Administrative Appeals Tribunal

DECISION AND REASONS FOR DECISION

[2016] AATA 681

Division	TAXATION & COMMERCIAL DIVISION
File Number(s)	**2015/0806**
Re	**PBKQ**
	APPLICANT
And	**Commissioner of Taxation**
	RESPONDENT

DECISION

Tribunal	**Ms G Lazanas, Senior Member**
Date	**5 September 2016**
Place	**Sydney**

1. The objection decision with respect to income tax is set aside and remitted to the Commissioner for determination in accordance with the concession that the Commissioner had already made and the reasons of the Tribunal.

2. The objection decision with respect to the penalty is affirmed except that the amount of penalty is to be recalculated on the basis of the tax shortfall.

……[sgd]……

Ms G Lazanas, Senior Member

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CATCHWORDS

TAXATION AND REVENUE – income tax – default assessment – deductibility of service charge – objection decision relating to tax set aside and remitted to Commissioner – administrative penalty – failure to provide document as required – question of remission – objection decision relating to penalty affirmed

LEGISLATION

Income Tax Assessment Act 1936 (Cth), s 167
Income Tax Assessment Act 1997 (Cth), s 8-1
Taxation Administration Act 1953 (Cth), s 14ZZK, Sch 1 ss 284-75, 298-20

CASES

Commissioner of Taxation v Rigoli [2013] FCA 784
Danmark Pty Ltd v Federal Commissioner of Taxation (1944) 7 ATD 333
Federal Commissioner of Taxation v Phillips (1978) 36 FLR 399
Rigoli v Commissioner of Taxation (2014) 141 ALD 529; [2014] FCAFC 29
Spriggs v Commissioner of Taxation; Riddell v Commissioner of Taxation (2009) 239 CLR 1; [2009] HCA 22
Temples Wholesale Flower Supplies Pty Ltd v Federal Commissioner of Taxation 91 ATC 4387

SECONDARY MATERIALS

Taxation Ruling TR 2006/2 Income tax: deductibility of service fees paid to associated entities: Phillips arrangements

REASONS FOR DECISION

Ms G Lazanas, Senior Member

5 September 2016

INTRODUCTION

1. The taxpayer is a private company that is referred to by the pseudonym PBKQ, or Service Recipient Pty Ltd in these reasons. It is in dispute with the Commissioner as to the deductibility of an amount that it claims to have paid to a related company, referred to as Service Provider Pty Ltd (another pseudonym) in the year ended 30 June 2012 (the relevant year). Service Recipient Pty Ltd contends that it paid a service charge to Service Provider Pty Ltd of the type considered in *Federal Commissioner of Taxation v Phillips* (1978) 36 FLR 399 (*Phillips*) and in the public taxation ruling, *Taxation Ruling TR 2006/2 Income tax: deductibility of service fees paid to associated entities: Phillips arrangements* (TR 2006/2). The taxpayer furthermore claims that the service charge is therefore deductible under s 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997). The taxpayer is also challenging the administrative penalty which was imposed at the rate of 75 per cent of the tax-related liability on the basis of it having failed to lodge its income tax return. Service Recipient Pty Ltd submits that it complied with the Commissioner's demand to lodge its return by a specific date.

2. The Commissioner approached the issues in dispute on the basis that Service Recipient Pty Ltd is not entitled to claim a deduction for the service charge for numerous reasons. The Commissioner did not agree with the taxpayer's characterisation of the service charge, nor that it is supported by *Phillips* or TR 2006/2. Furthermore, the Commissioner argued that Service Recipient Pty Ltd is not entitled to claim a deduction under s 8-1 of the ITAA 1997 for expenses that would not have been deductible had it incurred the expenses directly, rather than via a service arrangement with a related company. The Commissioner also submitted that Service Recipient Pty Ltd has not substantiated the expenses. With respect to the administrative penalty, the Commissioner submits that the taxpayer failed to lodge its income tax return on time and, furthermore, that there are no grounds warranting remission of penalty.

3. I have decided to set aside the Commissioner's objection decision with respect to the tax and to remit the matter to the Commissioner for determination in accordance with these reasons, essentially to allow for the concession that the Commissioner had made prior to the hearing, to which I will come shortly. I have decided to affirm the objection decision with respect to the penalty except that the amount of the penalty is to be recalculated on the basis of the reduced tax shortfall.

THE ISSUES BEFORE THE TRIBUNAL

4. The essential issue is whether Service Recipient Pty Ltd is entitled to claim a deduction under s 8-1(1)(b) of the ITAA 1997 for a service charge said to have been paid to Service Provider Pty Ltd in the year ended 30 June 2012. The service charge in dispute was apparently comprised of, amongst other items of expenditure, workers' compensation expenses, client entertainment expenses and certain payments made to certain third party subcontractors. The Commissioner acknowledged at the hearing that the latter, namely, the subcontractor expenses, were no longer in dispute and that he was satisfied as to the deductibility of those expenses.

5. Another issue is whether Service Recipient Pty Ltd is liable to pay an administrative penalty under s 284-75(3) of Schedule 1 of the *Taxation Administration Act 1953* (TAA 1953). If the penalty was properly imposed, the next issue is, should the penalty be remitted?

THE FACTUAL BACKGROUND AND EVIDENCE

6. Service Recipient Pty Ltd is part of a corporate group comprising itself and Service Provider Pty Ltd. Service Provider Pty Ltd was registered with the Australian Securities and Investments Commission (ASIC) in February 2006 and Service Recipient Pty Ltd was registered with ASIC in April 2010. Both companies have a common single shareholder and director. He is referred to as Mr Smith in these reasons to preserve his confidentiality.

7. Mr Smith, who was the only person to give evidence, has tertiary qualifications in commerce and has been practising as an accountant for over 22 years. He also has a public practice certificate issued by CPA Australia which he said enables him to undertake public accounting services and to use the 'CPA' branding with Service Provider Pty Ltd. A 'CPA' is a finance, accounting and business professional with a specific qualification.

8. Mr Smith has held various chief financial officer and other senior financial control positions in industry throughout his career. In 2006, he went into private practice and established Service Provider Pty Ltd with a view to providing professional accounting services to small and medium enterprises. Apart from providing traditional public accounting services to clients, Service Provider Pty Ltd was also engaged by clients to provide contract accounting services. Mr Smith stated that contract accounting services involved him being

contracted to work for clients for lengthy periods of time and that he was under the direct control and direction of the clients. He said that contract accounting services were distinguishable from public accounting services as the latter required him to apply a high degree of professional independence when providing advice to clients.

9. Mr Smith explained, and I accept, that he established Service Recipient Pty Ltd in order to address concerns following a quality assurance review undertaken by CPA Australia in 2011 with respect to the procedures and practices of Service Provider Pty Ltd. Mr Smith stated that those concerns emanated from CPA Australia's conclusion that potentially all of the services provided by Service Provider Pty Ltd fell within the definition of public accounting services as set out in the CPA Australia Professional Code. Mr Smith formed the view that an unnecessary administrative burden would be placed on Service Provider Pty Ltd if that was the case, because Service Provider Pty Ltd would be required to issue letters of engagement and letters of advice for each segment of work and additionally maintain detailed work papers.

10. Accordingly, Service Recipient Pty Ltd was established in order to mitigate the risk of Service Provider Pty Ltd not complying with its public practice certificate obligations, at least insofar as Mr Smith perceived there to be a problem. Mr Smith's solution was for Service Recipient Pty Ltd to undertake the contract accounting work for clients and for Service Provider Pty Ltd to continue to do any public accounting work for clients. However, a complicating factor, according to Mr Smith, was that virtually all of the work that was then being undertaken for clients by Service Provider Pty Ltd was in the nature of contract accounting services and some of the existing clients could not or would not engage Service Recipient Pty Ltd to do this contract accounting work. Mr Smith put it this way:

> *[u]nder the new structure, it was envisaged that all existing engagements held by [Service Provider Pty Ltd] for Contract Accounting Services would be transferred to [Service Recipient Pty Ltd]. However, due to the administrative rigidities of several of [Service Provider Pty Ltd]'s clients this proved not to be possible to execute.*[1]

[1] Exhibit A1, paragraph 9.

11. Mr Smith explained that he considered this situation could be resolved by both companies entering into a Services Agreement, which I find they did on or about 1 July 2011.[2] That Services Agreement relevantly provides as follows:

> ***RECITALS:***
>
> *A. [Service Provider Pty Ltd] is the holder of a Public Practice Certificate issued by CPA Australia, which is required for an entity that wishes to advertise and provide accounting services under the CPA professional designation.*
>
> *B. [Service Provider Pty Ltd] has long-term relationships with a number of entities in both the public and private sectors. Not all the services provided by [Service Provider Pty Ltd] to these entities falls within the definition of accounting services as defined by CPA Australia professional rules.*
>
> *C. Non-accounting services to existing [Service Provider Pty Ltd] clients will be provided by [Service Recipient Pty Ltd] the purpose of this arrangement is to clearly distinguish those services which are provided under the CPA Australia public practice certificate and those which are not. (sic)*
>
> *D. The parties have agreed that [Service Provider Pty Ltd] will continue to directly manage the relationship with the clients and will invoice [Service Recipient Pty Ltd] for all reasonable costs incurred by it in providing these services. In turn [Service Recipient Pty Ltd] will invoice [Service Provider Pty Ltd] for all services performed on behalf of [Service Provider Pty Ltd] clients.*
>
> *...*
>
> *3.1 During the term of this Agreement, [Service Provider Pty Ltd] must provide the Services specified in Schedule 1 to [Service Recipient Pty Ltd]…*
>
> *…*
>
> *4.1 [Service Recipient Pty Ltd] must pay [Service Provider Pty Ltd] the Service Charges for the Services provided…*
>
> *…*
>
> *Schedule 1*
>
> *(Services to be provided by [Service Provider Pty Ltd] to [Service Recipient Pty Ltd]):*

	Description of Services
1.	*Provision of office accommodation*
2.	*Billing and customer administration*
3.	*Professional staff hire*

[2] Exhibit A1, Attachment B.

4.	*Marketing and promotional*
5.	*Client management expenses*

12. The Services Agreement contains numerous other provisions with respect to the preparation by Service Provider Pty Ltd of estimates of the Service Charges payable for each quarter, as well as quarterly statements. Recital D in the Services Agreement, as extracted above at [11], also contemplated the respective parties issuing invoices. However, the evidence of Mr Smith was that the parties did not prepare estimates or statements or issue any invoices (or at least none with respect to the disputed Service Charge the subject of this proceeding). Instead, any amounts that were claimed to be owing by Service Recipient Pty Ltd to Service Provider Pty Ltd were by reference to general ledger statements which were then "settled" (using the terminology adopted by Mr Smith) by other journal entries in the loan accounts maintained by each entity.

13. As to the calculation of the Service Charge, it emerged from Mr Smith's evidence that what happened in practice is that Service Provider Pty Ltd "re-charged" to Service Recipient Pty Ltd, by way of journal entries, certain discrete expenses that it had incurred. Mr Smith stated that these expenses had been incurred by Service Provider Pty Ltd in providing the Services to Service Recipient Pty Ltd. Mr Smith stated that these various items of expenditure were treated by him as being "the Service Charge" or "the Service Charges" that Service Provider Pty Ltd was entitled to charge to Service Recipient Pty Ltd pursuant to the Services Agreement. The taxpayer, Service Recipient Pty Ltd, claimed to be entitled to a deduction for the so-called Service Charge under s 8-1(1)(b) of the ITAA 1997. In actual fact, Service Recipient Pty Ltd did not claim a deduction for the Service Charge in its tax return for the relevant year (when its return was belatedly lodged in August 2014); instead it claimed deductions for various expense categories, such as workers' compensation payments and client entertainment expenses. Mr Smith indicated that this was an error due to the fact that Service Recipient Pty Ltd had reported these expenses on the basis of its "management accounts" rather than as a Service Charge.

14. Mr Smith maintained at the hearing that it was the deductibility of the Service Charge that was in issue and not the expenses that constituted the Service Charge and I have proceeded on the same basis. Perhaps, for an abundance of caution, counsel for the Commissioner approached the question of the deductibility of expenses by additionally addressing the deductibility of the discrete expenses. For example, in relation to the

'workers' compensation expense' of $12,048.32, counsel for the Commissioner observed that Mr Smith had explained in correspondence to the Commissioner that the expense related to medical and hospital expenses paid in relation to an employee's knee injury (and not for a workers compensation expense). At the hearing, Mr Smith stated that it was his wife that had to undergo knee surgery and that she was an employed office manager of Service Provider Pty Ltd, but no documentation substantiating the medical and hospital expenses was provided throughout the audit or at the hearing. In all the circumstances, especially the taxpayer's insistence that the case was about the deductibility of the Service Charge, it is unnecessary for me to separately deal with the deductibility of the discrete expenses and, I do not do so.

15. In relation to the failure of Service Provider Pty Ltd to lodge its tax return on time, Mr Smith provided the following explanation. The Commissioner had sent a letter to Service Recipient Pty Ltd dated 21 May 2014 titled "Default assessment warning" in which it was stated that the company was required to lodge its outstanding tax returns by 18 June 2014 or else default assessments would be issued.

16. Mr Smith stated at the hearing that, on 18 June 2014, he received a phone call from an ATO officer reminding him that Service Recipient Pty Ltd was required to lodge its tax returns by the end of that day. Mr Smith claims that he told the ATO officer that he had prepared the tax return for the relevant year and was about to fax it. Mr Smith further stated that at about 4pm on the same day he tried to fax the tax return for the 2012 income year to the Commissioner but that the fax transmission was unsuccessful. A copy of a one-page fax transmission notice showing two unsuccessful attempts at faxing a document of 8 pages on 18 June 2014 at 4.11pm and 4.14 pm was amongst the T-documents before the Tribunal.[3]

17. When asked at the hearing what steps Mr Smith subsequently took after realising that the fax did not transmit, he confirmed that he did not call the taxation officer that day or at any time. He also said that he then arranged to post the income tax return to the Commissioner on or about the same date. However, the ATO's copy of the income tax return shows an official "date received" stamp of 13 August 2014, some two months after Mr Smith claimed to have posted it. Mr Smith could not explain why it took so long for the

[3] T8-41.

income tax return to be received if, as he asserted, the tax return was ready to be faxed to the ATO on 18 June 2014, and he had then posted it. On the basis of the evidence before the Tribunal, I find that the tax return was received by the Commissioner on 13 August 2014.

ADMINISTRATIVE BACKGROUND

18. Before turning to the relevant legal principles, it is helpful to briefly outline the administrative steps leading to this proceeding including the actions taken during the Commissioner's audit of Service Recipient Pty Ltd leading to the issue of a default assessment for the 2012 income year.

19. The Commissioner's audit of Service Recipient Pty Ltd started as a result of Service Recipient Pty Ltd failing to lodge an income tax return for the 2012 income year by the due date for lodgement.

20. On 21 May 2014, the Commissioner issued to Service Recipient Pty Ltd a default assessment warning letter for the lodgement of outstanding income tax returns and requiring their lodgement by 18 June 2014.

21. On 1 July 2014, the Commissioner issued a letter notifying Service Recipient Pty Ltd that it had failed to lodge its outstanding income tax return for the 2012 financial year and that the Commissioner would proceed to make a default assessment pursuant to s 167 of the *Income Tax Assessment Act 1936* (ITAA 1936), which he did by issuing a notice of assessment to Service Recipient Pty Ltd on 7 July 2014. The amount of taxable income assessed to Service Recipient Pty Ltd for the 2012 income year was $174,933, with resulting assessed tax payable in the amount of $52,479.90. A notice of assessment of administrative penalty also issued for the amount of $39,359.90 imposed at the rate of 75 per cent of the primary tax because the taxpayer failed to provide a document, that is, the tax return, as required.

22. On 13 August 2014, the Commissioner received an objection lodged by Service Recipient Pty Ltd. The following is relevantly stated in the objection:

> *[Service Recipient Pty Ltd] was issued with a default income tax assessment in respect of the 2012 year of income as it was claimed that the company had not lodged an income tax return for that year by 18 April 2014 (sic - should read 18*

June 2014) however, I believe the company did comply with this request by faxing a copy of the tax return to the ATO on 18 June 2014.

23. Also on 13 August 2014, the Commissioner received the income tax return for Service Recipient Pty Ltd for the relevant year. The 2012 tax return reported total income of $293,465 and total expenses of $273,836.00 with resulting taxable income of $19,629.00.

24. On 10 December 2014, the Commissioner issued a notice of objection decision to Service Recipient Pty Ltd. The Commissioner allowed the taxpayer's objection in part but disallowed the following expenses claimed by Service Recipient Pty Ltd:

Expenses claimed	**Amount disallowed**
Workers' compensation expenses	$12,048.32
Client entertainment expenses	$5,479.32
Payments to certain third party subcontractors	$8,224.32
Total	**$25,751.96**

25. The Commissioner's reasons for decision indicated that the workers' compensation expenses and the third party subcontractor expenses (which, as explained at [13] above had been claimed on an incorrect basis by the taxpayer) had been disallowed because, in each case, the taxpayer had not satisfactorily substantiated them whereas the client entertainment expenses had been disallowed because expenses of that nature are, in general, not deductible. At the hearing, as already noted at [13] above, Service Recipient Pty Ltd submitted that it was claiming a deduction for the Service Charge (not the various expenses which made up the Service Charge).

26. On 16 December 2014, the Commissioner issued a notice of amended assessment to Service Recipient Pty Ltd. The taxpayer's income was reduced to $45,381, with resulting tax payable of $13,614.30. The penalty was maintained at the 75 per cent rate but

recalculated in line with the reduced tax liability resulting from the amendment to the taxpayer's assessment.

27. On 20 February 2015, Service Recipient Pty Ltd lodged with the Tribunal an application for review of the Commissioner's objection decision.

28. At the hearing, the Commissioner acknowledged that Service Recipient Pty Ltd was entitled to claim a deduction for the payments for certain third party subcontractors for the sum of $8,224.32 as referred to in the table at [24] above and that that amount was no longer in dispute between the parties. I am prepared to proceed on the same basis and to not disturb the Commissioner's concession, notwithstanding the fact that the taxpayer insisted that it was the deductibility of the Service Charge that was in issue in this proceeding and not the deductibility of the expenses that constituted the Service Charge.

29. It is significant to note that the assessment in issue in this proceeding is a default assessment (as noted at [21] above) and that the process for a taxpayer proving that a default assessment is excessive is different to the process of proving that an ordinary assessment is excessive. The authorities conclusively establish that to prove that a default assessment is excessive, the taxpayer must prove what their actual taxable income was in the relevant year: *Commissioner of Taxation v Rigoli* [2013] FCA 784 (*Rigoli*) at [8] per Pagone J. The decision of his Honour was upheld by the Full Federal Court in *Rigoli v Commissioner of Taxation* (2014) 141 ALD 529; [2014] FCAFC 29. It is also significant to note that in a particular case the Commissioner may not require a taxpayer to prove what their actual taxable income was in the relevant year but that is the exception, as evident from the following passage in Pagone J's judgment in *Rigoli* at [9]:

> *It is clear from these passages that the combined effect of s 167 and the legal burden of proof falling upon the taxpayer is that for a taxpayer to succeed in establishing the excessiveness of an assessment under s 167* ***(absent agreement between the Commissioner and the taxpayer concerning the conduct of the proceeding)*** *requires the taxpayer to establish not that the amount assessed by the Commissioner under s 167 of the 1936 Act was wrong but, rather, by establishing what the actual amount was.*
>
> (Bolding is emphasis added)

The present proceeding is an example of a case where the Commissioner has agreed that the taxpayer does not have to establish what their actual taxable income was. It follows that, despite the s 167 default assessment issued to the taxpayer, the only substantive

matter in dispute in this proceeding is the deductibility of the Service Charge. As will become clear from my reasons set out below, the taxpayer did not prove that it was entitled to claim a deduction for the Service Charge, as it did not prove that the Service Charge was incurred in the relevant year.

THE LEGISLATIVE FRAMEWORK AND PRINCIPLES

30. Section 8-1 of the ITAA 1997 relevantly provides as follows:

> ***8-1 General deductions***
>
> *(1) You can* **deduct** *from your assessable income any loss or outgoing to the extent that:*
>
> *(a) it is incurred in gaining or producing your assessable income; or*
>
> *(b) it is necessarily incurred in carrying on a *business for the purpose of gaining or producing your assessable income.*
>
> … [original emphasis]

31. In relation to s 8-1(1)(a), the High Court said in *Spriggs v Commissioner of Taxation; Riddell v Commissioner of Taxation* (2009) 239 CLR 1; [2009] HCA 22 at [54]-[55], as follows:

> *[54] The issue, in respect of s 8-1(1)(a), is whether a particular "loss or outgoing" was "incurred in gaining or producing ... assessable income". There was no debate about the appellants' assessable income. It included amounts paid by their respective clubs for playing in matches; it also included promotional or marketing payments for exploiting the celebrity associated with their sporting prowess. It was not disputed that these payments were income according to the concept of "ordinary income" under s 6-5 of the ITAA, that is, within "the ordinary concepts and usages of mankind". It was also not disputed that the management fees were "outgoings" and were "incurred". The question which was debated was whether the management fees were incurred "in gaining or producing" the appellants' assessable income.*
>
> *[55] It is well settled that incurred "in" gaining or producing means incurred "in the course of" gaining or producing assessable income. In Ronpibon Tin NL v Federal Commissioner of Taxation ("Ronpibon Tin"), this Court explained:*
>
> > *"it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income."*
>
> *The essential question, rephrased in Federal Commissioner of Taxation v Payne ("Payne"), is: "is the occasion of the outgoing found in whatever is productive of*

actual or expected income?" In Federal Commissioner of Taxation v Day, the majority said:

> *"That no narrow approach should be taken to the question of what is productive of a taxpayer's income is confirmed by cases which acknowledge that account should be taken of the whole of the operations of the business concerned in determining questions of deductibility."*

(footnotes omitted)

32. In relation to s 8-1(1)(b), which is the essential provision that is relevant to this case, the High Court stated in *Spriggs and Riddell*, the following:

> *[74] The broad application of s 8-1(1)(a) of the ITAA, including its application to income derived from a business, means that, on the facts here, s 8-1(1)(b) adds little.*
>
> *[75] In Ronpibon Tin, the overlap between the limbs of the predecessor section to s 8-1(1) of the ITAA, which often renders the second limb otiose, was noted. It was held that a loss or outgoing will be "necessarily incurred in carrying on" a business if it is "clearly appropriate" or "adapted" for the carrying on of the business. Restating the test another way, the loss or outgoing will be "necessarily incurred" if it is "reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of the business".*
>
> (footnotes omitted)

33. Under s 14ZZK of the TAA, it is the taxpayer who bears the onus of proving that the assessment is excessive. The taxpayer must also establish the facts upon which it relies: *Danmark Pty Ltd v Federal Commissioner of Taxation* (1944) 7 ATD 333 at 337.

34. The legislative provisions and principles relevant to the imposition and remission of the penalty in issue are set out further below.

IS SERVICE RECIPIENT PTY LTD ENTITLED TO CLAIM THE DEDUCTION FOR THE SERVICE CHARGE?

35. Mr Smith argued at the hearing, on behalf of Service Recipient Pty Ltd, that the Service Charge that had been charged by Service Provider Pty Ltd to it was necessarily incurred by Service Recipient Pty Ltd in carrying on its business and therefore deductible under s 8-1(1)(b) of the ITAA 1997. He said that the test is to be seen through “the eyes” of Service Recipient Pty Ltd as the taxpayer and not from the perspective of Service

Provider Pty Ltd and so it was unnecessary, he argued, to focus on the discrete expenses that made up the Service Charge. He said that that is why the taxpayer also did not have to substantiate the discrete expenses.

36. Mr Smith submitted that, in the hands of the taxpayer, the expense is the Service Charge charged under the terms of the Service Agreement and, therefore, deductible to the taxpayer. In the taxpayer's view, the Service Charge was incurred in connection with a service arrangement of the type considered in *Phillips* and TR 2006/2. Mr Smith also argued that because there was a commercial explanation for the service arrangement, the Service Charge is deductible to the taxpayer, even to the extent that it comprised expenses that would not have been deductible if the taxpayer had directly incurred those expenses.

37. The problem with the taxpayer's position is that there was insufficient evidence to show that it incurred a Service Charge in carrying on its business. In particular, there was no evidence to prove that the Services were provided by Service Provider Pty Ltd to Service Recipient Pty Ltd, that any Service Charge was charged by Service Provider Pty Ltd or that any Service Charge was incurred by Service Recipient Pty Ltd. There was also insufficient evidence about the activities of Service Recipient Pty Ltd and the relevance of the so-called Service Charge to its business and income producing activities for the purposes of s 8-1(1)(b) of the ITAA 1997. That is, the taxpayer's entire case rested on the description of the Services in the Services Agreement as well as the provisions regarding the Service Charge in that Agreement but there was no supporting probative evidence. Furthermore, the oral evidence of Mr Smith suggested that there was in fact no Service Charge, because no invoices were issued nor were any payments made between the related entities. Indeed, the evidence of Mr Smith highlighted that the taxpayer did not adhere to the terms of the Services Agreement. The Services Agreement had, in other words, very little probative value and yet the taxpayer's position was that the deductibility of the Service Charge should be determined solely by reference to the Services Agreement. Mr Smith's explanation that journal entries recorded the Service Charge which were reflected in the loan accounts of the respective parties also did not persuade me that the taxpayer incurred the Service Charge. Journal entries are not of themselves evidence of payment, let alone of expenses having been incurred. In respect of the limitations of journal entries, see *Temples Wholesale Flower Supplies Pty Ltd v Federal Commissioner of Taxation* 91 ATC 4387. In all the circumstances, I find that no Service

Charge was incurred by Service Recipient Pty Ltd and so it is not entitled to claim a deduction for such an expense under s 8-1(1)(b) of the ITAA 1997. The taxpayer has failed to prove the facts upon which it relies and therefore also failed to prove that its assessment was excessive for the purposes of s 14ZZK of the TAA.

38. Additionally, I concur with the Commissioner's view that *Phillips* is not of any direct relevance or assistance to the taxpayer's case. In *Phillips*, the taxpayer was a partner of an accounting firm which had set up a unit trust to provide furniture, equipment and other services to the partnership. The Full Court held that the services and the items provided were essential to the conduct of the firm's accountancy practice and, therefore, the charges were deductible. It was a crucially important fact that the rates charged were found by the trial judge to be "realistic and not in excess of commercial rates". *Phillips* is not authority for the proposition that the taxpayer advanced in this case, namely, that the entire amount of an omnibus service fee paid to a related entity will be deductible for income tax purposes. Rather, *Phillips* is more concerned with the issue of whether the profit component of a service fee paid to an associated entity may be deductible. I also agree with the Commissioner's submission that there is a threshold, substantive issue of considering whether *any* service fee paid to a related entity is deductible according to the general principles for the deductibility of expenses under s 8-1 of the ITAA 1997. The Commissioner puts it this way in TR 2006/2 at [6]-[7]:

> *6. While the Commissioner accepts the correctness of the decision in Phillips, the case is not authority for the proposition that expenditure made under a service arrangement and calculated using the particular mark-ups adopted in that case will always be deductible under section 8-1 of the ITAA 1997.*
>
> *7. The question of whether expenditure made under a service arrangement is deductible depends on what the expenditure was calculated to achieve from a practical and business point of view. This is a question of fact.*

39. Accordingly, it follows, that the taxpayer's reliance on TR 2006/2 in this proceeding was similarly misplaced and it is not entitled to claim the deduction for any Service Charge in the relevant year.

IS SERVICE RECIPIENT PTY LTD LIABLE TO AN ADMINISTRATIVE PENALTY?

40. The administrative penalty in respect of the relevant year is described in the notice as being for "failing to provide a document". That document was the company's tax return for

the year ended 30 June 2012. The penalty was imposed under s 284-75(3) in Schedule 1 to the TAA, which provides, as follows:

> *(3) You are liable to an administrative penalty if:*
>
> *(a) you fail to give a return, notice or other document to the Commissioner by the day it is required to be given; and*
>
> *(b) that document is necessary for the Commissioner to determine a *tax-related liability (other than one arising under the *Excise Acts) of yours accurately; and*
>
> *(c) the Commissioner determines the tax-related liability without the assistance of that document.*
>
> *Note: You are also liable to an administrative penalty for failing to give the document on time: see Subdivision 286-C.*

41. The taxpayer submitted that the penalty should not be imposed as it had lodged its tax return by the Commissioner's deadline or, if the penalty was properly imposed, it should be remitted.

42. The Commissioner pointed to the failure of the company to lodge its tax return as required, and the fact that the taxpayer's circumstances met all of the criteria in s 284-75(3) of Schedule 1 to the TAA. The Commissioner further submitted that there were no compelling factors warranting remission of any part of the penalty.

43. As noted at [16] above, the fax transmission report is evidence of the fact that the fax was not successfully sent on 18 June 2014 to the Commissioner as required. It is clear on the evidence of Mr Smith that the tax return was not lodged by 18 June 2014 and, furthermore, no attempt was made by Mr Smith to inform the taxation officer afterwards about the situation. This was notwithstanding Mr Smith's claim that he told the taxation officer that he was preparing to fax the income tax return on 18 June 2014. The fact is that the tax return was not received by the Commissioner until 13 August 2014, after the Commissioner's deadline.

44. Having failed to receive the company's tax return, the Commissioner had to proceed to work out an "amount upon which in his … judgment income tax ought to be levied": s 167 of the ITAA 1936. The Commissioner needed a return to determine the company's liability

accurately and he proceeded to make an assessment on 7 July 2014 without the assistance of a tax return from the company. Accordingly, in my view, paragraphs (a) to (c) of s 284-75(3) in Schedule 1 to the TAA were satisfied and the administrative penalty was correctly imposed at 75 per cent under s 284-75(3) in Schedule 1 to the TAA.

SHOULD THE PENALTY BE REMITTED?

45. The taxpayer did not satisfy me that there is any basis for the Tribunal to exercise its discretion to remit any part of the penalty pursuant to s 298-20(1) in Schedule 1 to the TAA. There is nothing unjust or harsh about the imposition of penalties in this matter.

DECISION

46. Accordingly, for the reasons set out above, I set aside the Commissioner's objection decision for the year ended 30 June 2012 and remit the matter to the Commissioner to issue an amended assessment. The Commissioner is directed to have regard to the concession already made and to these reasons.

47. With respect to the objection decision regarding the administrative penalty, I affirm the Commissioner's decision as to the 75 per cent rate and the decision not to remit the penalty, however, the amount of the penalty is to be recalculated based on the reduced tax shortfall.

I certify that the preceding 47 (forty-seven) paragraphs are a true copy of the reasons for the decision herein of Ms G Lazanas, Senior Member

.....[sgd].....

Associate

Dated 5 September 2016

Date of hearing **2 March 2016**

Advocate for the Applicant	**Self represented**
Counsel for the Respondent	**Mr S Symon**
Solicitors for the Respondent	**ATO Review and Dispute Resolution**