



Taxpayer Alert

TA 2005/2

The Tax Office considers that this arrangement is a variation of the prepaid service warrant arrangement discussed in Taxation Determination [TD 2003/9](#), and the discussion of section [8-1](#) and [Part IVA](#) in that Determination applies equally. The 21 December 2006 decision of the Administrative Appeals Tribunal in *Brown v Commissioner of Taxation* [2006] AATA 1107 confirms that deductions are not allowable under section 8-1 in these types of arrangements where there is no partnership, and/or where no business is being carried on, and/or where no expenditure is incurred - refer paragraphs 5 and 6 of Taxation Determination [TD 2003/9](#).

FOI status: may be released

Taxpayer Alerts are intended to be an "early warning" of significant new and emerging higher risk tax planning issues or arrangements that the Tax Office has under risk assessment.

Taxpayer Alerts will provide information that is in the interests of an open tax administration to taxpayers. Taxpayer Alerts are written principally for taxpayers and their advisers and they also serve to inform tax officers of new and emerging higher risk tax planning issues. Not all potential tax planning issues that the Tax Office has under risk assessment will be subject of a Taxpayer Alert, and some arrangements that are the subject of a Taxpayer Alert may on further examination be found not to be of concern to the Tax Office.

Taxpayer Alerts will give the title of the issue (which may be a scheme, arrangement or particular transaction), briefly describe the issue and will highlight the features which the Tax Office considers give rise to taxation issues. These issues will generally require more detailed analysis to provide the Tax Office view to taxpayers.

Taxpayers who have entered into or are contemplating entering into an arrangement similar to that described in this Taxpayer Alert can seek a formal determination of the ATO's position through a Private Ruling. (It should be noted that the Taxation Administration Act 1953 sets out circumstances where the Commissioner may decline to issue such a ruling). Such taxpayers might also contact the tax officer named in the Alert and/or obtain their own advice.

This Taxpayer Alert is issued under the authority of the Commissioner.

TITLE: Prepaid Services Warrant Arrangement

This Taxpayer Alert describes an arrangement where a taxpayer claims large income tax deductions for business losses. The losses are created by the taxpayer or a partnership in which the taxpayer is a partner acquiring prepaid service warrants that

may be redeemable for the provision of legal and other professional services. The arrangement seeks to produce significant tax deductions for a relatively small cash outlay.

DESCRIPTION

The alert applies to arrangements having the following features.

1. The taxpayer or partnership claims to buy a series of warrants that are redeemable for professional services from a service provider.
2. Prior to buying the warrants, a taxpayer or a partnership purports to enter into a 'Business Agent Dealership' (dealership). The taxpayer or the partnership may claim to be in the business of acquiring and disposing of prepaid service warrants.
3. The taxpayer or partnership acquires a series of warrants by making a part payment, with the balance due when the warrants are redeemed. For example, a warrant with a stated value of legal services to be provided (a face value) of \$50,000 may be acquired by paying \$7,500 (15% of the face value) with the balance owing to the service provider.
4. The taxpayer's or the partnership's claimed objective is to endorse the warrants to a client for a fee so the client can redeem the warrant for legal or other professional services from the service provider. Alternatively, rather than paying a fee, the client assigns the taxpayer or the partnership an interest in a cause of action. That is, the warrants may be exchanged for a percentage of any proceeds recovered from litigation.
5. The service warrants generally have a life, described as an "eligible service period" of 13 months. However in some cases involving litigation the service period may be 4 years.
6. The taxpayer or the partnership may appoint an administrator to conduct the administration of the dealership including acquiring the warrants and seeking clients to whom the warrants will be endorsed.
7. The warrants are marketed on the basis that all warrants that have not been endorsed to clients by the end of the 13 month period are cancelled and refunded by the service provider at a discount. Generally this discount is equal to the part payment made at the time the warrants were purchased. The refund is credited against the balance outstanding on the purchase of the warrants, leaving no amount outstanding by the taxpayer or the partnership.
8. It is claimed that the purchase of the warrants will give rise to an allowable deduction equal to the face value of the warrants in the financial year they are acquired.
9. Where the dealership is a partnership, the partners claim a share of the partnership loss in their tax returns.

10. It is claimed that on endorsing the warrants to the client or on cancelling of the warrants by the service provider the taxpayer or the partnership would derive assessable income. Generally it is claimed that this assessable income would be derived in a financial year subsequent to that in which the deduction, referred to in paragraph 9 above, is claimed.
11. It is claimed that the arrangements are supported by the Federal Court decision in *Lamont v Commissioner of Taxation* [2005] FCA 513 (Lamont).
12. The warrants are marketed on the basis that a continuing deferral of income tax may be achieved by entering into purchases of warrants in subsequent financial years.

FEATURES WHICH THE TAX OFFICE CONSIDERS GIVE RISE TO TAXATION ISSUES

- (a) The arrangement seems artificial and lacks an ordinary business purpose in its design and execution.
- (b) For taxpayers using a partnership structure the arrangement raises questions about whether a partnership exists.
- (c) The arrangement raises questions about whether a business is being carried on.
- (d) The arrangement raises questions about the deductibility of the cost of the warrants.
- (e) The arrangement raises questions about the application of the anti-avoidance provisions in section 82KZME and section 82KZMF of the *Income Tax Assessment Act 1936* (ITAA 1936).
- (f) The arrangement raises questions about the application of the deferral of losses from non-commercial business activities provisions of Division 35 of the *Income Tax assessment Act 1997* (ITAA 1997).
- (g) The arrangement raises questions about the application of the general anti-avoidance provisions of Part IVA of the ITAA 1936.
- (h) The income tax consequences arising from the arrangement have not been determined by the Lamont decision. In his decision, which dealt with a private binding ruling, Hill J stated:

"It follows in my view that where an applicant asks the Commissioner to rule upon an arrangement where one of the facts are [sic] that the partnership of which the applicant is a member in fact carries on a particular kind of business, the Commissioner may proceed to rule upon that application on the basis that the facts as stated are correct. Of course, should it turn out that the facts as stated were incorrect, the applicant for the ruling will get no protection from the ruling. That however, is not a matter which need concern the Commissioner who is required to rule upon a stated arrangement having the factual parameters which the applicant sets out" (paragraph 23);
"Thus it is quite possible in the present case that the ruling will have no utility at all to the applicant or those others who have made similar applications" (paragraph 24);

"There may be thought to be a number of legal, commercial and ethical problems associated with the proposal. It is not for the court to comment upon any lack of commerciality which may appear to arise, although those matters may have relevance to the operation of Pt IVA of the ITTA 1936" (paragraph 30);

"However, because it is possible that the Commissioner might in any year of income make a determination under section 177F(1) and because in light of the facts, that determination may be correctly made, the answers to the question of deductibility and the question of whether income is assessable should be qualified by words to the effect that the answers could be altered if a determination were made under the provisions of Pt IVA which operated to disallow the deductions otherwise allowable" (paragraph 53).

- (i) Depending on the specific circumstances of the parties to the transaction and whether an enterprise is being carried on, the sale of the warrants may result in a liability to GST under the New Tax System (Goods and Services Tax) Act 1999.

The Australian Taxation Office is examining these arrangements.

subject references:

Prepaid service warrants

legislative references:

Section 8-1 of the ITAA 1997

Section 82KZME of the ITAA 1936

Section 82KZMF of the ITAA 1936

Division 35 of the ITAA 1997

Part IVA of the ITAA 1936

ANTS (GST)A 1999

related taxpayer alerts:

TA 2002/5 (TD 2003/9)

related practice statements:

PS LA 2008/15 - Taxpayer Alerts

related media releases:

file references:

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