


TA 2008/10 - Purported prepayment of service fees designed to postpone tax liability

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Taxpayer Alert

TA 2008/10

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: Purported prepayment of service fees designed to postpone tax liability

This Taxpayer Alert describes an arrangement for the prepayment of service fees from a trading entity to an associated service entity in which the dominant purpose of the arrangement was to secure a deduction in the year of alleged payment rather than in the year any services were provided.

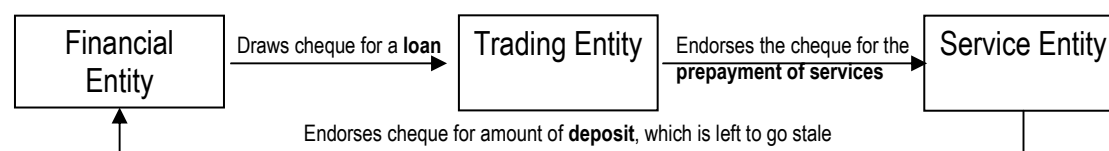
DESCRIPTION

The alert applies to arrangements having the following features:

1. A trading entity purportedly borrows funds from a financial entity that is associated with the promoter of the arrangement.
2. These funds are purportedly used by the trading entity to prepay for services to be provided by a service entity.
3. The purported borrowing and the purported prepayment are made as follows:

- i. A cheque is drawn in favour of the trading entity by a financial entity associated with the promoter.
 - ii. The cheque is endorsed by the trading entity in favour of the service entity.
 - iii. The service entity further endorses the cheque in favour of the original drawer, the financial entity, for the purported purpose of a 'deposit' with that financial entity.
 - iv. The cheque is to be held by the financial entity well after it becomes a stale instrument, but is never presented or banked for payment.
4. The promoter entity advises the trading entity that three conditions must be attached to the cheque, being that:
 - i. the cheque will not be presented and banked for payment,
 - ii. the cheque will not form the basis of a claim or marked for payment, and
 - iii. the cheque will be retained after it becomes stale.
5. In some cases, the services may not actually be provided by the service entity in the following income year.
6. The trading entity claims a deduction for the amount of the cheque in the first year.
7. The service entity declares the assessable income in the later year.
8. Due to the deferral of tax for each year, the trading entity enters into a subsequent arrangement the following year, with an ever-increasing amount of tax involved.

Diagram of typical arrangement



FEATURES WHICH CONCERN US

The Tax Office considers that an arrangement of this type gives rise to the following taxation issues that include whether:

1. such an arrangement or certain steps in it may be a sham.
2. the Trading Entity is entitled to a deduction under section 8-1 *Income Tax Assessment Act 1997* (ITAA 1997) and in particular, whether the amount purportedly paid to the service entity:
 - i. constituted a loss or outgoing;
 - ii. was to any extent incurred in gaining or producing the trading entity's assessable income; and
 - iii. was to any extent necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

3. section 82KK *Income Tax Assessment Act 1936* (ITAA 1936) applies so that the deduction is not allowable until the services for which it was purportedly incurred are provided by the service entity.
4. the general anti-avoidance rules contained in Part IVA ITAA 1936 operate to disallow the deduction until the services for which it was purportedly incurred are provided by the service entity.
5. any entity involved in the marketing of such an arrangement is a promoter of a tax exploitation scheme for the purposes of Division 290 of Schedule 1 to the *Taxation Administration Act 1953*.

The Tax Office has reviewed this arrangement in several cases and has determined that it is not effective because of some or all of the features set out above.

Note 1: Penalties of up to 50% of the tax avoided can apply where Part IVA is applied. Reductions in base penalty may be available if the taxpayer makes a voluntary disclosure to the Tax Office. If you have any information about the current arrangement, phone us on 1800 177 006. Tax agents wanting to provide information about people or companies who may be promoting arrangements covered by this alert should call the tax agent integrity service on 1800 639 745.

Note 2: Penalties of up to 5,000 penalty units for individuals, 25,000 penalty units for bodies corporate or up to twice the amount of consideration received or receivable may apply to promoters of tax exploitation schemes under Division 290 of Schedule 1 to the Taxation Administration Act 1953. The Commissioner can also apply to the Federal Court of Australia for restraining and performance injunctions against promoters where prohibited conduct has occurred, is occurring or is proposed.

subject references:

Arrangement
Associate
Prepayment
Endorsed cheque

legislative references:

Income Tax Assessment Act 1936
Section 82KK
Part IVA

Income Tax Assessment Act 1997
Section 8-1

Taxation Administration Act 1953
Division 290

related practice statements: Law Administration Practice Statement PS LA 2005/13

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