundamental failure in the service entity arrangement, such as a complete failure of the service trust to provide the contracted services (which we must admit is a situation we have witnessed more than once over the last few years).

More probably the ATO will be concerned about quantum rather than principle. In other words, the ATO will in principle accept that a service fee is deductible, but will argue that the amount claimed exceeds the amount which is deductible under Phillips Case. That is, concern will focus on whether the service fees are commercial, and to the extent they are not commercial, a deduction will not be allowed. Where a deduction adjustment is made, an income adjustment will be made on the service trust side. This correlating adjustment will usually mitigate, and may possibly negate, the extent of any financial loss suffered as a result of the disallowed deduction. So it's unlikely to be an all or nothing type of argument. Far more probably it will be a dispute as to quantum, i.e. what is a commercial charge for the service actually provided?

These circumstances do not involve tax avoidance or tax evasion and do not expose professionals to the heavy penalties. If there was a reasonable case for the original claim, and all the paper work was in place, no penalties will apply and the only extra cost will be the original under-paid tax and interest on this amount. If there was not a reasonable case for the original claim and/or the paper work was not in place, light penalties may apply on top of the original under-paid tax and interest. The heavy penalties will only apply in extreme cases where there is an element of tax avoidance, such as grossly inflated service fees and serious deficiencies in the paper work.

### **Can the ATO apply anti-tax avoidance rules to service entity arrangements?**

The potential application of the general anti-tax avoidance rules contained in Part IVA of the ITAA 1936 is discussed by the ATO in paragraphs 35 to 43 of the Ruling. These rules allow the ATO to disregard a transaction or series of transactions, (i.e. “a scheme”) where the sole or dominant purpose is to create a tax benefit for the taxpayer. A tax benefit usually consists of lower taxable income than would have been the case had the scheme not been entered into. Penalties also apply.

The setting up or continued use of a service entity arrangement is “a scheme” as defined and is usually intended to produce a tax benefit, i.e. a lower taxable income for the professional than would have been the case had the service entity arrangement not been used. This means that there is scope for the anti-tax avoidance rules to apply to virtually any service entity arrangement.

Practitioners should make sure that the documents underpinning their service entity arrangements record a commercial purpose other than the achievement of a lower taxable income for the professional. In most cases this other commercial purpose will involve asset protection issues. This is recognised by the ATO in paragraphs 42 of the Ruling where it writes:

*“...The Commissioner accepts that asset protection does make objective business sense where an arrangement has the effect of protecting assets employed by a firm in the conduct of its business. For example, in Phillips the service arrangement had the effect of protecting the physical assets and working capital used by the firm to generate its income against claims by the firm’s creditors.*

*The Commissioner does not accept, however, 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 the profit having been subject to tax in the firm’s hands. Indeed an arrangement of this kind may point towards a dominant purpose of enabling a taxpayer to obtain a tax benefit, being for example, the deduction for the excessive part of the charge.”*

In summary, these rules, and the associated penalties, will not apply to a professional using a service trust except in extreme cases. Extreme cases will usually involve service fee charges that are grossly excessive having regard to the actual scope of the services in fact provided to the professional by the service entity.

Professionals should also be aware that, apart from the general anti-tax avoidance rules discussed above, the general principles of deductibility disallow deductions where the amount of the claim is grossly excessive to the benefit it produces. This is because it cannot be said that the amount is incurred for the purpose of producing assessable income or as part of an assessable income producing business. Rather it is incurred for the purpose of producing a tax benefit and therefore is not deductible. Once again though, it can be expected that the ATO will not seek to apply this rule except in extreme cases.

The best protection a professional has against these rules is to make sure that every aspect of the service entity arrangement is commercial, in that it achieves benefits other than just tax planning

benefits, and in particular protects assets and has “the requisite commercial connection” with the professional practice’s activities.

**Disclaimer**

The comments in this practice managers’ guide are intended to be general comments only, and readers should obtain their own specific legal advice before making any decisions based on the information contained in this guide.