



WEEKLY TAX BULLETIN

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No 7

18 February 2011

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[198] Why the worry with Service Trusts?

by Brett Davies, Partner and Alyce Conway-Mortimer, Lawyer, Civic Legal Pty Ltd, Perth

The topic of trusts generally continues to be flavour of month for many practitioners and their clients, as well as the ATO. There are hundreds of thousands of them in Australia and the ATO, Treasury and the Government seem to be taking a far greater interest in them than ever before.

And of course, we have a potential rewrite of the tax law provisions concerning trusts on the horizon - although don't expect that in the near future!

While a number of trust structures exit, the use of service trusts has caused concern in the past.

Service trusts often polarise people. You either love them or are scared of them. I personally love them. Why? Because I believe that properly structured service trusts are neither tax planning nor tax avoidance. By every definition, they are (and must be) legitimate businesses. There's nothing wrong with running a legitimate business - so there's nothing wrong in choosing to structure that legitimate business through a

trust (also called a service trust, or service company).

Service trusts can fall foul of the law when those using them don't take the advice of their accountant, they use "mark-ups", or they don't run the service trust as a stand-alone legitimate business.

Clients need careful guidance by their accountants. So, how do you make sure your clients' service trusts are ATO compliant? I would suggest there are 3 service trust lessons to live by and I set these out below.

Lesson 1: Know why you have a service trust

Assume a business gets audited and the ATO asks why a service trust was set up. Possible answers might include:

- (a) I did it to save tax.
- (b) I did it for asset protection.
- (c) None of the above (I only answer questions when my accountant is present).

Why is (a) wrong?

Structuring one's affairs for the dominant purpose of saving tax raises the spectre of Pt IVA. Remember, there is a fine difference between tax planning and tax avoidance. (Part IVA is under review and is expected to get tougher). If a reasonable person in your position believes the service trust exists solely for the purpose of avoiding tax, then that's a problem.

Why is (b) wrong?

Cleverly (or so you think), you are adamant that your service trust is not there to save tax - you set it up for asset protection.

Later on, the business goes bust. Here lies the problem. You now can't plead in the insolvency court that your service trust was there to save tax. The ATO transcripts where you swear your service trust is there for asset protection reasons don't make good reading in the bankruptcy courts!

Why is (c) correct?

As all practitioners know, it is prudent to suggest that clients don't speak to the ATO unless their accountant is present (and possibly their lawyer too). This is not to put up walls against the ATO, but rather to protect the client's best interests and ensure the arrangements are on a professional footing.

I would suggest it is rarely wise to cite tax savings or asset protection as a reason for doing anything. There are legitimate and proper purposes for using service trusts including: Business Succession Planning, Estate Planning, keeping your businesses separate, family law (to keep your spouse happy) and modern business structures.

Lesson 2 - Set up your structures properly

Poorly drafted or incorrectly implemented service trust arrangements are the kiss of death!

So how to set up a service trust?

1. Make sure the core business structure is up-to-date. Update trust deeds and the Constitution.

2. Set up the new service trust vehicle: family trust, unit trust, hybrid trust or company. You now have your service trust (or service company - quite rare). The service trust provides as many services as it can to the main business: this includes cleaning, secretarial, serviced offices, book-keeping, chattel leasing, property leases etc.

3. Build a Service Trust Agreement. This is the "glue" between the core business and the service trust.

What are the other benefits of a service trust? They include:

- Asset protection - riskier assets can be held in the service trust. Use them to create services to the professional entity for a fee.
- Income splitting - The person or business getting paid to provide services can be different to the business receiving the services.
- Challenges to Wills - Family Trust assets can't generally be challenged by children and parents (only your spouse, mistress and defacto).
- Modern Business structures - if you have an old \$2 shelf company, then you are subject to over-regulation under the Corporations Act. Trusts generally are less regulated.

Lesson 3 - Charge commercial rates

The mantra is:

"My service trust always acts as though it is arm's length and a genuine business".

Your service trust can't be a sham or non-commercial. Forget about "mark-ups". A commercial business doesn't charge "mark-ups". It charges what the market can bear. It can only charge what the market would charge in a normal arm's length transaction. Not sure of what the market will bear? Then get some quotes from other businesses in that industry. Is your service trust providing exceptional quality administrative services? Then you can charge more - but only if the market would charge this amount anyway.

The case *FACT v Phillips* (1978) 8 ATR 783 is the most telling High Court authority regarding service trusts. The use of service

entities was accepted as explicable on commercial grounds. While the Commissioner accepts the correctness of the decision in *Phillips* (see Rulings IT 276 and TR 2006/2), the case is not authority for the proposition that expenditure made under a service arrangement and calculated using the particular mark-ups adopted in that case will always be deductible under s 8-1. Note also that in a subsequent tax statement, the Deputy Commissioner of Taxation stated (correctly in my view):

"There may have been widespread use of service trust arrangements which involved payments that were grossly excessive in relation to the benefit conferred by the service arrangement."

The Deputy Commissioner is correct. Service trusts are completely legal - as long as they are on valid commercial grounds. But what are valid commercial grounds?

The answers to the following questions will tell whether a service trust arrangement needs to be reconsidered before the ATO gives a friendly knock on the door.

- In all honesty, are the service fees charged grossly excessive or disproportionate to the benefits provided?
- Would an outside business pay the same money for the same product or service?

- Is the distinction between the service entity and the business blurred?
- Does the service entity make profits without actually ever doing anything?
- Is there a failure to keep good records of your service trust dealings?
- Is the service entity assured profits without there being any explanation?
- Are services provided without any consideration of their value to the professional entity?
- Is there an independent contractor's agreement (or Service Trust Agreement)?

Ruling TR 2006/2 acknowledges that where the benefits conferred by a service arrangement provide an objective commercial explanation for the whole of the expenditure made under the arrangement, the expenditure will be deductible under s 8-1. Service trusts need not be scary creatures! There are road maps and rules to follow that make their use safe.

[Brett Davies is co-author, with his colleague Tim Pepper, of the Estate Planning chapter of the Thomson Reuters Australian Financial Planning Handbook.]