TR 2005/D5 - Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements

This document has been finalised by TR 2006/2.

Draft Taxation Ruling

Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements

Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office.*

What this Ruling is about

1. This Ruling considers the operation of section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) and Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) in relation to service arrangements between associated entities of the kind considered in Taxation Ruling IT 276.

2. This Ruling supplements IT 276 by providing further guidance on the matter.

Class of person/arrangement

3. While service arrangements may vary widely in the precise steps used, they involve in essence a taxpayer incurring a deduction for fees and charges in the conduct of its business for the acquisition of staff, clerical and administrative services, premises, plant and/or equipment from an associated entity. These arrangements are sometimes called *Phillips* arrangements.

4. An arrangement which exhibits all or most of the features set out below is a service arrangement covered by this Ruling:

(a) the taxpayer, being an individual or an entity, carries on a business, alone or in partnership, for the supply of professional or other services to clients;

(b) there is a trust that is controlled or a company that is owned and/or controlled by the taxpayer and/or associates of the taxpayer (the service entity);

(c) the taxpayer, alone or in partnership, enters into an agreement with the service entity whereby the taxpayer agrees to pay certain fees and charges to the service entity in return for the service entity supplying the

taxpayer with a range of services which may include: staff hire and recruitment services, clerical and administrative services, premises, plant and/or equipment;

(d) typically, the service fees and charges are calculated by way of a mark-up on some or all of the costs of the service entity (although a fixed charge may be agreed by the parties up-front);

(e) the taxpayer claims a deduction for the service fees and charges as expenditure incurred by it in the conduct of its business;

(f) the service arrangement either gives rise to profits in the service entity, for both accounting and tax purposes, or would give rise to profits in the service entity but for remuneration or service fees paid to associates of the taxpayer or the taxpayer's partners; and

(g) the profits derived by the service entity are either retained by the service entity (usually where the service entity is a company) or distributed, directly or indirectly, to the taxpayer (and its partners in the case of a partnership) and or to associates of the taxpayer (and associates of its partners in the case of a partnership).

Date of effect

5. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. However, the final Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the final Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Related Rulings

6. Taxation Ruling IT 276 states in paragraphs 4 and 5 that:

> ….Given the view of the facts which the court adopted [in the case of *Federal Commissioner of Taxation v. Phillips* (1978) 8 ATR 783; 78 ATC 4361 (*Phillips*)], that is, a re-arrangement of business affairs for commercial reasons and realistic charges not in excess of commercial rates, the decision to allow a 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…

However the Ruling also notes the practical difficulties of reducing or disallowing claims for deductions where payments are marginally above commercial rates.

Ruling

7. Whilst the Commissioner accepts the correctness of the decision in *Phillips*, the case is not authority for the proposition that service fees calculated using the particular mark-ups adopted in that case will always be deductible under section 8-1 of the ITAA 1997.

8. If the benefits passing to the taxpayer under a *Phillips* service arrangement are connected to the conduct of the taxpayer's income earning activities or business and, having regard to the benefits delivered, the service fees and charges are commercially realistic then the presumption will be that the service fees and charges are a real and genuine cost of earning the taxpayer's income and the cost of that alone (*Phillips* at ATR 791; at ATC 4368).

9. Where, however, the benefits passing to the taxpayer under a service arrangement do not reveal an obvious connection with the conduct of the taxpayer's income earning activities or business and/or where the service fees and charges do not constitute a commercially realistic charge for the benefits delivered, then the service arrangement alone may not suffice, without more, to characterise the expenditure. In these circumstances there is no objective commercial connection between the outgoing and the taxpayer's income earning activities or business. Consequently it may be necessary to undertake a broader examination of all of the circumstances surrounding the expenditure to determine what the expenditure was for ('a broader examination'). Depending on the circumstances of the particular case, this may include an examination of the taxpayer's subjective purpose, motive or intention in incurring the expenditure.

10. Arrangements that may require a broader examination would include those that exhibit the following:

(a) service fees and charges that are disproportionate or excessive in relation to the benefits conferred by the service arrangement;

(b) service fees and charges that are calculated using arbitrary or fixed mark-ups that bear no apparent relation to the value of the services provided and/or that guarantee the service entity a certain profit outcome without an apparent commercial explanation; and

(c) service fees and charges that generate profits in the service entity in circumstances where there is no clear separation between the service entity's business activities and those of the taxpayer's and where there is no clear evidence that the service entity has added any value or performed any substantive functions.[1]

[1] This should not be taken to be an exhaustive list, nor are the situations described necessarily separate or distinct from each other.

11. It does not follow from the fact that a broader examination is required that the expenditure will be denied a deduction under section 8-1 of the ITAA 1997. A broader examination of the matter may determine that the expenditure under a service arrangement was, in whole or in part, incurred in connection with:

- the taxpayer's income earning activities or business; and/or
- the pursuit of an advantage independent of the taxpayer's income earning activities or business (an independent advantage).

12. Where upon a broader inquiry it is determined that the expenditure was incurred solely in pursuit of the taxpayer's income earning activities or business, the expenditure will satisfy the positive limbs of section 8-1 of the ITAA 1997. It is not for the Commissioner to say how much a taxpayer ought to spend in the conduct of his income producing activities or business.

13. Where, however, it is determined upon a broader inquiry that the expenditure was in fact incurred partly or wholly in the pursuit of an independent advantage then, to that extent, based on a fair and reasonable apportionment, the expenditure will not be deductible.

14. The characterisation of expenditure under a broader inquiry must always be resolved by a commonsense or practical weighing of the whole set of objects and advantages which the taxpayer sought in making the outgoing. In that context, if the expenditure is paid to a related service entity and it is grossly excessive then it would raise the presumption that the expenditure was not wholly payable for the purposes of the taxpayer's income producing activities or business but for some other purpose.

Part IVA

15. Part IVA of the ITAA 1936 may apply to service arrangements if a proper weighing of features such as those outlined at paragraphs 35 and 36, or other unusual features, would cause a reasonable person to conclude that a person or persons entered into the service arrangement for the dominant purpose of enabling a taxpayer to obtain a tax benefit in connection with the service arrangement.

Explanation

Application of section 8-1

General principles

16. Expenditure will satisfy the positive limbs of section 8-1 of the ITAA 1997 if its essential character is that of expenditure that has a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income: *Lunney v. Commissioner of Taxation* (1958) 100 CLR 478; (1958) 11 ATD 404 at CLR 497 & 499; ATD 412-413; and *Ronpibon Tin NL & Tongkah Compound NL v. Federal Commissioner of Taxation* (1949) 78 CLR 47; (1949) 8 ATD 431 (*Ronpibon*) at CLR 57; ATD 437.

17. The characterisation of particular expenditure is by its nature a question of fact. It involves an enquiry about what the expenditure was for and what it was intended to achieve in relation to the taxpayer's income earning activities or business from a practical and business point of view: *Magna Alloys & Research Pty Ltd v. Federal Commissioner of Taxation* 80 ATC 4,542; (1980) 11 ATR 276 (*Magna Alloys*) at ATC 4,549 and 4,551; ATR 284 and 287 and *Hallstroms Pty Ltd v. Federal Commissioner of Taxation* (1946) 72 CLR 634; (1946) 8 ATD 190 at CLR 648; ATD 196.

18. Ordinarily, the objective circumstances that gave rise to the expenditure would be expected to provide a clear explanation of the benefit intended to be achieved by the expenditure and thereby its essential character. As Dixon J pointed out in *Robert G Nall Ltd v. Federal Commissioner of Taxation* (1937) 57 CLR 695; (1936) 4 ATD 335 (*Robert G Nall*) at CLR 712; ATD 342,[2] '…the circumstances of the transaction must give it the complexion of money laid out in furtherance of a purpose of gaining income'. In the context of the ITAA 1936 this has been interpreted as meaning that the expenditure must be incurred in circumstances where it is 'conducive to the gaining or producing of assessable income or to the carrying on of a business by the taxpayer' (*Magna Alloys* at ATC 4,549; ATR 284).

19. Expenditure is 'conducive' to the production of assessable income or the conduct of a business to produce such income where it is 'incidental and relevant' to the gaining of the income or reasonably capable of being seen as 'desirable or appropriate' in the pursuit of the business ends of the business (*Ronpibon* at CLR 56; ATD 434-435; *Magna Alloys* at ATC 4,560-4,561; ATR 297).[3]

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[2] *Robert G Nall* was decided under the predecessor of the ITAA 1936, but related to the deductibility of expenses incurred by a company in the course of conducting a business.

[3] Note also the observation by Hill J in *Macquarie Finance* [2004] FCA 1170 at paragraph 47 that phrases such as 'incidental and relevant' 'serve to indicate the requirement that there be a sufficient connection between the outgoings on the one hand and the gaining or producing of assessable income or business as the case may be.'

20. Consistent with this, expenditure incurred in obtaining the supply of goods or services from another party under a contract will ordinarily be characterised by reference to both the contractual benefits passing to the taxpayer under the contract and the relationship that those benefits have to the taxpayer's income earning activities or business: *Magna Alloys* at ATC 4,548 & 4,559; ATR 283 & 295.[4]

21. Where, however, the relationship between the contractual benefits and the taxpayer's income earning activities or business is inadequate to explain objectively the whole of the expenditure then the contract alone will not suffice, without more, to characterise the whole expenditure as one which can truly be said to have been incurred in gaining or producing assessable income (*Fletcher & Ors v. Commissioner of Taxation of the Commonwealth of Australia* (1991) 173 CLR 1; 91 ATC 4950; (1991) 22 ATR 613 (*Fletcher*) at CLR 18-19; ATC 4,958; ATR 623, *Ure v. Federal Commissioner of Taxation* 81 ATC 4100; (1981) 11 ATR 484 (*Ure*) at ATC 4,109-4,110; ATR 494-495), or in pursuing the commercial ends of the business.[5]

22. Problem cases may be where the parties are not dealing with each other at arm's length and the charges are not at a commercial rate (see *Steele v. Deputy Commissioner of Taxation* (1999) 197 CLR 459; [1999] HCA 7 at paragraph 15, *Federal Commissioner of Taxation v. Firth* (2002) 120 FCR 450; [2002] FCA 413 (*Firth*) at paragraph 15, and *Hart v. Commissioner of Taxation* (2002) 121 FCR 206; [2002] FCAFC 222 (*Hart* (2002)) at paragraph 26); and/or where the expenditure is disproportionate to the benefits passing to the taxpayer under the contract (see *Robert G Nall* at CLR 706, 708-709, 712-713; ATD 338, 340, 342-343; and *WD & HO Wills (Australia) Pty Ltd v. Federal Commissioner of Taxation* (1996) 65 FCR 298; 96 ATC 4,223; (1996) 32 ATR 168 at FCR 329; ATC 4248; ATR 193).[6] To adopt the language of the Federal Court in *Ure* in cases such as these the circumstances of the expenditure will not 'offer an obvious commercial explanation for incurring it'.[7]

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[4] Note, however, if, the contractual arrangements constitute a sham then characterisation of the expenditure will not be determined by reference to the purported contract but by reference to the actual legal rights and obligations which the parties intended to create.

[5] This will be particularly true of arrangements between associates where the connection between the expenditure and the taxpayer's income earning activities or business cannot be 'inferred' but must be 'positively established' (see *Spassked Pty Limited v. Commissioner of Taxation* [2003] FCAFC 282 at paragraph 128).

[6] It is unclear whether these cases should be viewed as separate lines of authority or whether they simply represent different expressions of the same legal principle. Either way, the Commissioner takes the view that they have the same practical consequences when considering the deductibility of expenditure incurred under service arrangements.

[7] 81 ATC at 4,100 at 4,109; 11 ATR at 494.

23. If the relationship between the contractual benefits and the taxpayer's income earning activities or business is inadequate to explain the whole of the expenditure, then the characterisation of the expenditure cannot be confined to a 'juristic classification of the legal rights, if any, secured, employed or exhausted in the process': *Firth* at paragraph 10. Characterisation of the expenditure must be resolved by a 'commonsense' or 'practical' weighing' of 'the whole set of objects and advantages which the taxpayer sought in making the outgoing', including the direct and indirect objects and advantages sought by the taxpayer: *Fletcher* CLR 18-19; ATC 4958; ATR 623.

24. If, after conducting a broader inquiry into all the circumstances surrounding the expenditure, including the direct and indirect objects and advantages sought by the taxpayer, it can be fairly concluded that the whole expenditure is properly to be characterised as genuinely, and not colourably, incurred in the pursuit of the taxpayer's income earning activities or business, then the entire expenditure will be deductible, subject to the exclusory provisions within section 8-1 of the ITAA 1997: *Fletcher* CLR 19; ATC 4958; ATR 623 . This would be the position even if the taxpayer could have acquired the same contractual benefits by incurring a lesser amount of expenditure. It 'is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent': *Ronpibon* at CLR 57; ATD 437. Nor is it for the Commissioner to tell a taxpayer 'how to run his business profitably or economically': *Tweddle v. Federal Commissioner of Taxation* (1942) 180 CLR 1; (1942) 7 ATD 186 at CLR 7; ATD 190.

25. If, however, after a practical weighing of all the circumstances it can be concluded that a portion of the expenditure has been outlaid in the independent pursuit of a non-income producing advantage, and not as a cost of undertaking the taxpayer's income earning activities or business, then to that extent the expenditure is not an allowable deduction: *Fletcher* CLR 19; ATC 4958; ATR 623, *Ure* ATC 4110-4,111; ATR 495-496 and *Robert G Nall* CLR 706, 708-709, 712-713; ATD 338, 340, 342-343.

26. Depending on the individual circumstances, an independent advantage could be, amongst other things, the 'distribution of income gained' (see *Robert G Nall* at CLR 713; ATD 343), the making of a 'gift' (see Deane J in *Federal Commissioner of Taxation v. Isherwood & Drefyus Pty Ltd* (1979) 9 ATR 473; 79 ATC 4031 at ATR 474; ATC 4032), or the creation of a fund for the provision of financial benefits to family members or associates (see *Ure*).

27. In such cases it will be necessary to undertake a fair and reasonable apportionment of the expenditure having regard to all the relevant circumstances: *Ronpibon*.

Service arrangements and the decision in Phillips' case

28. Any decision of a court must be interpreted in the context of the facts found by the court and the principles of law applied to those facts. Consequently, while the court in the *Phillips* case concluded that the particular arrangement under review was 'commercial' this does not mean that the decision stands as authority that the particular mark up percentages used in the arrangement will always be appropriate. Nor does it mean that expenditure to pay fees calculated by using those mark ups will always be deductible.

29. In *Phillips* the taxpayer was a partner with a national firm of accountants. The facts before the Court were as follows:

- the firm set up a unit trust to provide furniture, equipment and non-professional services to the partnership;[8]
- units in the trust were, with one exception, held by the partner's family members, family companies or trusts;[9]
- the trustee and the manager of the trust were both companies in respect of which none of the partners held shares or directorships;[10]
- the trust was intending to employ its own executive staff who were to be responsible for its operation, administration, staff supervision and so on;[11]
- the service arrangement would relieve the firm from most problems of staff and office management and all financial obligations in respect of wages, sick leave, annual leave, workmen's compensation, statutory holidays and long service leave plus it would increase the amount of working capital available to the firm;[12]
- it was envisaged that the trust would sell its services both to the firm and direct to the business community in competition with existing commercial enterprises;[13]
- a central reason given by the firm for establishing the arrangement was to diminish the assets held beneficially by the firm and its individual partners and to increase the assets held for the benefit of their families outside the possibilities of loss to litigation minded clients and third parties;[14] and

[8] *Phillips v. Commissioner of Taxation* (1977) 7 ATR 345 at 351; 77 ATC 4169 at 4175.
[9] Ibid, ATR at 349; ATC at 4174.
[10] Ibid, ATR at 349; ATC at 4173.
[11] Ibid, ATR at 347, ATC at 4172.
[12] *Phillips* (1978) 8 ATR 783 at 790; 78 ATC 4361 at 4367.
[13] *Phillips v. Commissioner of Taxation* (1977) 7 ATR 345 at 347-348; 77 ATC 4169 at 4172.
[14] Ibid ATR at 347, ATC at 4171.

- importantly, the court found that 'the agreed rates for the relevant services were realistic and not excessive and that the rates fixed for hire of plant and furniture likewise could not be said to be excessive … [and that the] rates of interest charged on the moneys accrued were plainly reasonable.'[15]

30. Crucial to the Federal Court decision that the service fees were fully deductible was a finding that the services '… were realistic and not in excess of commercial rates'. Indeed, it was noted by Fisher J that '[t]he services were essential to the conduct of the firm's business and the fact that the charges paid were commercially realistic raise[d] at least the presumption that they were a real and genuine cost of earning the firm's income and the cost of that alone'. According to His Honour '[d]oubtless the converse would apply … if the rates were grossly excessive'.[16]

31. Given that the services provided by the trust were essential to the conduct of the firm's accountancy practice, and were provided at a commercial rate, the arrangement itself provided an obvious commercial explanation for the expenditure. It was therefore unnecessary for the Court to undertake any broader inquiry.

Application of Part IVA

32. In determining whether Part IVA of the ITAA 1936 applies to a service arrangement, the relevant question is whether the identified scheme was entered into or carried out in the particular way for the dominant purpose of obtaining a tax benefit for a relevant taxpayer in connection with the scheme (*Commissioner of Taxation of the Commonwealth of Australia v. Spotless Services Ltd & Anor* (1996) 186 CLR 404; 96 ATC 5201; (1996) 34 ATR 183; and *Federal Commissioner of Taxation v. Hart* [2004] HCA 26).

33. In such a consideration the identification of the relevant taxpayer and the nature of the tax benefit would be dependent on the facts of the case. For example, where grossly excessive fees are charged, the scheme could be the entering into the service arrangement and the charging of these fees. If a partnership is involved, a tax benefit could be the reduced share of partnership income flowing to a partner as a result of the excessive part of the expenditure incurred by the partnership. In these circumstances it may be fair and reasonable to make a compensating adjustment for any income assessed to the service entity and/or other associates as a result of the scheme.

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[15] Ibid ATR at 347*;* ATC at 4175.
[16] *Phillips* (1978) 8 ATR 783 at 791; 78 ATC 4361 at 4368.

34. The relevant purpose is to be predicated by reference to the objective factors set out in section 177D of the ITAA 1936. The ascertainment of the purpose in a particular case will depend on a careful weighing of each and every one of the matters referred to in paragraph 177D(b) (see Hill J in *Peabody v. Federal Commissioner of Taxation* (1993) 40 FCR 531; (1993) 25 ATR 32; 93 ATC 4104 at FCR 543; ATR 42; ATC 4113-4) having regard to the objective facts of that case.

35. Relevant considerations for *Phillips* arrangements may include:

- the manner in which the arrangement is entered into including any non-commercial aspects of the arrangement. For example, where the service fees are excessive and not negotiated in a commercial manner;
- any divergence between the form (that a separate service entity is providing the services) and the substance (which in a particular case may be the taxpayer assumes all risks and operates as if there were no separate service entity). For example, there may be no clear evidence that the service entity has added any value or performed any substantive functions independently of the taxpayer, or the service entity is so highly integrated with the professional practice that it is difficult to differentiate between the two; and/or
- the impact of the service entity arrangements on the on-going profitability of the taxpayer relative to what other possibilities existed. For example, the arrangements may not make any business sense regarding the long term profitability of the firm.

36. However, where:

- the service entity arrangements make objective business sense;
- the service entity actually performs its contractual duties such that there is an alignment between form and substance; and
- the service fees and charges are commercially realistic,

as was found to be the case in *Phillips*, and the arrangements do not contain unusual features (for example, use of loss entities as service providers) which suggest that the arrangement is tax driven, then Part IVA of the ITAA 1936 will not apply to these arrangements.

37. In this context it should be noted that when determining whether there is a scheme to which Part IVA of the ITAA 1936 applies it would be necessary to have regard to any objective asset protection benefits that may be obtained by any of the participants in the arrangement. 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. That kind of asset protection should be distinguished from arrangements designed to generate profits in a service entity that are separate from the firm's profits and therefore outside the reach of the firm's creditors. The existence of arrangements of this latter kind will also be relevant when determining objective purpose under section 177D of the ITAA 1936 and may point towards a dominant purpose of enabling a taxpayer to obtain a tax benefit.

Alternative views

38. Whilst there is general agreement that expenditure incurred by a business will not be deductible where it is 'grossly excessive' some commentators argue that the decision in *Fletcher* about when a broader examination may be required does not have any application under the second limb of section 8-1 of the ITAA 1997 or if it does, its application is restricted to cases where the outgoing exceeds the assessable income of the business. We take the view that the law allows a broader examination where there is an absence of an objective commercial connection between the outgoing and the taxpayer's income earning activities or business.[17]

39. It has been argued that asset protection alone has the requisite nexus for the purposes of section 8-1 of the ITAA 1997. While service trust arrangements may legitimately have this purpose, this does not of itself sanction service fees and charges that do not otherwise have the requisite commercial connection with the taxpayer's income earning activities or business.

40. In relation to Part IVA of the ITAA 1936, its application will be dependent on the facts and circumstances of the particular case, including the identification of the relevant taxpayer and the nature of the tax benefit. It may be the case that the factors that go to deductibility under section 8-1 of the ITAA 1997 would also be relevant to the possible application of Part IVA.

[17] See paragraph 12 of Taxation Ruling TR 95/33.

Examples

Example 1

The facts

41. The Eucalypt Partnership ('the Partnership') is a large firm that provides consulting services. The Partnership does not directly employ any professional or clerical staff.

42. The Partnership has an agreement with Melaleuca Pty Ltd as trustee of the discretionary trust known as the Melaleuca Services Trust ('the Services Trust') for the provision of:

- labour hire & personnel services;
- accounting services;
- marketing services;
- staff training services; and
- other related services.

43. All of the partners of the Partnership were directors of Melaleuca Pty Ltd, the corporate trustee of the Services Trust. Under the trust deed of the Services Trust, the objects of the trust were broadly defined to include the partners of the Partnership and their family members, and other nominated associates of the partners. The trustee had extensive powers of appointment and advancement. Upon joining the Partnership, each partner was required to nominate a family trust to receive distributions from the Services Trust.

44. The Partnership did not inquire whether any independent businesses existed which could provide these services; nor did the Partnership inquire about the rates that independent service providers might charge for the same or similar services.

45. The only documents evidencing the contractual relationship between the parties was an exchange of letters between the Partnership and the trustee of the Services Trust. These letters were very general in nature and did not record:

- a description of the services and the terms and conditions under which the services were to be provided by the Services Trust;
- the resources that were to be used by the Services Trust in providing the services;
- the way in which the gross services fee payable was to be calculated and/or reviewed vis-a-vis the individual services; and
- the risks and responsibilities that were to be assumed by the respective parties.

46. An examination of the Services Trust's activities revealed that the Partnership was the Services Trust's only client and that the activities of the Partnership and the Services Trust were so integrated and the documentation so scanty that it was impossible to separately identify or characterise the services that the trust had provided to the Partnership. Whilst the Services Trust purported to employ and then on-hire to the Partnership all of the professional and clerical/administrative staff engaged in the Partnership's business activities, the employment status of the staff was in fact unclear. In truth, the relationship between the Services Trust and the employees was minimal. The Services Trust had no real or effective involvement or control in any aspect of the employees' recruitment, day-to-day employment or dismissal, nor did the Services Trust have any real or effective power to overturn the decisions of the Partnership in relation to the staff. Indeed, it was impossible to identify any persons 'employed' by the Services Trust that were not under the control and direction of the Partnership. Significantly, all of the staff 'employed' by the Services Trust and on-hired to the Partnership were 'employed' on a permanent, full time basis in providing services directly to the Partnership.

47. Tax, superannuation and workers compensation matters applicable to the service entity were in fact handled by staff 'employed' by the service entity and on-hired to the Partnership.

48. The examination also failed to reveal any evidence of substantive business activities on the part of the Services Trust. The Services Trust did not hold any professional indemnity cover. The Partnership, rather than the Services Trust, paid for professional indemnity insurance in respect of the professional staff provided by the Services Trust. The Partnership purported to act as agent for the trustee in all matters even though there was no formal agency agreement in place, nor any evidence of any consideration of the respective rights and obligations of the parties. The Services Trust did not rent or own premises or equipment in its own name, nor did it own any fixed assets. Nor was there any evidence of the usual indicia of a business, for example business plans, costing documents, staff appraisals, records of governance and planning meetings, and so on.

49. Pursuant to the agreement entered into on 1 July 2002, the Partnership paid the Services Trust substantial service fees on a fortnightly basis. The quantum of the fees was not calculated on the basis of work performed or services provided. The fees were instead calculated by applying specified mark-ups to almost all of the trust's expenses. The fees charged were materially in excess of those charged by independent providers, and were arguably grossly excessive.

50. The profits of the Services Trust were distributed each year to the family trusts of the partners. A particular partner's family trust received the same proportion of the profits of the trust as the partner's proportional share of the profits of the partnership for that year.

51. The Partnership said that it entered into the arrangement for the purpose of accruing wealth in the hands of the partners' associates, separate from the profit made by the professional practice, and thereby outside the reach of the Partners' actual or potential creditors.

Deductibility of the service fees and charges

52. On an objective analysis, the contractual benefits passing to the Partnership under the service arrangement did not provide a commercial explanation for the whole of the expenditure. In particular:

- the evidence did not support the view that the Services Trust was independently in the business of providing the contracted services nor that it was adding any value in terms of the Partnership's staff hire arrangements:
  - the Services Trust performed minimal if any substantive business activities, and it had no employees who could be clearly identified as managing the trust's business, or carrying out its recruitment and training activities, for and on-behalf of the Trust;
  - the Services Trust also bore minimal risk – the pricing structure guaranteed it all of its costs together with a fixed profit mark-up; and
  - the Services Trust did not contribute any tangible or intangible assets (such as know-how or brand name);
- the Partnership, on the other hand, acquired little of any value or benefit from the arrangement above and beyond what it could have achieved by contracting with the staff directly:
  - the Partnership retained most if not all of the employment risks associated with the staff including, but not limited to, the risk that it may not be able to fully utilise the permanent staff;
  - the Partnership continued to carry out all of the management functions associated with the recruitment and personnel functions; and
  - the Partnership contributed the physical assets (for example, office space and equipment) and the intangible assets (for example, the brand name which attracts staff and the know-how invested in the management systems) necessary for the service entity to function;

- the Partnership was unable to explain how the mark-up figures were determined nor provide any independent benchmarks for the fees paid by it to the Services Trust and the rates charged were materially in excess of commercial rates; and
- the Partnership was significantly less profitable than the service entity even though it carried more risk and performed more significant functions than the service entity.

53. Because the contractual benefits passing to the Partnership under the service agreement were not adequate to provide an objective commercial explanation for the Partnership incurring the whole of the expenditure a broader examination of all of the circumstances surrounding the expenditure was required to determine what the expenditure was for.

54. Having regard to the broader facts and circumstances of this example, including the relationship between the parties, the nature, manner and extent of the dealings between the parties and the wealth protection objects with which the parties entered into the overall arrangement, it was inferred that the service fees were incurred by the Partnership, at least in part, in the pursuit of an independent advantage.

55. A fair and reasonable apportionment in such a case could be that the service fees are deductible to the extent to which they did not exceed the amount the Partnership would have incurred in directly acquiring the staff provided by the Services Trust.

56. Alternatively, if the fees in this case were deductible under section 8-1 of the ITAA 1997 the factors outlined above could provide a sound basis for the conclusion that one or more of the partners entered into the arrangement with the dominant purpose of avoiding tax. In particular, having regard to the factors set out in paragraph 177D(b) of the ITAA 1936, the manner in which the parties dealt with each other, the non-commercial aspects of the arrangement, including the excessive mark-ups, the divergence between form and substance with the partnership undertaking the actual duties of the service entity for all practical purposes, the on-going nature of the service entity arrangement notwithstanding its adverse impact on the partnership's profitability relative to other possibilities, and the non-arm's length connection between the parties all tip the balance to there being a dominant purpose of obtaining a tax benefit. In the circumstances, any possible wealth protection benefits obtained by the partners, whilst relevant, would be insufficient to tip the balance against a finding that there was a dominant purpose of obtaining a tax benefit.

Example 2

The facts

57. The Wattle Trust is a discretionary trust that was established for the purpose of providing a share registry service to a partnership and other, unrelated, clients. The shareholders and directors of the corporate trustee, Acacia Pty Ltd are associates of the partners of the Partnership. Under the trust deed, the objects of the Wattle Trust are broadly defined to include the partners of the Partnership and their family members, and other nominated associates of the partners. The trustee has extensive powers of appointment and advancement although in practice distributions are usually made to each partner's family members or associates (as a group), in equal proportions.

58. On 1 January 1998 the Partnership entered into an agreement with the Wattle Trust to provide the Partnership with specified share registry services for an agreed term. Pursuant to the agreement the Partnership was to pay the Wattle Trust fortnightly service fees. The documentation recording the agreement described in detail the services that were to be provided by the Wattle Trust and the resources that were to be used by the Trust in providing the services.

59. The fortnightly invoice provided by the Wattle Trust clearly set out how the gross service fees related to the services provided during the invoice period. The fees were calculated by applying an agreed formula to measurable service outputs and deliverables. This formula was worked out having regard to normal commercial rates for these types of services. Because the fees were calculated on the basis of work performed and outputs delivered, the gross service fee could vary greatly in amount from fortnight to fortnight.

60. The staff who performed the registry services were employed by the Wattle Trust on a permanent basis. The day to day supervision of the registry staff and their outputs was the responsibility of the Wattle Trust. While the services provided by the registry staff were performed at the Partnership's premises, most of the equipment that they used was equipment hired by the Wattle Trust. Liability for occupational health and safety issues was addressed in some detail in the service agreement.

61. The Wattle Trust had its own managers to oversee its business operations and the general performance of its staff. It also had its own personnel and administrative staff to manage staff pay, leave and other entitlements and its own finance and accounting areas. The Wattle Trust accommodated these staff by renting office premises which were fitted out with furniture and equipment hired by the Wattle Trust. The Wattle Trust payed for its own professional indemnity and public liability insurance, and attended to tax, superannuation and workers compensation obligations on its own behalf.

Deductibility of the service fees and charges

62. The service fees were commensurate with the benefits provided to the Partnership under the service arrangement. These benefits provide an objective commercial explanation for the partnership incurring the whole of the expenditure as part of its business activities:

- as the provider of the specialist registry services, the Wattle Trust guaranteed the Partnership a known cost structure for the services. As such, the Wattle Trust assumed the risk that the cost of providing the services could exceed the service fee allowed under the service contract or that it may not be able to deliver the services on time or to the required standard;
- the Wattle Trust carried on a distinct and independent business, contracted with third parties, engaged its own staff to manage the business and rented business premises;
- the gross service fees charged by the Wattle Trust were priced by reference to comparable arm's length service providers, and were reviewed on a regular basis;
- the net operating margins obtained by the Wattle Trust were consistent with industry standards; and
- the partners were able to focus on their profit-making activities freed from the management functions associated with the share registry activities, and benefited overall from the increased efficiency that flowed from accessing a specialist supplier of share registry services.

63. Because the contractual benefits passing to the Partnership under the service agreement did provide an objective commercial explanation for the whole of the expenditure a broader examination of all the circumstances surrounding the expenditure was not required to determine what the expenditure was for.

64. The service fees and charges would be deductible in full, and this would not be a case where Part IVA of the ITAA 1936 could apply.

Example 3

65. The Melaleuca Services Trust enters into an agreement with the Dingo Superannuation Fund (the Superannuation Fund) to lease Dingo House for 3 years at a market rent. Dingo House contains prime office space located in the heart of Melbourne city. The Services Trust immediately sublets the property to the Eucalypt Partnership (the Partnership) for the remaining term. The Service Trust charges the Partnership the full market rent marked up by 20%.

66. The rent imposed by the Services Trust far exceeds the value of any benefits obtained by the partners under the sublease. The Services Trust has not added any value or assumed any risks that would warrant the Partnership making rental payments in excess of the commercial rent that the Partnership could have negotiated with the Superannuation Fund directly. The contractual benefits passing to the Partnership under the service agreement are therefore incapable of providing an objective commercial explanation for the Partnership incurring the whole of the rent and a broader examination of all the circumstances is required to determine what the rent was for.

67. Having regard to the broader facts and circumstances of this example, including the relationship between the parties, the non-arm's length manner in which they dealt with each other and the significant mark-up on market rates, it may be inferred that the rent was incurred by the Partnership, at least in part, in the pursuit of an independent advantage.

68. A fair and reasonable apportionment is likely to result in the rent being non-deductible to the extent to which it exceeds a reasonable market rent. If, however, the Service Trust has performed a search and negotiation function then a further reasonable amount would also be allowed for a one-off arm's length finder's fee. Similarly, if the Service Trust incurs expenditure for the on-going maintenance of the premises, or assumes other obligations or risks that benefit the Partnership, it would also be entitled to a reasonable fee for these services. Indeed, these extra services might themselves provide the requisite objective commercial connection between the expenditure and the services provided.

Example 4

69. Take the facts in Example 3, but instead of subleasing the entire building to the Partnership, the Services Trust subleases half of the building to third parties and half of it to the Partnership. The Services Trust does this because the Partnership is expected to require the additional space in the near future, but cannot fill the space currently.

70. As a result of taking a lease over the whole building the Services Trust is able to negotiate a lower cost per square metre of floor area than would have been commercially possible if the Services Trust had only leased half the building with an option to lease more. The Services Trust has essentially negotiated a volume discount to reflect the greater risk assumed by it in leasing the entire building.

71. On these facts, unless the rental charge was clearly excessive, the general presumption would be that the expenditure was incurred for business purposes.

72. The expenditure would clearly be deductible if the Service Trust charged the Partnership a rental based on the commercial cost per square metre of the floor area that the Partnership would have had to pay an unrelated party for leasing half of the building, rather than the lower cost that the Service Trust had negotiated for the whole building.

Example 5

73. Mr Donnegal is a sole legal practitioner and a director of Boronia Pty Ltd, trustee for the Donnegal family trust. The Trust employs Mr Donnegal's wife in a clerical/secretarial role. A service arrangement has been in place between Mr Donnegal and Boronia Pty Ltd for several years. A two page written service agreement between Mr Donnegal and Boronia Pty Ltd records the terms of the arrangement. Under the agreement, Boronia Pty Ltd agrees to provide Mr Donnegal with the following services:

- disbursement of expenses such as floor fees and donations;
- provision of office furniture and computer equipment;
- maintenance of a professional library;
- secretarial and bookkeeping services;
- collection of debts; and
- other services agreed upon by the parties.

74. Boronia Pty Ltd does not provide services to any other clients.

75. The agreement provides that the fees payable by Mr Donnegal to Boronia Pty Ltd for the provision of the services by Boronia Pty Ltd will be the amount agreed between the parties and that the service fees payable may be varied by mutual agreement. No further detail is contained in the agreement regarding the size of the fees payable nor the method by which the fees payable are to be calculated.

76. On examination, it is found that the service fees for the year ended 30 June 2002 were calculated by marking up all of Boronia Pty Ltd's expenses by between 50% to 60% of the actual cost of providing the goods and services. This included the floor fees (marked up by 60%), the cost of paying donations (fully reimbursed by Mr Donnegal to Boronia Pty Ltd and charged at 50% of the amount of the donation), equipment (calculated as depreciation costs marked up by 50%), the payment of travelling and accommodation expenses of Mr Donnegal (fee consisting of actual costs plus a mark up of 50%), and superannuation contributions for the directors of Boronia Pty Ltd (were also charged by the service entity marked up by 60%).

77. The benefits flowing to Mr Donnegal from the service arrangement do not provide an obvious commercial explanation for the whole of expenditure incurred by Mr Donnegal in relation to the arrangement. In particular, the pricing arrangements between Mr Donnegal and Boronia Pty Ltd are arbitrary and have no relationship to the nature or value of the services provided. There is a gross disparity between the fees charged and the market value of the services provided. The arrangement makes little business sense for Mr Donnegal and a broader enquiry is required.

78. Whilst the characterisation of the expenditure will depend on a weighing of the whole set of objects and advantages which Mr Donnegal sought when he incurred the service fees, the grossly excessive nature of the service fees raises the presumption that the fees were incurred, at least in part, in the pursuit of an independent advantage.

Your comments

79. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date.

Due date:	**17 June 2005**
Contact officer:	**Kate Roff (02) 6216 1242**
	Lyn Bosley (02) 9374 2459
E-mail address:	**servicearrangementsfeedback@ato.gov.au**
Facsimile:	**(02) 6216 1247**
Address:	**Senior Tax Counsel**
	Tax Counsel Network
	2 Constitution Ave
	CANBERRA ACT 2600

Detailed contents list

80. Below is a detailed contents list for this draft Taxation Ruling:

Commissioner of Taxation
4 May 2005

Previous draft:
Not previously issued as a draft

Related Rulings/Determinations:
TR 92/20; TR 95/33; IT 276

Subject references:

Legislative references:
- ITAA 1936 Pt IVA
- ITAA 1936 177D
- ITAA 1936 177D(b)
- ITAA 1997 8-1
- TAA 1953 Pt IVAAA

Case references:
- Commissioner of Taxation of the Commonwealth of Australia v. Spotless Services Ltd & Anor (1996) 186 CLR 404; 96 ATC 5201; (1996) 34 ATR 183
- Federal Commissioner of Taxation v. Firth (2002) 120 FCR 450; [2002] FCA 413
- Federal Commissioner of Taxation v. Hart [2004] HCA 26
- Federal Commissioner of Taxation v. Isherwood & Drefyus Pty Ltd (1979) 9 ATR 473; 79 ATC 4031
- Federal Commissioner of Taxation v. Phillips (1978) 8 ATR 783; 78 ATC 4361
- Fletcher & Ors v. Commissioner of Taxation of the Commonwealth of Australia (1991) 173 CLR 1; 91 ATC 4950; (1991) 22 ATR 613
- Hallstroms Pty Ltd v. Federal Commissioner of Taxation (1946) 72 CLR 634; (1946) 8 ATD 190

- Hart v. Commissioner of Taxation (2002) 121 FCR 206; [2002] FCAFC 222
- Lunney v. Commissioner of Taxation (1958) 100 CLR 478; (1958) 11 ATD 404
- Macquarie Finance [2004] FCA 1170
- Magna Alloys & Research Pty Ltd v. Federal Commissioner of Taxation 80 ATC 4,542; (1980) 11 ATR 276
- Peabody v. Federal Commissioner of Taxation (1993) 40 FCR 531; (1993) 25 ATR 32; 93 ATC 4104
- Phillips v. Federal Commissioner of Taxation (1977) 7 ATR 345; 77 ATC 4169
- Robert G Nall Ltd v. Federal Commissioner of Taxation (1937) 57 CLR 695; (1936) 4 ATD 335
- Ronpibon Tin NL & Tongkah Compound NL v. Federal Commissioner of Taxation (1949) 78 CLR 47; (1949) 8 ATD 431
- Spassked Pty Limited v. Commissioner of Taxation [2003] FCAFC 282
- Steele v. Deputy Commissioner of Taxation (1999) 197 CLR 459; [1999] HCA 7
- Tweddle v. Federal Commissioner of Taxation (1942) 180 CLR 1; (1942) 7 ATD 186
- Ure v. Federal Commissioner of Taxation 81 ATC 4100; (1981) 11 ATR 484
- WD & HO Wills (Australia) Pty Ltd v. Federal Commissioner of Taxation (1996) 65 FCR 298; 96 ATC 4,223; (1996) 32 ATR 168

ATO references
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