TAX TIME TALKS: DEDUCTIONS AND SERVICE TRUSTS FOR LAWYERS

A paper presented by Michael Bennett for the NSW Law Society on 18 June 2013

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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. Overview

1.1 Being June, again, this talk is focused on what expenses lawyers can properly deduct in the 2013 tax year. Specifically, it will cover:

1.1.1 Assessability of reimbursements received by lawyers;

1.1.2 Deductibility of expenses of lawyers, including clothing and work related utensils;

1.1.3 Fees;

1.1.4 Fines; and

1.1.5 The proposed legislation regarding self-education expense deductions.

1.2 It will cover another topic that may not be purely deduction driven but are highly relevant to any lawyers final tax position. That is the use to be made of service trusts. In this way the presentation will focus on deductions for employed solicitors and structuring for principals of firms or sole traders.

1.3 The Australian Taxation Offices review of lawyers and accountant's tax compliance from 2000[1] is reason enough to ensure employee lawyers and principals of firms get their tax characteristics correct.

2. Assessment and Deductions Generally

2.1 Before focusing on the Commissioner of Taxation's ('**Commissioner**') specific guidance on these issues it pays to briefly note the legislative basis of an employed solicitor's liability to tax and ability to claim properly incurred allowable deductions.

The Tax equation

2.2 An employed solicitor, being an individual, is obliged to bring to account their 'assessable income'. From that they can deduct their allowable deductions. The remaining figure is their 'taxable income' on which they are assessed to tax. This is the equation in s 4-15(1) of the *Income Tax Assessment Act* 1997 (Cth) (the '**1997 Act**').

Income

2.3 There are classifications of income under the income tax legislation. This is significant because the term 'income' is not defined in the legislation; we turn to the common law for guidance.

[1] See Deputy Commissioner Mark Konza's speech to the *Taxation Institute of Australia* on 31 March 2009: 'Is the Tax Office widening its crackdown on lawyers and accountants?'

Further, what, if any, allowable deductions you may claim will depend on the type of income you are deriving.

2.4 Your assessable income includes 'ordinary income' (s 6-5(1) of the 1997 Act) and further amounts that are not ordinary income but which the income tax legislation includes as assessable to you. This is 'statutory income' (s 6-10 of the 1997 Act). A common form of statutory income is a capital gain realized in that income year. '*If an amount is* not *ordinary income, and is* not *statutory income, it is not assessable income (so you do not have to pay income tax on it).'*: s 6-15(1) of the 1997 Act.

2.5 Salary or wages are income according to ordinary concepts and therefore fall within ordinary income. So too does drawings/distributions from a partnership or, if an incorporated legal practice, dividends from a company. The primary source of revenue from billable work will therefore be assessable as ordinary income.

2.6 There are two further categories of income in the income tax legislation:

2.6.1 *Exempt income*: which is income that the income tax legislation or some other Commonwealth law exempts from income tax: s 6-20(1) of the 1997 Act; and

2.6.2 *Non-assessable non-exempt income*: which is any income that is not assessable (because it is not ordinary income or statutory income) and is not exempt income.

2.7 By note 1 to s 6-15(3) of the 1997 Act you cannot deduct any loss or outgoing incurred in deriving an amount of non-assessable non-exempt income. This is then confirmed in s 8-1(2)(c) of the 1997 Act, discussed in the next paragraph. For reference, s 11-55 contains an extensive list of items that will be non-assessable non-exempt income.

Deductions

2.8 Division 8 of the 1997 Act deals with deductions. These are called 'general deductions'. By s 8-1(1) you are permitted to deduct from your assessable income any loss or outgoing to the extent that it was incurred in gaining or producing your assessable income or it was necessarily incurred in carrying on a business for that purpose. Subsection 8-1(2) of the 1997 Act then limits this broad approach. It pays to set out s 8-1 in full as reference is made to it later:[2]

> (1) You can ***deduct*** from your assessable income any loss or outgoing to the extent that:
>
> (a) it is incurred in gaining or producing your assessable income; or
>
> (b) it is necessarily incurred in carrying on a * business for the purpose of

[2] See paragraph 5.5 below.

gaining or producing your assessable income.

Note: Division 35 prevents losses from non-commercial business activities that may contribute to a tax loss being offset against other assessable income.

(2) However, you cannot deduct a loss or outgoing under this section to the extent that:

(a) it is a loss or outgoing of capital, or of a capital nature; or

(b) it is a loss or outgoing of a private or domestic nature; or

(c) it is incurred in relation to gaining or producing your * exempt income or your * non-assessable non-exempt income; or

(d) a provision of this Act prevents you from deducting it.

For a summary list of provisions about deductions, see section 12-5.

(3) A loss or outgoing that you can deduct under this section is called a ***general deduction*** .

2.9 But Division 8 is not the only deduction provisions of the income tax legislation. It recognizes this in s 8-5 which allows deductions where other provisions permit it and limits deductions otherwise available if other provisions restrict it. A deduction allowable because of a provision outside Division 8 of the 1997 Act is called a 'specific deduction'.

2.10 The specific deduction provisions have particular relevance to lawyers as some of them may be available as a deduction.

3. TR 95/9 & the Ruling System

3.1 The Commissioner has expressed his view on what allowances and reimbursements are assessable to, and what losses or outgoings can be deducted by, an employee lawyer. It is *Taxation Ruling* TR 95/9: *Income Tax: employee lawyers – allowances, reimbursements and work-related deductions.* This will be the focus of this presentation (together with the use of service trusts).

3.2 I note, however, this is the Commissioner's view of the relevant income tax law and authorities. Many times have the Courts interpreted such law differently to that contained in the Commissioner's pronouncements. This will comfort those of you taking an opposing view to that expressed by the Commissioner; but it is a hollow victory unless you are willing to prove your interpretation in the Administrative Appeals Tribunal or the courts.

3.3 The Commissioner can[3] and does provides guidance as to his view on the interpretation of tax legislation (either assessing or administrative) and case law. This guidance is extremely helpful in considering your tax affairs as it is an indication how the Commissioner will treat a given circumstance.

3.4 This is especially so in relation to Taxation Rulings. The Commissioner issues various publications: for instance there are Taxation Rulings, Taxation Determinations, Interpretative Decisions, Decision Impact Statements, Private Binding Rulings, Public Statements on Law Administration and Taxpayer Alerts. Certain of them, including Taxation Rulings, will bind the Commissioner where they apply to a taxpayer who has relied on the ruling by acting in accordance with it: s 357-60 of Schedule 1 to the Administration Act. They are therefore powerful documents for a taxpayer to know. Importantly, only those parts of a ruling that state they are a public ruling hold the status. Each ruling contains various explanations or examples to assist in understanding the issues being discussed. The explanations or examples, unless otherwise stated, do not form part of the public ruling that binds the Commissioner.

3.5 *Taxation Ruling* TR 2006/10 explains the public ruling system, which includes taxation rulings. Although it applies from 1 January 2006, a public private or oral ruling in force immediately before then has effect on and after 1 January 006 as if it were made under the new rulings framework. Therefore *Taxation Ruling* TR 95/9 continues to have effect.

3.6 *Taxation Ruling* TR 95/9 states its own parameters in the first two paragraphs:

> *1. This Ruling applies to employee lawyers. For the purposes of this Ruling, an employee lawyer is a person who is employed as a solicitor, articled clerk, law clerk or as a paralegal.*
>
> 2. *This Ruling deals with:*
>
> *(a) the assessability of allowances and reimbursements received by employee lawyers; and*
>
> (b) *deductions for work-related expenses generally claimed by employee lawyers.*

3.7 It is convenient to consider assessable amounts – namely allowances and reimbursements – separately from deductions.

4. Amounts received by the employee lawyer

4.1 There are two amounts that will be considered: allowances and reimbursements. Although both deal with an employee receiving amounts they are different and treated differently for tax purposes.

[3] Under s 358-5 of Schedule 1 to the *Taxation Administration Act* 1953 (Cth) (the '**Administration Act**').

4.2 In general, a payment is considered to e a 'reimbursement' when the recipient is compensated exactly for an expense already incurred (in certain circumstances, a payment in advance of expenditure may also be treated as a reimbursement), whereas a payment is considered to be an 'allowance' when an employee is paid a definite predetermined amount to cover an estimated expense, regardless of whether the employee incurs that expense: *Taxation Ruling* TR 92/12. Therefore, an employer may prepay an 'estimate' expense for an employee lawyer, intending it to be a reimbursement, but will actually have paid an allowance.

4.3 Prior to the introduction of the *Fringe Benefits Tax Assessment Act* 1986 (Cth) the taxation of cash and non-cash fringe benefits, including certain allowances or reimbursements, was mainly governed by the former s 26(e) of the *Income Tax Assessment Act* 1936 (Cth) (the '**1936 Act**') that provides for the inclusion in a taxpayer's assessable income of all allowances, gratuities, compensations, benefits, bonuses and premiums provided to the taxpayer which related directly or indirectly to the taxpayer's employment or to services rendered by the taxpayer. Former s 26(e) of the 1936 Act became s 15-2 of the 1997 Act, which now has residual operation because it *does not* apply to a benefit that is a fringe benefit under the FBT legislation or to an amount that is assessable as ordinary income under s 6-5: s 15-2(3)(d) of the 1997 Act.

Allowances

4.4 It is first to be noted that the '*receipt of an allowance does not automatically entitle an employee lawyer to a deduction.': Taxation Ruling* 95/9 at paragraph 10. If received, allowances fall into the following categories:

4.4.1 Fully assessable to the employee with a possible deduction allowable, depending upon individual circumstances;

4.4.2 Fully assessable to the employee with a deduction allowable even though an allowance is received;

4.4.3 Fully assessable to the employee with a deduction allowable for expenses incurred subject to special substantiation rules (see paragraph **Error! Reference source not found.**); and

4.4.4 Not assessable to the employee because the employer may be subject to fringe benefits tax.

4.5 Thus, the allowance will always be assessable to the employee lawyer, unless the employer is subject to fringe benefits tax, and the question becomes what deductions are available. Deductions are considered under the next heading.

4.6 The reference in paragraph 4.4.3 to substantiation provision is the Commissioner's annual Taxation Ruling that indicates amounts considered reasonable in relation to expenses for overtime meal expenses, domestic travel expenses and overseas. No substantiation is required

if an allowance is received and the amount of the claim for expenses incurred is no more than the 'reasonable amount' determined in the Commissioner's annual ruling. However, if the deduction claimed is more than the reasonable amount, the whole claim must be substantiated, not just the excess over the reasonable amount.

Reimbursements

4.7 '*Generally, if an employee lawyer receives a reimbursement, the amount is not required to be included in his or her assessable income and a deduction is not allowable'*: *Taxation Ruling* TR 95/9 at paragraph 14. This is a practical approach which removes the need to account for the allowance as income and claim the corresponding expense. The payment remains deductible to the employer (provided it otherwise satisfies the requirements).

4.8 There are, however, some reimbursements that do not fall within this general category:

4.8.1 If motor vehicle expenses are reimbursed by an employer on a cents per kilometer basis, the amount is included as assessable income of the employee lawyer under s 26(eaa) of the 1936 Act. The employee lawyer may be otherwise claiming motor vehicle expenses, to which see paragraph 5.36 below.

4.8.2 If the reimbursement by an employer is for the cost of a depreciable item (such as a laptop computer) a deduction is allowable to the employee lawyer for the depreciation.

5. Deductible amounts

5.1 Other than a 'tax offset', which reduces the tax payable dollar-for-dollar, a deduction is the way to reduce tax payable. However, paragraph 18 of *Taxation Ruling* TR 95/9 tells us that a deduction is only allowable if an expense:

5.1.1 Is actually incurred;

5.1.2 Meets the deductibility tests; and

5.1.3 Satisfies the substantiation rules.

5.2 Each of these three requirements is considered before some commonly incurred expenses are discussed. The significance of them, however, is that they show the trend of deductibility. The detailed consideration of commonly occurring items (set out below) are examples of these common rules applied to specific circumstances. An understanding of the general rules therefore assists analyzing the specific circumstances.

Expenses actually incurred

5.3 Although somewhat obvious to state, the expense must actually be incurred by the employee lawyer to be considered for deductibility. A deduction is not allowable for expenses not

incurred by an employee lawyer. For instance, if an item would normally be payable but the taxpayer obtains it without charge for some reason the usual price cannot be claimed.

5.4 I note, for completeness, that s 51AH of the 1936 Act denies a deduction to the employee lawyer if the expense is reimbursed (see paragraphs 4.7 and 4.8 above concerning reimbursements).

Deductibility test

5.5 The basic test for deductibility of work-related expenses are set out in s 8-1 of the 1997 Act, to which see paragraph 2.8 above. Before the 1997 Act the general deduction provision was s 51(1) of the 1936 Act. It has been held that authorities relating to s 51 apply with equal force to the interpretation of s 8-1.

5.6 A number of significant authorities have determined that for an expense to satisfy the positive requirements of the general deduction tests:

5.6.1 It must have the essential character of an outgoing incurred in gaining assessable income or, in other words, of an income producing expense: *Lunney v FCT; Fayley v FCT* (1958) 100 CLR 478;

5.6.2 There must be a nexus between the outgoing and the assessable income so that the outgoing is incidental and relevant to the gaining of assessable income: *Ronpibon Tin NL v FCT* (1949) 78 CLR 47;

5.6.3 It is necessary to determine the connection between the particular outgoing and the operations or activities by which the taxpayer most directly gains or produces his or her assessable income: *Charles Moore & Co (WA) Pty Ltd v FCT* (1956) 95 CLR 344; *FCT v Cooper* (1991) 29 FCR 177; *Roads and Traffic Authority of NSW v FCT* (1993) 43 FCR 223; and *FCT v Hatchett* (1971) 125 CLR 494.

5.7 There is then the negative limbs that may exclude otherwise allowable deductions. By subsection 8-1(2), in four circumstances your deduction is denied: if it is of capital or of a capital nature, if it is private or domestic, if it is incurred in relation to gaining exempt income or non-assessable non-exempt income and where a provision of the income tax legislation expressly denies the deduction.

5.8 It should be made clear that private or domestic expenditure is considered to include costs of living such as food, drink and shelter. For instance in *Case T47* 18 TBRD (NS) 242 at 243 J F McCaffrey (Member) said:

> *In order to live normally in our society, it s requisite that individual members thereof be clothed, whether or not they go out to work. In general, expenditure thereon is properly characterized as a personal or living expense …*

5.9 There are therefore limits on how far your deductions will be permitted.

Substantiation rules

5.10 The income tax legislation requires substantiation of certain work-related expenses. However, if the total of these expenses is $300 or less, the employee lawyer can claim the amount without getting written evidence of the expenditure.[4] A record of how the claim was calculated must be retained.

5.11 Otherwise, a deduction is not allowable if substantiation of the expense cannot be made.

Commonly incurred expenses

5.12 The common work-related expenses an employee lawyer incurs, and the extent to which they are allowable deductions, is discussed below. I have set them out in alphabetical order so that easy reference may be made to them at a later time. It may prove beneficial to review the entire list, rather than merely as a reference point, as allowable deductions you have paid but may not know are claimable could be in this list.

5.13 Admission fees: a deduction is not allowable for the cost of admission fees. These are considered to be capital or of a capital nature. For instance, in *Case J30* 77 ATC 282 a law clerk claimed a deduction for admission fees to practices as a solicitor. After admission he continued in the same employment performing the same duties on increased salary. The claim was disallowed by the majority. It was considered the expense was not incurred in doing work as a law clerk but in obtaining work as a solicitor and this would be so notwithstanding that it was with the same employer. Other cases are to the same effect.

5.14 Annual practicing certificate: a deduction is allowable for the cost of renewing an annual practicing certificate.

5.15 Answering machines, beepers, mobile phones, pagers & other telecommunications equipment: a deduction is allowable for the work-related portion of the rental cost or for depreciation on the purchase price of these items. See apportioning at paragraph 5.55 below. See also telephones etc discussed at paragraph 5.49 below.

5.16 Bank fees: a deduction is allowable, as a work-related expense, for Financial Institutions Duty ('FID') that relates to the direct depositing of salary and wages into the employee lawyer's bank accounts. A deduction is not allowable for any other bank fees as a work related expense: *Taxation Ruling* IT 2084.

[4] This does not apply to certain car, travel allowance and meal allowance expenses. See paragraph 6 below for more details.

5.17 Briefcases: A deduction is allowable for depreciation on the cost of a briefcase, to the extent of its work-related use. For example, an employee lawyer may use a briefcase to carry books and files, confidential material or legal information to court hearings or meetings (see also *Taxation Ruling* IT 2661).

5.18 Calculators and electronic organizers: a deduction is allowable for the work-related portion of depreciation on the purchase price of calculators and electronic organisers.

5.19 Childcare expenses: a deduction is not allowable for childcare expenses. This is so even if it is a prerequisite for an employee lawyer to obtain and pay for child care so that he or she can go to work to earn income. The High Court held in *Lodge v FCT* (1972) 128 CLR 171 that childcare expenditure was neither relevant nor incidental to gaining or producing assessable income and was therefore not an allowable deduction. The expenditure was also of a private or domestic nature (see also *Jayatilake v FCT* (1991) 101 ALR 11). *Taxation Determination* TD 92/154 provides further information on this issue.

5.20 Clothing, uniforms and footwear: a deduction is allowable for the costs of buying, hiring or replacing clothing, uniforms or footwear if the items are: (a) protective, (b) occupation specific, (c) compulsory[5] and meet the requirements of *Taxation Ruling* IT 2641, (d) non-compulsory but entered on the Register of Approved Occupation Clothing or approved in writing by the ATO before 1 July 1995, and (e) convention[6] but satisfy the deductibility tests explained in *Taxation Ruling* TR 94/22. For maintenance of these items see paragraph 5.34 below.

5.21 Club membership fees: a deduction is not allowable for club membership fees.

5.22 Computers and software: a deduction is allowable for depreciation on the cost of computers and software, if purchased together, that are used for work-related purposes. If the software is bought separately from the computer, a deduction is allowable in full in the year of purchase. The deduction must be apportioned between work-related and private use. See apportioning at paragraph 5.55 below.

5.23 Conferences and seminars: a deduction is allowable for the cost of attending conferences, seminars and training courses to maintain or increase an employee lawyer's knowledge, ability or skills in the legal field. In *FCT v Finn* (1961) 106 CLR 60 at 70 the High Court said, about an architect voluntarily studying architectural development overseas:

[5] A 'corporate' uniform or wardrobe (as detailed in *Taxation Ruling* IT 2641) is a collection of inter-related items of clothing and accessories that are unique and distinctive to a particular organization. Paragraph 10 of that ruling lists the factors to be considered in determining whether clothing constitutes a 'corporate' wardrobe or uniform.

[6] The Commissioner's views on the treatment of costs of buying and maintaining conventional clothing are set out in *Taxation Ruling* TR 94/22 and following the Full Court of the Federal Court's decision in *FCT v Edwards* (1994) 49 FCR 318 where Ms Edwards, the personal secretary to the wife of a former Queensland Governor established that clothing allowances were appropriate due to the number of wardrobe changes in one day. The test for this requirement remains quite high.

> *.... a taxpayer who gains income by the exercise of his skill in some profession or calling and who incurs expenses in maintaining or increasing his learning, knowledge, experience and ability in that profession or calling necessarily incurs those expenses in carrying on his profession or calling …*

However, there must be a relevant nexus with current work activities of the employee lawyer. A common example is an overseas holiday coinciding with a conference. *Taxation Ruling* TR 95/9 summarises the issue at paragraph 69:

> *If the dominant purpose in incurring the costs is the attendance at the conference, seminar or training course, then the existence of any private activity would be merely incidental and the cost would be fully deductible. If the attendance at the conference, seminar or training course is only incidental to a private activity (e.g. a holiday) then only the costs directly attributable to the conference, seminar or training course are an allowable deduction.*

It is therefore important to plan the holiday around your conferences, not your conferences around your holidays.

5.24 Depreciation of equipment: a deduction is allowable for depreciation to the extent of the work-related use of the equipment. There are two methods that can be used to calculated depreciation. The prime cost method is calculated as a percentage of the cost of the equipment. The diminishing value method is calculated initially as a percentage of the equipment's cost and therefore as a percentage of the written down value. The diminishing value method – compared to the prime cost method – provides greater deductions in the early years and less in the later years.

5.25 Driver's licence: a deduction is not allowable for the cost of acquiring or renewing a driver's licence. The costs associated with obtaining a driver's licence is a capital or a private expense. The cost of renewing the licence is a private expense. In *Case R49* 84 ATC 387 it was held that even though travel was an essential element of the work to be performed by the taxpayer, a driver's licence was still an expense that was private in nature and the cost was not an allowable deduction.

5.26 Fares: a deduction is allowable for the cost of using public transport for work-related travel. This does not include travelling from home to or from the normal place of work. See paragraph 5.50 below.

5.27 Fines: a deduction is not allowable for fines imposed under a law of the Commonwealth, a State, Territory or foreign country or by a court.

5.28 First aid courses: a deduction is allowable if it is necessary for an employee lawyer, as a designated first aid person, to undertake first aid training to assist in emergency situations. If

the cost of the course is met by the employer, or is reimburse to the employee lawyer, no deduction is allowable.

5.29 Glasses and contact lenses: a deduction is not allowable for the cost of buying prescription glasses or contact lenses. These expenses related to a personal medical condition and are therefore private in nature.

5.30 Home office expenses: a deduction is allowable for:

5.30.1 a proportion of the running and occupancy expenses if an area of the home has the character of a 'place of business'.

5.30.2 The running expenses of a private study to the extent tat the private study is used for work performed at home.

Taxation Ruling TR 93/30 distinguishes between two types of expenses:

- *Occupancy expenses* relating to ownership or use of a home, that are not affected by the taxpayer's income-earning activities. These include rent, mortgage interest, municipal and water rates, property taxes, house insurance premiums and repairs to the home; a
- *Running expenses* relating to the use of facilities in the home. These include heating/cooling and lighting expenses, cleaning costs, depreciation, leasing charges and the cost of repairs to furniture and furnishings in the home office.

A deduction is not allowable for the cost of occupancy expenses for employee lawyers who maintain an office or study at home if they carry out income-earning activities at home as a matter of convenience. Two high profile barristers have made this clear: *Handley v FCT* (1981) 148 CLR 182 and *FCT v Forsyth* (1981) 148 CLR 203.

A deduction is allowable for the cost of occupancy expense and for running expenses if an area of the home has the character of a 'place of business'.[7] This is a question of fact. In *Case 49/94* ATC 429 a sales representative claimed a deduction for home office expenses. The Tribunal held that there was no evidence that the space was dedicated to business and separate from the rest of the home. '***It is not considered that an employee lawyer, in his or her capacity as an employee, would use part of their home as a principal place of business.*** *However, an employee lawyer may also conduct a business from home.*': *Taxation Ruling* TR 95/9 at paragraph 109.

[7] This may render that part of the home subject to capital gains tax, as it would no longer satisfy the main residence exemption in Subdivision 118-B of the 1997 Act.

However, an employer may maintain an office or home study (e.g. carrying out research, reading client briefs, preparing submissions, etc). For this are to allow deductible expenses it must be exclusively used for this purpose: *FCT v Faichney* (1972) 129 CLR 38.

Additional running costs (e.g. lighting, heating and cooling) may be an allowable deduction even though an area of the home has not been set aside as a private study. The circumstances when this may occur are where the employee lawyer uses a room at a time when others are not present or uses a separate room. Evidencing this will be difficult and records should be maintained.

5.31 Insurance (income protection): a deduction is allowable for insurance premiums to the extent that they are paid to cover the loss of income: *FCT v Smith* (1981) 147 CLR 578. In *Taxation Rulings* It 208 and It 2230 the Commissioner states that policies providing for both income and capital benefits require the premiums to be apportioned and only that portion referable to the income benefits may be claimed as an allowable deduction.

5.32 Insurance (equipment): a deduction is allowable for the cost of insurance to the extent of its work-related use.

5.33 Interest: a deduction is allowable for interest on money borrowed to finance the purchase of equipment to the extent to which equipment is used for work-related purposes.

5.34 Laundry and maintenance of clothing, uniforms and footwear: a deduction is allowable for the cost of laundry and maintenance of supplied or purchased clothing, uniforms or footwear if these items are of a kind described at paragraph 5.20.

5.35 Meals: a deduction is not allowable for the cost of meals eaten during a normal working day. A deduction may be allowable if the meal costs are incurred by the employee lawyer who travels for work-related purposes. In *FCT v Cooper* (1991) 9 FCR 177 the Full Court of the Federal Court considered a professional footballer eating because of his coach's direction. At 201 Hill J said:

> *Food and drink are ordinarily private matters, and the essential character of the expenditure on food and drink will ordinarily be private rather than having the character of a working or business expense. However, the occasion of the outgoing may operate to give to expenditure on food and drink the essential character of a working expense in cases such as those illustrated of work-related entertainment or expenditure incurred while away from home.*

For instance, the Commissioner will not permit you to claim the cost of a meal over and above what you would have paid to eat at home.

5.36 Motor vehicle expenses: a deduction is allowable for the cost of using a motor vehicle for work-related travel. However, there are a number of statutory limitations to the above:

5.36.1 a depreciation balancing adjustment may be necessary on the disposal of a motor vehicle that has been used for work-related activities; and

5.36.2 a deduction is not allowable for car expenses incurred by an employee lawyer in certain circumstances where a motor vehicle is provided by an employer.

5.37 Newspapers: a deduction is not allowable for the cost of newspapers. It is a private expense. This is the case even if the information in the paper assists the employee lawyer in their work because the benefit gained is too remote and the proportion of the expense that relates directly to work is incidental to the private expenditure: see also *Case P30* 82 ATC 139.

5.38 Parking fees and tolls: a deduction is allowable for the cost of parking fees (but not fines), bridge and road tolls paid by the employee lawyer while travelling in the course of employment. For instance between offices or from the office to court.

5.39 Professional indemnity insurance: a deduction is allowable for the cost of professional indemnity insurance taken out by an employee lawyer. If the cost is met by the employer, or is reimbursed to the employee lawyer, no deduction is allowable.

5.40 Professional library: a deduction is allowable for depreciation of a professional library to the extent of its work-related use. In *Munby v Furlong (Inspector of Taxes)* [1976] WLR 410 it was held that the word 'plant' was not confined to objects that were used physically by a professional man but extended to objects used by him intellectually in the course of carrying on his profession and therefore included books purchased by a barrister for the purpose of his practice.

The content of reference material must be directly relevant to the income-earning activities. For instance, in *Case P26* 82 ATC 110 a university lecturer was allowed a claim for depreciation on legal books, but was denied a deduction for depreciation on general reading and fiction books.

A distinction is drawn between textbooks purchased for use in a course of study and books forming part of a professional library. A student's books will generally be used only during the course of study, and in most cases only during the year of purchase. A deduction is allowable for the cost of the books in the year of purchase providing there is a nexus between the study and the earning of assessable income.

5.41 Removal and relocation expenses: a deduction is not allowable for the cost of taking up a transfer in existing employment or in taking new employment with a different employer.

5.42 Repairs: a deduction is allowable for the cost of repairs to equipment to the extent that the equipment is used in income-producing activities.

5.43 Self education expenses: a deduction is allowable for the cost of self education if there is a direct connection between the course of education and the employee lawyer's current income-earning activities. These expenses include fees, travel, books and equipment. If self-education expenses are allowable but also fall within the definition of 'expenses of self education' in s 82A of the 1936 Act,[8] the first $250 is not an allowable deduction. Five general rules for self education expenses are:

5.43.1 A deduction is allowable for self education expenses if the education is directly relevant to the taxpayer's current income-earning activities. This particularly applies if a taxpayer's income-earning activities are based on skill/knowledge and the education enables him or her to maintain or improve that skill/knowledge.

5.43.2 A deduction is allowable if the education is likely to lead to an increase in the taxpayer's income from his or her current income-earning activities.

5.43.3 A deduction is not allowable if the education is designed to enable a taxpayer to get employment, or to obtain new employment or to open up a new income earning activity.

5.43.4 Self education includes courses undertaken at an education institution (whether leading to a formal qualification or not), attendance at work-related conferences or seminars, self-paced learning and study tours.

5.43.5 Self education expenses include fees, travel expenses (e.g., attending a conference interstate), transport costs, books and equipment.

In *Case U186* 87 ATC 1066 the applicant was an employee lawyer working with a legal firm, and a part-time law lecturer. He was offered a place in a Masters course in the United States and after accepting the offer, he resigned both jobs in August 1982. Both employers were willing to re-employ him when he returned and, on his return in June 1983, he resumed employment with the same legal firm. In 1984 he resigned and took up employment with a law firm in Hong Kong. In August 1985 he returned to Australia and commenced to practice law on his own account. The Tribunal held that the applicant was not entitled to a deduction for travel, study and living expense on the ground that they were not incurred 'in the course of' the derivation of any

[8] Defined as: ***"expenses of self-education"*** means expenses necessarily incurred by the taxpayer for or in connection with a prescribed course of education but does not include:
(ba) a student contribution amount within the meaning of the *Higher Education Support Act 2003* paid to a higher education provider (within the meaning of that Act); or
(bb) a payment made in respect of, or in respect of the reduction or discharge of, any indebtedness to the Commonwealth under Chapter 4 of that Act; or
(c) a payment made in respect of, or in respect of the reduction or discharge of, any indebtedness to the Commonwealth or to a participating corporation under Chapter 2B of the *Social Security Act 1991* or Part 4A of the *Student Assistance Act 1973* .

relevant income. In addition they were denied on the ground that they were incurred at a point too soon in time.

5.44 Social functions: a deduction is not allowable for the cost of attending staff dinners, client gatherings or similar functions if food, drink or recreation is provided.

5.45 Stationary: a deduction is allowable for the cost of log books, diaries, etc, to the extent to which they are used for work-related purposes.

5.46 Supreme Court library fees: a deduction is allowable if Supreme Court library fees are paid on an annual basis. This is not the case if they are paid only once, on admission. Why the Supreme Court library is singled out for mention is not known.

5.47 Suspension from practice: a deduction is no allowable for the cost of defending the right to practice.

5.48 Technical or professional publications: a deduction is allowable for the cost of buying or subscribing to journals, periodicals and magazines that have a content specifically related to an employee lawyer's work and are not general in nature.

5.49 Telephone, mobile phone, pager, beeper and other telecommunications equipment expenses: a deduction is not allowable where these items are supplied by the employer. If they are not supplied, a deduction is allowable for the rental costs or for depreciation on the purchase price to the extent of the work-related use of the item. Specifically:

5.49.1 The cost of calls that are work related are an allowable deduction.

5.49.2 The cost of installing or connecting a telephone is not deductible.

5.49.3 Rental costs, for a proportion of telephone/equipment rental cost, is deductible if the employee lawyer can demonstrate that he or she is 'on call' or required to telephone their employer on a regular basis.

5.49.4 No deduction is allowed for the cost of obtaining a silent telephone number.

5.50 Transport expenses: transport expenses include public transport fares and the costs associated with using a motor vehicle, motor cycle, bicycle, etc for work-related travel. They do not include accommodation, meals and incidental expenses. Travel expenses incurred by the employee lawyer in specific circumstances:

5.50.1 No deduction is allowable for the costs of travelling between home and the normal place of work as it is generally considered to be a private expense. Performing incidental tasks en route or travelling outside normal working hours does not alter this principle.

5.50.2 However, a deduction is allowable if the transport expenses between home and the normal place of work and the transportation of bulky equipment or material is involved. It is not available, however, if the transport is for matters of convenience. Taking files home to work on them rather than staying later in the office therefore falls short of this requirement.

5.50.3 Travel from the normal place of work (say the office) and an alternative (say court) is deductible. So to is travel back or travel directly home.

5.50.4 Likewise, travel from home to an alternative place of work (say court) for work-related purposes and then to the normal place of work or directly home is deductible.

5.50.5 Finally, travel between two places of work or travel between a place of work (employment) and a place of business is deductible.

5.51 Travel expenses: a deduction is allowable for the cost of travel (fares, accommodation, meals and incidentals) incurred by an employee lawyer when travelling in the course of employment. For instance attending an interstate conference. The general rule is that no deduction is allowed for work-related travel expenses unless written evidence, such as a receipt, is obtained. However, special substantiation rules apply to travel expenses if an employee lawyer receives a travel allowance. If the travel allowance received in relation to a claim no higher than the 'reasonable amount' (see paragraph 4.6 above) no substantiation is required. Otherwise, it is required and for the whole claim, not just that part which exceeds the reasonable amount.

5.52 Union fees and professional association fees: a deduction is allowable for annual fees paid to unions and professional associations, although a deduction is not allowable for joining fees. A deduction is not generally allowable for levies.

5.53 Wigs worn by lawyers for appearances in court: a deduction is allowable for depreciation of the cost of wigs worn by employee lawyers for court appearances.

5.54 The following table summarises the foregoing:

Expenditure	Deductible	Not Deductible
Admission fees	•	
Annual Practicing Certificate	•	
Answering machines, beepers, mobile phones, pagers and other telecommunications equipment	• (work related portion)	
Bank fees	• (FID)	• Otherwise
Briefcases	• (work related portion)	
Calculators and electronic organisers	• (work related portion)	

Childcare expenses		•
Clothing, uniforms & footwear	• (if requirements met)	
Club membership fees		•
Computers and software	• (work related portion)	
Conference and seminars	• (if improving relevant knowledge)	
Depreciation of equipment	• (work related portion)	
Driver's licence		•
Fares	• (for work related travel)	
Fines		•
First aid courses	• (if designate safety person)	
Glasses and contact lenses		•
Home office expenses	• (for the relevant portion)	
Insurance – income protection	•	
Insurance – equipment	•	
Interest	• (if borrowings used to purchase equipment for income work-related purpose)	
Laundry and maintenance of clothing, uniforms and footwear	• (for relevant items)	
Meals		• (unless certain travel meals)
Motor vehicle expenses	• (subject to certain limitations)	
Newspapers		•
Parking fees and tolls	• (if travelling in the course of employment)	
Professional indemnity insurance	•	

Professional Library	• (if work-related)	
Removal and relocation expenses		•
Repairs	• (if equipment had a work related purpose)	
Self education expenses	•	
Social functions		• (if food, drink or recreation provided)
Stationary	•	
Supreme Court Library fees	• (if renewals but not if once off)	
Suspension from practice		•
Technical or professional publications	•	
Telephone, mobile phone, pager, beeper and other telecommunications equipment expenses: *Though see the variations on this item*		• (if supplied by employer)
Transport expenses: *Though see the variations on this item*	*Depends on circumstances*	
Travel expenses	• (if in course of employment)	
Union fees and professional association fees	•	
Wigs worn by lawyers for appearance in court	•	

Partially work related

5.55 '*If an expense is incurred [by an employee lawyer] partly for work purposes and partly for private purposes, only the work-related portion is an allowable deduction.': Taxation Ruling* TR 95/9 at paragraph 19. The proportion will be determined on a case-by-case basis.

Compulsorily or voluntarily acquired items

5.56 Whether the expense is incurred voluntarily will not bear on its deductibility: see *Taxation Ruling* IT 2198. Paragraph 28 of *Taxation Ruling* TR 95/9 includes this example '*Spiro, an employee lawyer, is provided with writing materials by his employer and also voluntarily buys a $200 fountain pen for use at work. A deduction is allowable for depreciation on the cost of the pen. As the cost is less than $300, depreciation at the rate of 100% is allowable.'*

5.57 The corollary is that merely because an expense is incurred by an employee lawyer at the direction of his or her employer does not mean that a deduction is automatically allowable. In

FCT v Cooper (1991) 9 FCR 177 Hill J held that a professional footballer's purchase of food and drink at his coach's direction – to maintain weight during the football season – was a private expense. At 200 his Honour said:

> *… the fact that the employee is required, as a term of his employment, to incur a particular expenditure does not convert expenditure that is not incurred in the course of the income producing operations into a deductible outgoing.*

5.58 We see here again, the deductibility will be determined on a case-by-case basis.

6. Substantiation requirements

6.1 *Taxation Ruling* TR 95/9 at paragraph 5 says '*The substantiation provisions are not discussed in depth in this Ruling.'* That they are mentioned at all, however, shows they need to be satisfied to claim deduction.

6.2 Substantiation has been mentioned above at various times. For instance, no substantiation is required if an allowance is received and the amount of the claim for expenses incurred is no more than the 'reasonable amount' determined in the Commissioner's annual ruling: *Taxation Ruling* TR 95/9 at paragraph 13.

7. Proposed self education expenses

7.1 On 13 April 2013 the Federal Government announced a proposal to introduce a $2,000 cap per person for all work-related self-education expenses. The cap is planned to take effect from 1 July 2014.

7.2 The Treasurer's announcement includes:

> *Education expenses include formal qualifications and associated tuition fees, textbooks, stationery and travel expenses and also conferences, seminars and self-organised study tours.*
>
> *Without a cap on the amount that can be claimed under this deduction, it's possible to make large claims for expenses such as first class airfares, five star accommodation and expensive courses.*
>
> *…*
>
> *Currently employers are not liable for fringe benefits tax for education and training they provide to their employees – this treatment will be retained, unless an employee salary sacrifices to obtain these benefits. This is in recognition of the need to encourage employers to continue to invest in the skills of their workers.*
>
> *…*

According to the most recent ATO data, the typical claim for formal qualifications is less than half the proposed cap at $905. For other expenses, such as conferences, seminars and workshops, including those held locally, the typical claim is only a few hundred dollars, remaining well below the cap.

7.3 It is said the reform will save around $520 million over the forward estimates.

7.4 In May 2013 the Federal Government then released a discussion paper of the proposed changes. Expenses that will be caught within the requirements of the proposed regime include, but are not limited to:

7.4.1 Tuition fees, including fees payable under FEE-HELP and self-education expense paid with the OS-HELP loan;

7.4.2 Registration fees for conferences, workshops or seminars;

7.4.3 Textbooks and professional or trade journals;

7.4.4 Stationery and photocopying;

7.4.5 Computer expenses, including depreciation;

7.4.6 Student union fees and student services and amenities fees;

7.4.7 Accommodation and meals when participating in a course that requires a person to be away from home for one or more nights;

7.4.8 Running expenses if there is a room set aside for education purposes – such as the cost of heating, cooling and lighting that room while used for studying; and

7.4.9 Travel expenses for travel from home to a place of education and back, and from work to a place of education and back.

7.5 Other salient points to note from the *Reform to deductions for education expenses – Discussion Paper* are:

7.5.1 Where an education expense is included in a payment for broader services, the component relating to education will need to be apportioned and will be included in the calculation cap.

7.5.2 If the f the membership fee of a professional association includes a certain number of hours of professional development or training programs that are included in the membership, the education element of the membership fee must be apportioned and included in the cap.

7.5.3 T here are several expenses that will still be able to be claimed without being subject to the cap as they will be unaffected by the proposed self-education rules. These expenses are: professional membership fees, overtime meal expenses, travel expenses, home office expenses, professional indemnity and income protection insurance or protective clothing and uniform expenses.

7.5.4 Requirements for claiming education expenses or the types of expenses that may be claimed will remain the same. A taxpayer will still need to ensure that the education relates to current income producing activities of the taxpayer.

7.5.5 P repayment rules as they currently exist will remain.

7.5.6 It is not proposed that the cap be indexed.

7.6 The discussion paper indicates that the otherwise deductible rule may no longer apply to education expenses in excess of the $2,000 cap if the measure is introduced. This may result in employers being liable for FBT on any education expenses over the cap of $2,000, incurred by them on behalf of their employees. The government has indicated that it will ensure no FBT liability arises in respect of employer-provided education expense payments. This will not apply however to salary packaging arrangements.

8. Service entities generally

8.1 A service entity is the most efficient and effective means of directing wealth from professional practices, including counsel, to persons or entities associated with those professionals. For professional, ethical and tax reasons the risk-free entity should rarely be involved in the business as a participant.

8.2 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 objectives:

8.2.1 the facilitation of asset protection;

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

8.2.3 tax planning opportunities, in particular income splitting.

8.3 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"). For solicitors (or other professional firms such as accountants) the size of the firm may allow the second objective to be attained.

8.4 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.

8.5 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 professional'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.

8.6 You might expect that the Commissioner does not view these entities favorably; you would be right. It took the 1970s sanction of these entities by the Full Court of the Federal Court for their use to grow – and since then they have grown. 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.[9]

8.7 The Commissioner has summarized the issues with service entities, as he sees them, thus:[10]

> *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.*

8.8 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.

[9] *Handley v FCT* (1981) 81 ATC 4165; 41 ATR 644
[10] *Your service entity arrangements* (NAT13086-04.2006) (the "Guide") at 3

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

9. Phillips Case

9.1 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

9.2 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 employed 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 insurance cover and whether it might be impossible in the future to obtain the necessary cover at an appropriate cost.

9.3 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.

9.4 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.

9.5 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.

9.6 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.

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

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

9.7.2 a fee for provision of clerical and secretarial staff based on a 50% mark up;[11]

9.7.3 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.

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

9.9 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%.

9.10 There were multiple benefits to Fell & Starkey including:

9.10.1 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;

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

9.10.3 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

9.10.4 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).

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

First instance

[11] 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.

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

9.12.1 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

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

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

9.14 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

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

9.16 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.*

9.17 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.*

9.18 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.***
>
> [emphasis added]

9.19 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 that it does.

10. Commissioner's Response

10.1 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.*

10.2 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.

10.3 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 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 trusts 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 all 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.

10.4 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:

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

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

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

10.5 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,[12] such as *Taxation Ruling TR 2006/2*, however, the more important Guide (not being a public ruling) will not bind the Commissioner.

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

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

10.6.2 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.

10.6.3 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

[12] Section 170BA of the 1936 Act.

service charges: produce a benefit to the acquirer of the services and are commercially realistic.

10.6.4 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.

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

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

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

10.7.3 a higher rate may be appropriate if adequately benchmarked.

10.8 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.

10.9 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 lawyers are concerned – between a sole medical practitioner and a barrister or a solicitor practicing on their own. On this reasoning a 45% profit ceiling would also apply to barristers and solicitors practicing on their own. Although 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.

10.10 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.

11. Counsel's & Solicitor's dilemma

11.1 Of particular interest to barristers and solicitors practicing as a shareholder 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:

11.1.1 Disbursement of expenses such as floor fees and donations;

11.1.2 Provision of office furniture and computer equipment;

11.1.3 Maintenance of a professional library;

11.1.4 Secretarial and bookkeeping services;

11.1.5 Collection of debts; and

11.1.6 Other services agreed upon by the parties.

11.2 Further, the trustee did not offer these services to anyone other than the sole practitioner. Further, and possibly the saving grace for barristers or sole trading solicitors, 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.*

11.3 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 and sole trading solicitors however is that the Commissioner's view will be determinative unless you are willing to follow the argument through an appeal process. Most lawyers know the advantages of avoiding litigation so this may be unlikely.

12. Policy v Law

12.1 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.

13. Conclusion and Recommendations

13.1 In my view there is potential for a service trust for barristers and solicitors. 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.

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

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

13.2.2 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);

13.2.3 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;

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

13.2.5 6-8% mark-ups on supply of premises – for instance, this appears to be the rate residential real estate agents charge.

13.3 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 one-page suggestion and consideration should be given to what else may be required before adopting the suggestion. A multiple page agreement would be more favourably viewed by the Commissioner).

13.4 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 highest marginal tax rate will be applied to every dollar thereof.[13] 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 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

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

that amount is reduced to nil, cause capital gains to occur under CGT Event E4.[14] Quite often this effect is overlooked when a unit trust is involved.

* * * *

[14] 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.*