

Resuscitating Service Trusts



INTRODUCTION

The restrictive views expressed by the Commissioner of Taxation (Commissioner) in *Ruling* TR 2006/2¹ and the accompanying *Guide*² has encouraged the restructure of professional partnership practices (Firms) into companies (Incorporated Practices) or partnerships of trusts to permit winding-up of *Phillips*³ service trust arrangements whilst retaining protection of the wealth generated by Firms and flexible taxation advantages.

However, it is often impossible to restructure a Firm (or some of its functions) due to regulatory restrictions and unacceptable tax and transaction costs. A complying service trust arrangement may continue to be an appropriate planning structure in these circumstances.

Unless the Firm is prepared to litigate the Commissioner's views, the Firm will need to either abandon the advantages provided by a service trust arrangement or operate within the Commissioner's administrative regime.

The Commissioner has extended to 30 April 2007 the period to review and (if necessary) modify existing service trust arrangements providing a further opportunity to reconsider current service trust arrangements.

This article examines a number of impediments to incorporating a Firm. Where those impediments effectively preclude restructuring, the use of a complying service trust arrangement may continue to provide asset protection benefits and income tax advantages.

Legislative references are to the *Income Tax Assessment Act 1936* (1936 Act), the *Income Tax Assessment Act 1997* (1997 Act) and

the *Taxation Administration Act 1953* (1953 Act), unless stated or the context otherwise requires.

TR 2006/2 & GUIDE TO PHILLIPS ARRANGEMENTS

TR 2006/2 and the *Guide* have been extensively criticised by commentators.⁴ In summary the views expressed by the Commissioner incorrectly reinterpret the law and are inconsistent with the weight of current authority. Further, legislation does not support the *Guide*'s pricing methodology requirements.

However, unless a Firm is willing to accept the potential costs and risk of litigation against the Commissioner, the Firm will need to restructure or abandon the tax advantages of the service trust arrangement (or both) or operate within the administrative regime. Compliance with the Commissioner's administrative regime raises several tax administration issues.

The *Guide* extends the time for review of existing arrangements from 30 June 2006 to 30 April 2007. This provides additional time to investigate and vary service trust arrangements to comply or to restructure the Firm and wind-up the service trust.

RESTRUCTURING

Firm restructuring may be appropriate to permit the winding-up of service trust arrangements. Practice structures other than partnerships of individuals may achieve similar asset protection, development of alternate income streams and taxation advantages.

Often, regulatory restrictions or unacceptable tax consequences and transaction costs may preclude restructuring. In these

circumstances, retention of a service trust arrangement may be beneficial.

REGULATORY RESTRUCTURING RESTRICTIONS

Although liberalised, there remains legislative and professional association restrictions on the choice of structure. Legislative variations between States add to the complexity of structuring national practices to comply with the requirements of all jurisdictions.

Accountant Example

The ICAA's *Practice Structure Guide*⁵ endorses liberal practice structures. However, the ICAA generally requires more than 50 per cent of the professional advisors of the practice entity to be ICAA members for the entity to identify itself as Chartered Accountants.

Further, the *Practice Structure Guide* discusses a number of legislative restrictions. In particular the *Practice Structure Guide* states that '... there are questions as to whether a practice is able to operate through a trust and maintain its tax agent, auditor and liquidator registrations'.⁶ There are also other ownership and qualification restrictions for auditors and liquidator service providers under the *Corporations Act 2001* (Cth). We consider that appropriate structuring can manage such issues.

When incorporating the accounting Firm, it may be necessary to have separate structures for the tax agent, auditor and liquidator functions. Service trusts may continue to be relevant where these entities cannot separately incorporate or to act as a central administration and services entity for the practice group.

Lawyer Example

Lawyers also have restrictions on the permissible structure of legal practice, even in those jurisdictions that have enacted legislation based on the National Legal Profession Model Bill.⁷ For example, under the *Legal Profession Act 2004* (Vic) the definition of 'Law Practice' requires a partnership to consist only of individual 'Australian lawyer' practitioners.

Arguably, a Law Practice cannot be a partnership of companies or a mix of individuals and companies. Therefore, a corporate trustee of one trust or of multiple trusts or a partnership of discretionary trusts with individual practitioner trustees is permissible, but a partnership of discretionary trusts with separate corporate trustees is not. We consider that appropriate structuring can manage such issues.

Service trust arrangements may remain beneficial where the legal practice cannot restructure into an incorporated legal practice or trust structure.

TAX RESTRUCTURING RESTRICTIONS

The most significant impediment to restructuring is usually the capital gains tax and stamp duty costs.

Divisions 122-A and 122-B of the 1997 Act may defer the capital gains tax consequences of incorporation through qualification for rollover relief (Rollover Relief). However, Rollover Relief may be restricted or unavailable.

Further, the incorporation of a no or defined goodwill partnership may not be desirable, because after incorporation, the admission and retirement of shareholders may have increased tax costs.

Rollover Relief Limitations

An individual or trustee or a partnership⁸ may transfer their interests in a practice to a company in return for the issue of shares or the issue of shares and the company assuming liabilities and may choose to disregard any capital gain that would otherwise occur. A pre 20 September 1985 (pre-CGT) asset or interest will be replaced by a pre-CGT share.

Amongst other requirements, to obtain Rollover Relief:

- the market value of the shares issued and the interest in the business transferred

must be substantially the same; and

- the transferring entity must own the shares issued in the company in the same capacity as the interest in the business was owned before the transfer.

A Partnership Agreement may selectively grant priority to income and capital to certain partners and restrict the admission of new partners, grant first rights of refusal and compulsory sales and impose funding contribution and return rights on partnership interests. It may not be possible to equate or fully equate these rights in respect of the shares of an Incorporated Practice.

Where it is not possible to equate the share rights and obligations with the previous partnership rights and obligations, the market value of the shares issued and the transferred interest in the business may not be 'substantially the same'. It may be prudent to create different classes of shares and include appropriate rights and obligations in the Constitution and Shareholders' Agreement to ensure the market value of the shares and transferred interests are substantially the same. A qualified valuer should verify the comparative values where there is any doubt.⁹

The shareholder or the capacity of the shareholder cannot be substituted under Rollover Relief. The former provision expressly required ownership of the shares to be 'on the same trusts'.¹⁰ The 1997 Act does not express this requirement. The Explanatory Memorandum to the 1997 Act does not indicate an intended change.¹¹ The conservative position requires that the shares be held on the same trusts.

How an *Everett*¹² assignment affects Rollover Relief is unclear. The partner of an *Everett* assignment is a trustee for the assignee because of the peculiar nature of a partnership and the subordinate interest granted to the assignee. It is difficult to apply that reasoning to shares after the rollover. It may be difficult to assert that the interest in the shares is held on the same trust as the interest in the partnership (although it may continue to be held on trust). If Rollover Relief is only available where the shares are held on the same trust, Rollover Relief may not be possible at all where one or more partners have granted an *Everett* assignment. It may be necessary to collapse the *Everett* assignment as a precondition to the rollover.

No or Defined Goodwill Partnerships

A Firm may admit and retire partners without payment for goodwill (No Goodwill Partnership) or based on a formula that is less than the market value of the interest (Defined Goodwill Partnership). The Commissioner accepts that the CGT market value substitution rules do not apply to increase the capital proceeds received and CGT payable on the transfers of interests in partnership assets.¹³

It appears that a similar administrative concession will not apply in respect of a No Goodwill Incorporated Practice or a Defined Goodwill Incorporated Practice, which effect transfers of shares or interests on a predetermined or agreed basis.

Accordingly, a No Goodwill Partnership or a Defined Goodwill Partnership may not wish to incorporate as incorporation may emerge the previously unrecognised or under-recognised value of goodwill in the value of subsequent share transfers. This would increase the share transferor's tax liability without a corresponding increase in consideration received or, alternatively, make the buy-in price for new practitioner shareholders unacceptable.

Duty

All States (other than Victoria) levy business stamp Duty on the transfer of certain business assets such as goodwill.¹⁴ Accordingly, restructuring may have duty consequences.¹⁵

STRUCTURING A SERVICE TRUST ARRANGEMENT

To retain a complying service trust arrangement, the arrangement should mirror (as far as possible) the *Phillips* structure and incorporate the views of the Commissioner. This requires a high degree of formality, including (arguably) that:

Service Trust Structure

- the service entity be a unit trust to provide certainty in respect of the return on investment and to support the desire to establish a second income stream;¹⁶
- the corporate trustee and daily management of the service trust be (to the greatest extent possible) independent of the Firm and of each other so that there is no blurring of activities between the entities for which remuneration under the service agreement is referable;

- the direct and indirect rights of the practitioners to enforce distributions under the Firm and the service trust not be stapled/interdependent which may evidence non-business purposes affecting deductibility of the service fees for the Firm;

Services Provided

- the services be the subject of a detailed and well drafted written contract;
- the provision of services (or any particular service) to the Firm by the service trust not be exclusive or mandatory, which may evidence non-business purposes affecting deductibility of the service fees for the Firm;
- the service trust stand prepared to offer or at least not be prohibited from offering similar services at similar costs to independent third parties to support the arms' length rate of the service fees;
- the service entity operate as a separate costs centre with separate invoicing, bank accounts and overdraft facilities;
- the service entity develop its own office systems, policies and procedures manuals and intellectual property;
- the service trust own the business assets or be able to justify leasing the assets from third parties and subleasing or licensing the assets to the Firm with a mark-up to support the asset protection motive and mark-up rate;
- the service trust have sole liability for non-professional staff entitlements and statutory obligations and liabilities and not on charge for those entitlements and obligations;
- the service fees be set under a sustainable methodology and that process be documented and reviewed regularly;
- the service fee be paid monthly and, if accrued, be subject to commercial interest to properly and commercially remunerate the service trust;
- the documentation not refer to a motive of transferring or deriving profits outside the Firm to quarantine it from the Firm's creditors, which may indicate an intention by the practitioners to obtain a tax benefit under Part IVA of the 1936 Act or an intention by the practitioners to defeat creditors for the purposes of the *Bankruptcy Act 1966* (Cth); and

Practice Services Retained

- the Firm directly employ all professional staff to quarantine professional practice risks and claims in the Firm to support the asset protection motive.

Non-observance of one or more of the above formalities will not necessarily invalidate the service trust arrangement. However, greater compliance will assist in evidencing that the service trust arrangement is a commercial business venture.

BENCHMARKING SERVICE FEES

The Firm bears the onus on an adverse assessment to substantiate the service fees charged by the service trust. The *Guide* indicates that:

- an audit would not ordinarily commence unless there is substantial divergence with the indicative rates provided or substantiation requirements in the *Guide*;
- if the arrangement comes within the indicative rates in the *Guide*, there is a low risk of audit; and
- a higher rate may be appropriate if adequately benchmarked.

Indicative Rates & Profits

The *Guide* provides two methods of determining whether costings are appropriate. The *Guide* provides both indicative net mark-ups of 3.5 per cent to 7.5 per cent (Net Mark-ups) and gross mark-ups of 10 per cent to 30 per cent (Gross Mark-ups) on certain costs depending on the type of service provided. For convenience, either method may be used.

As a crosscheck, the use of the Mark-ups must not result in greater than 30 per cent of the combined profits of the Firm and the service trust being earned by the service trust due to the service arrangement (Profit Ceiling). The *Guide* provides a 40 per cent to 45 per cent Profit Ceiling for medical practitioners and rural and sole medical practitioners respectively.

Preliminary modelling indicates that the Mark-ups and Profit Ceilings are generally consistent. The 30 per cent Profit Ceiling may not result in sufficient net profits for the service trust arrangement to be viable. However, a 45 per cent Profit Ceiling is likely produce an acceptable net-profit for the service trust (depending on the size of the Firm and the extent of the services provided).

The *Guide* does not provide an exhaustive list of services Mark-ups. For example, no guidance is given for the costs of the Firm's professional employee training and development generally and in respect of practice specific procedures and technologies and for IT support and help desk consulting services. The cost of these services require separate benchmarking and (arguably) command premium mark-up on costs.

Acceptance of Indicative Rates & Profits

The Profit Ceilings are not themselves a safe-harbour. The correct methodology is to model the services on the Mark-ups. The Profit Ceiling is a check on the overall appropriateness of the fees charged for services rendered. A Services Agreement that merely provide a formula earning the service trust a maximum 30 per cent of the gross service fees is unlikely to satisfy the *Guide*'s methodology.

If the Profit Ceiling is within the appropriate range, the service trust should fully model the fees to evidence the appropriateness of the arrangement. This should be relatively inexpensive once modelling software is established.

Accountants and lawyers may desire to exceed the 30 per cent Profit Ceiling to obtain sufficient net profitability for the arrangement to be viable. Exceeding the indicative Profit Ceiling is likely to result in a review or an audit. Accordingly, benchmarking will necessarily be sophisticated and robust.

Alternate Pricing Methodologies

International transfer pricing provides several acceptable methodologies for determining comparable prices or comparable profits.¹⁷

Comparable pricing methodologies include:

- comparable uncontrolled price (CUP) – benchmarking against comparable transactions between independent enterprises or between one party and an unrelated enterprise;
- cost plus (CP) – benchmarking by adding to the supplier's costs a mark-up determined by comparable transactions between independent enterprises or between one party and an unrelated enterprise; and
- resale price (RP) – benchmarking by subtracting from the price of a comparable transaction between independent enterprises a mark-up recovering the

supplier's costs and appropriate profit. Comparable profit methodologies include:

- profit comparison method (PCM)
 - benchmarking the net profits achieved against the industry norm (for example, the ratio of net profits to operating expenses);
- profit split method (PSM) – benchmarking so that each entity receives the same rate of return on capital employed (for example, an arbitrary rate or determined on risks allocation); and
- transaction net margin method (TNM)
 - benchmarking the net profit of associated transactions with the average net profit achieved with transactions with independent enterprises.

The *Guide's* methodologies include aspects of these.

These methodologies applied appropriately and consistently can substantiate a sustainable pricing model.

For example, CUP can be used where the service trust leases a large area and subleases comparable smaller floor areas to the Firm and to an independent tenant. The rent obtained from the independent tenant sets the appropriate market rent for the Firm. Similarly, the margin obtained on the independent lease can be set per square metre and that rate per square metre applied under CP when the floor area of the Firm differs from the independent tenant.

MANAGING RISKS

A Firm may abandon an existing service trust so that historical administrative and management concerns are less likely to be examined by the Commissioner. Establishing a new complying service trust before 30 April 2007 may be appropriate.

Careful documentation, administration and benchmarking below the Profit Ceiling will reduce the risk of audit and adverse assessments but will not provide any real protection against the Commissioner changing his position.

The Commissioner cannot issue an assessment that is contrary to a public ruling such as TR 2006/2.¹⁸ However, the more important *Guide* (not being a public ruling) will not bind the Commissioner.

Further, under the Uniform Penalties Regime,¹⁹ the Commissioner may impose a 25 per cent penalty in respect of a tax shortfall where in applying a tax law a Firm does not

have a reasonably arguable position. A matter is reasonably arguable if it would be concluded in the circumstances, having regard to the relevant authorities, that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect.

TR 2006/2 and the *Guide* have been so extensively criticised as being inconsistent with the weight of current authority and not supported by legislation that it must be difficult (if not impossible) for the Commissioner to successfully defend a position that a service trust arrangement that is properly benchmarked is not as likely or is not more likely to be correct as incorrect.

Accordingly, the pricing methodologies in the *Guide* are not safe harbours and are of questionable administrative protection for taxpayers.

It is unusual to recommend applying for a private ruling, however, the *Guide* clearly anticipates a Profit Ceiling of more than 30 per cent for accountants and lawyers in appropriate matters. A Profit Ceiling at least equal to the 40 per cent or 45 per cent provided to doctors appears possible and justifiable.

In this unusual circumstance, a private ruling may be appropriate to obtain comfort and protection. The Commissioner cannot issue an assessment contrary to a private ruling.²⁰ A carefully drafted application may require the Commissioner to indirectly rule on the pricing methodology and Mark-ups and Profit Ceilings used.

OTHER ISSUES SUCH AS THE PSI RULES

Assuming that a service entity satisfies the requirements of TR 2006/2 and the *Guide*, other tax provisions will also require careful consideration. For example, Cooper²¹ considers that the Personal Services Income Rules²² may have a residual operation in respect of the service trust.

Essentially, a service trust that hires out labour is unlikely to satisfy the results test because a contract for the hire of staff is (arguably) not a contract to produce a result and the service trust will not have an obligation to rectify its defective work.

CONCLUSION

The retention of a complying service trust arrangement should be considered, particularly where the Firm cannot restructure to retain

similar business and taxation advantages.

Doctors (with the 45 per cent Profit Ceiling) benefit most from the Commissioner's current position. Accountants and lawyers may also benefit, particularly where proper benchmarking and administration indicates a 45 per cent Profit Ceiling instead of a 30 per cent Profit Ceiling (in line with Doctors) to be appropriate.

Where a private ruling would provide the needed comfort to retain a service trust arrangement, Firms should make the application immediately to permit it to be determined and acted upon before expiry of the review period on 30 April 2007.

Ron Jorgensen
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Reference notes:

- 1 TR 2006/2 *Income Tax: deductibility of service fees paid to associated service entities: Phillips arrangements* (20 April 2006).
- 2 Australian Taxation Office, 'Your service entity arrangements', NAT 130086-04.2006.
- 3 Phillips 77 ATC 4169; (1977) 7 ATR 345; appeal 78 ATC 4361; (1978) 8 ATR 783.
- 4 For example, W. Thompson, 'Should you be moving on from Service Trusts', 21st National Convention, TIA, 2006; J. de Wijn QC, 'Service Trusts: Basic Elements of Deductibility Revisited', Tasmanian State Convention, TIA, 2005.
- 5 Institute of Chartered Accountants in Australia, 'Practice Structure Guide', 2006.
- 6 Practice Structure Guide, *ibid* 34.
- 7 Standing Committee of Attorneys-General, *National Legal Profession Model Bill* (23 April 2006); *Legal Profession Act 2004* in Queensland, New South Wales and Victoria.
- 8 Subdivision 122-A of the 1997 Act and Subdivision 122-B of the 1997 Act respectively.
- 9 Taxation Determination TD 10.
- 10 Section 160ZZN(4)(c) of the 1936 Act.
- 11 Tax Law Improvement Act (No. 1) 1998 (Cth).
- 12 Everett (1980) 143 CLR 440.
- 13 Ruling IT 2504, paras 13 & 14.
- 14 A. Tolhurst et al, 'Australian Revenue Duties', Butterworths, para 48.0030.
- 15 Duty exemptions or concessions may be available in some States (for example in restructuring legal practices).
- 16 This may not be an imperative, as the *Guide* appears to accept discretionary trusts as an acceptable service entity. However, the use of a discretionary trust may reduce the development of a second income stream purpose.
- 17 For a detailed discussion refer to Ruling TR 97/20 *Income Tax: arm's length transfer pricing methodologies for international dealings* (5 November 1997).
- 18 Section 170BA of the 1936 Act.
- 19 Part 4-25 of the 1953 Act.
- 20 Section 170BB of the 1936 Act.
- 21 G. Cooper, 'How to Structure Your Professional Services Firm', Victorian State Convention, TIA, 2005, page 11.
- 22 Divisions 84 to 87 of the 1997 Act (inclusive).