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Service Trusts for Counsel

A paper presented by Michael Bennett at the Floor CPD

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This paper is for presentation purposes only and not advice on how to establish a service entity nor what rates at which the services can be charged without attracting the Commissioner of Taxation's attention.

1. Service entities generally

1.1 A service entity is the most efficient and effective means of directing wealth from professional practice including counsel. For professional, ethical and tax reasons the risk-free entity can rarely be involved in the business as a participant.

1.2 Service entities usually comprise unit trusts, joint ventures of discretionary trusts and less often companies. They can also be discretionary trusts. They have three main general objectives:

1.2.1 the facilitation of asset protection;

1.2.2 the conduct of a separate business from the professional practice; and

1.2.3 tax planning opportunities, in particular income splitting.

1.3 The first and third of these objectives are particularly relevant to counsel, as counsel would generally be less concerned with establishing an independent business. It will be seen that the lack of the second objective may raise issues with the Commissioner of Taxation ("Commissioner").

1.4 In the context of a professional practice that is risk exposed – e.g. in particular accounting and law – the asset protection aspect is very significant. How this is so is obvious – the more value or wealth that can be moved to the service entity the less wealth there is to pursue in litigation.

1.5 For counsel practicing as sole proprietors, where the next dollar of income will always be assessed at our marginal rates, the tax planning opportunities are also significant. The tax advantages lie in obtaining deductions against the barrister's personal assessable income where those payments are received by an entity through which lower tax rates can be achieved. It is a tax rate arbitrage.

1.6 You might expect that the Commissioner does not view favorably these entities; you would be right. The tax history of these entities commenced in the 1970s with the sanction of the Full Court of the Federal Court and has grown since then. In response to this growth the Commissioner has increased his reviews in the area and published information seeking to reign in their use. As often occurs the Commissioner's restrictive view, more restrictive than the law

in my opinion, should be respected unless you have the funds and the inclination to test that view and get your name in the reports. We don't all end up as Handley Q.C.[1]

1.7 The Commissioner has summarized the issues with service entities, as he sees them, thus:[2]

> *We understand that it is common for accountants, lawyers and other professionals (particularly those who are required to operate their businesses as individuals or as partnerships) to engage associated entities to provide them with labour hire, recruitment, clerical, administrative and other services (also known as service arrangements). These arrangements can also be used in the broader business community.*
>
> *We also understand that it is common for professionals to view service arrangements as an effective means of protecting their assets from professional negligence actions and other claims.*
>
> *Our concern is whether the service fees being claimed are deductible under the income tax law.*
>
> *If you have a conventional service arrangement where your payments are correctly calculated and the services are reasonably connected to the conduct of your business, then the presumption will be that your service fees and charges are a real and genuine cost of our business and deductible in full.*

1.8 To concern of deductibility can be added whether the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act* 1936 (Cth) (the "1936 Act") apply.

1.9 This paper will track the development of service entities, consider what govern their use today, what benefits they have for us as counsel and what issues we need to consider if using them.

2. Phillips Case

2.1 To my knowledge service entities were not prevalent before the Full Court of the Federal Court's decision in *FCT v Phillips* (1978) 78 ATC 4361. Indeed a reading of that decision suggests the arrangement was a novel concept for a professional services organization.

Background

[1] *Handley v FCT* (1981) 81 ATC 4165; 41 ATR 644

[2] *Your service entity arrangements* (NAT13086-04.2006) (the "Guide") at 3

2.2 A large accounting firm, Fell & Starkey, carried on business throughout Australia as a member of an international partnership in conjunction with British and United States firms. It was a partnership of individuals that employee substantial numbers of staff, both professional and non-professional. In 1970 a substantial judgment was entered in the Supreme Court against another large firm of chartered accountants based on professional negligence. This caused the relevant partners to consider their own position for asset protection. There was also "disquiet" over the considerable increase in premiums payable to obtain cover and whether it might be impossible in the future to obtain the necessary cover at an appropriate cost.

2.3 The relevant service entity was a unit trust created after consultation with solicitors. Two companies were incorporated – one to be the trustee of the unit trust and the other to be the management company of the unit trust. Units were applied for by family members or entities associated with the partners in amounts based on the partnership interest of that particular partner. Two Melbourne solicitors held the only two issued shares in, and were directors of, the trustee company. There were two shareholders of the management company, neither of whom was at the time a partner of the firm, who held the two shares in the management company.

2.4 A memorandum was circulated amongst all Fell & Starkey partners explaining the scheme and its advantages and disadvantages and seeking the consent of the partners. The reasons for the establishment of the scheme were stated as follows: to move assets away from partners to minimize consequences of unsuccessful litigation and to reduce taxes, income tax during a partner's lifetime and death duty upon death. The partners received verbal advice from the Commissioner that he could not accept that the scheme would have the desired income tax consequences. The Fell & Starkey partners nonetheless proceeded.

2.5 The firm terminated all of its non-professional staff who were then all offered employment by the management company on behalf of the trustee company. All staff accepted the offer. That day the management company purchased on behalf of the trustee company the whole of the furniture, office machines, partitions and office equipment owned by the firm. The

2.6 The management company carried out specified business undertakings on behalf of the trustee including the leasing of office furniture, machines, partitions and equipment, provision of clerical and secretarial staff, provision of share registry services and printing and photocopying services, making of deposits at call and acting as insurance agents. These activities were said

not to be limited to Fell & Starkey, though this is what in fact happened. The management company also paid salary to its manager.

2.7 The management company charged Fell & Starkey for the services performed as follows:

2.7.1 a percentage on purchase price for the lease of office furniture and equipment;

2.7.2 a fee for provision of clerical and secretarial staff based on a 50% mark up;[3]

2.7.3 a fee for share registry services at the rate of 0.95 cents per shareholder as a maintenance fee and 0.95 cents for each transfer.

2.8 The offer of services to Fell & Starkey, who accepted the offer, was a general one and was not for a specific time frame.

2.9 The service charges were made on a monthly basis and were either paid by the firm or alternatively accrued under a further agreement, which effectively allowed Fell & Starkey not to pay the service charges on a monthly basis but to accrue the charges and to pay interest on the outstanding amounts at 10% per annum. Later the repayment of these amounts was secured by way of a first charge over Fell & Starkey's book debts and the interest rate was reduced to 8.5%.

2.10 There were multiple benefits to Fell & Starkey including:

2.10.1 they were relieved from most problems of staff and office management and all financial obligations in respect of wages, sick leave, annual leave, workman's compensation, statutory holidays and long service leave;

2.10.2 the sale of plant and equipment under the arrangement released working capital and enabled a distribution to be made of profits so released;

2.10.3 the deferred payment arrangement increased the working capital in the firm and reduced the assets of the firm, thereby protecting it from unsuccessful litigation; and

[3] Which, significantly, was the rate one of Fell & Starkey's clients in the labour hire industry charged its own clients. Evidence of this was led at the trial.

2.10.4 there was no obligation on the firm to use the services of the management company (although there was an incentive to do so in that the benefits would flow back to the associated entities of the Fell & Starkey partners).

2.11 The Commissioner disallowed the deductions Fell & Starkey claimed for these various expenses.

First instance

2.12 At first instance Waddell J in the New South Wales Supreme Court (77ATC 4169) allowed the taxpayers' appeal on the basis that:

2.12.1 the deductions were allowable under s 51(1) of the 1936 Act. By making the payments the taxpayer did not acquire any legally enforceable right other than to the performance of those services so there was no basis for denial of the deduction for the reason that the expenses were not necessarily incurred in carrying on a business to gain assessable income or to apportion the expenditure between payment incurred for that purpose and for any collateral purpose; and

2.12.2 s 260 of the 1936 Act – the former anti-avoidance provision before Part IVA – was not applicable to avoid the transaction.

2.13 The Commissioner had run both of these arguments before Waddell J.

2.14 Importantly his Honour found that the mark ups used by the management company were commercially realistic. The Commissioner did not challenge this finding on appeal. Indeed, the Commissioner did not pursue the s 260 argument appeal.

Full Court of the Federal Court

2.15 The Full Court comprised Bowen, Deane and Fisher JJ. Although unanimous in dismissing the Commissioner's appeal, Bowen and Deane JJ delivered a joint judgment with Fisher J delivering separate reasons.

2.16 The Commissioner argued that the purpose of establishing the arrangement was private and domestic, being to divert income to other family members or entities, and that each payment was therefore not deductible to Fell & Starkey. Justice Fisher's reasons at 4368-9 state the outcome simply:

A crucially important circumstance in the present matter is the unchallenged finding of the trial judge that the charges paid by the firm were realistic and not in excess of commercial rates. The services were essential to the conduct of the firm's business and the fact that the charges paid were commercially realistic raises at least the presumption that they were a real and genuine cost of earning the firm's income and cost of that alone…

Doubtless the converse would apply, namely, if the expenditure was grossly excessive, it would raise the presumption that it was not wholly payable for the services and equipment provided, but was for some other purpose. Such is not the case here.

2.17 While on this point, it is noteworthy that these observations pre-empt the decisions of *Ure v FCT* (1981) 81 ATC 4100 and *Fletcher v FCT* (1991) 91 ATC 4590 that stand for the proposition that the Commissioner may look to the indirect purpose of the taxpayer in order to establish the true object of the expenditure. Justices Deane and Sheppard in *Ure's Case* at 4110 said:

One of the most difficult aspects of the problem of characterizing an outgoing is the assessment of what, if any, weight is to be given to indirect objects which a taxpayer had in mind in incurring the outgoing. Such objects form part of the relevant circumstances by reference to which the problem of characterization must be resolved. There is however no rigid principle which can be applied in determining what, if any, weight should be given to them. In the ordinary case, such as, for example, where the immediate object achieved by the outgoing is the production of assessable income which is commensurate with the amount of the outgoing or where it is clear that the outgoing was for the purchase of stock-in-trade or the acquisition of services or hire of equipment used in earning assessable income, indirect objects or motives of a personal or domestic character will plainly not prevent the characterization of the outgoing as having been incurred in earning assessable income (see, for example, Cecil Bros Pty Ltd v FC of T *(1964) 111 CLR 430;* Phillips v FC of T *77 ATC 4169). In other cases, the immediate object or effect of an outgoing will not suffice either to explain or to characterize it. In such cases, indirect objects or motives can assume a sometimes decisive importance.*

2.18 Given the Commissioner's later position in *Taxation Ruling 2006/2* (discussed below) Fisher's J following comments are relevant:

The finding of the trial judge that the expenditure under consideration was commercially realistic raises a presumption that it was laid out for the purposes of obtaining assessable income. Only if the expenditure had been found to be grossly excessive would the finding of dual purpose of acquiring services and raising a family benefit be opened. It is nothing to the point that it might be possible for the services to be provided in other ways more cheaply and this principle applies equally to the provision of services and to the acquisition of trading stock. The family benefit which accrue in consequence of the

use by the firm of the unit trust's services was an inducement or incentive to the firm to avail and to continue to avail itself of this source of services. It was not a purpose of the expenditure. ***It is only if the taxpayer obtains for a consideration which is identifiable and quantifiable an additional advantage unconnected with the business activity that it can be said that portion of his expenditure is laid out for a purpose other than the acquiring of assessable income. It is in this circumstance that the identifiable portion would not be an allowable deduction.***

2.19 In short, *Phillips Case* decided that where there is a commercially realistic mark-up of fees the payments to a service entity will be deductible to the professional firm or worker. However, the restricted arguments the Commissioner ran in the Full Court might mean that it stands for less than the profession has hoped it does.

3. Commissioner's Response

3.1 In 1978 following the decision in *Phillips* the Commissioner released *Taxation Ruling IT 276.* It remains in force today. The Commissioner accepted *Phillips Case* as correct, having stated the facts he considered to have a normative effect, but that it did not require a change to his stated positions. At paragraph 3 of the ruling the Commissioner restricted the case as follows:

Despite the substantial transfer of income, the taxpayer was able to satisfy the trial judge that the rates charged by the trust were realistic and not in excess of commercial rates. This was a crucial finding which could not be effectively challenged on appeal. Additionally, it was accepted that there were sound commercial reasons for the arrangement quite apart from tax savings. The sale of plant and equipment by the firm to the trust released working capital and enabled accrued profits to be distributed; assets were moved away from the firm and thus protected against possible litigation based on professional negligence.

3.2 Practitioners did not accept the Commissioner's limited view of the case. The use of service arrangements continued in prevalence from the time of *Phillips Case* to the present.

3.3 In a speech titled "Issue Confronting Australia's Tax System" delivered to the Financial Review – Leader's Luncheon on 29 July 2002 the former Commissioner (Michael Carmody) raised the issue of service entities as an issue on his radar. The alarm was sufficiently raised that the comments are worth setting out in full:

> *The Phillips' case authorized the use of services trusts to provide administrative services to professional partnerships.*
>
> *The arrangements became quite common with the service trust, a fixed unit trust, effectively being owned by trust established for the benefit of partners' wives and family members.*
>
> *Lately we have seen cases where the arrangements have varied significantly from those reflected in the Phillips' case.*
>
> *For example, the service trusts are discretionary trusts rather than fixed unit trusts with distributions to family trusts related to the annual performance based profit sharing arrangements for partners.*
>
> *Further unlike Phillips' case, no substantial assets such as premises and equipment are owned by the trust and al staff, including professional staff, are employed by the service trust and charged back to the partnership.*
>
> *The partnership is a beneficiary of the service trust and the great bulk of the partnership profit ends up in the trust. Ultimately the arrangements are such that the partners have complete flexibility to take the full profit from the partnership or to divert a large part of it through the service trust to a family trust.*
>
> *We are not seeking to re-open the Phillips' decision, but we are examining whether features of the kind outlined tip the scale beyond what was accepted in that case as explicable on commercial grounds.*

3.4 The next installment in the Commissioner's interest in service entities was correspondence in 2005 with the Law Council of Australia the Assistant Treasurer indicated that cases which have come to the Australian Taxation Office's ("ATO") attention indicate that some service trust arrangements are not of the kind contemplated by *Phillips Case* and do not appear to justifiable on commercial grounds. Such cases are said to include those where:

3.4.1 the service trust is charging far in excess of commercial rates;

3.4.2 the service trust ahs been paid for services it did not provide; and

3.4.3 the service trust is receiving a very large proportion of the firm's income.

3.5 The Commissioner then issued *Taxation Ruling TR 2006/2* and the accompanying Guide. These are significant as the Commissioner cannot issue an assessment that is contrary to a public

ruling,[4] such as *Taxation Ruling TR 2006/2*, however, the more important Guide (not being a public ruling) will not bind the Commissioner.

3.6 The approach taken in *Taxation Ruling TR 2006/2* is:

3.6.1 To accept the correctness of the decision in *Phillips Case*.

3.6.2 To note that 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 1997 Act. This is a reference to the fact that following the decision in *Phillips* the use of service trusts became widespread. Generally, given the ATO's acceptance of the decision in *Phillips*, tax advisers and their professional organization clients came to regard the facts in *Phillips* as a "safe harbor" not only in relation to the type of structure which might be adopted in a service trust arrangement, but also in relation to the manner of calculation of the service charges. Given the findings of fact by Waddell J the mark-ups of 50% on non-professional staff wages and 15%, effectively, on equipment, were applied as a safe "rule of thumb" which became commonly referred to as the "15/50 rule". This has been a matter of common knowledge among professional tax advisers and the ATO for almost 30 years.

3.6.3 To require taxpayers to establish in each case that service charges are deductible under section 8-1 (or under section 51 of the 1936 Act) and that Part IVA does not apply. The Commissioner will require to be satisfied in order for deductions to be available, that the service charges: produce a benefit to the acquirer of the services and are commercially realistic.

3.6.4 Failing that, the Commissioner will accept that a service charge for certain types of services is deductible only be reference to charges for those services which the Commissioner has identified as charged by certain listed public company providers of those services.

3.7 The Guide provides parameters for mark-ups and profit margins that the Commissioner will accept as appropriate. That is, the Guide indicates that:

[4] Section 170BA of the 1936 Act.

3.7.1 an audit would not ordinarily commence unless there is substantial divergence with the indicative rates provided or substantiation requirements in the Guide;

3.7.2 if the arrangement comes within the indicative rates in the Guide, there is a low risk of audit; and

3.7.3 a higher rate may be appropriate if adequately benchmarked.

3.8 The Guide provides two methods of determining whether costings are appropriate. The Guide provides both indicative net mark-ups of 3.5% to 7.5% (net mark-ups) and gross mark-ups of 10% to 30% (gross mark-ups) on certain costs depending on the type of service provided.

3.9 There is a further cross-check in that the use of the mark-ups must not result in greater than 30% of the combined profits of the firms and the service trust being earned by the service trust due to the service arrangement (profit ceiling). Strangely the Guide provides a 40% to 45% profit ceiling for medical practitioners and rural and sole medical practitioners respectively. It's hard to see the difference – so far as the tax characteristics of counsel are concerned – between a sole medical practitioner and a barrister. On this reasoning a 45% profit ceiling would also apply to barristers. Accountants and lawyers may desire to exceed the 30% 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.

3.10 It is important to note that the profit ceilings are not in themselves a safe harbor. They are a cross-check. It remains necessary to comply with the pricing structure.

4. Counsel's dilemma

4.1 Of particular interest to barristers is example 5 of *Taxation Ruling TR 2006/2* which considers a sole legal practitioner. The service entity was a family trust with a corporate trustee. A 2 page service agreement between the practitioner and trustee records the terms of the agreement under which the trustee provided the sole practitioner with the following services:

4.1.1 Disbursement of expenses such as floor fees and donations;

4.1.2 Provision of office furniture and computer equipment;

4.1.3 Maintenance of a professional library;

4.1.4 Secretarial and bookkeeping services;

4.1.5 Collection of debts; and

4.1.6 Other services agreed upon by the parties.

4.2 Further, the trustee did not offer these services to anyone other than the sole practitioner. Further, and possibly the saving grace for barristers, is that the mark ups in this example were 50% to 60%, being excessive mark-ups in any event. The Commissioner's conclusion on this example is:

> *84. 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 charge and the market value of the services provided. The arrangement makes little business sense for Mr Donnegal and a broader enquiry is required.*
>
> *85. Whilst the characterization 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.*
>
> *86. In the alternative, the apparent non-commercial nature of the arrangement suggests there may be scope for Part IVA of the ITAA 1936 to apply.*

4.3 This view may not accord with the law itself, in that a court may decide the asset protection purpose of the arrangement, or the mark-ups being commercial themselves may be the view taken by a court on review. The problem for counsel however is that the Commissioner's view will be determinative unless you are willing to follow the argument through an appeal process.

5. Policy v Law

5.1 It can be seen that the Commissioner's view is more restrictive than what the case law suggests should be applied. *Phillips Case* tells us a commercial rate in setting the fees is sufficient for these purposes. Through policy applied via public rulings and pronouncements however the Commissioner has progressively limited the scope of service arrangements. He has done this by

setting guidelines and standards that the particular service trust or entity would apply. Beyond these "benchmarked" amounts the risk of audit and amended assessment is possible.

6. Conclusion and Recommendations

6.1 In my view there is potential for a service trust for barristers. The all of the services outlined in example 5 of *Taxation Ruling 2006/2* would be useful in such an arrangement. Unlike that example, however, mark-ups less than 50% to 60% are recommended.

6.2 In my view the following consideration for the services provided should be in the range of:

6.2.1 a retainer fee of $10,000 to $15,000;

6.2.2 a calendar monthly fee of $150% of all salary, wages and remuneration incurred by the service entity – though this mark up includes payment for sick-leave, holiday pay and other costs of providing the employment services (that is, it cannot be separately charged);

6.2.3 a calendar monthly fee of 115% of all payments made by the service entity or a commission of 15% if the payments are made by the service entity from the counsel's funds;

6.2.4 a monthly fee of 7.5% for debt collection; and

6.2.5 6-8% mark-ups on supply of premises – for instance, this appears to be the rate residential real estate agents charge.

6.3 The agreement would need to be sufficiently commercial and arms' length. I have set out a draft suggested agreement at Annexure A to this paper (though this is only a suggestion and consideration should be given to what else may be required before adopting the suggestion).

6.4 Two further points bear comment if a service trust is to be used. First, any service trust must ensure there is present entitlement to all of the income of the trust each year. To the extent an amount exists to which no one is presently entitled the to marginal tax rate will be applied.[5] This is a problem common to all discretionary trusts. Secondly, and relevantly to unit trusts that act as service trusts, where the service trust is not adequately capitalized – which may be the

[5] Pursuant to s 99A of the 1936 Act.

selected strategy for a number of reasons – distributions of accounting income that exceed the tax income will reduce the cost base in the units and, when that amount is reduced to nil, cause capital gains to occur under CGT Event E4.[6] Quite often this effect is overlooked when a unit trust is involved.

* * * *

[6] Pursuant to s 104-70 of the 1997 Act.

Annexure A – Suggested Agreement terms

SERVICES

The Service Entity shall from time to time during the term of this Agreement supply to X Counsel for the carrying on by X Counsel of their practice the fallowing office administrative services:

1 ***Clerical Services***

(a) The supply of all receptionist secretarial and clerical typing and photocopying services;

(b) The preparation forwarding and collection of all accounts and reminders and for the payment of accounts relating to the supply of services or for disbursements duly rendered to or incurred on behalf of clients of the Business by the Service Entity and the receipt and banking into the name of X Counsel of all payments of such accounts and taking of all steps and performance of all acts including the institution and prosecution of any proceedings at law to enable collection of such account;

2 ***Office Services***

(a) The procurement of all stationary and other office or commercial supplies and articles;

(b) The examination of all electricity, water, gas, insurance and other bills, invoices and accounts incurred by X Counsel in carrying on the practice and the preparation and forwarding as agent of X Counsel of cheques or other payment thereof;

(c) The acquisition and maintenance of all professional books, journals or periodicals of use by X Counsel.

3 ***Premises Plant and Equipment***

(a) The lease or acquisition of such premises and facilities as X Counsel shall from time to time require for the conduct of the Business and the due performance of all obligations relating to the lease or acquisition of such premises or facilities;

(b) The supply of all other plant and equipment which X Counsel shall require for the conduct of the practice and which the Service Entity shall agree from time to time to supply.

4 ***Other Services***

The supply of such other non-professional office and administrative staff and services as may from time to time be agreed between X Counsel and the Service Entity.

AND *the Service Entity shall engage all such staff and acquire all such equipment, plant, facilities or services as may be necessary from time to time to enable the Service Entity to carry out and perform all the non-professional office and administrative services required to be carried out or performed by it under the terms of this Agreement.*