Australian Government

Inspector-General of Taxation

Review of Tax Office's management of complex issues – Case study on service entity arrangements

A report to the Minister for Revenue and Assistant Treasurer

Inspector-General of Taxation

24 January 2007

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Reviewer:

Helen Warner

Australian Government
Inspector-General of Taxation

Telephone: (02) 8239 2111
Facsimile: (02) 8239 2100

Level 19, 50 Bridge Street
Sydney NSW 2000
GPO Box 551
Sydney NSW 2001

24 January 2007

The Hon Peter Dutton MP
Minister for Revenue and Assistant Treasurer
Parliament House
CANBERRA ACT 2600

Dear Minister

I am pleased to present to you my report on findings and recommendations in respect of the review of the Tax Office's ability to identify and deal with issues concerning service entity arrangements. This review was announced as one of the three case studies which I would examine pursuant to my review into the Tax Office's ability to identify and deal with major, complex issues within reasonable timeframes. This report has been prepared under section 10 of the *Inspector-General of Taxation Act 2003* (the Act).

I have provided the Commissioner of Taxation with the opportunity to respond to the report's findings and recommendations. The Tax Office's response, including the relevant covering letters, is in Appendix 2 to the report. In finalising the report, I have fully considered the Tax Office's response.

The Tax Office agrees with the majority of my recommendations. There are, however, some recommendations where the Tax Office has disagreed completely and others where it has indicated a less than full endorsement of implementation.

The Tax Office in its principal covering letter to the report has indicated that it has disagreed with many of the recommendations and that it could not find a lot to agree with in the report. These dismissive comments do not take into account the following:

- The Tax Office has fully agreed with seven of the 12 recommendations, including five of the nine key recommendations and has partly agreed with three of the remaining five recommendations.

- During the course of this review, the Tax Office implemented a number of changes to address concerns raised during this review. These include the following:

  – The Tax Office issued final guidance on service entities which addressed a number of the concerns raised by the community on previous drafts of this guidance.

  – The Tax Office issued some public guidance on the meaning and effect of the term 'general administrative practice'. Previously there had been no such guidance material.

  – The Tax Office recommenced a process for monitoring the time it was taking to issue public rulings and determinations. This process was recommenced as a result of the Inspector-General finding that the Tax Office had halted this monitoring for a two year period.

- The Tax Office introduced a feedback process for public rulings.
- The Tax Office announced changes to its consultation processes which were in line with the Inspector-General's recommendations.
- The Tax Office modified its conduct in relation to a number of ongoing audits of service entity arrangements.

I propose to engage in a process of further dialogue with the Commissioner in relation to the two key recommendations the Commissioner does not agree with and the remaining recommendations which the Tax Office agrees with only in part. This process would, I expect, consider alternative approaches to achieving the remaining improvements sought by the review. The Tax Office was not prepared to discuss within a reasonable timeframe the recommendations from the review before the report was finalised.

One of the key recommendations that the Tax Office has expressed disagreement with relates to my view that in relation to service entities the Tax Office has changed a previous general administrative practice.

Further dialogue on this and other recommendations should be undertaken as part of the process leading up to the finalisation of my final and overall report on the Tax Office's ability to deal with major complex issues within reasonable timeframes. This report will be finalised once all case studies which form part of this overall review are completed.

I offer my thanks for the support and contribution of many government bodies, professional bodies, business groups and individuals to this review. The willingness of many to provide their time in preparing submissions and discussing issues with myself and my staff is greatly appreciated.

Yours sincerely

David Vos AM
Inspector-General of Taxation

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CHAPTER 1: INTRODUCTION

1.1 This is the report on the review conducted by the Inspector-General of Taxation (Inspector-General) of the Australian Taxation Office's (Tax Office or ATO) ability to identify and deal with issues concerning service entity arrangements. This report is made under section 10 of the *Inspector-General of Taxation Act 2003* (IGT Act).

1.2 The review was announced as one of the case studies which the Inspector-General would examine pursuant to his review into the Tax Office's ability to identify and deal with major, complex issues within reasonable timeframes. This review was announced on 31 October 2005. Its terms of reference are reproduced in Appendix 1 to this report. Details of how the review was conducted are also given in Appendix 1.

1.3 The decision to undertake the review was prompted by concerns raised with the Inspector-General by industry and tax practitioners.

1.4 A number of key and subsidiary recommendations arose from the review. These are listed in Chapter 2 which also contains a summary of the review.

1.5 Chapter 3 of the review contains a description of the nature of service entity arrangements and a history of the Tax Office's approaches to these arrangements, while Chapter 4 outlines the comments and concerns raised in submissions to this review on the Tax Office's approach to service entity arrangements.

1.6 Chapter 5 sets out the review's findings on the Tax Office's timeframes and consultation processes for dealing with service entity arrangements. Chapter 6 deals with the review's findings in relation to the Tax Office's legal and compliance approaches to service entity arrangements. Chapter 7 discusses the review's findings in relation to the Tax Office's communication processes for service entity arrangements.

1.7 During the course of the Inspector-General's review, the Tax Office made or proposed a number of changes to its processes for dealing with service entity arrangements. Some of those changes directly addressed concerns raised with the Inspector-General. All changes made or proposed by the Tax Office are noted in this report wherever relevant.

1.8 The Commissioner of Taxation's response to the review is in Appendix 2. The Commissioner's detailed comments on each recommendation of the report are set out immediately below each recommendation.

CHAPTER 2: OVERVIEW AND KEY RECOMMENDATIONS

2.1 This review has looked at how the Tax Office handled service entity arrangements. It was prompted by concerns that the Tax Office took too long to identify and resolve the tax issues associated with these arrangements and that this delay led to considerable uncertainty and (in some cases) unnecessary costs for affected taxpayers.

2.2 There is no doubt that there were compliance issues associated with the operation of service entity arrangements by a number of taxpayers and that these have persisted for a number of years. These issues included taxpayers charging service entity fees that were well in excess of commercial rates and failing to ensure that these arrangements were properly established and operated (for example, by ensuring that expenses claimed by the service entity were in fact incurred by that entity).

2.3 However, in the Inspector-General's view, the Tax Office bears some responsibility for the development of this state of affairs and its persistence during the period from 1978 until at least the middle of 2005. This is because of various actions and inactions by the Tax Office over this time period.

2.4 Service entity arrangements are commonly used within a number of professional firms. They are present in a wide range of industries (including the legal, accounting and health industries) and are present within a wide variety of different business structures (ranging from sole practitioners through to partnerships, companies and trusts).

2.5 Under these arrangements, service entities, which are usually trusts, employ staff and acquire other services, premises, plant and equipment which they on-supply to a related-party professional firm. The fee charged for these services is usually set at a mark-up to the amounts paid by the service entities for the relevant staff, services and equipment. This mark-up allows the service entity to make a profit which can be distributed to the parties who have a membership interest in the relevant service entity (usually the principals in the relevant professional firm and/or their families).

2.6 The Tax Office first challenged the deductibility of fees paid under a service entity arrangement in the 1978 case of *Phillips*.[1] However, this case upheld the validity of these types of arrangements for a professional firm where the amount charged by the service entity to the firm involved mark-ups of 50 per cent on the direct costs of staff and 6 to 8 per cent on the cost of plant and equipment.

2.7 Following this decision, the Tax Office issued a short ruling (IT 276), which it later made publicly available, where it indicated that it accepted the result in this case. This Tax Office ruling contained no comment on the specific mark-ups used in that case. The ruling noted only that the court found that the charges were not in excess of commercial rates and that this must be accepted as reasonable. It appears to have been widely believed by taxpayers and their advisers (with some justification) that mark-ups at the kinds of levels considered in the *Phillips* case would henceforth be acceptable to the Tax Office.

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1 *F C of T v Phillips* (1978) 8 ATR 783.

2.8 The Tax Office's internal assessing manual for trusts which was released to the public in 1985 appeared to confirm this understanding by taxpayers and advisers. This manual expressly stated that the *Phillips* case 'established guidelines for net fees with mark-ups approximating 50% on wages claimed in providing the service and 15% of other expenses'.[2]

2.9 During the 1990s service fees charged by the service entities of accounting firms rose considerably due to a change in the professional practice rules issued by the professional accounting bodies. This rule change permitted the service entities of accounting firms to now employ professional accounting staff as well as other staff. This rule change did not affect legal firms and their service entities continued to only employ non-legal staff.

2.10 During the 1990s a number of Tax Office staff made speeches to private audiences of tax professionals where they acknowledged that it was a common practice amongst taxpayers to apply a 50 per cent mark-up on wages and 15 per cent on other expenses in setting the fees charged by a service entity. In these speeches, the relevant officers stated that the Tax Office did not endorse any particular percentages as a suitable level for mark-ups. They also drew attention to a number of compliance issues that the Tax Office were concerned about with these arrangements.

2.11 However, the comments made in these speeches were not embodied in any formal public guidance material on service entities at this time.

2.12 Also, although these speeches in the early 1990s flagged that there were compliance issues with service entity arrangements at this time (which included the charging of possibly excessive service fees) the Tax Office did not commence any audit activity on these arrangements until late in 1999. This audit activity followed on from a project that was formally begun in 1996 to investigate the tax affairs of large accounting and legal firms. When this audit activity did begin it was confined to two large accounting firms only.

2.13 In 2001 the Commissioner flagged in his Annual Report that there were compliance concerns with service entities. These concerns were repeated in subsequent speeches and liaison group minutes but were not embodied in any formal guidance material issued to taxpayers at this time.

2.14 Following the conclusion of the audits of the service entities of two accounting firms in 2002, the Tax Office made a formal decision to address the compliance issues associated with the amount of service entities fees being claimed as deductions by issuing public guidance to taxpayers on these issues. This guidance was not however issued to the public in draft form until the middle of 2005 and in final form until early 2006. This final guidance took the form of a Tax Office Ruling TR 2006/2 and an accompanying service entities guidance booklet.

2.15 When this guidance was issued in final form the Tax Office changed the mark-ups referred to in *Phillips* case and the trusts assessing manual (and seemingly endorsed in IT 276) quite significantly. These rates were now to be a maximum of 30 per cent on labour costs and 10 per cent on equipment and were to be subject to an overriding cap of being not more than 30 per cent of the total combined net profit of the service entity and associated

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2 Australian Taxation Office, *Trusts Assessing Manual*, Chapter 13 at paragraph 14.13.2, reproduced in Appendix 4 to this report.

firm. The guidance also set out other methods of calculating service entity fees for tax purposes which did not involve the application of mark-ups to specific expenses.

2.16 When releasing the final version of the ruling and booklet the Tax Office announced that most taxpayers who might be adversely affected by the terms of the final ruling and booklet were to be given a 12 months period of grace in which to review their existing service arrangements and implement any necessary changes. This period would end on 30 April 2007.

2.17 In the final booklet, the Tax Office also stated that audits of service entity arrangements for prior year periods would be conducted (and the above 12 months period of grace would therefore not apply) where there were serious questions as to whether the services were in fact provided by the service entity and also in cases where the following three conditions were satisfied:

- the service fees were over $1 million;
- the service fees represented over 50 per cent of the gross fees or business income earned by the professional firm; and
- the net profit of the service entity represented over 50 per cent of the combined net profit of the entities involved.

2.18 Normally, when the Tax Office issues public guidance to taxpayers on the operation of the tax laws which differs from that which it has previously provided it accepts that this new guidance will operate only prospectively. This practice is embodied in various administrative and legislative guidelines concerning the effect of a change in the Tax Office's general administrative practice.

2.19 However, in the case of service entity arrangements, the Tax Office has denied that any of these rules concerning the prospective application of a change in general administrative practice apply. The Tax Office contends that its view of how the law applies to service entity arrangements as set out in its draft and final guidance on service entity arrangements that were issued in 2005 and 2006 respectively has not changed from the view on these arrangements which it initially expressed in IT 276.

2.20 The Inspector-General considers that this view is not supported by the evidence which his office has gathered during the course of this review. He considers that the changes the Tax Office has announced in setting new and lower mark-up rates that can be used to calculate service entity fees and in establishing other methods for calculating these fees amount to changes in how it is administering the law on service entity arrangements.

2.21 In this review the Inspector-General therefore finds that the Tax Office did change its view on how to calculate the amount of a service entity fee that will be deductible.

2.22 Put simply, the Inspector-General considers that the 'safe harbour' rates in the recent Tax Office booklet are essentially a proxy for what is acceptable as being 'commercial', and that the earlier rates specified in the Tax Office assessing manuals and in advice to some taxpayers were essentially the same thing. The new rates are different to the old ones and give a different result. Therefore, a change has occurred. The old assessing manuals were publicly available and, in the absence of any other guidance, used by tax advisers and tax staff, even if they were not binding on the Tax Office nor endorsed as a basis for making claims.

2.23 The review recommends (Key Recommendation 4) that the Tax Office accept and publicly acknowledge that it has changed its view and outline the consequential implications for affected taxpayers.

2.24 The Tax Office has dismissed the review's evidence and conclusions on this important point and it has disagreed with Key Recommendation 4.

2.25 The Inspector-General believes that the Tax Office's disagreement with Key Recommendation 4 reinforces the Inspector-General's Key Recommendation 6 which deals with the need for the Tax Office to provide detailed guidance, which is publicly available, of its view of when a 'general administrative practice' of the Tax Office will arise and the implications that arise when that practice has changed. The Inspector-General notes that the Tax Office has agreed with Key Recommendation 6.

2.26 Furthermore, the Inspector-General considers that the Tax Office's conduct in not clarifying its views on service entity arrangements via any announced change to IT 276 and/or to the material set out in its assessing manual until mid-2005 and in undertaking only limited and belated audit action on this issue provide further reasons for the Tax Office adopting an approach of applying its new guidelines in TR 2006/2 and its accompanying booklet on a prospective basis only.

2.27 In the light of the above comments, the Inspector General considers that the Tax Office should not be making tax adjustments for service entity arrangements conducted prior to the 12 months period of grace which is referred to in TR 2006/2 (which ends in April 2007) in cases where the only significant issue is that service fees were calculated in accordance with the 50/15 per cent method set out in the Tax Office's previous trusts assessing manual, rather than any of the methods flagged either in the draft or final version of the service entity ruling and booklet.

2.28 The view set out above would not preclude the Tax Office from investigating and making tax adjustments for service entity arrangements conducted prior to April 2007 in cases where the fees are considered to be grossly excessive, in cases of fraud or evasion, or in other cases where there are features of the arrangements which raise issues as to the genuineness of the service entity's operations during the relevant period. Examples of such features would include cases where the service entity has no staff of its own who carry out its business or where the entity has no legal entitlement to property which it allegedly supplies to the professional firm.

2.29 A prospective approach would provide important protection for service entity arrangements which are audited by the Tax Office after its current period of grace for these arrangements ends in April 2007. If such an approach is not implemented, audited entities could face retrospective adjustments, penalties and interest going back as far as 2003. This is a time before the new approaches being taken by the Tax Office were known.

2.30 The review has also found that there are issues with how and when the Tax Office pursues the payment of primary tax for previous years in cases where the Tax Office has changed a previous general administrative practice. New laws relevant to this issue were enacted following *The Review of Aspects of Income Tax Self Assessment* (the RoSA review) that was conducted by Treasury in 2004.

2.31 The Tax Office does not consider that this new law gives taxpayers protection against the payment of primary tax where, as in the case of service entity arrangements, a

new Tax Office practice is set out in a guidance booklet rather than a public ruling. The Tax Office also does not consider that this new law gives taxpayers protection where a public ruling which sets out the change is issued but that change has been made previously and the ruling simply confirms the previous change.

2.32 The Inspector-General believes that it is a fundamental principle of good tax administration that the Tax Office should not, as a general rule, pursue the payment of primary tax in situations where it has changed a general administrative practice. In his view, this principle operates regardless of the means by which the relevant change is made (that is, it does not matter whether or not the relevant change has been made by a formal public ruling).

2.33 This principle is founded on the view that in a self assessment environment it is not fair to require taxpayers to retrospectively pay tax for a previous year where they originally calculated their tax liability for the relevant year in accordance with a general Tax Office practice which existed and was widely known at the relevant time.

2.34 In the case of service entities, the Tax Office has effectively sidestepped the application of this principle. It has done so by asserting that it has not in fact made any change in its general administrative practice. It continues to make this assertion despite the overwhelming evidence which has been gathered during the course of this review that it has changed its general administrative practice in this area.

2.35 The Tax Office has then further sidestepped this principle of good administration by contending that, in any event, it only legally needs to consider this principle in the case where it has made a change in its general administrative practice by issuing a public ruling.

2.36 This principle and the overall concepts and protections of general administrative practice are only available if the Tax Office agrees that the practice existed and that it has been changed. The application and effectiveness of the general administrative practice provisions therefore rely on the Tax Office behaving fairly, objectively and being willing to admit that it has contributed to a behaviour that it seeks to change. However, the Inspector-General has noted in other reports that the Tax Office can be reluctant to admit fault, can have a tendency to defensiveness, and on occasion displays a 'win at all costs' mentality.

2.37 The Inspector-General therefore concludes that there is a systemic weakness in relying on Tax Office fairness and objectivity to provide access to the principles, protections and provisions of a changed general administrative practice.

2.38 The Inspector-General will consider this systemic issue further in the course of his final report on all three case studies which form part of his overall review of the Tax Office's ability to deal with complex tax issues. However, as a first step towards addressing this systemic issue, the Inspector-General has, in this review, made two recommendations. The first is that before any compliance enforcement activity, the Tax Office should test how well it has met its obligations to provide adequate and contemporary guidance to taxpayers on the relevant issue (Key Recommendation 1). The second is that the Tax Office should produce a practice statement giving a clear indication (with examples) of how it will consider if a general administrative practice exists and if it has been changed (Key Recommendation 6). The Tax Office has not agreed with Key Recommendation 1, but has agreed with Key Recommendation 6.

2.39 The review also found that the greater part of the final ruling as well as the booklet on service entities arrangements have been issued in the form of advice which is only administratively, not legally, binding on the Tax Office. The review notes that this does not seem to be giving full effect to the principle which underlies a number of recommendations from the previous RoSA review. This principle is that the Tax Office should provide its guidance wherever possible in the form of a legally binding ruling in the interests of providing taxpayers with greater certainty in a self assessment environment.

2.40 From this review, there is no doubt that the compliance issues associated with service entities could have been resolved much more quickly. In the Inspector-General's view public guidance on this issue could have been issued by as early as 2001 rather than in 2006. The Inspector-General notes that the Tax Office has agreed that there could have been an improvement in the timeliness of publishing the ruling and booklet for service entities.

2.41 The review has examined in some detail the reasons for the seven year delay between the Tax Office formally identifying that there were compliance issues with service entities in 1999 and the issue of the final ruling and booklet on these arrangements in 2006.

2.42 The review found that one significant cause of the Tax Office's tardiness in issuing detailed guidance on service entities during this period was that the senior Tax Office personnel who were responsible for handling service entity arrangements held an underlying belief that these arrangements were not acceptable per se. While the former Commissioner took action to quell the effect that this belief was having on the timely and objective resolution of the service entities issue in mid-2004, in the Inspector-General's view this action should have been taken much earlier.

2.43 Another reason for the Tax Office's tardiness on service entity arrangements during this period was that the Tax Office personnel who were managing this issue did not give sufficient weight to the need for taxpayers in a self assessment environment to be provided as early as possible with sufficient guidance to help them comply with the law.

2.44 A further factor which contributed to the Tax Office's tardiness in resolving this issue was that the Tax Office's existing timeliness standards for public rulings did not operate effectively.

2.45 The Tax Office has sought to defend its failure to issue final detailed public guidance on service entities any earlier than 2006 on the basis that its approach of issuing this guidance in the form of a compliance booklet setting out fact-based guidance on how to calculate the amount of service fees that would be deductible is an 'innovation'. It further asserts that this level of guidance represents a development that is 'unsurpassed by any other national tax administration in the world'.

2.46 In the Inspector-General's view, these comments ignore the vast amount of guidance material on facts based and quantum issues that the Tax Office has issued since its very early days. Furthermore, these comments suggest that senior management within the Tax Office may not wholeheartedly endorse the view that part of the Tax Office's role in a self assessment environment is to provide detailed guidance to taxpayers on how to apply the law. This is despite the fact that the provision of such guidance has been referred to in a number of key Tax Office documents as being one of its core values.

2.47 The review also found that the Tax Office's processes of communicating with the community on the service entities issue were deficient in a number of respects. It recommends the following improvements.

2.48 Firstly, the Tax Office should ensure that it is living out its core value of providing sufficient guidance to taxpayers on how to comply with the law in a self assessment system. To be effective, this guidance needs to be provided on a timely basis.

2.49 Secondly, the Tax Office should ensure that it employs appropriate communication processes to let taxpayers know its view of the application of the law to significant issues. These views should be set out in material that is accessible to all taxpayers and which is recognised by taxpayers as being a source of guidance on such issues. These views should not, as occurred in the case of service entity arrangements, only be set out in media releases, speeches given to private audiences or in minutes of liaison group meetings.

2.50 Thirdly, the Tax Office should ensure that, if its view of the law on a significant issue is made in the form of draft guidance, this draft guidance always contains a very clear statement of its intended date of effect.

2.51 The report has also found deficiencies in aspects of the Tax Office's performance standards for public rulings.

2.52 Under these standards, draft public rulings are to be issued within six months from the date of notification of the proposed ruling to the Public Rulings Branch for inclusion on the Public Rulings Program, while final public rulings are to be issued within six months of the draft ruling being issued.

2.53 The review found that the Tax Office has not been monitoring its adherence to these standards in accordance with a previous recommendation of the Auditor-General that it do so. Monitoring of the Tax Office's performance against these standards was only recommenced during this review after the Inspector-General drew attention to this lapse. This monitoring revealed that for the last two financial years only 50 per cent of public rulings have met either of these existing Tax Office standards for public rulings.

2.54 The review has recommended that the existence of these standards and the degree to which they have been met by the Tax Office should be publicised by the Tax Office in the same manner as it publicises and reports on its other performance standards.

2.55 The review also recommends that the content of these standards should be changed to better deal with complex issues that are addressed by the issue of public rulings, such as service entity arrangements.

2.56 Firstly, the Inspector-General considers that these standards should operate from when a compliance issue is first identified, rather than when the matter is first referred to a certain internal unit within the Tax Office.

2.57 Secondly, they should be altered so that if a ruling is to be accompanied by detailed practical guidance which contains commercial benchmark rates for a number of industries, such as occurred in the case of service entities, both documents are issued within a maximum period of 24 months of the relevant compliance issue being identified.

2.58 Thirdly, they should stipulate that if a ruling and any accompanying guidance material are issued more than two years after any relevant compliance issue is identified, the date of effect of both the ruling and any accompanying guidance should be prospective only.

2.59 The report also makes recommendations which address certain undesirable audit practices which came to light during the review. These recommendations seek to address the following matters:

- In a number of service entity audits, the Tax Office did not appear to be considering the individual circumstances of the relevant taxpayer.
- In some cases, these individual circumstances included the fact that the relevant taxpayer had been issued with a prior private ruling or opinion in relation to how their service entity fees should be calculated. However, the Tax Office sought to argue that these opinions were no longer valid as they had been withdrawn by subsequent speeches.

2.60 Finally, the report notes that ATO consultation processes on the service entity ruling and booklet were conducted secretly for a considerable period of time and that this led to perceptions that members of the private sector who were engaged in these consultations processes had obtained an unfair advantage for themselves and their clients over other taxpayers with service entities. The report recommends that, to prevent such perceptions arising, Tax Office consultation processes on key documents should be conducted openly at all times.

2.61 The Inspector-General's key and subsidiary recommendations from this review, together with the Tax Office's responses, are set out below.

KEY RECOMMENDATIONS

KEY RECOMMENDATION 1

Before it decides on an approach to any compliance issue, the Tax Office should test how well it has met its obligations, in a self assessment system, to provide adequate and contemporary guidance to taxpayers on the relevant issue. The Tax Office should introduce formal processes and procedures to ensure that it tests itself against this obligation before finalising the approaches that it will adopt to the relevant issue. It should not tolerate any internal culture which ignores the need to provide such adequate and contemporary guidance to taxpayers.

Tax Office response

2.62 The Tax Office does not agree with this recommendation. Providing guidance is not appropriate for every compliance issue, for example, where deliberate fraud or evasion is uncovered. In other situations where lack of understanding is a major contributor to non-compliance, an educative approach is appropriate. This approach is summarised in the compliance model applied by the Tax Office.

2.63 In relation to service entity arrangements, the Tax Office's interpretation of the law, and expectations regarding compliance, were widely known and well understood in the tax community. This is evidenced by the number of articles written by tax practitioners in widely distributed professional journals and presentations given at major tax industry conferences.

The matter was also raised at the National Tax Liaison Group (NTLG). The people represented by members at the NTLG, and the professional associations who published and conducted conferences which dealt with the Tax Office's position on service entity arrangements, account for over 95 per cent of all businesses across every industry in Australia. We observe that taxpayers do take the advice of their tax practitioners in matters like service entity arrangements.

2.64 The Tax Office's current compliance approach to service entity arrangements is consistent with the established and widely understood principles on the relevant issues involved. The central tax issue is that fees under a related-party service entity arrangement must be commercial. This has at all times been identified by the Tax Office as the tax compliance issue on which appropriate advice has been published. The answer to this issue is a question of fact which means that the correct amount deductible under the law can only be determined in relation to the circumstances of each particular arrangement. Whether a particular arrangement is commercial is a business issue and is not a tax issue.

2.65 Nevertheless, the Tax Office has responded to uncertainty on these matters of ordinary business judgment and indicated what, in its opinion, would reflect commercial conditions in the type of conventional service entity arrangements described in the booklet. Taxpayers can choose to adopt these arrangements and manage the risk of audit of their tax affairs. The degree of compliance risk borne by Tax Office in offering this approach has been subject to careful management.

2.66 We have adopted a compliance strategy that has regard to our existing advice, and most arrangements are not subject to audit under our current audit program. Only the highest risk cases are currently subject to potential audit. The selection of these cases had regard to the degree of potential non-compliance and the circumstances in which taxpayers could reasonably have complied with the law on the basis of existing guidance in case law, IT 276, and other information available at the time, without the need for the additional guidance material now in the booklet.

2.67 The Tax Office does not accept that there is any evidence of an internal culture that ignored the need for adequate and contemporary guidance. We note that reasonable views can differ on the sufficiency and appropriateness of guidance on issues. Discussion of different views in the course of developing compliance approaches are an important part of good administration and good decision making.

Inspector-General's comments on Tax Office response

2.68 The Tax Office asserts that its interpretation of the law and expectations regarding compliance were widely known and well understood in the community. However, this assertion is not supported by any of the evidence gathered during this review. It is also not supported by the community concerns which led to this review being conducted. Furthermore, this assertion is also inconsistent with the Tax Office's other statement in this response that there was uncertainty on the relevant issues.

2.69 In its more detailed response (see Appendix 2) the Tax Office cites a number of articles and speeches by practitioners as evidence that the Tax Office position was widely known. The Inspector-General notes that the vast majority of these occurred after the Commissioner had made public his concerns in his Annual Report of 2001 (tabled in November 2001).

2.70 The Tax Office's response confirms that, in the case of service entities, the Tax Office has adopted an internal culture of ignoring the need for adequate and contemporary guidance.

2.71 The Inspector-General agrees that providing guidance is not appropriate for every compliance issue (for example those involving fraud or evasion). The recommendation does not expressly deal with such cases because, as confirmed by the Tax Office elsewhere in its comments on this report (see for example its comments on paragraph 6.73), in most service entity cases there was no evidence of fraud or evasion.

2.72 In any event, Recommendation 1 is not about providing guidance on all compliance issues. It simply suggests that the Tax Office, before embarking on a compliance strategy, should check if it has contributed to non-compliance through not having provided adequate (clear and contemporary) information to enable taxpayers to comply. Evidence gathered during the course of this review indicates that the Tax Office may rush to an aggressive enforcement without fully appraising why the situation has occurred.

KEY RECOMMENDATION 2

The Tax Office's timeliness standards for public rulings should be made public in the same manner as its other service standards.

The content of these standards should be altered as follows.

Where a compliance issue arises which gives rise to the possible need to issue a ruling, the Tax Office should reach a decision to issue a ruling and then should actually issue the relevant ruling in final form no later than 12 months after the compliance issue is identified. If the ruling is to be accompanied by detailed practical guidance which contains commercial benchmark rates for a number of industries, such as occurred in the case of service entities, both documents should be issued within a maximum period of 24 months of the relevant compliance issue being identified.

If a ruling and any accompanying guidance material are issued more than two years after any relevant compliance issue is identified, the date of effect of both the ruling and any accompanying guidance should be prospective only.

Tax Office response

2.73 Agree in part, as part in existence prior to commencement of review. Timeliness standards for public rulings are already published on the ATO website. However, we do not agree with the rest of the recommendation.

2.74 First, it is not clear at what point a 'compliance issue' may be said to have arisen, making the measurement of time from that point problematic. Further, the setting of the time period to apply to such 'issues' which gives rise to the 'possible need' to issue a ruling makes the recommendation so vague as to be unadministerable.

2.75 More fundamentally, giving rulings only prospective application where the time limits suggested are not met would deny taxpayers the protection that public rulings offer. Public rulings give the Commissioner's opinion as to what the correct interpretation of the

law has always been, and so generally have both a past and future application, which taxpayers may then rely upon.

2.76 The Commissioner recognises that there may be situations where, for the proper administration of the relevant provisions, giving a public ruling both a past and future application would, on an objective consideration of all the factors, produce an unfair, absurd or unjustifiable result. This could be, for example, where the ruling departs from an earlier ruling or general practice. This was not the case in relation to service trusts.

Inspector-General's comments on Tax Office response

2.77 The Inspector-General welcomes the Tax Office's decision to publish service standards for public rulings in the same manner as it publishes its other service standards and notes that, once this recommendation is implemented, these service standards will be located in the same place as all its other service standards.

2.78 The Inspector-General also welcomes the Tax Office's confirmation that its general practice is to give a public ruling a prospective application where a failure to do so will produce an unfair, absurd or unjustifiable result.

2.79 The Tax Office's assertion that part of the recommendation is unadministerable has been made without engaging in any dialogue with the Inspector-General on the reasons for this assertion. The Inspector-General believes that the principles which underlie this recommendation can be given effect to and suggests that the Tax Office should engage in a wider dialogue with interested parties (including the Inspector-General) on this issue. The aim of these discussions should be to achieve an outcome which ensures that its timeliness standards for rulings actually achieve the result of ensuring that these rulings are issued in a timely manner.

2.80 The Inspector-General also notes that in its response to paragraph 5.85 of the review the Tax Office has agreed that for service entities 'the timeliness of publishing the ruling and booklet could have been improved on', and that two years was a reasonable time within which to have finalised its guidance on service entities.

KEY RECOMMENDATION 3

The Tax Office should monitor and assess the degree to which public rulings are meeting its internal service standards on timeliness for these rulings on at least an annual basis. The results of this monitoring and assessment process should be publicly reported in the same way as its performance against other service standards is reported.

Tax Office response

2.81 Agree, as existing prior to commencement of review.

2.82 The Tax Office already monitors and assesses the timeliness of public rulings. This information is available on the Tax Office's website.

Inspector-General's comments on Tax Office response

2.83 The Inspector-General welcomes the Tax Office's agreement with this recommendation, but notes that the Tax Office needs to remain vigilant to ensure that this

monitoring is not suspended for any significant period of time, particularly if this monitoring indicates that a significant breach of these standards is occurring. As discussed in the report, prior to this review the Tax Office had last monitored its performance against these standards for the 2003/04 year and had not taken steps to review its performance against these standards for subsequent years. The monitoring process for the 2003/04 year indicated that two-thirds of public rulings sampled under this process had not met relevant timeliness standards.

KEY RECOMMENDATION 4

The Tax Office should acknowledge, in a public statement, that it has changed its view on how to calculate the amount of a service entity fee that will be deductible with effect from the date of issue of TR 2006/2 and its accompanying booklet on 12 April 2006. It should confirm that this change will be applied prospectively from that date and that this prospective application will include a 12 months period of grace for taxpayers to adjust their service entity arrangements.

The Tax Office should, in this public statement, outline the consequences (including those relating to the remission of penalties, interest and prior year tax adjustments) that this change in view has for all taxpayers with service entities, including:

- *taxpayers who are currently subject to prior year audits of service entity arrangements;*
- *taxpayers who have entered into prior settlement arrangements with the Tax Office in relation to their service entities; and*
- *taxpayers whose service entity arrangements will be subject to audit after 30 April 2007.*

Tax Office response

2.84 Disagree.

2.85 The Tax Office's view on how to calculate service fees has not changed. IT 276 refers to the need for commercial reasons and realistic charges not in excess of commercial rates. IT 276 did not specify particular allowable rates, and this approach is consistent with the law in this area. Handbooks used by assessors in 1987 are therefore irrelevant to the calculation of commercial rates almost 20 years later. In any case, internal assessing guidelines identified rates to guide Tax Office staff in the performance of their assessing duties. The use of these rates for the purpose of making claims for service fees was not endorsed by the Tax Office, and could not be endorsed as deductible rates in terms of legal principles. The Tax Office's assessing manuals did not contain public guidance. This position was further explained in TD 1994/45 and in an addendum to TR 1992/20. Other public statements by the Tax Office consistently identified the overriding requirement for fees to be commercially realistic. Particular rates were never endorsed in public advice. This position was well understood by the tax profession, and is consistently reflected in publications and presentations by members of the tax profession.

2.86 The booklet provides additional material covering:

- the steps that can be taken to establish the commerciality of a service entity arrangement,
- information on rates that the Tax Office uses in relation to comparable fees,
- information on how the Tax Office reviews arrangements for compliance risk purposes.

2.87 The guidance material published in the booklet is not contrary to any existing general public advice, and is of a kind not previously published. Also, as commerciality is a question of fact, and commercial circumstances change over time, direct reliance on any information regarding commerciality of fees that is out of date is patently unreasonable. Such information fails to provide any support or evidence on the question whether a particular contemporary arrangement is commercially realistic.

2.88 The Tax Office has based its administration of this issue on a risk assessment approach to the compliance risks and issues involved and decisions about priorities and the application of resources available. This approach provides support for the Tax Office to meet its obligations to collect tax payable under the law and its obligations under the *Financial Management and Accountability Act 1997*.

2.89 Under this approach, a small number of service entity cases are subject to our current audit program. These cases are dealt with in accordance with the law. Our approach in these cases reflects ordinary principles on commercial dealings.

Inspector-General's comments on Tax Office response

2.90 The Tax Office's assertions that it has not changed its view on how to calculate service entity fees is not supported by any of the evidence gathered during this review.

2.91 The Inspector-General considers that the 'safe harbour' rates in the recent Tax Office booklet are essentially a proxy for what is acceptable as being 'commercial', and that the earlier rates specified in the Tax Office assessing manuals and in advice to some taxpayers were essentially the same thing. The new rates are different to the old ones and give a different result, therefore a change has occurred. The old assessing manuals were publicly available and, in the absence of any other guidance, these were used by tax advisers and tax staff, even if they were not binding on the Tax Office nor endorsed as a basis for making claims.

2.92 The Inspector-General believes that the Tax Office's disagreement with this recommendation reinforces the Inspector-General's Key Recommendation 6 which deals with the need for the Tax Office to provide detailed guidance, which is publicly available, of its view of when a 'general administrative practice' of the Tax Office will arise and the implications that arise when that practice has changed. The Inspector-General notes that the Tax Office has agreed with Key Recommendation 6.

KEY RECOMMENDATION 5

When conducting audits of any taxpayer (including any audits of prior year service entity arrangements), the Tax Office should ensure that it fully considers all the relevant taxpayer's individual circumstances. It should also, as part of the audit process, clearly demonstrate to the taxpayer that it has done so, for example, by addressing these circumstances specifically if the taxpayer has raised these circumstances in a written submission.

Tax Office response

2.93 Agreed.

2.94 The Tax Office has consistently adopted this approach in relation to its active compliance activities on service entity arrangements.

Inspector-General's comments on Tax Office response

2.95 The Inspector-General welcomes the Tax Office's agreement with this recommendation. The Inspector-General notes that evidence gathered during this review (discussed in detail in chapter 6) indicates that an approach of fully considering all the relevant taxpayer's individual circumstances was not always applied in the Tax Office's compliance activities in respect of some taxpayers. The evidence also indicates that some taxpayers perceived that the Tax Office had not considered their individual circumstances.

KEY RECOMMENDATION 6

The Tax Office should issue comprehensive guidance to its staff, in the form of a practice statement which is made publicly available, on the meaning of the term 'general administrative practice' and on the implications with regard to penalties, interest and primary tax which arise if the Tax Office has changed such a practice. This guidance should also provide practical examples and should be subject to public consultation prior to being issued.

Tax Office response

2.96 Agree.

2.97 Taxation Ruling TR 2006/10 issued on 4 October 2006 deals with this issue.

Inspector-General's comments on Tax Office response

2.98 The Inspector-General welcomes the Tax Office's agreement with this recommendation. He also notes that by agreeing to produce a practice statement on this issue the Tax Office has agreed to provide further guidance material than is currently set out in TR 2006/10.

2.99 As noted in the report, the Inspector-General considers that the comments in PS LA 2006/2, PS LA 2006/8 and TR 2006/10 are a positive first step towards providing further guidance on the meaning and application of the term 'general administrative practice'. However, as also noted in the report, he considers that more needs to be done to provide Tax Office staff with guidance on this issue in the context of both the application of

penalties, the remission of interest and the imposition of primary tax. The Inspector-General considers that comments in all three documents are too brief. They do not contain any practical examples of cases where a general administrative practice may exist but has not been set out in an ATO Practice Statement.

2.100 The Inspector-General also considers that, in the proposed practice statement, the Tax Office should explain how it will administer the law whose effect is to protect taxpayers against the payment of primary tax for previous years in cases where there has been a change in general administrative practice. In the Inspector-General's view this new law should have the effect of giving taxpayers protection against the payment of primary tax for previous years regardless of the means by which the a change in administrative practice is made (that is, it should not matter whether or not the relevant change has been made by a formal public ruling).

KEY RECOMMENDATION 7

The Tax Office should ensure that when it is dealing with a compliance issue that affects a significant segment of the taxpayer population it employs appropriate communication processes to ensure that its concerns on this compliance issue are made known to that population directly and as soon as possible. The Tax Office should not seek to rely on communicating these concerns only in publications or speeches to limited audiences.

Tax Office response

2.101 Agreed in part, and that part met in this case.

2.102 The Tax Office identified potential compliance risks with the use of service entity arrangements in the legal and accounting sector in the course of reviewing tax performance in these industries. The Tax Office considers that a correct leverage point was used for the communication of our concerns with members of these professions. Speeches and articles by practitioners in these professions demonstrates a wide awareness of the issue and that our concerns were well understood.

2.103 The Tax Office does not agree that direct communication to the taxpayer population will be an effective or efficient means of communicating compliance information. Members of professional bodies involved with these speeches and articles provide advice, including tax advice, to over 95 per cent of businesses. It is also our experience that communication with this group of professionals is highly effective as a communication strategy to reach the broader business community on tax related issues. The taxpayer population affected will, in many cases not be able to be individually identified by the Tax Office and many will not be in a position to fully understand the issues involved. Communication via their agents is what they and their agents would expect.

Inspector-General's comments on Tax Office response

2.104 The Inspector-General welcomes the Tax Office's agreement in part with this recommendation. However, he notes the Tax Office's assertion that direct communication to the taxpayer population is not an effective or efficient means of communicating compliance information. This assertion strongly implies that the Tax Office does not fully appreciate that communicating with tax advisers does not equate to communicating with taxpayers.

2.105 The Inspector-General notes that the Tax Office has previously been strongly criticised (for example in Senate inquiries[3]) for a failure to communicate compliance issues directly to affected taxpayers.

KEY RECOMMENDATION 8

The Tax Office should, in the interest of providing maximum certainty to taxpayers in a self assessment environment, ensure that all guidance which is of a significant nature and which applies to a substantial segment of the taxpayer population is, to the maximum extent possible, embodied in the form of guidance which is legally binding on the Tax Office.

Tax Office response

2.106 The Tax Office agrees with this in principle. The Tax Office considers material in the booklet to be inappropriate for inclusion in a public ruling. For example, indicative rates set out the Tax Office's approach to auditing arrangements and the risk of being audited.

Inspector-General's comments on Tax Office response

2.107 The Inspector-General welcomes the Tax Office's in principle agreement with this recommendation. However, he notes that the Tax Office's response does not indicate why it considers that the material it has listed in its response is not appropriate for inclusion in a public ruling.

2.108 The Inspector-General notes that one of the principles underlying the RoSA review is that all guidance which is of a significant nature and which applies to a substantial segment of the taxpayer population is, to the maximum extent possible, embodied in the form of guidance which is legally binding. This principle provides taxpayers with greater certainty in a self assessment system.

2.109 The Inspector-General also notes that the Tax Office's guidance material on service entities was one of the first guidance materials to be issued in final form after the date of effect of the changes to the rulings regime made as a result of the RoSA review. However, only a small portion of this guidance material has taken the form of a binding ruling.

KEY RECOMMENDATION 9

The Tax Office should ensure that when any form of draft guidance is issued to taxpayers, that draft always contains a very clear statement of the intended date of effect of that guidance. This requirement should be set out in a Tax Office practice statement or other internal document which provides guidance to its staff.

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3 See, for example, Parliament of the Commonwealth of Australia, Senate Economics Reference Committee, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection*, Final report, February 2002 at paragraphs 1.38 to 1.59.

Tax Office response

2.110 The Tax Office agrees.

SUBSIDIARY RECOMMENDATIONS

Subsidiary recommendation 1

The Tax Office's consultation processes with the community for public rulings should be conducted openly at all times and should commence as soon as possible during the drafting process. These processes should not involve, to any significant degree, consultation with only a select group of taxpayers that may be affected by the ruling.

Tax Office response

2.111 Agreed in part, and during the time of this review announced changes to the consultation process that are in line with this. There may continue to be situations where a public ruling is being developed to address a particular issue in a particular industry and where the development process is enhanced by consultation with a targeted group both before the draft ruling is publicly released for comment and after. In some situations, early consultation can also be effective in allowing the Tax Office to form a view on the extent of compliance and to consider the most appropriate resolution strategy in situations where the law is not being complied with.

2.112 Service entity arrangements were added to the public rulings program in January 2004. This followed the decision made in December 2003 to prepare a public ruling on the issue. The program is publicly available. Consultation with NTLG members commenced after this time.

Subsidiary recommendation 2

The Tax Office's key decision makers on any proposed public ruling (or any proposed ruling which is to be accompanied by detailed practical guidance) should be engaged in the process of developing the ruling no later than the time when that ruling and any accompanying guidance is subject to public consultation processes.

Tax Office response

2.113 This recommendation is consistent with Tax Office's management processes for priority technical issues which may lead to the preparation of a public ruling.

2.114 The NTLG serves a role in providing the tax community's perspective on the importance and merits of particular issues, including those on the public rulings program. This perspective assists the Tax Office in providing commensurate resources and leadership on issues. Feedback from this consultation resulted in escalation of the issue with direct leadership provided at Deputy Commissioner level.

Subsidiary recommendation 3

The Tax Office should state in a practice statement or other guidance document that is issued to its staff that prior year advices given to taxpayers will not be considered to have been withdrawn unless the withdrawal is specifically brought to the attention of affected taxpayers.

Tax Office response

2.115 The Tax Office will give consideration to providing guidance to staff on the circumstances in which taxpayers are entitled to rely on prior year advice.

2.116 The Tax Office notes that the application of private rulings is covered by law under which they apply for the particular years to which a ruling relates.

2.117 Tax Office publications include a commitment statement on the protection that taxpayers have when following advice in a Tax Office publication. This protection is explained on the inside front cover of the booklet on service entity arrangements.

2.118 The booklet also provides the following explanations on page 4 about specific advice that taxpayers may have acted on:

> If you have acted on specific advice from the Tax Office you would generally be excluded from our current audit program, but you may need to review your arrangements for the future. In any examination of these cases we would need to consider the terms of the specific advice and whether there are material factors relevant to the operation of the service arrangements that were not disclosed in connection with the advice.

CHAPTER 3: SERVICE ENTITY ARRANGEMENTS — NATURE OF ARRANGEMENTS AND HISTORY OF TAX OFFICE APPROACHES

NATURE OF SERVICE ENTITY ARRANGEMENTS

3.1 Service entity arrangements are commonly used within a number of professional firms. They are present in a wide range of industries (including the legal, accounting and health industries) and are present within a wide variety of different business structures (ranging from sole practitioners through to partnerships, companies and trusts). Under these arrangements, service entities, which are usually trusts, employ staff and acquire other services, premises, plant and equipment which they on-supply to a related-party professional firm. The fee charged for these services is usually set at a mark-up to the amounts paid by the service entities for the relevant staff, services and equipment. This mark-up allows the service entity to make a profit which can be distributed to the parties who have a membership interest in the relevant service entity (usually the principals in the relevant professional firm and/or their families).

3.2 Appendix 3 contains an extract from an April 2006 Tax Office publication on service arrangements which provides more detail on what the Tax Office considers to be the typical features of a service entity arrangement.

3.3 The deductibility of fees paid under a service entity arrangement was accepted by the Full Federal Court in the 1978 decision in the case of *Phillips*[4] (provided a number of conditions were met). These conditions included a requirement that commercial rates were charged by the service entity.

HISTORY OF TAX OFFICE'S APPROACHES TO SERVICE ENTITY ARRANGEMENTS

Tax Office approach up to *Phillips* case

3.4 In *Phillips* the Tax Office challenged the deductibility of fees paid under a service entity arrangement.

3.5 In *Phillips* the taxpayer was a partner in the chartered accounting firm of Fell & Starkey. In 1971 the firm set up a unit trust, with a trustee company and separate management company. Partners of the firm were to neither act as directors of these companies nor beneficially own shares. The unit holders were either the firm's partners or (more usually) their spouses, children and other associated entities. The unit trust employed all the non-professional staff of the accounting practice together with certain professional staff who conducted the firm's share registry business. It also purchased the firm's office plant, furniture and equipment. It then supplied the staff and plant, furniture and equipment to the accounting firm for a service fee which involved the cost of direct salary paid to staff being marked up by 50 per cent and the cost of the plant and equipment being marked-up by between 6 to 8 per cent. The 50 per cent mark-up for salaries was the same rate of mark-up that was then being adopted by an office personnel hire company which was a client of the accounting firm. Unpaid service fees bore interest at between 8.5 to 10 per cent per annum.

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4 *F C of T v Phillips* (1978) 8 ATR 783.

3.6 Prior to the establishment of the trust, the firm wrote to the Commissioner of Taxation stating that the trust would sell its services to the business community. However, this did not in fact occur and its services were provided only to Fell & Starkey. In its letter to the Commissioner the firm also stated that the establishment of the trust was to meet a desire of the firm to diminish the assets held by the firm and its partners and increase the assets held for the benefit of their families so as to protect these assets against legal claims that might be made against the firm. At the time of the establishment of the trust a circular was sent to partners saying that the reasons for having a service organisation were to remove the assets from the ownership of partners and to reduce income tax and death duties.

3.7 The Commissioner disallowed deductions claimed by the firm for service fees paid to the unit trust for the years ended 30 June 1972 and 1973. The taxpayer appealed against the disallowance of these deductions. The Commissioner supported the assessments on the following two grounds.

3.8 The first ground was that the fees were either not wholly deductible or were only partly deductible under the general deduction provision of the income tax law. This provision was, at the time of the case, section 51(1) of the *Income Tax Assessment Act 1936* (ITAA 1936). The modern-day equivalent, which is in very similar terms, is section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997)).

3.9 The second ground was that the service fee arrangement attracted the application of the anti-avoidance provision of the income tax law. This anti-avoidance provision was, at the time of the case, section 260 of the ITAA 1936. The modern-day equivalent of this provision is Part IVA of the ITAA 1936, which differs substantially from the former section 260.

3.10 The taxpayer appealed against the disallowance of a deduction for the service fee. The matter was heard by Justice Waddell of the Supreme Court of NSW who held that the fees were fully deductible under section 51 and that section 260 did not apply. His Honour held that the previous Privy Council case of *Europa Oil*[5] supported the fee being fully deductible under section 51 and that the previous High Court case of *Cecil Bros*[6] supported the view that section 260 did not apply.

3.11 The Tax Office appealed against Justice Waddell's decision in respect of section 51 (but not in respect of section 260) to the Full Federal Court. The Full Federal Court upheld Justice Waddell's decision and allowed the deduction. It relied on his finding (which had not been challenged in the appeal by the Tax Office) that the service fee charges were realistic and not in excess of commercial rates. The Court however noted that:

> if the expenditure had been grossly excessive, it would raise a presumption that it not been wholly payable for the services and equipment provided, but was for some other purpose.[7]

By this comment, the Court appeared to infer that if the fees had been grossly excessive a deductibility issue would then arise.

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5 *Europa Oil (NZ) Ltd (No 2) v I R Comr (NZ)* (1976) 5 ATR 744.
6 *Cecil Bros Pty Ltd v F C of T* (1964) 111 CLR 430; 9 AITR 246.
7 *F C of T v Phillips* (1978) 8 ATR 783 at page 792.

Tax Office approach from 1978 to 1985

3.12 In September 1978, in a Head Office Memorandum, Tax Office staff were advised that the Commissioner would not seek special leave to appeal against the Full Federal Court's decision in the *Phillips* case.

3.13 In the same month, the Commissioner issued a short taxation ruling to its staff on service entity arrangements. This ruling was IT 276.

3.14 In the preamble to this ruling, the Commissioner noted that a significant effect of the service entity arrangements in *Phillips* was, in his view, to divert income. However, the Commissioner stated that the taxpayer in the case was able to satisfy the trial judge that the rates charged for services by the service entity were realistic and not in excess of commercial rates and that this was a crucial finding that could not be effectively challenged on appeal.

3.15 In the preamble to IT 276, the Commissioner stated that additionally it was accepted that there were sound commercial reasons for the service entity arrangement quite apart from the tax saving. The sale of the 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.

3.16 Following the preamble, the ruling itself stated that the decision to allow a deduction in *Phillips* must be accepted as reasonable but that the decision indicated the need for a close examination of all relevant facts before deductions were allowed in cases of this kind.

3.17 IT 276 was made publicly available in September 1983 in accordance with the terms of the *Freedom of Information Act 1982*.

3.18 In 1981, the Tax Office released Taxation Ruling IT 25. This ruling dealt with the tax issues associated with the incorporation of medical practices. Paragraph 12 of this ruling noted that in a considerable number of cases service arrangements had been entered into by medical practitioners and that these arrangements generally complied with the official guidelines in this area and had been approved by the Tax Office's branch offices.

3.19 In 1985, further material on the Tax Office's approach to the case of *Phillips* became publicly available when Butterworths and CCH Australia Ltd published edited versions of the Tax Office's assessing manuals obtained under the *Freedom of Information Act 1982*. As at October 1985 these manuals were used within the Tax Office to give its assessors a guide to both the procedural and technical aspects of assessing income tax returns.[8] This was a time when the Tax Office, rather than taxpayers, assessed the amount of tax that was payable by taxpayers.

3.20 Volume 4 of these assessing manuals deals with the assessment of trusts. The relevant extract from the Tax Office internal version of this manual is reproduced in Appendix 4. This appendix indicates, by way of footnote, the parts of this document which were not reproduced in the version of this manual that was published by CCH Australia Limited.

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8 CCH Australia Limited, *Australian Taxation Office Assessing Handbook – Trust Volume 4*, Current at October 1985 at page 3.

3.21 As can be seen from Appendix 4, the version of this document that was published by CCH Australia Limited stated that the *Phillips* case 'established guidelines for net fees with mark-ups approximating 50% on wages claimed in providing the service and 15% of other expenses'. The version of this manual that was published also contained two examples from the Perth branch of the Tax Office of how these guidelines on mark-ups were to be applied, one involving where rental income was not derived by the service entity and one where such rental income was derived. The examples noted that rental income and expenses are not taken into account when determining the allowable mark-up and that the commerciality of the rent charged should be reviewed if it was considered excessive.

3.22 The assessing manual's statement that the *Phillips* case established guidelines of 15 per cent on other costs does not appear to be consistent with the facts of the case itself, which as noted above, involved mark-ups of between 6 to 8 per cent on plant and equipment.

Tax Office approach from 1985 to 1996

3.23 For the period from 1985 until 1996 the only additional guidance that was provided by the Tax Office to taxpayers generally on its approach to service entities was issued in 1988 and 1989. In these years the Tax Office issued Taxation Rulings IT 2494, 2503 and 2531 all of which contained paragraphs which referred to service entity arrangements. IT 2503 in particular confirmed that the comments in IT 25 which dealt with medical practices still applied.

3.24 During this period the Tax Office made the following comments on service entity arrangements in speeches made to groups of tax practitioners:

- In 1986 when addressing the Taxation Institute of Australia (TIA) Queensland Division's Annual Tax Convention the then Commissioner stated that 'the operation of a service company or trust where the charges are commercially realistic does not attract the operation of section 260'.

- In March 1994 an ATO officer presented a paper at a Taxation Institute of Australia Convention on service entity arrangements. This paper contained detailed comments on how to calculate service entity fees and indicated that the Commissioner was not specifically targeting service entity arrangements in its audit program at the time. It also referred to there being a common practice to apply a 50 per cent mark-up on wages in setting the fees charged by the service trust but noted that the Tax Office did not endorse any particular percentages as a suitable level for mark-ups.[9]

3.25 During this period the Tax Office also issued Taxation Determination TD 94/45, together with an addendum to Taxation Ruling TR 92/20 which stated that it considered that Taxation Office Assessing Handbooks that were issued during the period when the Tax Office itself assessed returns could not be relied on as evidence of the Tax Office's position.

3.26 There was little other activity by the Tax Office in relation to service entity arrangements during this period. However, in 1990 and 1991 the Tax Office issued at least two opinions to a major accounting firm which confirmed that mark-ups of service fees that were consistent with those set out in its previous trust assessing manual were acceptable and that these mark-ups could be applied to clients of the firm as well as to the firm itself.

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9 O'Donohue, P, *The ATO perspective on Phillips*, paper given to SA Annual Convention of the Taxation Institute of Australia, March 1994.

3.27 During this period the quantum of service fees charged by the service entities of accounting firms rose due to a change in the professional practice rules issued by the professional accounting bodies. This rule change permitted the service entities of accounting firms to now employ professional accounting staff as well as other staff. This rule change did not affect legal firms and their service entities continued to only employ non-legal staff.

Tax Office approach from 1996 to mid-2005

Public statements provided by the Tax Office

3.28 From 1996 to mid-2005 statements by the Tax Office on its approach to service entity arrangements increased. However, the statements provided during this period did not take the form of a ruling or other public advice. Taxpayers not could rely on these statements either legally or under the Tax Office's administrative practices for treating certain forms of its advice as being binding. The statements that were made were as follows.

3.29 In May 1998 a paper was presented at a Taxation Institute seminar by an ATO officer. This paper noted that some taxpayers believed that a rule of thumb existed that a 50 per cent mark-up on wages and a 15 per cent mark-up on all other costs would always be accepted by the Tax Office. However, the paper noted that all cases had to be determined on their own facts.[10]

3.30 In November 1998 another paper on service entities was delivered by an ATO officer at a TIA seminar.[11] This paper noted that the Tax Office had accepted for some time that professional practitioners could establish service entities to provide non-professional and administrative duties. The paper discussed the potential application of Part IVA to these arrangements and concluded that such arrangements, where they were established on a commercial footing and where the rates payable were realistic, would not warrant the application of Part IVA. However, it did flag that where these arrangements involved the service entity employing professional staff to provide professional services rather than administrative staff then the Commissioner would examine the case to see if Part IVA might apply.

3.31 The paper also flagged that, although certain mark-up rates were accepted in the *Phillips* case it would be quite inappropriate for the Commissioner to say that those rates were acceptable in all cases.

3.32 The paper further stated that the Tax Office did not intend at that stage to challenge the validity of such arrangements by litigation. Neither this paper nor the previous May 1998 paper flagged that the Commissioner was investigating service entity arrangements as part of a legal and accounting project it had begun in 1996. This project is discussed further below.

3.33 In November 2001 the Commissioner in his 2000/2001 Annual Report, in the chapter dealing with 'Aggressive Tax Planning', noted that the Tax Office had reviewed the service entity arrangements of some legal and accounting firms and that in some cases under examination the Tax Office had concerns whether the arrangements were commercial and effective for tax purposes.

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10 Forsyth, S, *Professional income structures and personal service income*, paper given at Taxation Institute of Australia Queensland State Convention, May 1998.

11 Sharma, C, *Service Entities (Trusts/ Companies): The Commissioner's Perspective*, paper given at Sunrise Seminar of the South Australian Division of the Taxation Institute of Australia, 4 November 1998.

3.34 From 2001 to 2004 the Commissioner made general references to cases involving service entity arrangements in a number of speeches, documents (such as its Annual Compliance Program) and in published minutes of National Tax Liaison Group (NTLG) meetings. In this material the Tax Office noted that the arrangements it had seen varied significantly from those reflected in *Phillips* and that there was an issue as to whether the service fees charged were commercially realistic.

3.35 In one speech[12] the Commissioner stated that the variances in arrangements that the Tax Office was seeing from those reflected in *Phillips* were as follows:

- In *Phillips*, only administrative staff were employed by the service entity, while in the arrangements seen by the Tax Office all staff of the firm (including the professional staff) were employed by the service trust.
- In *Phillips*, substantial assets such as premises and equipment were owned by the service trust, whereas in the arrangements seen by the Tax Office no such assets were held by the trust.
- In *Phillips*, the service trust was a fixed unit trust while in other arrangements seen by the Tax Office the service trusts were discretionary trusts, with distributions being based on the annual performance-based profit-sharing arrangements for the professionals who were principals or partners in the firm.
- In arrangements seen by the Tax Office the partnership was a beneficiary of the service trust.
- In these arrangements the great bulk of the partnership profit ended up in the trust.

3.36 In April 2002, an article written by a tax officer was published in the Institute of Chartered Accountants magazine. This article noted concerns that service arrangements were being used in a manner seemingly beyond the scope of the decision in the *Phillips* case.[13]

3.37 At a meeting of the NTLG held in September 2002 professional bodies raised the issue of service entity arrangements and in particular whether the Tax Office proposed to issue a ruling. The Tax Office indicated that it was not planning to issue a ruling. It sought input from the members of this group on this and other appropriate strategies to deal with concerns about service entity arrangements.

3.38 At the NTLG meeting of 26 March 2003, NTLG members sought an update from the Tax Office on the progress of the service trust issue and also sought to have the Tax Office clearly outline what arrangements were acceptable so as to provide a 'safe harbour' for taxpayers who follow them. The Tax Office advised that its review of service arrangements in the legal and accounting sectors would continue and that, on completion, it anticipated issuing a discussion paper and/or public ruling setting out the Tax Office view on the way forward. The Tax Office also stated that other features of service arrangements it was seeing which raised issues as to whether the service fees were commercially realistic were as follows:

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12 Commissioner of Taxation, *Issues confronting Australia's tax system*, speech given to Financial Review — Leaders' Luncheon, 29 July 2002.

13 Fitzpatrick, K, 'ATO plans aggressive attack', *Charter*, Institute of Chartered Accountants, April 2002.

- Net mark-ups for service fees were well in excess of market rates for the provision of equivalent services. For example, in some instances the service entity was more profitable than comparable labour hire firms or the professional firm itself.

- The professional firm remained responsible for the oversight of staff and services provided by the trusts. The firm was therefore not relieved of all the employment risk associated with staff nor of the economic costs typically associated with the employment of permanent staff.

- The service arrangements were not established and conducted on an arm's length basis and documentation was poor.

- It was difficult to identify any service entity staff who were not on-hired to the professional firm and who were responsible for the operation and administration of the trust.

3.39 At the NTLG meeting of December 2003 the Tax Office invited members of the group to form a subgroup to assist with development of a ruling on service entity arrangements.

3.40 Details of other public comments made by the Commissioner during this period are provided in Appendix 5.

Other activities conducted by the Tax Office that were generally not made public

3.41 During the period from 1985 to 2005 the Commissioner also conducted certain other activities in relation to service entity arrangements. Some details of these activities were reported in the financial press. However, press reports on these activities were not based on any detailed information provided by the Tax Office, other than that which is listed above. These Tax Office activities are set out below.

3.42 In 1996 the Tax Office commenced a review which involved a data mining exercise of the accounting and legal profession. Service arrangements were one of a number of issues identified during the course of this review.

3.43 In 1998 the previous review was re-badged as an accounting and legal project which was conducted by the Tax Office's Large Business Area. Senior leadership was provided by a senior executive from the Tax Office's Aggressive Tax Planning area. This project involved sending out questionnaires covering a number of tax issues to 10 large legal and accounting firms and covered the income periods 1 July 1995 to 31 March 1998. From the responses to these questionnaires, service entity arrangements were identified as an issue which should be audited by the Tax Office to ascertain the commerciality of service fee pricing and the extent of the use of service entities for income alienation.

3.44 In 1999, a number of taxpayers, including two large accounting firms were notified that their activities would be audited, with service entity arrangements being one of the issues to be examined. In March 2002 the Tax Office decided to desist with other cases and focus its efforts on the audits of the two large accounting firms. At an internal ATO workshop held the same month to discuss the progress of these audits the Tax Office decided to look at the pricing structures of the two cases under audit to see if the service fees paid were commercially realistic. It engaged a Tax Office economist to establish the current commercial rates for independent businesses carrying on similar activities to service trusts. The methodology to be used to determine these rates was essentially the same kind of

methodology the Tax Office was using for the purposes of its rules on international profit shifting by multinational companies. These rules are also known as 'the transfer pricing rules'. Position papers on the service trust issue were presented to each firm in November 2002. The two audits were settled in 2003 and 2004.

3.45 In December 2002, the Tax Office commenced further work to identify cases where they considered there was a high risk that service trust arrangements were not being implemented in accordance with the law. Under this project, in June 2003 the Tax Office sent questionnaires to 56 accounting and legal firms to better understand their use of service entities.

3.46 During this review, the Tax Office has stated that this project was undertaken following a request to do so made by the NTLG group. The Inspector-General has not found any evidence which supports this statement and notes that the recorded minutes of 2003 NTLG meetings do not suggest that any such request was made.

3.47 In December 2002 the Tax Office decided to issue public guidance on service entity arrangements but was unsure at the time whether that guidance would be in the form of a public ruling or a practice statement. In October 2003, following advice from the Public Rulings Panel, the Tax Office decided to issue a public ruling. An embargo was then issued to Tax Office staff restricting the issue of advice in relation to the deductibility of expenses for any cases with similar features to *Phillips* service entity arrangements.

3.48 In May 2004 the Tax Office issued a preliminary version of a draft ruling on service entity arrangements to members of a special subgroup of the NTLG on a confidential basis.

3.49 In September 2004 the NTLG members involved in the confidential consultation process for the draft ruling wrote a joint letter to the Commissioner expressing concerns in relation to the project to date and seeking executive level intervention to set the project on a proper path.

3.50 The concerns expressed in this letter included the following:

- the Tax Office personnel who were engaged in the confidential consultation on the ruling did not appear to accept the legitimacy of service entities, contrary to the previously publicly expressed views of the Commissioner;
- assuming that these arrangements were legitimate, the draft ruling did not provide any form of assistance to the community by the omission of guidance in areas where the Commissioner would accept levels of charges;
- the ruling should operate prospectively; and
- the draft ruling neither addressed *Phillips* case in any detail nor accommodated the proper balance of authorities relevant to the question of deductibility.

3.51 In the same month, the Tax Office decided to issue a draft booklet alongside the proposed ruling that would provide practical guidance to taxpayers and their advisers on service entity arrangements. A first draft of this practical guidance booklet was provided to the special NTLG subgroup in December 2004, together with a further draft of the proposed ruling.

3.52 In late 2004, overall management of the service entity issue was transferred from the Large Business and Aggressive Tax Planning areas to the Small Business area of the Tax Office. The Large Business area of the Tax Office (but not the Aggressive Tax Planning area) remained involved in this issue via an internal Tax Office Steering committee. The aim of the committee was to ensure that the Tax Office approach to service entities was applied consistently, that appropriate risk analysis tools were used and that only those cases which required audit activity were targeted.

3.53 In May 2005, the Tax Office estimated that, based on figures for the 2000/01 year, the annual amount of tax that the Tax Office may not be collecting as a result of partnerships in the legal and accounting profession not correctly applying the law on service entity arrangements could be as high as $26 million (for the accounting profession) and $35 million (for the legal profession). These figures did not include any estimate of revenue leakage for service entities conducted by sole practitioners in the legal and accounting profession or by other groups of professionals. These figures were considerably less than earlier estimates made by the Tax Office of the potential revenue leakage which had ranged up to $215 million.

Tax Office approach in 2005/06

3.54 In May 2005, the Tax Office issued to the public a new draft ruling on service entities. The ruling made no mention of what the Tax Office's approach would be to auditing service entity arrangements for periods prior to the date of issue of the ruling. The new draft ruling stated that once finalised it would not replace, but rather would supplement, the previous ruling IT 276.

3.55 In June 2005 this draft ruling was supplemented by the issue of an accompanying draft booklet which set out certain indicative mark-up rates (which may be described as 'safe harbours') which the Tax Office would accept for fees paid to service entities.

3.56 This booklet contained a statement that the Tax Office would continue with its existing audit program for periods prior to the date of release of the draft ruling and booklet and would be auditing cases where the following two conditions were satisfied:

- the service fees were over $1 million; and
- the service fees represented over 50 per cent of the gross fees or business income earned by the professional firm.

This statement in the booklet confirmed a statement which the Commissioner had made to a Senate Committee about four weeks prior to the booklet being issued.[14]

3.57 The booklet also stated that the Tax Office would look at cases under its audit program where there were serious questions as to whether the services were in fact provided by the service entity.

3.58 The draft booklet indicated that under this approach about 80 prior year audits would be conducted. At a subsequent liaison group meeting, the minutes of which were

14 The statement was made at the Senate Economics Legislation Committee hearing of 2 June 2005 (see page E165 of the hearing transcript).

published in February 2006[15], the Tax Office stated that these audits would be conducted by staff of the Small Business area of the Tax Office.

3.59 The draft booklet outlined two approaches that taxpayers could choose in working out whether service fees were acceptable. The first approach was to determine comparable market prices for the relevant service provided by the service entity. The second approach was to determine comparable profits achieved by independent suppliers in respect of the same or similar services using one of two methods — either a 'cost plus 'approach or a 'net profit' approach.

3.60 The draft booklet gave 'safe harbour' mark-up rates for staff hire and equipment only for cases where a net profit approach was used. These safe harbour mark-up rates were as follows:

- for temporary staff hired by the service entity and on-hired to the practice entity: five per cent of the direct and indirect operating costs associated with the on-hiring;
- for permanent staff hire by the service entity and on-hired to the practice entity: three and a half per cent of the direct and indirect operating costs associated with the on-hiring; and
- for equipment owned by the service entity and on-hired to the practice entity: a rate which resulted in the service entity deriving a return on net assets of less than or equal to nine per cent of the written down value of the assets used in the hiring activity.

3.61 For real property leased by the service entity to the practice entity the draft booklet provided only a comparable price approach. This comparable price was stated to be equal to market rates for the relevant property plus finder fees where appropriate.

3.62 The safe harbour net profit mark-up rates for staff and equipment were calculated using a sophisticated net profit methodology of the kind that was and still is typically used by economists to determine what represents a reasonable level of profit that should be derived by a foreign owned entity from its Australian-based operations for the purposes of Australia's transfer pricing rules.

3.63 The draft booklet did not provide any 'safe harbour' rates where professional firms wanted to employ a cost plus approach to setting service fees of the kind employed in the *Phillips* case and the Tax Office's previous assessing manuals. This cost plus approach is generally perceived to be less complex and less costly than a net profit (transfer pricing) based approach.

3.64 The net profit mark-up rates provided in the booklet for staff and equipment could be converted to give approximate acceptable 'cost plus' mark-up rates. However, the booklet did not provide these conversions, not did it give any guidance on how to make them. It was therefore left to taxpayers with service entities to determine how to make these conversions and then to actually make them. Once these conversions were made, it became apparent to many of these taxpayers that the cost plus mark-ups that they had previously employed (such as the 50/15 per cent rates set out in the Tax Office's assessing manuals, the rates

15 Minutes of the meeting of the Small to Medium Enterprises Sub-committee of the National Tax Liaison Group, 26 August, 2005 at page 6. These minutes are available on the Tax Office's website at www.ato.gov.au.

referred to in previous Tax Office advice and the rates used in the *Phillips* case itself) were now no longer considered acceptable by the Tax Office. This had the result that these firms were put on notice that, in the Tax Office's view, they may have incorrectly calculated the amount of service fees that should be charged by their service entity for previous years of income.

3.65 In April 2006 final versions of the ruling and booklet were issued. The final version of the ruling (TR 2006/2) and booklet differed from the original draft versions in a number of ways. The main differences were as follows.

3.66 Firstly, the 'safe harbour' mark-up rates set out in the original draft booklet were generally re-named in the final booklet as 'comparable' market rates. During this process one of the net profit rates set out in the draft booklet (being that for equipment) was lowered.[16] The new booklet stated that these comparable rates would be the benchmark rates the Tax Office would generally apply if it conducted an audit of a service entity.[17]

3.67 Secondly, a new set of rates were provided which were higher than the safe harbour mark-up rates set out in the draft booklet. These new mark-up rates were described as 'indicative rates' and were the rates which, when applied by taxpayers, would mean that the arrangement was at little risk of being audited. However, the rates would only give this result provided they did not result in the relevant service fee being greater than 30 per cent of the combined profits of the professional firm and service entity.

3.68 These indicative mark-up rates were as follows:

- For labour hired by the service entity and on-hired to the practice entity:
  - If the net mark-up on costs method was used: 10 per cent of the direct and indirect operating costs associated with the on-hiring;
  - If the gross mark-up on costs method was used: 30 per cent of the salary and benefits of the on-hired staff, provided that all direct and indirect operating costs associated with the on-hiring were absorbed by the mark-up. Operating costs also needed to be a minimum of 18 per cent of salary and benefits.
- For expenses paid by the service entity:
  - Here, the booklet only provided a net mark-up on costs rate for determining the relevant mark-up. This was to be a maximum of 10 per cent of the direct and indirect operating costs associated with the expense payment activities.
- For equipment owned by the service entity and on-hired to the practice entity:
  - Here, the booklet only provided a gross mark-up on costs rate, which was 10 per cent of the cost to the service entity of the equipment (provided all relevant costs relating to the equipment were met by that service entity).

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16 In the final booklet, the rate for equipment was set out as being the rate which results in the service entity deriving a return on net assets of less than or equal to 7 ½ per cent of the opening written down value of the assets used in the hiring activity.

17 Australian Taxation Office, *Your service entity arrangements*, Guide Nat 13086-04.2006, April 2006 at page 14.

- For real property leased by the service entity to the practice entity: a mark-up (if any) which resulted in the rent being set at market rates plus finders fees where appropriate.

3.69 When releasing the final version of the ruling and booklet the Tax Office announced that most taxpayers who might be adversely affected by the terms of the final ruling and booklet were to be given a 12 months period of grace in which to review their existing service arrangements and implement any necessary changes. This period would end on 30 April 2007.

3.70 In the final booklet, the Tax Office also stated that audits for prior year periods would still be conducted (and the above 12 months period of grace would therefore not apply) where there were serious questions as to whether the services were in fact provided by the service entity and also in cases where the following three conditions were satisfied:

- the service fees were over $1 million;
- the service fees represented over 50 per cent of the gross fees or business income earned by the professional firm; and
- the net profit of the service entity represented over 50 per cent of the combined net profit of the entities involved.

3.71 The third of these conditions was new. It had not been announced by the Tax Office in any previous publication on service entity arrangements, although it had been referred to by the Commissioner in a statement made to a Senate Committee in November 2005.[18]

3.72 The Tax Office did not publicly reveal the number of cases it expected would now be subject to prior year audits as a result of these three conditions.

3.73 The Tax Office has also not revealed its planned audit activities on service entity arrangements after the 12 months period of grace ends on 30 April 2007. At the NTLG meeting of 15 March 2006 (the minutes of which were released on the Tax Office's website during May 2006) the Tax Office did indicate that two industries — the legal and accounting professions — were being monitored for service entity arrangements and that there were 1200 firms in the Tax Office's data base. It also advised the meeting that, as at that date, there had been a moderation of service entity returns.

18 Senate Estimates Committee hearing, transcript of 3 November 2005 at page E51.

CHAPTER 4: COMMENTS MADE AND CONCERNS RAISED BY STAKEHOLDERS ON TAX OFFICE'S APPROACH TO SERVICE ENTITY ARRANGEMENTS

4.1 Stakeholders have made a number of comments and raised a number of concerns in submissions to this review about the manner in which the Tax Office has dealt with service entity arrangements.

4.2 These comments and concerns can be divided into comments and concerns with respect to the processes the Tax Office has employed to resolve this issue (that is, concerns over the Tax Office's administration of this issue) and comments and concerns over the validity of the view which the Tax Office has reached on these arrangements (that is, concerns on whether this view is either legally correct or appropriate).

4.3 The Inspector-General is not empowered to conduct reviews into matters involving the validity of the Tax Office's view of the law on a particular matter. This report therefore does not deal with the comments and concerns raised in submissions that related to this issue.

4.4 However, this report notes that most submissions did raise strong concerns as to the validity of the Tax Office's view. These concerns particularly centred on whether the Tax Office has the power to determine what is a reasonable amount that professional firms should be entitled to deduct for fees paid to service entities where the relevant fee is not subject to any of the specific provisions of the income tax law (such as the transfer pricing provisions) which grant the Commissioner such a power.

Comments and concerns with respect to Tax Office processes applied to service entity arrangements

4.5 The comments and concerns which relate to the processes which the Tax Office has used in relation to the service entity issue which were raised in submissions fall into the following five headings:

- concerns regarding the length of time the Tax Office has taken to resolve the service entity issue;
- comments and concerns on whether the Tax Office was using the rulings and advice process as a way of altering the law to ensure that its own view prevails;
- comments and concerns relating to the Tax Office's audit approaches with respect to service entity arrangements, including whether the Tax Office was changing its prior general administrative practice on these arrangements;
- comments and concerns with respect to the consultation processes which the Tax Office employed for service entities; and
- concerns with respect to the manner in which the Tax Office has communicated its approach to service entity arrangements.

The Tax Office has taken too long to reach a final position on service arrangements

4.6 Most submissions to this review have asserted that the Tax Office has taken too long to reach a final position on service trusts. Submissions gave differing views on the length of this time period. The length of this period was regarded as being either:

- 28 years (being the time between the decision in the *Phillips* case and the issue of TR 2006/2);
- 23 years (being the time between the decision in the *Phillips* case and the date of the Commissioner's statement about his concerns on service entity arrangements in his 2001 Annual Report);
- 10 years (being the time between the Tax Office's commencement of a project on legal and accounting firms in 1996 and the date of issue of TR 2006/2);
- 8 years (being the time between the Tax Office's survey of accounting firms on the service entity issues in 1998 and the date of issue of TR 2006/2);
- 4½ years (being the time between the date of the Commissioner's statement about his concerns on service entity arrangements in his 2001 Annual Report and the date of issue of TR 2006/2);
- 2 years (being the length of time between the provision of a draft ruling on service entities to certain parties that were external to the ATO who were invited to provide their comments on that document and the date when the final ruling and booklet was issued); or
- 10 months (being the length of time between the issue of the draft and final versions of TR 2006/2 and accompanying booklet.)

4.7 An associated concern was that any delay in issuing detailed Tax Office advice on *Phillips* may indicate a systemic failure in the processes for determining what matters are to be given priority status for the Tax Office's Public Rulings program. These submissions argued that the failure of this topic to emerge on this program earlier was because the processes for giving priority status to certain topics were too heavily skewed in favour of issues that were of concern to the Tax Office (for examples issues involving revenue leakage) rather than issues of concern to taxpayers (such as how to apply *Phillips*).

Has the Tax Office used the rulings and ATO advice process to alter the law on service trusts?

4.8 A number of submissions have asserted that the Tax Office is using the ruling and booklet it has issued on service entities as a disguised and inappropriate means of challenging the decision reached in the *Phillips* case.

4.9 The Taxation Institute of Australia noted that the draft ruling contained a statement (which remains in the final ruling) that the *Phillips* 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 ITAA 1996.[19]

4.10 The submission then states that:

> It is hard to see what the case is authority for, if not authority for these very rates. It is a case determined by its facts.

4.11 The Taxation Institute's submission later states:

> Clearly the Commissioner is not bound forever by decisions against him. Law changes and Courts' attitudes shift. If the Commissioner is dissatisfied with the result in a prior case, such as *Phillips* case, and feels that its outcome is no longer appropriate, the way to challenge the existing position is either by running a test case, or else by securing the passage of amending legislation. Until either of these things occur, the Commissioner should administer the law as it stands. The appropriate means of challenging *Phillips* case is for the Commissioner to fund a test case or for him to secure a legislative amendment, not simply to announce contradictory views.

4.12 In a similar vein, some submissions have argued that the ruling has been used as an ambit claim by the Tax Office to generate more tax and that it is biased towards the Tax Office's view of the law.

4.13 On the other hand, some submissions have asserted that the ruling and booklet do not embody any change to the law on service entities and in some cases have queried whether it was necessary to issue these documents at all.

Comments and concerns on the practices which the Tax Office is adopting in service entity audits

4.14 Submissions have made a number of comments and raised a number of concerns under this broad heading.

Should the Tax Office be conducting audits on service entity arrangements for periods prior to the date of issue of the final ruling and booklet?

4.15 Submissions have generally supported the Tax Office conducting audits of service arrangements for years prior to the date of the final ruling and booklet in cases where those arrangements exhibited features of fraud or evasion. An example of such a case mentioned in submissions was where there was a serious question as to whether any services were provided by the relevant service entity.

4.16 Submissions however have varied in their support for the Tax Office conducting prior year audits of service entity arrangements which do not involve fraud or evasion. A number of submissions strongly argued that, absent fraud or evasion, no such audits should be conducted. Other submissions acknowledged that the Tax Office should audit prior years in cases where it could be said that the *Phillips* case principles were being abused. However, submissions offered different views on the circumstances in which this abuse would be present. For example, some argued that an example of a case where *Phillips* principles were

19 TR 2006/2 at paragraph 6.

being abused could be where the service entity was deriving a substantial portion of the combined profits of the professional firm and service entity. However, submissions offered different views on what level of 'substantial' profits in the service entity should give rise to the result of being subject to prior year audits.

The Tax Office has altered its general administrative practice on service entity arrangements

4.17 A number of submissions have asserted that the final Tax Office view on service entities as stated in TR 2006/2 and the accompanying booklet represents a change in the Tax Office's general administrative practice on service entity arrangements. They asserted that the Tax Office has falsely represented that there has been no such change in its practice so as to maximise the extent to which it can levy additional tax, penalties and interest on taxpayers whose service arrangements for prior years are audited.

4.18 If the Tax Office has changed a general administrative practice for service entities the Tax Office would be legally bound to consider the application of section 284-215 of the *Taxation Administration Act 1953* (TAA 1953)[20] in any service entity audit. This section would prevent it from levying an administrative penalty on a taxpayer where they have followed the Tax Office's previous practice in prior years of income.

4.19 Such a change in practice would also mean that for things done on or after 1 January 2006 the Tax Office would be legally unable to charge interest on underpaid tax to such a taxpayer under section 361-5 of the TAA 1953.

4.20 Furthermore, such a change in practice would mean that the Tax Office would need to consider whether its own rulings, other internal guidelines (such as TR 92/20 and its replacement TR 2006/10) or section 358-10 of the TAA 1953 prevented it from collecting tax underpaid by such a taxpayer.

The Tax Office has walked away from previous advice it has given

4.21 Submissions have asserted that, in audits the Tax Office has conducted on service arrangements for periods prior to the issue of the service entity ruling and booklet, the Tax Office has 'walked away' from previous advice it has given to specific taxpayers that a 50 per cent mark-up on labour costs and a 15 per cent mark-up on other expenses would be an acceptable way to determine the amount of service fee to be charged by the service entity.

Tax Office audit activity on service entities has been retrospective

4.22 Submissions have asserted that the Tax Office's approach to auditing certain service entities prior to the issue of the draft ruling and booklet has amounted to retrospective taxation. Submissions noted that a number of audits of service entity arrangements were initiated and/or completed prior to the date of either the release of the Tax Office's draft guidance on these arrangements or the release of its final guidance on such arrangements. A number of submissions also asserted that some of these audits involved questionnaires being issued to taxpayers which were based on the draft booklet at a time when that booklet was still the subject of confidential discussions and was not therefore publicly available.

Tax Office audit activity on service entities has been discriminatory

4.23 Submissions have also raised concerns that the Tax Office's approach to auditing service entities for years prior to the issue of the draft ruling only in cases where three

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20 Section 226V of the ITAA 1936 for years of income prior to 2000/01.

specific criteria are met, one of which is that the relevant service fee is over $1 million, was discriminatory.

4.24 One group of submissions asserted that this approach was discriminatory because the $1 million threshold meant that only accounting and legal firms of a certain size would be subject to this audit activity.

4.25 A second group of submissions asserted that this approach was discriminatory because the $1 million threshold meant that the accountants and lawyers who did not meet this criterion for retrospective audit activity were being given preferential tax treatment when compared with certain other sectors of the taxpaying community. These submissions noted that the Tax Office does not generally exempt taxpayers from audit activity merely because a disputed deduction is less than $1 million. They noted that a de minimus exemption of this nature did not operate during the Tax Office's audit activity on mass marketed tax effective investments or on employee benefit arrangements.

4.26 A third set of submissions asserted that partners in professional firms as at June 2005 have effectively been discriminated against, when compared with partners who retired prior to that date or with partners who have joined a professional firm after that date. These submissions asserted that retired pre-June 2005 partners have enjoyed the tax benefits associated with the original *Phillips* mark-ups and were not generally affected by the Commissioner's new approach to service entities (unless they belong to a firm being retrospectively audited). These submissions further asserted that new (that is, post-June 2005) partners were able to structure their involvement in the partnership in the light of the Commissioner's announced approach. However, taxpayers who were partners in firms as at June 2005 face the costs of having to review and, if necessary, unwind structures associated with their involvement in the firm, a process that could entail numerous costs, including additional tax costs, depending on the method of unwinding that is chosen. These submissions also noted that the Commissioner's final published guidance on service entity arrangements does not deal with any restructuring issues.

Compensating adjustments

4.27 Submissions have also stated that, in audits on service arrangements, the Tax Office is asserting that it is entitled to apply double taxation. This double taxation is said to arise because the Tax Office is asserting that the entity which has paid the fee is to be denied an income tax deduction for that fee and also that the same fee will be still be assessable as income in the hands of the service entity (or of the beneficiaries of that entity).

4.28 These submissions stated that the Tax Office claims that there is no specific power in the ITAA 1936 or elsewhere for it to make a compensating tax adjustment in these circumstances so as to reduce the tax on the fee income that has been paid by the beneficiaries of the service entity. These submissions however noted that the Tax Office accepts that if the service entity arrangement is struck down by the anti-avoidance provision (Part IVA) it does have the specific power to make such compensating adjustments.

4.29 Submissions to this review stated that by taking the stance that it only has the power to make compensating adjustments where Part IVA applies the Tax Office is effectively forcing taxpayers who wish to settle a service entity dispute to admit that the arrangement is struck down by Part IVA even where the circumstances may not warrant such a conclusion. These submissions asserted that the Tax Office should not be seeking to exert pressure on such taxpayers by relying on an ability to levy double tax in this situation. Instead the Tax Office should be seeking to penalise such taxpayers, where appropriate, only

in accordance with either the administrative penalty regime or the regime that applies for tax prosecutions.

Taxpayers' ability to challenge Tax Office view on service entities

4.30 One set of submissions has also noted that the Tax Office has to date confined its auditing of service entity arrangements to those which exist in legal and accounting firms. By doing so, it is claimed, the Tax Office has effectively prevented any challenge to the view which it has adopted on service arrangements. This is because legal and accounting firms are unwilling to challenge the Tax Office's position because the nature of their business involves representing other taxpayers in dealings with the Tax Office and this business would be seriously jeopardised if the firm was itself in dispute with the Tax Office.

4.31 Submissions have also asserted that the Tax Office has effectively minimised the prospect of challenges to its view on service entity arrangements through its process of auditing arrangements for years of income that ended up to three to four years previously. These submissions noted that, where audits are conducted over such lengthy periods, the amount of tax payable will usually include both a penalty and a significant amount of interest. As a result, the final tax payable as a result of the audit will be much greater than just the additional tax arising from the audit itself. If a taxpayer challenges the Commissioner in respect of the audit, but is unsuccessful, they will have to pay this total tax amount. These submissions asserted that the prospect of paying a tax bill of this size at the end of such a challenge is sufficient, in many cases, to deter taxpayers from launching any such challenge.

Consultation processes

4.32 Submissions have raised a number of comments and concerns under this broad heading.

4.33 A number of positive comments were made in submissions that the consultation processes on the ruling and booklet had been beneficial and had been conducted by the Tax Office in a professional manner.

4.34 The concerns that were raised in submissions about these consultation processes were as follows.

4.35 Firstly, a number of submissions stated that the consultation processes did not occur until late in the drafting process.

4.36 Second, submissions asserted that the parties that were involved in these processes did not represent all industries which have service arrangements.

4.37 Third, submissions asserted that the consultation processes on the ruling and booklet involving parties external to the Tax Office took a total time period of around two years which was too long.

4.38 Fourth, submissions asserted that key Tax Office decision makers were not engaged early in these consultation processes.

4.39 Fifth, submissions asserted that the Tax Office took a 'negotiation' style approach during these consultation processes which was inappropriate, given that the Tax Office should have been endeavouring to reach an objective view of how the relevant law should be applied.

4.40 Sixth, submissions asserted that these consultations should have been conducted in a completely open and transparent way from the time the Tax Office first became aware of the relevant issues.

4.41 Seventh, submissions asserted that certain accounting and legal firms that were involved in the confidential consultations which the Tax Office employed for the ruling and booklet gained knowledge of the Tax Office's proposed new approach to service entities earlier than other affected parties. The firms that were privy to this consultation were therefore able to adjust their tax affairs between 2002 and 2005 so that they would not be subject to retrospective audit action. Submissions claimed that this opportunity was not available to other parties that were not involved in these confidential consultations.

4.42 Finally, some stakeholders asserted that during these consultation processes they were led to believe that the Tax Office agreed with certain contentions (and that as a result the Tax Office would change the ruling or booklet to reflect this agreement) when in fact the Tax Office had not accepted the relevant contentions.

Manner in which the Tax Office has communicated its approach to service entity arrangements

4.43 Submissions have raised a number of concerns about the manner in which the Tax Office has sought to communicate its approach to service entity arrangements.

4.44 The principal concern raised in submissions to this review on the Tax Office's communication processes for service entities was that the Tax Office did not express it views on these arrangements in any formal detailed consolidated statement or set of statements until mid-2005.

4.45 A second concern was that the Tax Office's communication processes on service entity arrangements were, as a result of the confidential consultation processes it employed, carried out secretly and selectively for at least a one year period, if not longer.

4.46 Other communication concerns related to the content of the final service entities ruling and booklet. These concerns that were administrative in nature (and which are therefore matters which can be the subject of review and comment by the Inspector-General) were:

- whether the Tax Office's views as expressed in these two documents had been developed on an objective basis;
- whether these documents were needed at all;
- whether these documents were sufficiently complete and clear;
- whether the documentation requirements referred to in the booklet were too impractical and onerous; and
- whether taxpayers would be protected against retrospective taxation in the future if they followed these documents.

4.47 A number of other major concerns of an administrative nature raised in submissions which related to the content of the ruling and booklet on service entities referred specifically to the content of the draft service entity booklet. These concerns were:

- that the safe harbour mark-up rates in the draft booklet were unrealistically low and would lead to professional firms abandoning service entity arrangements;

- that no such safe harbour mark-up rates were given for cases where it was appropriate to apply a 'cost plus' methodology to determine a commercially realistic service fee; and

- that the draft booklet required all taxpayers (including small business taxpayers) to undergo a detailed benchmarking exercise to justify the size of their service entity fees that was in some respects more onerous than the benchmarking work which the Tax Office requires of multinational companies in a transfer pricing context.

The Inspector-General of Taxation notes that these major concerns have all been substantially addressed by the terms of final ruling and booklet.

4.48 Other communication-related concerns raised in submissions to this review dealt with the manner in which the Tax Office had communicated its proposed audit approaches to service entity arrangements both before the issue of the draft booklet and for the period between the date of issue of the draft booklet and the date of issue of the final booklet.

4.49 One submission asserted that the Tax Office never issued any Taxpayer Alert to highlight its concerns with service entities and should have done so at least by the time when the Commissioner first raised compliance concerns with these entities in his 2001 Annual Report.

4.50 Other submissions stated that the Tax Office failed to properly communicate its audit approaches to service entities for the period between the date of issue of the draft and final service entity booklet by:

- failing to communicate the addition of the third profits-related criterion for prior year audits at an appropriate time; and

- failing to make it clear that the 12-month period of grace to allow taxpayers to restructure their service entity arrangements referred to in the draft booklet would not end 12 months from the date of issue of that booklet but 12 months from the date of issue of the final booklet.

4.51 Submissions asserted that the failure of the Tax Office to properly communicate its views on, or approaches to, service entities in all the areas referred to above has caused unnecessary angst, uncertainty and, in some cases, unnecessary additional costs to taxpayers with service entities. They urged that the Tax Office should review its practices and procedures so that the speed, clarity, openness, impartiality, efficiency and effectiveness of the Tax Office's communication processes with taxpayers on complex matters such as service entities are all significantly improved.

CHAPTER 5: INSPECTOR-GENERAL'S FINDINGS — TIMEFRAMES AND CONSULTATION PROCESSES

5.1 This chapter deals with the Inspector-General's findings and recommendations on the Tax Office's timeframes and consultation processes for dealing with service entity arrangements.

TIMEFRAMES FOR THE TAX OFFICE TO COMPLETE ITS ACTIVITIES IN RELATION TO SERVICE ENTITIES

5.2 A timeline which summarises the key events in the Tax Office's handling of service entity arrangements in the period from 1978 to date is in Appendix 5.

5.3 This timeline indicates that the Tax Office's investigative or compliance-based activities with respect to service entity arrangements first obtained a project status within the Tax Office in June 1996. From that year it then took approximately 10 years for the Tax Office to settle additional details of its view of the law on service entities beyond that which it had set out in IT 276. It provided these additional details in TR 2006/2 and the accompanying booklet both of which were issued in April 2006.

5.4 This 10-year timeline can be broken down into the following three time periods:

- the time taken to reach a decision to issue public guidance;
- the time from when a decision to issue public guidance was made to the date when the guidance was issued to the public in draft form; and
- the time from when the guidance was issued to the public in draft form to when it was issued in final form.

Time taken to reach a decision to issue public guidance on service entity arrangements

5.5 The Inspector-General has gathered evidence which indicates that the Tax Office made an internal decision to issue further details of its view on service entity arrangements in the form of either a ruling or a practice statement in December 2002. This evidence consists of internal Tax Office material together with the published minutes of the National Tax Liaison Group meetings held in September 2002 and March 2003. At the September 2002 meeting the Tax Office indicated that a ruling on this topic was not in planning. However, by the time of the March 2003 meeting the Tax Office advised that it anticipated issuing either a discussion paper or ruling on this matter.

5.6 During the course of this review the Tax Office has rejected this evidence and asserted that a decision to issue a ruling on service entities was not made until late in 2003.

5.7 Regardless of whether the date of decision to issue a ruling was made in December 2002 or a year later, the Inspector-General considers that a decision to issue public guidance on service entities should have been made after the Tax Office formed the view (via the survey it conducted in 1998) that this matter was a significant issue for members of the

legal and accounting profession and that there was an issue about the commerciality of service entity fees that were being charged by members of those professions.

5.8 As indicated in the timeline in Appendix 5, the Tax Office reacted to the findings of its 1998 survey of legal and accounting firms by commencing an audit program on service entities. No public announcement was made of this decision at this time, nor was there any public announcement of the results of the 1998 survey. A number of taxpayers, including two large accounting firms, were notified they would be audited under this program in 1999. In November 2001, two years after these audits commenced, the Commissioner first publicly flagged that the Tax Office was auditing the service entity arrangements of some accounting and legal firms and that it had concerns with some of these arrangements. One year later, in December 2002, came the decision to issue detailed guidance to the public on these arrangements. This decision to issue further public guidance was made at about the same time as position papers were issued to the two major accounting firms whose service entity arrangements had been subject to audit since late 1999.

5.9 The Inspector-General considers that it was appropriate for the Tax Office to have commenced an audit program following the 1998 survey. However, he considers that it was not appropriate for the Tax Office to have waited until the issue of position papers to the two firms who were subject to this program to make a decision to issue detailed public guidance for the benefit of all taxpayers generally on how they should be calculating fees paid to service entities.

5.10 The Tax Office's failure to make a decision to issue this further guidance following the analysis of its 1998 survey results (which was completed by April 1999) effectively meant that for a considerable period of time the only two taxpayers that were actually aware of the Tax Office's detailed views on service entities were those that were being subject to audit.

5.11 The Inspector-General considers that the Tax Office's failure to start work on providing detailed public guidance on this matter immediately after analysing the 1998 survey results is particularly unacceptable given the very significant role which the large accounting and legal firms that were the subject of this survey play in providing advice on tax matters to taxpayers generally and to other smaller professional accounting and legal firms. This advisory role should have led the Tax Office to conclude from its 1998 survey results that it was potentially dealing with a tax risk that was far greater than that which was directly attributable to the service entity arrangements being conducted by the surveyed firms. This risk could have been as large as the risk that taxpayers as a whole did not properly understand or apply the tax law or as small as the risk that other taxpayers with service entities did not properly understand or apply the tax law relating to these entities.

5.12 The Inspector-General considers that the Tax Office should have identified these potential risks at the time of its 1998 survey and then have properly evaluated them. The Tax Office has provided no evidence to the Inspector-General which indicates any such risk identification and assessment process was properly carried out. The Tax Office did not, for example, at this time assess either the extent of the operation of service entity arrangements in sectors other than the legal and accounting industry or the scale of tax that may be being underpaid as a result of these arrangements in other industries. The failure to carry out an adequate risk assessment of this nature is evidenced by the manner in which the Tax Office conducted an assessment of the total possible revenue at risk from these arrangements after

the 1998 survey. This assessment did not include firms that were not in the legal and accounting industry.[21]

5.13 The Inspector-General considers that, had the Tax Office conducted an adequate risk assessment process at this time, it would have become aware of the prevalence of these arrangements in other industries such as the medical profession and gained an appreciation of the potential minimum level of the tax risk associated with these arrangements.

5.14 The Inspector-General believes that, had this been done, a need to issue detailed guidance to the public on this matter would have immediately become obvious.

5.15 The above comments lead to the following key finding.

KEY FINDING 5.1

The Inspector-General considers that a decision to issue public guidance on service entities should have been made at least by April 1999, or within a very short time thereafter (such as by no later than the following month that is, by May 1999). This is three years six months before the Tax Office actually reached a decision to issue such guidance, which occurred in December 2002.

5.16 During this review, the Tax Office has indicated that it needed to complete the audits of the service entities of two large accounting firms so that it had sufficient material to commence preparing a ruling and detailed guidance on service entities.

5.17 However, the Inspector-General considers that all of the major material that was eventually embodied in the first draft versions of both the ruling and booklet that were issued to the public in May/June 2005 was either available by April/May 1999 or could have been obtained within a reasonable time thereafter (say, within six months) so as to allow that material to be embodied in the first drafts of these documents that were issued to parties outside the Tax Office. The major material that was already available by April/May 1999 was:

- detailed guidelines for calculating service entity fees. These were contained in the 1994 paper on service entities that was authored by a tax officer and presented at a Taxation Institute of Australia convention;[22] and

- detailed guidelines for using either a 'cost plus' or 'net profit' approach to determine an arms length fee (for example, for internal management fees paid within a multinational corporate group). These were contained in Taxation Ruling TR 99/1 that was issued in January 1999.

5.18 The major material that could have been obtained within a further six month period was the comparable profits achieved by labour hire firms. The Inspector-General notes that

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21 In a briefing paper prepared on 27 April 1999 following the 1998 survey, the Tax Office estimated that $150 million was being underpaid through a number of activities being conducted by accounting partners (including the alienation of income through service entities). It estimated a similar level of revenue was at risk from the activities of legal partners.

22 O'Donohue, P, *The ATO perspective on Phillips*, paper given to SA Annual Convention of the Taxation Institute of Australia, March 1994.

during the audits of the service entities of the two major accounting firms the Tax Office's Economists Unit was able to obtain this material within six months of being requested to do so.[23]

5.19 In any event, the Inspector-General considers that the nature of public guidance material on any matter is that it is not specific to any individual taxpayer or group of taxpayers. In the Inspector-General's view, it is therefore not appropriate for the Tax Office to assert that the preparation of any such material is or was dependent on the outcome of specific taxpayer audits.

Time from the date of the Tax Office's actual decision to issue guidance to the date of issue of this guidance in draft form

5.20 After reaching a decision to issue public guidance on service entities in December 2002 the Tax Office issued a draft form of this guidance in May and June 2005. This is two and a half years after its decision to issue such guidance.

5.21 This two and a half year time period involves a breach of the Tax Office's internal standard for the time by which a draft ruling is to be issued. This standard states that draft public rulings are to be issued within six months from the date of notification of the proposed ruling to the Public Rulings Branch for inclusion on the Public Rulings Program. The date of notification of the proposed ruling on service entities to the Public Rulings branch was 31 January 2004, while the date of issue of the draft ruling was May 2005. This time period is 15 months and exceeds the relevant Tax Office internal timeliness standard by nine months.

Time from the date of the Tax Office's actual decision to issue guidance to the date of issue of this guidance in final form

5.22 The Tax Office issued final guidance on service entities in April 2006. This date is 10 months after the date it issued draft guidance, three years and four months after it decided to issue such guidance and four and a half years after the Commissioner first publicly flagged that he had concerns with service entities in his 2001 Annual Report.

5.23 This date is also seven years from the May 1999 time when the Inspector-General considers it should have reached a decision to issue such guidance.

5.24 The 10 month period to issue a final ruling following the issue of a draft form of that ruling involves a breach of the Tax Office timeliness standard for final rulings. This standard states that a final public ruling is to be issued within six months of the draft ruling being issued.[24] The date of issue of the final ruling was April 2006 while the date of issue of the

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23 The request was made in March 2002 and responded to by September 2002.

24 This timeliness standard as well as that for draft rulings are referred in Australian National Audit Office, *Administration of Taxation Rulings Follow up Audit*, Audit Report No. 7 of 2004-05, dated 9 August 2004 at paragraph 2.34. They are also documented in the Tax Office's Public Rulings Manual. These standards differ from those that were in place when the ANAO conducted its original 2001 review of the Tax Office's administration of tax rulings. During that review, the Tax Office's Rulings Manual set an ideal of six months from commencement of drafting to finalisation of a public ruling, including a period of three months between the draft and final ruling for public rulings which are relatively complex (see Australian National Audit Office, *The Australian Taxation Office's Administration of Taxation Rulings*, Audit Report No. 3 of 2001-01, dated 17 July 2001 at para 3.23). The ANAO

draft ruling was May 2005. This time period is 11 months and exceeds the relevant Tax Office's internal timeliness standard by five months.

Causes of delays

5.25 The Inspector-General considers that an appropriate period over which to examine the causes of any delay in the Tax Office issuing its final guidance on service entities is the seven years that lapsed between May 1999 and April 2006. This seven year period commences at the time when the Tax Office first identified internally that there were concerns about service entities and ends when finalised guidance was issued to the public on these entities.

5.26 The Inspector-General's review has found that there are several factors which led to unnecessary delay during this seven year period. These factors differ according to the various time periods which make up this time period.

April 1999 to December 2002

5.27 The period from April 1999 to December 2002 starts at the time when the Tax Office had internally identified that there were concerns about service entities and ends when it decided to issue public guidance on this matter. It is a period of three years and seven months.

5.28 The Inspector-General considers that the first reason for this three year seven month time lapse is that the Tax Office did not conduct a proper risk assessment of the service entity issue by May 1999 which would have immediately prompted a decision to issue public guidance on this issue. This cause of delay was entirely within the Tax Office's control and is unacceptable.

5.29 A second reason for this three year seven month time lapse was internal dissent within the Tax Office between its Tax Counsel Network (TCN) area and the Large Business (LB) area as to the content of any public guidance on service entity arrangements.

5.30 The TCN area became involved in the service entity issue from at least March 2000. From this date, it maintained that the existing IT 276 should remain on foot and that the appropriate strategy to address the compliance issues discovered in respect of service entity arrangements was to finalise any relevant audits and, if necessary, proceed to litigation.

5.31 The LB area's view from the beginning of its involvement with service entities was that the Commissioner should announce by way of press release that service entity arrangements were no longer acceptable and that IT 276 was to be withdrawn.

5.32 The Inspector-General considers that this second cause of delay in reaching a decision to issue public guidance was also entirely within the control of the Tax Office and is unacceptable. He considers that a decision should have been made at an appropriate senior level within the Tax Office to resolve any actual or potential internal dissent within at least one month of the service entity issue being identified as a compliance issue in April/May 1999.

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concluded that this review period was, however, unrealistic and that a more realistic target might be six months between the date of draft and final public ruling.

December 2002 to October 2003

5.33 The period from December 2002 to October 2003 marks the time between the date when the Tax Office made a decision to issue its public guidance on service entities and the date when it commenced drafting this public guidance. It is a period of 10 months.

5.34 This decision took 10 months because TCN wanted the guidance to issue as a practice statement while the LB area wanted it to issue as a ruling.

5.35 The Inspector-General considers that this internal dissent factor is an unacceptable cause of delay. The Inspector-General considers that internal dissent on the nature of the proposed public guidance should have seen resolved at an appropriate senior level within the Tax Office within at least one month of the decision to issue public guidance being made.

5.36 These comments lead to the following key finding.

KEY FINDING 5.2

The Inspector-General believes that the Tax Office should have reached a decision to issue public guidance on service entities in the form of a ruling rather than as a practice statement within a period of one month. The Tax Office actually took a 10 month period to reach this decision because there were competing internal views inside the Tax Office as to whether this guidance should take the form of a ruling or a practice statement. There was therefore an unnecessary delay of nine months in reaching this decision.

October 2003 to May/June 2005

5.37 The period from October 2003 to May/June 2005 marks the time between the date when the Tax Office commenced drafting public guidance on service entities and the time when this guidance was issued in draft form to the public. It is a period of one year and eight months.

5.38 The factors which may have unnecessarily prolonged this time period were as follows:

- the process of actually preparing the draft ruling;
- the review of the draft ruling which occurred via a number of meetings of the Tax Office's internal Public Rulings Panel. These meetings were held in December 2003, February 2004 , March 2004, September 2004 and March 2005;
- confidential consultation processes that were conducted with members of a NTLG subgroup on the draft ruling between May 2004 and May/June 2005;
- the process of drafting the practical guidance booklet; and
- the involvement of very senior ATO executives in the drafting process for both the final ruling and booklet from at least October 2004.

5.39 Each of these factors is discussed below.

Drafting of the ruling

5.40 The Appendix 5 timeline indicates that it took two to three months for the TCN area of the Tax Office to prepare an initial draft of the ruling on service entities. This time period appears to be reasonable.

Review of the ruling by the Public Rulings Panel

5.41 During the next six months after the three month period of drafting of the ruling the ruling was reviewed by the Public Rulings Panel (Rulings Panel). The Inspector-General considers that this six months time period is excessive for the following reasons.

5.42 Firstly, this time period is prima facie excessive in view of the Tax Office's current internal timeliness standard for public rulings. This standard states that the entire period of time between the date of decision to issue a ruling being notified on the rulings program and its date of release in draft form should be a maximum of six months. This standard therefore suggests that the panel should have taken no more than three months to review the ruling.

5.43 Secondly, the Inspector-General's review of the changes made to the ruling as a result of going through this initial six months of consideration by the Rulings Panel were not as significant as the changes made to the ruling firstly during the 12 months confidential consultation process with NTLG members and then during the subsequent 10 month public consultation process. The Inspector-General therefore believes that, in hindsight, the extent of the changes that arose as a result of the process of being reviewed by the Rulings Panel did not justify that panel taking any longer than three months to consider the first version of the ruling.

5.44 The Inspector-General has been advised that members of the Rulings Panel were not aware until around April 2004 that the ruling would be subject to confidential scrutiny by members of the NTLG prior to its public release. It therefore appears that the Rulings Panel, for at least part of the six months that they were considering the ruling, were operating under the belief that they would be the only group that would be scrutinising the ruling prior to its public release.

5.45 Nevertheless, the Inspector-General notes that the end result of the Tax Office's confidential consultation processes on the ruling involved a degree of duplicated effort, in that the ruling was first scrutinised for six months by one group of tax experts comprising tax professionals that were both internal and external to the Tax Office and then for a further 12 months by another group that consisted only of tax professionals who were external to the Tax Office. The Inspector-General notes that this duplication would not have occurred had the ruling been released to the public for consultation immediately after being considered by the Rulings Panel.

5.46 The above comments lead to the following key finding.

KEY FINDING 5.3

The Tax Office's Rulings Panel spent a period of six months reviewing the service entities ruling. This is three months more than the standard time period it should have spent on this task.

NTLG confidential consultation processes

5.47 The final 12 months prior to the date of issue of a draft ruling to the public was taken up by the Tax Office engaging in a confidential consultation process with a special subgroup of the NLTG on the terms of the proposed ruling and (from December 2004) a proposed guidance booklet. The decision to engage in this confidential consultation process was made by the Commissioner at the NTLG meeting of December 2003. These processes led to the Tax Office deciding to issue a practical guidance booklet to accompany the draft ruling on service entities.

Preparation of the guidance booklet and involvement of senior Tax Office staff in the drafting of the ruling and booklet

5.48 The detailed practical guidance booklet on service entities was first prepared by the Tax Office's Small Business area in conjunction with its Large Business area in the three month period between September 2004 and December 2004.

5.49 This three month period to actually draft this booklet appears to be reasonable. However, the Inspector-General considers that this three month period should have been commenced and concluded much earlier. He considers that it should have commenced by no later than the time when the related ruling was first made available for consultation with NTLG members, and possibly earlier.

5.50 Starting the drafting of the booklet at the time when NTLG consultation on the ruling commenced would have shifted both the three month period of the drafting of the booklet from September to December 2004 as well as the subsequent three month consultation period on this document with NTLG members that occurred between January and March 2005. This is a six month period in total. The Inspector-General considers that, had the process operated in this way, the total 12 months confidential consultation period with NTLG members that actually occurred on both documents would have been reduced to, at the very least, a period of six months only.

Reasons why the Tax Office did not commence work on the booklet until September 2004

5.51 As explained further below, the principal reason why the Tax Office did not commence drafting of the booklet until September 2004 was because the personnel who were involved in the service entities issue, and those who managed them, did not consider that such a booklet was either appropriate or necessary. These personnel considered that the Tax Office should not be issuing detailed guidance which set out any level of 'safe harbour' service fees. This was because of a fear that any levels set by the Tax Office in such a document could be too high and therefore could lead to revenue leakage.

5.52 This view is reflected in one internal Tax Office document which states:

> To provide safe harbours would be to facilitate the behaviour the ATO is trying to discourage; safe harbours would be open to manipulation and would encourage creeping functionality in the service entities; safe harbours would distract attention from the central mischief which in most of these arrangements is a fundamental mischaracterisation of the commercial benefits, if any, flowing to the taxpayer.

5.53 As so stated, this view appears to be based on an underlying belief that service entity arrangements are unacceptable per se. As noted earlier[25], this was the view which the Large Business area held at the beginning of its involvement in service entities.

5.54 In September 2004, during the period of confidential consultation, members of the NTLG subgroup wrote a joint letter to the Commissioner which raised a number of concerns about the manner in which the Tax Office was dealing with service entities. These concerns included the following:

- The Tax Office personnel who were engaged in the confidential consultation on the ruling did not appear to accept the legitimacy of service entities, contrary to the previously publicly expressed views of the Commissioner; and

- The draft ruling did not provide any form of assistance to the community by the omission of guidance in areas where the Commissioner would accept levels of charges.

5.55 The Commissioner immediately took steps to address both these concerns.

5.56 Firstly, responsibility for the service entities issue was transferred to the Tax Office's Small Business area.

5.57 Secondly, over the following six to eight months, he took steps to ensure that the Tax Office issued a booklet on service entities which included 'safe harbours' and that both the existing ruling and this new booklet reflected the Tax Office's corporate view on these arrangements. As discussed later in this chapter, he did so by becoming personally involved in the drafting of these documents.

5.58 As indicated earlier, the Inspector-General considers that these additional months of work, while necessary to ensure that these documents reflected the Tax Office's actual corporate views on service entities, should have occurred earlier in the process of drafting the ruling. If this had occurred the Inspector-General considers that at the very least the NTLG consultation processes on the ruling could have been reduced from 12 months to six.

5.59 The Inspector-General considers that it should not have required external representations being made to the Commissioner for him to either:

- become aware that the members of his staff who were preparing the public guidance on service entities had a fundamental belief that these arrangements were not legitimate which was contrary to the Tax Office's corporate view on this issue; or

- reach a decision to issue detailed public guidance to taxpayers on how they could calculate their service entity fees.

5.60 The above comments lead to the following key findings.

25 See paragraph 5.31.

KEY FINDING 5.4

The Tax Office did not commence drafting of a detailed practical guidance booklet on service entities until September 2004 because the staff who were involved in the service entities issue, and those who managed them, did not consider that such a booklet was either appropriate or necessary. This view was based on an underlying belief held by the relevant staff and/or those who managed them that service entity arrangements were unacceptable. This was a view which these staff and/or their managers had held since the beginning of their involvement in service entities. It was not the Commissioner's view on these entities.

Once the Commissioner became aware that these staff still held this view he:

- changed management responsibility for the service entities issue;
- authorised a decision to issue a detailed practical guidance booklet which contained 'safe harbour' mark-up rates for service entities; and
- took steps to ensure that this booklet and the related ruling reflected the Tax Office's corporate view on these arrangements by becoming personally involved in the drafting of these documents.

These management changes better facilitated resolution of the service entities issue. The culture and strategies employed by the Large Business and Aggressive Tax Planning areas of the Tax Office on this issue prior to this management change were not conducive to the objective progression and resolution of this issue.

KEY FINDING 5.5

The Tax Office spent six months preparing its detailed practical guidance booklet and having this booklet reviewed by a NTLG subgroup. This six month period should have occurred earlier in the process of drafting the proposed guidance on service entities. If this had occurred, the NTLG consultation processes on the proposed guidance for service entities, which took place over a one year period, could have been reduced to at most six months.

5.61 The Inspector-General also notes that the conduct of the Large Business area in not preparing any detailed practical guidance on service entities indicates that there may be a serious misunderstanding within this area of the nature of the current self assessment system and of the Tax Office's obligations under this system with regard to the issue of detailed public guidance to taxpayers which will enable them to voluntarily comply with the law.

5.62 Under this system, the Tax Office is obligated to issue such detailed public guidance on how to apply the law to taxpayers in all possible cases (including those which may be considered not to be legitimate), subject only to resource constraints and risk management and other prioritisation processes.

5.63 This obligation is reflected in some key Tax Office documents. For example, the Tax Office's Public Rulings Manual states:

the Tax Office must provide sufficient education, assistance and information to facilitate self-regulation.

5.64 The Inspector-General notes that by at least September 2004 the Tax Office's Large Business area was aware, from the audit work which had been conducted on two large accounting firms and from other activities that it had conducted by this time (such as its 2003 survey of other legal and accounting firms) that the issue of the level of service fees that were deductible for tax purposes had all of the following characteristics:

- it involved a matter that was not clearly set out in the law;
- it involved large numbers of taxpayers at least in the legal and accounting industry;
- it had led to widely divergent claims by taxpayers; and
- it involved large amounts claimed as tax deductions.

5.65 It therefore was clearly an issue for which detailed public guidance was both appropriate and necessary in a self assessment environment, even if the terms of the ultimate guidance on this issue accorded with the Large Business area's view that these arrangements were not legitimate.

5.66 These comments lead to the following key finding and recommendation.

KEY FINDING 5.6

The senior Tax Office personnel who were responsible for handling service entity arrangements did not consider the adequacy of the Tax Office's existing detailed practical guidance to taxpayers in this area, particularly in relation to the manner in which service entity fees were to be calculated. These personnel did not act to update or correct any previous practical guidance material that taxpayers may have been relying on. This issue was only addressed when the Commissioner made a decision to issue such practical guidance in September 2004.

KEY RECOMMENDATION 1

Before it decides on an approach to any compliance issue, the Tax Office should test how well it has met its obligations, in a self assessment system, to provide adequate and contemporary guidance to taxpayers on the relevant issue. The Tax Office should introduce formal processes and procedures to ensure that it tests itself against this obligation before finalising the approaches that it will adopt to the relevant issue. It should not tolerate any internal culture which ignores the need to provide such adequate and contemporary guidance to taxpayers.

May/June 2005 to April 2006

5.67 The period from May/June 2005 to April 2006 starts from the date when draft guidance was issued and ends when final guidance was issued. It amounts to a total of 10 months.

5.68 The Inspector-General's review has established that there were at least four factors which contributed to this 10 month time period. They were as follows:

- the continued involvement of very senior Tax Office executives in the drafting process for the final ruling;
- the need for the final ruling to be further considered by the Public Rulings Panel;
- revised international benchmarking work conducted by the Tax Office; and
- the need for the Tax Office to consider submissions received from the public generally on the draft ruling. These submissions included submissions from the legal and accounting bodies who had previously been consulted on the ruling via the NTLG subgroup process. However, these submissions also now included submissions from other industries whose members operated service entity arrangements. These other industries (which included the medical profession) had not been a party to the confidential consultations previously held on the ruling and booklet.

5.69 All of these factors are capable of being fully or partly controlled by the Tax Office.

5.70 The Inspector-General considers that the 10 month period of community consultation on the ruling and booklet was not excessive. This is because of the following factors:

- the Tax Office did not, prior to the issue of the ruling and booklet, consult with any industry that would be affected by the ruling other than the legal and accounting profession;
- consultation with the legal and accounting profession was confined to a select group from those industries; and
- the booklet contained commercial benchmark rates for all industries who have service entity arrangements. The Inspector-General considers that it is appropriate for the Tax Office to set such rates only after extensive consultation with industries who conduct such arrangements.

However, as discussed further below, the Inspector-General considers that this 10 month consultation period should have commenced at the same time as NTLG members became involved with these documents. He also considers that, if this had been done, it is possible that the total time period between the date of release of the ruling to NTLG members and the date of its publication in final form could have been truncated from the 22 months years this process did take to perhaps as short as 12 months.

5.71 These comments lead to the following key finding.

KEY FINDING 5.7

The Inspector-General considers that the 10 month period of community consultation on the service entities ruling and booklet was not excessive.

INSPECTOR-GENERAL'S OVERALL COMMENTS AND CONCLUSIONS ON TIMEFRAMES

Periods of Tax Office-generated delay

5.72 The Inspector-General has concluded that the seven years that lapsed between the Tax Office identifying the existence of a potential compliance issue for service entities and issuing a final ruling to address this issue involved at least four significant time periods that could have been reduced by appropriate Tax Office action.

5.73 The first of these time periods was the three years and seven months which lapsed while the Tax Office reached a decision to issue public guidance. The Inspector-General considers this time period should have taken no more than one month.

5.74 The second of these significant time periods was the 10 months it took the Tax Office to reach to a decision on whether to issue the guidance on service entities in the form of a ruling or a practice statement. Again, the Inspector-General considers that this decision should have taken no longer than a month to reach.

5.75 The third significant time period was the three months of additional time spent by the Rulings Panel on reviewing the ruling that was beyond the standard time period it should have spent.

5.76 The fourth significant time lapse was the six month period the Tax Office spent on firstly preparing and then conducting consultation on the draft practice booklet with NTLG members. The Inspector-General considers that this six month period should have taken place over a period that was no later than, and coincided with, the first six months of the ruling's actual 22 month external consultation processes.

5.77 The total of the above time periods (ignoring the two one month periods that are considered to be reasonable) is five years.

5.78 The Inspector-General considers that better project and/or risk management processes within the Tax Office could have reduced all the above time periods.

What would have been a reasonable total time period for the issue of final guidance on service entities?

5.79 The Inspector-General considers that a reasonable maximum time period for the preparation and finalisation of both the ruling and booklet on service entities would have been two years. This is the sum of the following time periods:

- two months (being a one month period to reach a decision to issue guidance once the compliance issue had been identified plus a further one month period to decide on the form of this guidance);
- three months (being a reasonable time to draft the ruling);
- three months (being a reasonable period for the ruling to be reviewed by the Tax Office's internal Public Rulings Panel);
- three months (being a reasonable period for the guidance booklet to have been prepared). During this time the ruling itself could have been released for consultation; and

- thirteen months (being a reasonable time for subsequent consultation on both documents).

5.80 The last two components of this time period give rises to a total of 16 months of consultation. This time period is equal to the six month period the Inspector-General considers was a reasonable period for the Tax Office to have consulted with NLTG members to reach the version of the ruling and booklet which was released to the public in May and June 2005, followed by the additional 10 month period of consultation with other taxpayer groups which then in fact occurred to reach the final version of the ruling and booklet that was released in April 2006.

5.81 The Inspector-General considers that this period is reasonable, given that the guidance that was issued on service entities incorporated commercial benchmark rates for a number of industries. The Inspector-General considers that it is appropriate for the Tax Office to set such rates only after extensive consultation with the relevant industries. The Inspector-General further notes that where the Commissioner determines benchmark commercial rates in other contexts (such as when he determines the effective life of assets that are subject to capital allowances) the practice is to consult extensively with relevant industries and that this period of consultation is generally expected to take up to a year.

5.82 Had the ruling process started in April/May 1999 and taken the two year benchmark period referred to above, final guidance on service entities could have been issued as early as April 2001. Instead, final guidance on this matter was only issued some five years later.

5.83 The Inspector-General therefore considers that there has been at least an unnecessary delay of five years in producing the final versions of the service entity ruling and booklet.

5.84 The Inspector-General notes that the Tax Office has not itself conducted an internal examination of whether the service entities ruling and booklet may have been unnecessarily delayed for any period. This is despite the fact that the time periods involved breaches of firstly, the Tax Office's benchmark time for issuing a draft public ruling and secondly, its benchmark time for converting a public ruling into a final ruling.

5.85 The above comments lead to the following key findings.

KEY FINDING 5.8

The seven years that lapsed between the Tax Office identifying the existence of a potential compliance issue for service entities and issuing a final ruling to address this issue involved a total period of unnecessary delay of five years.

KEY FINDING 5.9

The Inspector-General considers that a reasonable maximum time period for the preparation and finalisation of both the ruling and booklet on service entities would have been two years. Had this period commenced when the Tax Office first identified a potential compliance issue for service entities, the service entities ruling and booklet could have been issued by April 2001.

OTHER RECOMMENDATIONS RELATING TO TIMEFRAMES

5.86 The Tax Office aspires to provide excellent service when providing guidance to taxpayers and has internal service standards relating to the timeliness of public rulings to help it meet this aspiration. However, the Inspector-General's review of the manner in which the Tax Office has handled the issue of public guidance on service entities indicates that there is a need for changes to be made to the manner in which these standards are communicated to the public, to how the Tax Office is assessing the extent to which they are being met and to the content of these timeliness standards. The changes that he believes need to be made in all these areas are discussed below.

Manner in which the Tax Office's timeliness standards for public rulings are published

5.87 The Tax Office does not publicise its timeliness standards for public rulings in the same manner as it notifies the public of its timeliness standards for other activities. The principal reference to the Tax Office's timeliness standards for public rulings is at the beginning of the Tax Office's Public Rulings Register which is published on its website. This reference, while it states that the Tax Office should meet timeframes of six month for issuing both draft and final rulings, does not actually state that these timeframes are internal Tax Office service standards. The Inspector-General believes that the Tax Office should notify the public that these timeframes are standards and should publicise both the existence of these standards and the degree to which they are met in the same manner as it deals with other service standards. [26]

Assessing the Tax Office's adherence to timeliness standards for public rulings

5.88 The Inspector-General considers that the Tax Office should ensure that it is assessing the timeliness of all its public rulings on at least a once a year basis.

5.89 The ANAO in its 2001 review of the ATO's administration of rulings recommended that the Tax Office should introduce a process to periodically self assess the timeliness of its public rulings. In its follow up review in 2004 the ANAO considered that this recommendation was in the process of being addressed because the Tax Office was at that time conducting an internal review of the timeliness of public rulings.

5.90 The Inspector-General has obtained a copy of the report from the internal review that was referred to in the ANAO's 2004 report. This report, which was completed for the 2003/04 year, concluded that, during that year, two thirds of the 21 rulings that were reviewed for the purposes of the report had not meet internal ATO timeliness standards.

5.91 Despite the negative findings of this report, the Tax Office only conducted subsequent reviews of the timeliness of its public rulings for each of the years ended 30 June 2005 and 2006 during the course of this current review. These reviews occurred after the Inspector-General drew the Tax Office's attention to this matter.

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26 The service standards for 2005/06 for a number of Tax Office activities, and the degree to which they have been met in the year to date are available on its website at www.ato.gov.au.

5.92 The reviews by the Tax Office found that, for each of the years ended 30 June 2005 and 2006, only 50 per cent of all draft public rulings and 50 per cent of all final public rulings met the relevant internal ATO timeliness standards.

5.93 The Tax Office has therefore not been consistently monitoring and assessing the timeliness of public rulings on an annual basis, despite the ANAO's earlier recommendation that it establish a periodic process of this nature. The Inspector-General believes that the Tax Office should take steps to ensure that such a process is conducted at least annually and that its results should be published.

5.94 These comments lead to the following key finding.

KEY FINDING 5.10

The Tax Office has not been consistently monitoring and assessing the timeliness of public rulings on an annual basis, despite the ANAO's earlier recommendation that it establish a periodic process of this nature.

Suggested changes to the content of the timeliness standard for rulings

Starting point for measuring timeliness

5.95 The Tax Office's current benchmark time periods for the issue of both a draft and final version of a public ruling only commence from the date when a decision to issue a ruling is notified to its internal rulings unit. The Inspector-General considers that this starting point is inappropriate as it fails to capture time periods that may occur prior to this time that may involve unacceptable delays.

5.96 The time periods that will not be captured will include any time period that occurs between the time when the Tax Office identifies that there is a compliance issue which it needs to address and the date of reaching a decision to address this issue by the release of a ruling. It will also fail to include any period between the date when the Tax Office decides to issue a ruling and the date when this is decision is communicated to the relevant area of the Tax Office which will manage the production of the ruling. In the case of service entities, both these time periods involved Tax Office-generated delays. Together they were responsible for a very significant portion — four years and three months — of the total five years of unnecessary delay in producing these documents.

5.97 During the course of this review the Tax Office has advised the Inspector-General that any risk of unacceptable delays which arise from monitoring the time taken to issue a public ruling from the date when a decision to issue a ruling is notified to its internal ruling unit is reduced by the fact that this internal unit is also responsible for monitoring the progress of all Priority Technical Issues, some of which are addressed by the issue of a public ruling.

5.98 All of the above comments on timeframes lead to the following key finding.

KEY FINDING 5.11

The Tax Office's current benchmark time periods for the issue of both a draft and final version of a public ruling have not been made public in the same manner as other Tax Office service standards. The Tax Office has also not published it performance against these standards. These time period standards also only commence from the date when a decision to issue a public ruling is notified to its internal rulings unit. The Inspector-General considers that this starting point is inappropriate as it fails to capture time periods that may occur prior to this time that may involve unacceptable delays. For the service entities ruling and booklet these time periods accounted for four years and three months of the total five years of unnecessary delay in producing these documents.

Other suggested changes to the content of the timeliness standards for public rulings

5.99 The Inspector-General considers that, in the light of the findings from this review, the content of the Tax Office's existing service standards for public rulings should be altered in the following ways:

- the service standards should operate from the date when any compliance issue giving rise to the need to consider the issue of a public ruling is identified; and

- the standards should be extended to cover situations, such as the case of service entities, where the Tax Office issues at the same time both a ruling and detailed accompanying guidance material which contains commercial benchmark rates for a number of industries.

5.100 The Inspector-General believes that this review indicates that the following benchmarks for the timely provision of public rulings are appropriate and achievable:

- the benchmark time to issue public guidance in the form of a final ruling only: 12 months from the date when the relevant compliance issue is identified; and

- the benchmark time to issue public guidance which takes the form of a ruling and associated detailed guidance which contains commercial benchmark rates for a number of industries: no more than 24 months from the date when the compliance issue to be addressed by the ruling is first identified.

5.101 The Inspector-General notes that the second of these benchmarks is twice as long as the first. He considers that this is appropriate given that, in this second case, there are two detailed guidance documents being produced rather than one. Furthermore, in this case, the second guidance document contains detailed commercial benchmark rates for a number of industries. It is therefore a document for which extensive consultation is appropriate.

5.102 As discussed further in the next chapter, the Inspector-General also believes that there should be an absolute time limit on the issue of any guidance (whether in the form of a Tax Office publication or a ruling or both) where this guidance is to take retrospective effect.

5.103 The Inspector-General considers that the retrospective application of detailed Tax Office guidance is generally undesirable, particularly in a self assessment system. However, it is particularly inappropriate where, as in this case, it has taken the Tax Office seven years

to issue that detailed guidance and throughout this period it was aware that the absence of this guidance was causing compliance problems.

5.104 The Inspector-General believes that there should be an absolute time limit on the issue of any such guidance which is to take retrospective effect of no more than two years. A two year upper limit of this nature would be consistent with the maximum two year period which applies whenever the Tax Office is seeking to correct the amount of tax that has been paid by taxpayers in previous years under the current rules for amending assessments for individuals and many small businesses. It would also impose a discipline on the Tax Office to ensure that all rulings, even those which contain statements of the law which are generally accepted, are in fact issued within a two year period.

5.105 This two year upper limit period was breached in the case of service entities as it took the Tax Office seven years to issue detailed guidance on this issue from the date when the relevant compliance issue was first identified.

5.106 The above comments lead to the following key finding and recommendations:

KEY FINDING 5.12

The Inspector-General believes that there should be an absolute time limit on the issue of any guidance (whether in the form of either a Tax Office publication or a public ruling or both), where this guidance is to take retrospective effect. This time should be that the relevant guidance is issued no more than two years from the date when any compliance issue to be addressed by that ruling is first identified. A two year upper limit of this nature would be consistent with the maximum two year period which applies whenever the Tax Office is seeking to correct the amount of tax that has been paid by taxpayers in previous years under the current rules for amending assessments for individuals and many small business taxpayers.

KEY RECOMMENDATION 2

The Tax Office's timeliness standards for public rulings should be made public in the same manner as its other service standards.

The content of these standards should be altered as follows.

Where a compliance issue arises which gives rise to the possible need to issue a ruling, the Tax Office should reach a decision to issue a ruling and then should actually issue the relevant ruling in final form no later than 12 months after the compliance issue is identified. If the ruling is to be accompanied by detailed practical guidance which contains commercial benchmark rates for a number of industries, such as occurred in the case of service entities, both documents should be issued within a maximum period of 24 months of the relevant compliance issue being identified.

If a ruling and any accompanying guidance material are issued more than two years after any relevant compliance issue is identified, the date of effect of both the ruling and any accompanying guidance should be prospective only.

KEY RECOMMENDATION 3

The Tax Office should monitor and assess the degree to which public rulings are meeting its internal service standards on timeliness for public rulings on at least an annual basis. The results of this monitoring and assessment process should be publicly reported in the same way as its performance against other service standards is reported.

5.107 During the course of this review the Tax Office has advised that it considers that the existing content of its service standards for rulings and that the current difficulties it is experiencing with meeting the existing six months timeliness standards for the issue of both final and draft public rulings indicate that there is a need to lengthen these timeliness standards rather than to shorten them. The Inspector-General considers that any extension of the timeframes referred to in the Tax Office's timeliness standards for public rulings is unacceptable in a self assessment environment because it will prolong taxpayer uncertainty on the Tax Office's view of the application of the law in contentious matters.

Other concerns raised by stakeholders regarding the timeliness of the Tax Office's provision of public guidance on service entity arrangements

5.108 Stakeholders also raised a concern that the 28 year time period between the date of the final decision in the *Phillips* case and the issue of TR 2006/2 and its accompanying booklet indicated a systemic problem with the Tax Office's processes for the prioritisation of public rulings.

5.109 The ANAO in both its 2001 audit into the Tax Office's administration of rulings and 2004 follow-up audit also raised the issue of the Tax Office's prioritisation processes for public rulings as a matter of concern. In its 2004 follow-up audit the ANAO noted that, since 2001, the Tax Office had introduced a 'priority technical issue' (PTI) process for prioritising the management of public rulings. One of the aims of this priority process was to improve the timeliness of public rulings by the Tax Office allocating its most experienced technical resources to those rulings identified by this process as having the highest priority.

5.110 The Inspector-General notes that the service entity ruling was given a 'priority one' status under this process but this did not achieve the result of the Tax Office meeting relevant Tax Office timeliness standards in relation to the progress and finalisation of this ruling.

5.111 This finding raises concerns as to the effectiveness of the Tax Office's current priority process for the management of high priority public rulings and on the level of competent resources available within the Tax Office to progress such issues. These concerns may be the subject of a future review or reviews by the Inspector-General.

CONSULTATION PROCESSES

5.112 As indicated in the timeline in Appendix 5, the Tax Office's consultation processes in respect of its proposed ruling and booklet on service trusts commenced in May 2004. This was the date when a copy of the proposed ruling was issued to a subgroup of the NTLG for comment. Subgroup members provided written comments on the proposed ruling over the next two months. In September 2004, the Tax Office convened two workshops (one in Sydney and one in Melbourne) with members of this group to discuss the comments they had made on the ruling. Around the time of these workshops the Tax Office decided to split the proposed service entity ruling into two separate documents. The first of these documents was a ruling and the second was a booklet that was to provide practical guidance to

taxpayers. Draft versions of these two new documents were provided confidentially to members of the NTLG for comment in December 2004. Comments on these documents were received in February and March 2005. In May of that year a draft version of the ruling was issued to the public generally, followed in the next month by the release of the booklet.

5.113 During the next 10 months a period of formal public consultation occurred on the draft ruling and booklet. Members of the NTLG subgroup continued to provide feedback to the Tax Office on the terms of the ruling and booklet. During this period the Tax Office also received feedback on the ruling from other taxpayer groups who operated service entities and who had not previously been involved in the consultation processes. These groups included the Australian Medical Association Limited (AMA) which is the organisation which represents medical practitioners.

5.114 The Inspector-General's comments and conclusions on the Tax Office's consultation processes for the service entity ruling and booklet are as follows.

Confidential consultation processes with members of the NTLG subgroup

5.115 The Inspector-General considers that the process of consulting with members of the NTLG which took place before the release of the draft ruling and booklet was beneficial in the sense that it allowed the Tax Office to produce a ruling and booklet on service entities for presentation to the public as a draft with knowledge of the views of these stakeholders on these documents.

5.116 However, he considers that this process should not have been structured in the manner that it was.

5.117 Firstly, this process should not have been conducted with only a select group of affected taxpayers — being those which, in the main, represented accounting and legal professionals only. By not involving potentially affected stakeholders from industries outside the legal and accounting profession the Tax Office ran the risk that it would need to do further work on the ruling to accommodate the circumstances of other taxpayer groups with service entity arrangements who were not a part of this consultation process.

5.118 This risk became a reality. Following the release of the draft ruling, the Tax Office spent time re-considering and altering the booklet to accommodate the specific concerns of other taxpayer groups with service entities (notably medical professionals). Following the release of the final ruling the Tax Office has also has indicated to the Inspector-General that it may have to issue specific guidance (possibly in the form of fact sheets) to the other major taxpayer groups with service entities (such as dentists and pharmacists).

5.119 The Inspector-General considers that the Tax Office should have avoided the need for any additional work on the service entity booklet to accommodate the concerns of industries other then the accounting and legal profession by proactively seeking the input of all industries potentially affected by the ruling and booklet far earlier in the process of drafting the ruling and booklet. The Tax Office's failure to do so has essentially meant that the material it has produced to date on service entities represents a 'work in progress' at least for a number of industries. For these industries whose circumstances have not yet been fully considered by the Tax Office the time periods of delay discussed earlier in this chapter will all therefore be further lengthened by the additional time that it takes for the Tax Office to issue detailed guidance to these industries.

5.120 Secondly, the Inspector-General considers that consultation with a NTLG subgroup should only have commenced after the draft ruling was issued to the public. By starting a confidential consultation process on the draft ruling with professionals who were members of this subgroup the ATO ran the risk that these parties would or potentially could obtain a tax advantage not available to either other members of their profession, or to the rest of the community generally. This actual or potential advantage was that these subgroup members could adjust the fees paid to any service entities in their own professional firms (or in their clients' firms) during the period they were engaged in confidential consultation with the Tax Office to the level which the Tax Office considered to be acceptable. The service entities (or those of their clients' firms) would therefore not be subject to tax adjustments in any ATO audit that was conducted for this period.

5.121 The Tax Office has advised the Inspector-General that members of the NTLG subgroup were obliged to sign confidentiality agreements which prohibited them from divulging information received from the Tax Office during these consultation processes to other parties. Furthermore, the Tax Office has advised that it considers that the only market sensitive information that was provided to members of this group were details of the actual mark-up rates for service fees that the Tax Office provided in its service entity booklet. These rates were only provided to members of this subgroup in December 2004.

5.122 The Inspector-General notes that the Tax Office comments confirm that for at least a six month period (being the period between December 2004 and the date of public release of the service entity booklet in June 2005) NTLG subgroup members were privy to market sensitive information that was not available to other taxpayers.

5.123 The Inspector-General has obtained no evidence which suggests that NTLG members may have acted to adjust the service fees paid by their own firms or those of their clients during this period. Nevertheless, the Inspector-General notes that, as evidenced in a number of submissions made to this review, the Tax Office's conduct in making this information available to this select group has created the perception that members of this group (and/or their clients) may have received an advantage that was not available to others. This perception has undesirable and negative connotations for both the Tax Office and members of the NTLG subgroup. This perception could have been avoided if the Tax Office's consultation with members of the NTLG subgroup had taken place at the same time as the public consultation processes on the ruling.

5.124 As indicated earlier, the Inspector-General believes that the one year confidential consultation processes with members of the NTLG on service entities could have realistically been truncated by six months, with the first three months of this period involving the Tax Office preparing the detailed guidance booklet and then the next three months being spent on consultation on both the ruling and practical guidance. If this had been done, then the total length of time spent on consultation on both of these documents would have been reduced from 22 months to 16 months.

5.125 During the course of this review, the Tax Office has advised the Inspector-General that it will no longer employ confidential consultation processes of the kind involved in the service entities issue.

5.126 The above comments lead to the following key findings.

KEY FINDING 5.13

The Inspector-General considers that the process of consulting with members of the NTLG which took place before the release of the draft ruling and booklet was beneficial in the sense that it allowed the Tax Office to produce a ruling and booklet on service entities for presentation to the public as a draft with knowledge of the views of these stakeholders on these documents.

However, he considers that this process should not have been conducted with a select group and that any detailed consultation with this group should only have commenced after the draft ruling was issued to the public.

KEY FINDING 5.14

The Inspector-General considers that at most a 16 month period of public consultation should have occurred on the service entities ruling and/or booklet. This period is six months shorter than the total period of 22 months of consultation which actually occurred on these documents.

Tax Office conduct during the consultation processes

5.127 A number of positive comments were made in submissions from participants in that the consultation processes on the ruling and booklet had been conducted by the Tax Office in a professional manner.

5.128 The concerns that were raised in submissions about the Tax Office's conduct during these processes were as follows.

5.129 Firstly, a number of submissions asserted that these processes took too long.

5.130 Secondly, a number of submissions stated that public consultation processes commenced too late in the drafting process.

5.131 Thirdly, submissions asserted that key Tax Office decision makers were not engaged early in these consultation processes.

5.132 Fourthly, submissions asserted that the Tax Office took a 'negotiation' style approach during these consultation processes which was inappropriate, given that the Tax Office should have been endeavouring to reach an objective view of how the relevant law should be applied.

5.133 Finally, some stakeholders asserted that during these consultation processes they were led to believe that the Tax Office agreed with certain contentions (and that as a result the Tax Office would change the ruling or booklet to reflect this agreement) when in fact the Tax Office had not accepted the relevant contentions.

5.134 The Inspector-General's comments on these concerns are as follows:

Consultation processes were too long and commenced too late

5.135 The timeline contained in Appendix 5 indicates that consultations on the content of the proposed service entity ruling with members of the NTLG subgroup commenced six

months after a discussion paper/initial version of the ruling was first prepared. These confidential NTLG consultations then took place over a further one year period. Public consultation on the ruling and an accompanying booklet then commenced at the end of this confidential consultation and this took an additional 10 month period.

5.136 As discussed earlier in this chapter, the Inspector-General considers that all these time periods, other than the 10 month period of public consultation, were too long. Also as discussed earlier, he considers that the public consultation processes on these documents commenced too late in the drafting process.

Key decision-makers were not involved early in the drafting process

5.137 The Inspector-General has established, through his fieldwork for this review that during the time the ruling and booklet were being drafted by the Tax Office there were a number of different areas of the Tax Office with different responsibilities in relation to these documents. The corporate management arrangements for these documents were as follows:

- until September 2004, responsibility for these documents resided with the Large Business area of the Tax Office (with a senior executive from the Aggressive Tax Planning area having executive oversight). Thereafter this responsibility was transferred to the Small Business area of the Tax Office;

- throughout the entire period of the drafting of the ruling, this drafting was the responsibility of the Tax Counsel Network (TCN). This area reported at all relevant times to a Second Commissioner. Under the usual Tax Office procedures for rulings, as set out in the Tax Office's internal Rulings Manual, the TCN area is not usually responsible for the drafting of rulings. Usually their role is to approve and review rulings. The usual author of a ruling is a member of the relevant Centre of Expertise (COE) for the subject matter of the ruling.

- preparation of the booklet was initially the responsibility of the Large Business area of the Tax Office but was subsequently transferred to the Small Business area of the Tax Office. From September 2004, this area reported to the Commissioner directly on this matter.

5.138 As a result of these managerial arrangements, there was from September 2004, one key ATO decision-maker in relation to the ruling (the Second Commissioner) and two key decision makers in relation to the booklet (the then Commissioner and the head of the ATO's Small Business area). The second group of key decision-makers were not involved in the processes of preparing the ruling which had taken place prior to the decision to create the booklet.

5.139 These arrangements therefore meant that two key members of the Tax Office whose decisions on content issues were ultimately crucial to the final form of guidance that was issued to the public on service entities were not in fact involved in the Tax Office's processes for drafting this guidance until one year after drafting processes for this guidance commenced and four months after the confidential consultations with NTLG members on this guidance commenced.

5.140 The Inspector-General therefore agrees with the concerns raised in submissions that key Tax Office decision-makers were not involved in the processes for drafting the ruling (including the consultation processes that were used for the ruling) until some time after these processes had commenced.

5.141 The Inspector-General considers that it is desirable for the Tax Office to ensure that all key decision-makers on a high priority issue such as the guidance that was prepared on service entities are involved as early as possible in the process. Their involvement should begin at least from the time when this issue is subject to consultation with parties that are external to the ATO or shortly thereafter.

5.142 During the course of this review the Tax Office has advised that its current processes normally result in the engagement of key decision-makers at the time when a Priority Technical Issue which may give rise to the issue for a ruling is formally registered as an issue on the Tax Office's Priority Technical issues register. However, these processes do not appear to have operated effectively in the case of the service entities ruling. As noted earlier, the service entities issue was designated as a 'priority technical issue'. This designation was however made well before the time when the ultimate key decision-makers on the ruling and booklet were engaged in the development of these documents.

5.143 A failure to engage key decision-makers early in such consultation processes can, as in the case of service entities, have a number of undesirable consequences. One of these consequences is that this failure will prolong these processes. A second undesirable feature is that the guidance may be being prepared in a way which does not accord with the key decision-maker's view of the relevant subject matter. As discussed earlier, this adverse consequence did arise in the case of service entities, although the Commissioner did take steps to address this once he became aware that it was occurring. A third undesirable feature is that external stakeholders who are involved in these processes may be unwilling to participate further in those processes or in subsequent similar processes because of a belief that their time and energies (which are often being given for no remuneration) are being wasted because they are not dealing directly with parties who are making the key relevant decisions.

5.144 The identity of the key decision-makers is also a matter which should be carefully considered by the Tax Office when it is allocating managerial responsibility for key issues, such as service entities. The Inspector-General notes that in this case the key decision-makers were all at the very top of the ATO's managerial structure and all had other significant tax administration responsibilities.

Other practices adopted by the Tax Office during consultation processes

5.145 The Inspector-General considers that the consultation processes employed for the service entities ruling booklet were not adversely affected by the Tax Office adopting a negotiation style during these consultations. The Inspector-General notes that this can be a feature of any process which involves the discussion of issues where not all parties to the discussion are in agreement. The Inspector-General also notes that during his review the Tax Office confirmed that there was one instance where a junior officer represented to a professional body that was involved in the consultation that the ATO had accepted an important contention made by that body when in fact the relevant key decision-maker had not accepted this contention. The Tax Office has indicated that it has subsequently apologised to the professional body concerned.

5.146 The above comments lead to the following key findings and recommendations.

KEY FINDING 5.15

Key Tax Office decision makers were not involved in the processes for drafting the service entities ruling (including the consultation processes that were used for the ruling) until some time after these processes had commenced.

Subsidiary recommendation 1

The Tax Office's consultation processes with the community for public rulings should be conducted openly at all times and should commence as soon as possible during the drafting process. These processes should not involve, to any significant degree, consultation with only a select group of taxpayers that may be affected by the ruling.

Subsidiary recommendation 2

The Tax Office's key decision makers on any proposed public ruling (or any proposed ruling which is to be accompanied by detailed practical guidance) should be engaged in the process of developing the ruling no later than the time when that ruling and any accompanying guidance is subject to public consultation processes.

Tax Office response during the review

5.147 During the course of this review, the Tax Office has stated that the consultation processes employed to deal with the service entities issue were appropriate because the group that was involved in secret consultations with the Tax Office represented more than 95 per cent of all businesses across every industry in Australia. The Tax Office also asserts that it was through this consultation that issues with service entities in the medical industry were identified.

5.148 These comments ignore the fact that, unlike most other consultation arrangements held with members of the NTLG, the service entities issue involved a matter which directly affected these NTLG members as taxpayers and they were therefore not in the usual position of acting as disinterested parties who advise affected taxpayers.

5.149 The Tax Office's comments that the NTLG consultation processes led to service entities issue for the medical profession being identified is not correct. Evidence gathered during the course of this review clearly indicates that the industry association which represents this industry was not aware of the effect of the proposed ruling on this industry until it was issued publicly in draft form.

CHAPTER 6: INSPECTOR-GENERAL'S FINDINGS ON TAX OFFICE'S LEGAL AND COMPLIANCE APPROACHES TO SERVICE ENTITY ARRANGEMENTS

6.1 This chapter deals with the Inspector-General's findings in relation to the Tax Office's legal and compliance approaches to service entity arrangements.

ISSUE OF WHETHER THE TAX OFFICE USED THE RULINGS AND TAX OFFICE ADVICE PROCESS TO ALTER THE LAW ON SERVICE ENTITIES

6.2 The history of the Tax Office's approach to service entity arrangements indicates that from 1978 (being the year of issue of IT 276) to at least the early 1990s (when the Tax Office issued two advices on these arrangements to a major accounting firm) the Tax Office accepted the following two statements:

- that deductions for fees paid by professional firms to service entities were, in accordance with *Phillips* case, were allowable for tax purposes if they were realistic and not grossly in excess of commercial rates; and

- that these deductions would be allowed if they were set using a 50 per cent mark-up on direct salary costs and a 15 per cent mark-up on other expenses.

6.3 The Inspector-General considers that the first of these statements is a statement of the law on service entity arrangements, while the second is a statement of how the law on service entity arrangements will be applied by the Commissioner, in the sense of how the deductible amount of a service fee will be calculated.

6.4 By the time the Tax Office issued its draft ruling and booklet on service entities in 2005, the Tax Office did not accept either of the above statements.

6.5 By this time, the Tax Office considered that a correct summary of the law on service entities was as follows:

- Deductions for fees paid by professional firms to service entities were allowable for tax purposes only if they were commercially realistic in the sense that they would be the same as the amounts which a party that was not related to the service entity would pay for the property or services provided.[27]

6.6 It considered that a correct statement of how to calculate the deductible amount of a service fee was as follows:

- Deductions would be allowed if service entity fees for professional firms were set with reference to comparable market rates and involved net mark-ups of no more than

27 Draft booklet at page 7.

3 ½ per cent (for the provision of permanent staff) and 5 per cent (for the provision of temporary staff and most other expense payments).[28]

6.7 These new 'draft' statements reflected a belief within the Tax Office that service entity fees were only deductible if their amount matched an arm's length price that would be paid to a service provider that was not related to the relevant professional firm. This arm's length pricing was to be calculated using the same kinds of economic methodologies that were used to calculate the level of arm's length pricing within a multinational corporate group for the purposes of the Australian Taxation Office's rules on cross-border profit shifting.

6.8 Based on the fieldwork for this review, the Inspector-General considers that the Tax Office's view of the law on service entities set out in TR 2005/D5 and its view on how to determine the level of deductible service fees, as set out in the booklet which accompanied TR 2005/D5, although labelled as 'draft' views of the Tax Office, were both actually adopted in practice by the Tax Office from at least March 2002 at least with respect to large accounting firms. This was the date when the Tax Office decided to engage an economist to determine a commercially realistic price for the service fees being paid by the two major accounting firms that were being audited between 1999 and 2003 or 2004.

6.9 By April 2006, when the Tax Office finalised its ruling and booklet on service entity arrangements, the Tax Office had changed its first summary statement of the law on service entities back to that which it had adopted from 1978 to the early 1990s that is, it stated that service fees would be deductible provided they were 'realistic and not grossly excessive'.

6.10 At this time the Tax Office also changed its statement on how to determine the amount of service fees involving labour-hire services that would be deductible.

6.11 This statement sets out the current circumstances in which deductions for service entity fees will either be at a low risk of audit or accepted. Service fees will be at a low risk of audit if the fees do not exceed 30 per cent of the combined profits of the service entity and either:

- labour costs are marked up by 30 per cent (with operating costs being at least 18 per cent of those labour costs) and other expenses are marked up by 10 per cent; or
- the service entity derives a net mark-up not exceeding more than 10 per cent of the direct and indirect costs associated with the on-hiring of staff or the payment of other expenses.

Service fees will be accepted as a deduction if the fees are set by reference to comparable market rates and involve net mark-ups of no more than 3 ½ per cent (for the provision of permanent staff) and 5 per cent (for the provision of temporary staff and most other expense payments) (although higher commercial benchmark rates may be acceptable if appropriate evidence is provided).

6.12 The above comments indicate that the Tax Office's view of the law on service entities, as stated in its final 2006 ruling and booklet, is essentially the same view of the law which it had on these arrangements in 1978. This view was that deductions for service entity fees would be allowable if they were realistic and not grossly in excess of commercial rates.

28 Draft booklet at page 11.

This being the case, the Inspector-General does not consider that the final ruling and booklet on service entity arrangements evidences any change in the Tax Office's view of the law on these arrangements from the view which the Tax Office expressed on these arrangements in IT 276 in 1978.

6.13 However, the above comments do indicate that the Tax Office did in practice adopt a new view of the law on service entities between the dates of March 2002 and April 2006 and that this new view of the law was embodied in the draft version of the service entities ruling that was issued in May 2005.

6.14 The Inspector-General considers that the above comments also indicate that:

- between March 2002 and April 2006, the Tax Office was adopting a view on how to calculate the amount of service fee that would be deductible that was different from that which it had set out in previous public and private documents (such as its assessing manual and in earlier private rulings). This new view was made public in TR 2005/D5 and its accompanying draft booklet; and

- when it issued its final public ruling and booklet on service entities in April 2006, the Tax Office adopted another view of how to calculate these service fees. This new view was different to both the view on the pricing of fees which it had expressed in its draft ruling and booklet, and to its view on the pricing of these fees which it had expressed in its previous assessing manual and other documents.

6.15 These comments lead to the following key finding.

KEY FINDING 6.1

The final ruling and booklet on service entity arrangements does not evidence any change in the Tax Office's view of the law on these arrangements from the view which it expressed on these arrangements in IT 276 in 1978.

However, the Tax Office did in practice adopt a new view of the tax law on service entities between the dates of March 2002 and April 2006.

When it issued its final public ruling and booklet on service entities in April 2006, the Tax Office adopted a view of how to calculate service entity fees which was different to all previous views it had expressed on the pricing of these fees.

Tax Office comments on whether it has altered its view of the law on service entity arrangements or how that law is to be applied

6.16 Throughout this review (and also the period of development of the final ruling and booklet on service entity arrangements) the Tax Office has denied that either it has ever altered its view of the law on service entity arrangements or how that law is being applied. Its reasons for these views are set out below.

6.17 Firstly, the Tax Office states that it has not altered its view of the law on service entities in TR 2006/2. It states that TR 2006/2 specifically confirms that it 'supplements'

rather than replaces IT 276 and provides further guidance on service entity arrangements.[29] It also points to various statements it has made during the life of the development of the ruling and booklet where it stated that it was not seeking to re-open or challenge the decision in the *Phillips* case.[30]

6.18 As discussed above, the Inspector-General agrees that the Tax Office's view of the law on service entity arrangements as stated in the final version of TR 2006/2 is essentially the same as that in *Phillips* case and IT 276. However, as also discussed above, the Inspector-General considers that the Tax Office did in practice change its view of the law in this area for the period between at least March 2002 and April 2006.

6.19 Secondly, the Tax Office considers that it has not changed its view on how the amount of deductible service fees is to be determined. This is mainly because neither the Tax Office itself nor any court has ever made a definitive statement on how this is to be done. In support of this argument it makes the following assertions.

6.20 Firstly, it asserts that *Phillips* case 'is not authority for the proposition that expenditure made under a service arrangement and calculated using the particular mark-ups in that case will always be deductible under section 8-1 of the ITAA 1997'[31] and that that this statement applies to years of income commencing prior to the date of issue of TR 2006/2 and its accompanying booklet;[32]

6.21 Secondly, it asserts that the statements made in its 1985 trust assessing manual concerning the acceptability of 50 per cent and 15 per cent mark-ups do not amount to statements of Tax Office practice.

6.22 One reason for this, according to the Tax Office, is that its assessing manuals operated as risk assessment guidelines for assessment purposes rather than statements of the law itself, or even of the application of the law to particular circumstances.[33]

6.23 A second reason is that, according to the Tax Office, the trusts assessing manual contained other guidelines which indicated that any particular mark-ups used had to be consistent with ordinary business dealings and not be demonstrably out of line with the commercial value of the services rendered.

6.24 The Tax Office asserts that a third reason why its assessing manuals do not amount to a statement of Tax Office practice is that the statements in these manuals did not bind Tax Office staff on an Australia-wide basis. These statements, according to the Tax Office, represented only the views of particular branch offices of the Tax Office during a time when those branch offices could formulate their own views of the practical application of the tax law to taxpayers in their jurisdiction.

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29 TR 2006/2 at paragraph 2.

30 See, for example the comments made in the following speech: Commissioner of Taxation, *Future Directions in Tax Administration (A Relationship of Mutual Dependency)*, 17 June 2003 available on the Tax Office's website at www.ato.gov.au.

31 See TR 2006/2 at paragraph 6.

32 TR 2006/2 at paragraph 17.

33 ATO Minute No IGT 10-ST-2006, dated 10 July 2006 at attachment B.

6.25 A fourth reason is that in 1994 the Tax Office issued TD 94/45 and an addendum to TR 92/20, both of which indicate that taxpayers should not rely on Tax Office assessing manuals as evidence of the Tax Office's interpretation, policy or practice.

6.26 The Tax Office's alternative argument is that, if it has changed its view on the way in which service fees are to be calculated, this changed view has been made known to the community from at least 2001 onwards (and arguably from the early 1990s) via numerous statements in various documents (such as annual reports, Commissioner's speeches and liaison group minutes).

Inspector-General's view

6.27 In examining the above assertions by the Commissioner it is important to recognise that since both the decision in *Phillips* case and the date of the trust assessing manual Australia has adopted a self assessment system for income tax.

6.28 From 1986, this self assessment system meant that taxpayers, rather than the Tax Office, bore the responsibility of interpreting the tax law and applying it to their circumstances in order to self assess the amount of tax they had to pay. Under the new system, the Tax Office became obliged to provide taxpayers with sufficient information and support to ensure that taxpayers could correctly interpret and apply tax laws.

6.29 From 1986 until the dates of issue of draft versions of TR 2006/2 and its accompanying booklet the only official Tax Office publications which provided guidance to taxpayers on how to calculate their service entity fees were IT 276 and the Tax Office's 1985 assessing manual. The only court case on this issue was *Phillips* case. In the absence of any other material the Inspector-General believes that in a self assessment environment taxpayers (including those who provide tax advice for a living) should have been be entitled to rely on this material and this material only in setting the levels of deductible service entity fees for any period up to at least the date of issue of the draft version of TR 2006/2 and its accompanying booklet in May/June 2005. When determining the effect of taxpayers reliance on the draft guidance for the period between May 2005 and April 2006 the Tax Office should have also taken into account the fact that this guidance was clearly labelled as being of a 'draft' nature only.

6.30 The Inspector-General considers that the Tax Office should not expect taxpayers to be either aware of or bound by any comments made on how the tax law applies to service entities in documents such as speeches (whether by the Commissioner or by other tax officers), liaison group minutes, or annual reports. In a self assessment environment neither taxpayers nor their advisers perceive that these kinds of documents have a role in providing definitive guidance on the Tax Office's view of the application of any particular tax law. This is because these kinds of documents are prepared for other, quite different purposes. In a self assessment environment, taxpayers and their advisers rely for guidance on the Tax Office's view of an issue only on publications such as rulings, fact sheets and other materials which are expressly prepared by the Tax Office for the purpose of providing such guidance either to its own staff or to taxpayers generally.

6.31 Furthermore, the Inspector-General considers that it is unrealistic for the Tax Office to expect taxpayers and their advisers to have been aware of these other documents. A number of these documents were either not publicly available at all (as in the case of the four speeches by tax officers that were made to TIA conventions) or were only made publicly available some time after they had been originally prepared (as in the case of liaison group minutes).

6.32 The Inspector-General also notes that the Tax Office's assertions that it has not changed its view on how the law on service entities will be applied are incompatible with the lengthy confidential consultation processes which it engaged in prior to the issue of TR 2006/2 and its accompanying booklet to the public.

6.33 Furthermore, the Inspector-General notes that, as discussed in Chapter 3, there was a delay of seven years between the time when the Tax Office first identified that legal and accounting firms may not be correctly applying the laws on service entities and the date when the Tax Office settled and issued detailed guidance on how those laws should be applied.

6.34 The Inspector-General considers that the retrospective application of detailed Tax Office guidance is generally undesirable, particularly in a self assessment system. However, it is particularly inappropriate where, as in this case, it has taken the Tax Office seven years to issue that detailed guidance and throughout this period it was aware that the absence of this guidance was causing compliance problems. The Inspector-General believes that in such circumstances the Tax Office should not apply this guidance retrospectively.

6.35 As discussed in Chapter 3, the Inspector-General believes that the Tax Office should generally take no more than two years to issue detailed guidance on how particular tax laws are to be applied in cases where he becomes aware that the absence of this guidance is causing compliance problems and the form of that guidance consists of a public ruling accompanied by detailed practical guidance which contains commercial benchmark rates for a number of industries. The Inspector-General also believes that there should be an absolute time limit on the issue of any such guidance which is to take retrospective effect of no more than two years. A two year upper limit of this nature would be consistent with the maximum two year period which applies whenever the Tax Office is seeking to correct the amount of tax that has been paid by taxpayers in previous years under the current rules for amending assessments for individuals and many small businesses.

6.36 In light of the above comments, the Inspector-General considers that the Tax Office should not be making tax adjustments for service entity arrangements conducted prior to the 12 months period of grace which is referred to in TR 2006/2 (which ends in April 2007) in cases where the only significant issue is that service fees were calculated in accordance with the 50/15 per cent method set out in the Tax Office's previous trust assessing manual, rather than any of the methods flagged either in the draft or final version of the service entity ruling and booklet.

6.37 The Inspector-General notes that, as at the date of this report, there appear to be a number of audits being conducted by the Tax Office on service arrangements for periods prior to April 2007 where this appears to be either the only matter or at least the principal matter at issue.

6.38 The view set out above would not preclude the Tax Office from investigating and making tax adjustments for service entity arrangements conducted prior to April 2007 in cases where the fees are considered to be grossly excessive (and therefore are in breach of the law as originally stated in *Phillips* case), in cases of fraud or evasion, or in other cases where there are features of the arrangements which raise issues as to the genuineness of the service entity's operations during the relevant period. Examples of such features would include cases where the service entity has no staff of its own who carry out its business or where the entity has no legal entitlement to property which it allegedly supplies to the professional firm.

6.39 The above view would also be consistent with the way in which the Tax Office applies other changes it makes to how a tax law is to be applied, in the sense of how the quantum of a deduction is to be calculated.

6.40 One common example of a change which the Commissioner makes in the quantum of a deduction is the changes he makes to the amount of capital allowances that will be deductible where there has been a re-assessment of the effective life of the relevant capital assets. These changes are only ever applied prospectively by the Tax Office.

6.41 When the Commissioner re-assesses the effective life of a particular capital asset he makes a decision as to what is an acceptable commercial rate of write-off for that asset. This process involves a commercial assessment which is made in the light of various factors, including commercial conditions prevailing at the relevant time.

6.42 A change made by the Tax Office in the commercial rate of tax write off for a capital asset is similar to the change which the Tax Office has made in TR 2006/2 and its accompanying booklet to the amounts of service entity fees that will be considered to be commercially realistic (and therefore deductible). The Inspector-General believes that it is appropriate for both these kinds of changes to be applied only prospectively in a self assessment environment.

6.43 The above comments lead to the following key findings and recommendation:

KEY FINDING 6.2

From 1986 until the dates of issue of draft versions of TR 2006/2 and its accompanying booklet the only official Tax Office publications which provided guidance to taxpayers on how to calculate their service entity fees were IT 276 and the Tax Office's 1985 assessing manual. The only court case on this issue was *Phillips* case.

In the absence of any other material the Inspector-General believes that in a self assessment environment taxpayers (including those who provide tax advice for a living) should have been be entitled to rely on this material and this material only in setting the levels of deductible service entity fees for any period up to at least the date of issue of the draft version of TR 2006/2 and its accompanying booklet in May/June 2005.

When determining the effect of taxpayers' reliance on its draft guidance for the period between May 2005 and April 2006 the Tax Office should also take into account the fact that this published guidance was clearly labelled as being of a 'draft' nature only.

KEY FINDING 6.3

The Inspector-General considers that the Tax Office should not be making tax adjustments for service entity arrangements conducted prior to the 12 months period of grace which is referred to in TR 2006/2 (which ends in April 2007) in cases where the only significant issue is that service fees were calculated in accordance with the 50/15 per cent method set out in the Tax Office's previous trust assessing manual.

KEY RECOMMENDATION 4

The Tax Office should acknowledge, in a public statement, that it has changed its view on how to calculate the amount of a service entity fee that will be deductible with effect from the date of issue of TR 2006/2 and its accompanying booklet on 12 April 2006. It should confirm that this change will be applied prospectively from that date and that this prospective application will include a 12 months period of grace for taxpayers to adjust their service entity arrangements.

The Tax Office should, in this public statement, outline the consequences (including those relating to the remission of penalties, interest and prior year tax adjustments) that this change in view has for all taxpayers with service entities, including:

- *taxpayers who are currently subject to prior year audits of service entity arrangements;*
- *taxpayers who have entered into prior settlement arrangements with the Tax Office in relation to their service entities; and*
- *taxpayers whose service entity arrangements will be subject to audit after 30 April 2007.*

TAX OFFICE AUDIT PRACTICES AS REGARDS SERVICE ENTITIES

6.44 The Tax Office has advised the Inspector-General that the production of the final ruling and booklet is its principal strategy for addressing the compliance risks associated with service entity arrangements.

6.45 The Tax Office is expecting that the detailed guidance it has provided on service entity arrangements will result in accounting and legal firms ensuring that their own service entity arrangements meet Tax Office guidelines for the future. It should also assist with similar compliance being achieved by those firms' clients. The Tax Office has advised that this 'rulings based' approach to achieving compliance already appears to have had the result of moderating taxpayer behaviour with respect to service entities.

6.46 While the Tax Office's principal compliance activity in relation to service entities has been the production of the ruling and booklet it has, as indicated in the previous chapter and in timeline in Appendix 5, either completed or is currently conducting a small number of audits on the service entity arrangements of legal and accounting firms for periods prior to the date of release of TR 2006/2.

6.47 The Inspector-General has found, from his fieldwork on these audits, that these audits were largely carried out in accordance with internal Tax Office requirements in existence at the relevant time, and other legal and administrative guidelines. This was particularly the case for audits carried out by the Large Business area of the Tax Office. However, the following five areas of Tax Office activity or behaviour associated with these audits give rise to tax administration concerns:

- the criteria used by the Tax Office to select service entity cases for prior year audits;
- the practices adopted by the Tax Office in conducting service entity audits for small to medium size legal and accounting firms (SMEs);

- the Tax Office's conduct in cases involving prior specific taxpayer advice;
- the Tax Office's assertions that it has not changed any prior general administrative practice practices as regards service entities; and
- the Tax Office's requirements of taxpayers when setting the final level of tax payable as a result of a service entity audit.

6.48 Each of these five areas of concern in the Tax Office's audit practices for service entity arrangements is discussed in detail below.

Current Tax Office criteria for selecting prior year audit cases

6.49 The previous chapter indicates that the Tax Office is currently conducting prior year audits of service entity arrangements where all the following three conditions are satisfied:

- the service fees were over $1 million;
- the service fees represented over 50 per cent of the gross fees or business income earned by the professional firm; and
- the net profit of the service entity represented over 50 per cent of the combined net profit of the entities involved.

6.50 In addition it is also looking at cases where there are serious questions as to whether the services were in fact provided by the service entity.

6.51 The Tax Office has stated that it established the $1 million and 50 per cent of gross income conditions to limit the number of potential prior year audit cases to a maximum of 10 per cent of legal and accounting firms.[34]

6.52 As noted in the previous chapter, submissions have asserted that these conditions are discriminatory in a number of respects. The Inspector-General agrees with most of these assertions. He also considers that these criteria apply retrospective conditions to service entity arrangements and fail to adequately target potential cases of fraudulent, non-genuine or grossly excessive service entity arrangements.

6.53 Although only a small number of taxpayers may be affected by these criteria, their existence, especially when coupled with the existence of similar criteria in other areas of current Tax Office audit activity, undermine community confidence in the extent to which the Tax Office is administering the tax system on an impartial, non-discriminatory and effective basis.

6.54 The first of these conditions eliminates from Tax Office audit scrutiny all prior year service entity arrangements where the relevant fee does not exceed a certain amount (other than in cases where there are serious questions as to whether the services were in fact provided). In effect this largely eliminates from prior year scrutiny professional firms with a

34 Australian Taxation Office, *Draft guidance on service arrangements*, Media Release Nat-2005/42 dated 29 June 2005.

turnover of less than $1 million and, depending on the taxpayer's circumstances, a number of taxpayers with turnovers of more than that amount.[35]

6.55 Anecdotal evidence suggests that serious compliance issues with service entities in these prior years may be more prevalent amongst taxpayers with less than $1 million in turnover. The Tax Office has advised the Inspector-General during the course of this review that this anecdotal evidence does not accord with the Tax Office's experiences. However, the Inspector-General notes that this Tax Office comment does not appear to be based on any significant audit activity that was conducted on these entities.

6.56 The first criterion, in the Inspector-General's view, is also discriminatory in that accountants, lawyers and others who do not meet this $1 million criterion for retrospective audit activity but who have conducted non-genuine service entity arrangements will be given preferential tax treatment for these activities. Retrospective audits for most other taxpayers (including large groups of taxpayers such as Mass Marketed Tax Effective Investment (MMTEI) and Employee Benefit Arrangement (EBA) taxpayers) have generally embraced all relevant taxpayers. These audits have not excluded taxpayers merely because their relevant activities were small.

6.57 The second and third conditions for selection as a high risk service entity audit case introduce two requirements for service entity arrangements in prior years which were not mentioned in any Tax Office guidance material on service entities that was issued prior to the draft versions of TR 2006/2 and its accompanying booklet.

6.58 The third condition for selection as a high risk prior year audit case — that the profits of the service entity exceed 50 per cent of the combined profits of both the service entity and professional firm — is also at odds with the much smaller 30 per cent profits cap which the Tax Office intends to apply when selecting service entity arrangements for audit after 30 April 2007.

6.59 The Tax Office has advised the Inspector-General that the reason for the different rates is because the 50 per cent test was applied for the purposes of case selection during a period when the Tax Office would only be auditing the highest risk cases. The 30 per cent test is for a different purpose and puts a cap on a taxpayer's ability to rely on the indicative rates approach.

6.60 The Inspector-General believes that the Tax Office should have developed far more refined and less discriminatory conditions for identifying cases of fraudulent, grossly excessive and non-genuine service entity arrangements for prior years. He considers that the Tax Office would have been able to do so quite easily, especially given the degree of information it collected on these types of arrangements over the 10 years prior to TR 2006/2 via its two surveys of accounting and legal firms and the audits it conducted on two major accounting firms.

6.61 The Inspector-General considers that a more refined and properly targeted set of conditions would have included criteria such as:

- the amount of the service fees (without setting any minimum level of fees which were to be excluded from consideration);

35 One commentator has estimated that the $1 million test will generally be failed by any firm that has more than four partners.

- the relative proportion those fees bore to the firm's total gross income (without setting any particular figure for what proportion would be acceptable or unacceptable);
- the level of the firm's profits versus those of its service entity (again without setting any figure on what level of profits in the service entity would be acceptable or unacceptable);
- the prior compliance history of the principals in the relevant business;
- the identity of the legal lessee or owner of the firm's premises; and
- for firms which had responded to the Tax Office's 2003 survey questionnaire, data supplied in that survey, such as:
  - the existence of any written service agreement;
  - the nature of expenses subject to mark-up;
  - the evidence used to justify the commercial reality of those mark-ups and resulting profit of the service entity; and
  - whether the firms had marked up or re-charged all of the costs of the service entity (thereby indicating there might have been no employees who were engaged in the service entity's own business operations or no other expenses incurred by that entity in conducting its own business).

6.62 Furthermore, all these selection criteria should have been considered together in selecting audit cases. The audit selection process should not have involved, as it has to date, the overly simplistic approach of considering the first three of these criteria in isolation from all other factors.

6.63 During the course of this review, the Tax Office has commented that it is unsure of what aspects of unacceptable taxpayer history would be relevant for such a case selection process and has also indicated that there would be difficulties obtaining any such material at the case selection phase. These comments raise broader questions as to the degree to which the Tax Office actually considers that a taxpayers' prior compliance history is relevant for an audit case selection process and the extent to which tax officers are able to actually access such a history. Further investigation of these matters is outside the scope of this review but may be the subject of future review by the Inspector-General.

6.64 These comments lead to the following key finding.

KEY FINDING 6.4

The criteria which the Tax Office has used to select prior year audits of service entities are discriminatory, apply retrospective conditions to service entity arrangements and fail to adequately target potential cases of non-genuine service entity arrangements.

Tax Office's practices in conducting prior year audits on SME service entities

6.65 As stated above, the three selection criteria which the Tax Office is currently using to identify service entity arrangements for prior year audits all focus on aspects of the amount of the relevant service fees rather than the nature of the service entity arrangement as a whole.

6.66 This focus on the amount of the fee has carried through to the manner in which the Tax Office has conducted all of its recent audits on service entity arrangements.

6.67 The application of these criteria — in particular the $1 million criterion — has meant that the Tax Office is not currently conducting prior year audits of accounting and legal firms whose service fees are less than $1 million, except for cases where it obtains evidence that no service entity arrangements actually exist.

6.68 The application of these three current selection criteria has also meant that the Tax Office is not currently conducting any further audits on large accounting and legal firms beyond the two it commenced in 1999.

6.69 The Tax Office's current prior year audit activity is therefore focussed almost exclusively on small to medium size accounting and legal enterprises (SMEs).

6.70 The two audits of major accounting firms which were started by the Tax Office in 1999 and completed in 2003 and 2004 were conducted by the Large Business (LB) area of the Tax Office. This area is responsible for all taxpayers with a turnover of over $100 million. In both these audits, the Tax Office's focus was on gathering evidence not only on the amount of the fee but on all the surrounding circumstances. Extensive evidence gathering was a feature of these audits, with the Tax Office gathering as part of that process a detailed understanding of the nature of the service entity's operations, including relevant documentation (such as copies of all major contracts entered into by the service entity, including leases of equipment, employment contracts and the service agreement itself, details of all personnel who were involved in the service entity's operations and the extent to which their salaries were subject to mark-ups). The extent of this evidence gathering can be gauged from the fact that in one audit the Tax Office established an office inside the premises of the relevant firm being audited.

6.71 For audits of service entity arrangements conducted by SMEs, most of which were commenced after September 2004, the extent of the Tax Office's evidence gathering at the initial stages has been limited to obtaining material relating to the size of the service fee. This material consists of copies of the financial statements of the service entity and relevant professional firm together with a copy of the relevant service agreement (if one exists). Copies of relevant leases, employment contracts, details of the personnel actually involved in the service entity's operations and other documents going to the genuineness of the service entity arrangements have not been sought by the Tax Office at this initial stage of the audit. As a result, the Tax Office has not during this phase of the audit gained an understanding of the extent to which the service arrangements were genuine that is, properly implemented.

6.72 The Tax Office has then, based on this limited evidence, proceeded to settle an acceptable level of service fee with a number of these taxpayers being audited. These settlements have been based on the levels of service fees the Tax Office obtained in their settlements with the two major accounting firms where far more evidence of the relevant service entity operations had been gathered.

6.73 For taxpayers who have not settled with the Tax Office at this stage, evidence relating to the genuineness of the service entity arrangement has only started to be gathered once the taxpayers have made it clear that they will not settle without a full audit being conducted. In some cases, however (such as where the taxpayers appear to be willing to settle) this evidence has not been gathered even, in one case, as late as 21 months into the relevant audit.

6.74 The Inspector-General has also obtained other evidence that, in its prior years audits of service entities, the Tax Office is unwilling to consider that there may be factors that are specific to a particular professional firm (such as a significant downturn in its business) which provided a reasonable explanation for the relevant service entity fee exceeding Tax Office benchmarks. In this kind of case, the firm may still be committed to paying fees to its service entity to cover overhead expenses that are surplus to the firm's actual needs.

6.75 In one case of this kind that was examined by the Inspector-General the taxpayer made a written submission to the Tax Office which detailed both the effect of a business downturn on its service fees and its overall behaviour in attempting to comply with the published ATO guidelines on service trusts. The Tax Office's response to this submission did not address any of the points raised by the taxpayer. Rather, the response stated that the submission did not establish grounds for the Tax Office to depart from its 'general guidelines'.

6.76 The manner in which the Tax Office has approached these audits strongly suggests that it is attempting, in its current prior year audits, to use the audit results it has obtained from the two large accounting firm audits as a simplistic 'one size' solution to all service entity arrangements, without adequately considering the individual circumstances of other arrangements. This kind of an audit approach is in breach of Taxpayers' Charter principles which require the Tax Office to take into account individual taxpayer's circumstances in its compliance activities.

6.77 The approach adopted by the Tax Office in prior year service entity audits also involves attempts to apply audit results reached with large and influential firms to much smaller firms.

6.78 A failure by the Tax Office to consider taxpayer's individual circumstances has been the subject of adverse comment in previous reviews of Tax Office behaviour which have been conducted both by the Inspector-General and by other review bodies such as Senate Committees. The Tax Office's justification for this kind of behaviour is that it has limited resources, that this approach leverages off previous work that the Tax Office has done in the area and that this approach is efficient from an administrative viewpoint. The Inspector-General notes that these kinds of justifications have more validity in cases where thousands of taxpayers may be subject to the relevant audit activity, as in the case of MMTEIs and EBA arrangements. However, they have far less validity in cases such as the subject of this report where only a relatively small number of taxpayers are involved (a maximum of 80 in this case).

6.79 The above comments lead to the following key finding and recommendation:

KEY FINDING 6.5

The manner in which the Tax Office has approached the prior year audits it is conducting of the service entity arrangements of small to medium size accounting and legal firms strongly suggests that it is attempting to use the audit results it has obtained from the two large accounting firm audits as a simplistic 'one size' solution to all service entity arrangements, without adequately considering the individual circumstances of other arrangements. This kind of an audit approach is in breach of Taxpayers' Charter principles.

KEY RECOMMENDATION 5

When conducting audits of any taxpayer (including any audits of prior year service entity arrangements), the Tax Office should ensure that it fully considers all the relevant taxpayer's individual circumstances. It should also, as part of the audit process, clearly demonstrate to the taxpayer that it has done so, for example, by addressing these circumstances specifically if the taxpayer has raised these circumstances in a written submission.

Other Tax Office behaviours evidenced in service entity audits

6.80 The Inspector-General's fieldwork on service entity audits has produced other evidence of other Tax Office behaviour which is in breach of Taxpayers' Charter principles and/or other relevant legal guidelines.

6.81 This behaviour, which is discussed below, includes the Tax Office walking away from previous advices it has given, refusing to accept that it has changed its prior general administrative practice for service entities and effectively forcing taxpayers to admit that they have engaged in anti-avoidance behaviour in order that they are able to receive a total tax bill which is fair and reasonable in the circumstances.

6.82 Apart from the behaviour discussed below, all other Tax Office conduct in relation to these audits that was the subject of examination for this review appears to have been conducted in accordance with Taxpayers' Charter principles.

The Tax Office has 'walked away' from previous advices

6.83 Submissions assert that in audits it has conducted on service entity arrangements for periods prior to the issue of the service trust ruling and booklet the Tax Office has 'walked away' from previous advice it has given to specific taxpayers that a 50 per cent mark-up on labour costs and a 15 per cent mark-up on other expenses would be an acceptable way to determine the amount of service fee to be charged by their service entity.

6.84 The Inspector-General's fieldwork has confirmed that these assertions are correct. In at least two of the audits the Tax Office has conducted the relevant taxpayers have been in receipt of specific advice that 50 per cent/15 per cent mark-ups were acceptable for their service entity arrangements. The relevant advice was given in the early 1990s and took the form of what the Tax Office considers to be non-binding advice. When the firms were subsequently audited the Tax Office asserted that it was entitled to ignore this advice because it has been rescinded in a 1994 speech that was given to the TIA by a tax officer. This speech was however not provided at the time specifically to the relevant taxpayers and has never

been made available by the Tax Office to the public. It was and is now only accessible to members of the TIA.

6.85 The Inspector-General considers that it is unacceptable, particularly in a self assessment environment, for the Tax Office to assert that it has rescinded specific taxpayer advice by comments made in a speech which it has neither provided to that taxpayer nor made publicly available. This is the case, even if the speech was given at a forum where members of the firm who received the relevant advice may have been attendees. In a self assessment system taxpayers should be entitled to rely on specific advices given to them by the Tax Office, unless they receive notice directly from the Tax Office that those advices are no longer considered to be correct. In the two cases under consideration, the earliest time when both taxpayers would have received such direct notice was during the relevant audits.

6.86 In the Inspector-General's view, this advice should have resulted in the Tax Office accepting that, for periods prior to when the relevant advice was formally rescinded, the taxpayers were entitled to apply 50/15 per cent mark-ups in setting the level of their service entity fees. If the relevant arrangements exhibited no other significant tax issues, these taxpayers should not then have been subject to any prior year tax adjustments (including penalties and interest).[36]

6.87 The above comments lead to the following key finding and subsidiary recommendation:

KEY FINDING 6.6

The Tax Office has 'walked away' from previous advice it has given to specific taxpayers for use by their clients and themselves that a 50 per cent mark-up on labour costs and a 15 per cent mark-up on other expenses would be an acceptable way to determine the amount of service fee to be charged by their service entity.

Subsidiary recommendation 3

The Tax Office should state in a practice statement or other guidance document that is issued to its staff that prior year advices given to taxpayers will not be considered to have been withdrawn unless the withdrawal is specifically brought to the attention of affected taxpayers.

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36 This would be in accordance with:

- for periods prior to 1 January 2006: the administrative rules contained in TR 92/1, TR 97/16 and PS LA 2001/4 (especially paragraphs 73 and 74) and the legal rules contained in section 284-215 of the TAA 1953; and
- for periods after 1 January 2006: the above legal and administrative rules (other than TR 92/1 and TR 97/16 which have been withdrawn with effect from 5 April 2006), TR 2006/10 and sections 358-10 and 361-5 of the TAA 1953.

The Tax Office has changed a prior general administrative practice but has failed to take this into account in determining the amount of tax, penalties and interest payable

6.88 As stated in a previous chapter, a number of submissions assert that the final Tax Office view on service entities as stated in TR 2006/2 and the accompanying booklet represent a change in the Tax Office's general administrative practice on service arrangements. They assert that the Tax Office has incorrectly represented that there has been no such change so that legal and administrative rules (which require it to refrain from levying additional tax, penalties and interest in cases where it has changed such a practice) do not apply.

6.89 Earlier in this chapter the Inspector-General has stated that he believes that the Tax Office has not changed its view of the law on service entity arrangements as stated in its final ruling and booklet on service trusts from that which it held in 1978. However, the Tax Office has, in these documents, changed its view on how this view of the law will be applied to such arrangements (in the sense of how to calculate the amount of service fees). These documents incorporate guidelines and tests for calculating the amount of service fees that are new.

6.90 The Inspector-General believes that the change the Tax Office has made in 2006 from the view it has in 1978 on how to calculate service entity fees amounts to a change in a prior 'general administrative practice', despite assertions to the contrary by the Tax Office.

What is a prior Tax Office 'general administrative practice'?

6.91 In examining the issue of whether the Tax Office has changed a prior general administrative practice it is first necessary to reach a view on the meaning of this term. The following matters need to be considered in this respect.

6.92 Firstly, there is limited public material on the meaning of this term. The only public statements on this term have been those made in one court case, in an Explanatory Memorandum and (from March 2006) in two Tax Office practice statements and one Tax Office ruling.

6.93 Secondly, the term is capable of being interpreted either widely or narrowly.

6.94 The court case where the term 'general administrative practice' was considered is *Prebble v F C of T* (2002) 51 ATR 459. In this case, at page 470 Justice Cooper noted that, although there was some evidence of a general administrative practice of the Commissioner in the circumstances of the case that practice must still exist at the time a taxpayer makes a statement in a tax return for it to be a ground for the non-application of any penalty.

6.95 The term was discussed in the Explanatory Memorandum which accompanied *Tax Laws Amendment (Improvements to Self Assessment) Bill (No. 2) 2005* (TLAB (No. 2) 2005). This bill introduced a new legislative regime for Tax Office rulings and also introduced changes in the extent to which reliance by a taxpayer on a Tax Office general administrative practice would protect that taxpayer from the imposition of interest (and also possibly of primary tax). All these changes took effect from 1 January 2006.

6.96 The comments in this Explanatory Memorandum on the meaning of the term 'general administrative practice' may strictly only have relevance after 1 January 2006. However, the term was used in the tax law prior to this date.

6.97 The Explanatory Memorandum makes the following points on the meaning of the term 'general administrative practice':[37]

- 'General administrative practice' will usually be established by the Tax Office having communicated consistently to a wide range of taxpayers on a particular issue.
- It will often be documented in a Tax Office practice statement, a Tax Office policy document or other precedential material (such as an ATO interpretive decision).
- Where a draft public ruling represents the Commissioner's only public statement on an issue, the draft ruling will usually represent the Commissioner's general administrative practice.
- A 'general administrative practice' is not established merely because there are several similar private rulings on a matter, although evidence of a significant number of uncontradicted private rulings on a matter over time will tend to support such a conclusion.
- A bare failure by the Commissioner to take some action within his power does not establish a general administrative practice, but a repeated failure by the Commissioner to exercise that power after the issue is drawn to the Commissioner's attention will tend to do so.
- Mere silence or failure to issue a public ruling on a matter does not constitute general administrative practice but it will be established where, following identification of an issue, ATO officers have accepted it as the basis on which taxpayers should treat the issue in a range of situations.

6.98 The only guidance which the Tax Office has issued on the meaning of the term 'general administrative practice' is contained in:

- two practice statements that were issued after 1 January 2006 during the course of this review. These are PS LA 2006/2 (which deals with penalties for false and misleading statements) and PS LA 2006/8 (which deals with the remission of interest); and
- a Tax Office ruling — TR 2006/10— which was also released after 1 January 2006 and during the course of this review. This ruling contains comments on the non-application of primary tax to arrangements entered into prior to a change in the Commissioner's general administrative practice. It only applies however where a change in practice has been made by the issue of a binding public ruling and not where that change has been made by other means.

6.99 None of these Tax Office statements contain a comprehensive statement of the meaning of the term 'general administrative practice'.

6.100 TR 2006/10 contains the most comprehensive commentary on this term. This ruling essentially repeats what is already set out in the Explanatory Memorandum to TLAB (No. 2) 2005. However, it appears to contain an additional statement which contradicts

37 Commonwealth of Australia, *Explanatory Memorandum to Tax Laws Amendment (Improvements to Self Assessment) Bill (No. 2) 2005* at paragraph 3.130 to 3.132.

what is in the Explanatory Memorandum. As noted above, the Explanatory Memorandum states that:

> A general administrative practice … will often be documented. … in other precedential material (such as an ATO Interpretative Decision).

6.101 However, TR 2006/10 states that:

> ... not all precedential material (such as ATO Interpretative Decisions (ATO IDs)) indicate a general administrative practice. An ATO ID will only be accepted by the Tax Office as representing general administrative practice where the view contained therein is supported by other evidence of a pattern of Tax Office treatment of the issue consistent with the view expressed in the ATO ID (for example, a significant number of private rulings on the same matter which reach the same conclusion).

6.102 Neither this ruling, nor either of the two practice statements referred to above, contains any practical examples to guide tax officers and taxpayers on the meaning and application of this important term.

6.103 The Inspector-General considers the lack of comprehensive public guidance on the meaning of the term 'general administrative practice', especially prior to 1 January 2006, has caused the Tax Office to adopt an overly narrow view of this term and its application in the context of service entity arrangements.

Tax Office grounds for asserting there has been no change in a general administrative practice on service entities

6.104 The evidence and grounds that the Tax Office relies on for asserting that it has not made any change in its prior general administrative practice for service entities are essentially the same grounds the Tax Office relies on for its assertions that it has not changed the manner in which it applying the law on service entities. These grounds differ from those discussed earlier in this chapter only in that they deal specifically with the term 'general administrative practice'. They are as follows.

6.105 Firstly, the Tax Office argues that it has not changed a prior general administrative practice for service entity arrangements because there was no such practice to change.

6.106 Secondly, it argues that, if there was a practice on service entities evidenced in documents such as the 1985 trust assessing manual, this practice was not a 'general' one because its assessing manual only gave specific guidance to particular Tax Office branch offices in respect of particular years of income.

6.107 The Tax Office's third argument is that the term 'administrative practice' does not embrace situations where, as in service entity arrangements, the Tax Office changes its view of how a deductible amount is to be calculated. This is because this issue involves a question of the application of the law rather than an administrative matter.

6.108 The Tax Office's fourth argument is that even if it did have a general administrative practice on service entities as set out in its trust assessing manual that practice was changed before the date of issue of TR 2006/2 and its accompanying booklet via a number of Tax Office statements in annual reports, liaison group minutes and Commissioner's speeches.

6.109 A final argument is that even if there was a general administrative practice still in existence by 2006 it was not appropriate to apply any change in this practice that was made

by TR 2006/2 and its accompanying booklet prospectively because this practice was being exploited by professional firms in an egregious manner to avoid tax.

6.110 The Inspector-General considers that none of the above Tax Office assertions should be fully accepted. He considers that the method for calculating service entity fees set out in the 1985 trust assessing manual represents a practice which existed at that time. This practice was not contradicted in any public guidance document issued by the Tax Office until the time when the draft versions of the service entities ruling and booklet were issued in 2005. This practice was also both 'general' (as it was made known to the public) and 'administrative' in nature, given that it was the method which the Tax Office stated was an acceptable means for determining the amount of a service fee deduction.

6.111 There are also difficulties with the Tax Office's assertion that a change in its general administrative practice will have no impact if the Tax Office considers that the practice has been exploited by taxpayers to avoid tax. This is because the legal provisions dealing with the consequences of a change in a general administrative practice (which are discussed further below) do not contain any express proviso that taxpayers will not be protected from paying tax for previous years in cases where the Tax Office considers that a previous practice has been exploited. However, the Inspector-General notes that there is a view that an implied proviso to this effect can be read at least into the provision which provides taxpayers with protection against the payment of interest for previous years as this protection only applies where the taxpayer was 'reasonably relying in good faith' on the relevant practice.[38] The Inspector-General also notes that paragraph 3.132 of the Explanatory Memorandum to TLAB (No. 2) 2005 appears to contain a statement that the Commissioner would not apply a new practice prospectively where tax avoidance is involved or the previous practice has been exploited in an unintended way.

6.112 The Inspector-General further notes that, even if the Tax Office is correct and the term 'general administrative practice' does not apply to a case where it changes its view of how the amount of a deduction is to be calculated (because this is not an 'administrative' matter but rather a matter of law), this term almost certainly embraces a situation where the Tax Office has changed the administrative parameters it uses for determining whether particular arrangements will be subject to audit. It is clear from the Tax Office's own comments that the parameters for audit which are set out in its 2006 final booklet on service entity arrangements have been changed from those which it set out in its trust assessing manual in 1985. This change of itself therefore amounts to a change in a general administrative practice by the Tax Office.

6.113 The Inspector-General's view that the Tax Office has changed a general administrative practice in respect of service arrangements is also supported by the discussion of the meaning of this term in the Explanatory Memorandum to TLAB 2005 (No. 2).

6.114 As noted above, this Explanatory Memorandum states that a 'general administrative practice' can be embodied in a Tax Office interpretive decision. It therefore clearly supports the Inspector-General's view that a Tax Office statement on the application of a tax law to a set of circumstances can amount to a general administrative practice.

6.115 This Explanatory Memorandum also states that a failure by the Commissioner to take some action within his power after an issue is brought to his attention will tend to

38 See section 361-5 of the TAA 1953.

establish a general administrative practice. In this regard, it could be argued that the Tax Office's failure to issue any form of detailed practical guidance on how to calculate service entity fees for three and a half years after his 2001 Annual Report amounts to evidence of a general administrative practice in respect of those fees at least for this three and a half year period.

6.116 The Inspector-General's view that the Tax Office has changed a general administrative practice in respect of service arrangements is also supported by:

- a survey covering 1,000 service entities which the Institute of Chartered Accountants (ICAA) conducted of its members after the release of the draft ruling and booklet but prior to the release of the final ruling and booklet;[39]
- the fact that the Tax Office felt it was necessary to make consultations held with NTLG members on the ruling and booklet prior to their public release confidential;
- the fact that the Tax Office suspended most of its audit activity on service entities for roughly the period between the date of issue of the draft and final versions of the ruling and booklet. The Inspector-General queries why such a suspension was considered necessary by the Tax Office if neither the draft or final ruling and booklet had or would change the Tax Office's previous administrative practice on service trusts;
- evidence which has been obtained by the Inspector-General which shows that:
  - in 1990 and 1991 the Tax Office issued at least two opinions to a major accounting firm which confirmed that mark-ups of service fees that were consistent with those set out in its previous trust assessing manual were acceptable and that these mark-ups could be applied to clients of the firm as well as to the firm itself; and
  - prior to 1999, a number of taxpayers with service entity arrangements had been subject to audit by the Tax Office either in respect of their overall tax affairs or in relation to their service entity arrangement specifically and had received either written confirmation, oral confirmation or acquiescence from the Tax Office that they were entitled to deduct fees paid to their service entity where those fees were calculated using mark-ups that were the same as, or close to, those used in the *Phillips* case; and
- every submission to this review which dealt with this issue (other than those made by the Tax Office).

6.117 The above comments lead to the following key finding.

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39 According to the ICAA the results of this survey indicated that 80 per cent of ATO audit activity up until very recent times resulted in no adjustment to service entity arrangements or no challenge to the service arrangement, that 83 per cent of members participating in the survey considered that TR 2005/D5 represented ' a high to extremely high' shift in attitude by the ATO towards service entities and that most if not all such members would find that their own or their clients' arrangements would not satisfy the requirements of the draft ruling and booklet.

KEY FINDING 6.7

The Inspector-General believes that the change the Tax Office made in 2006 to the view it had in 1978 on how to calculate service entity fees, which incorporates new tests, amounts to a change in a prior 'general administrative practice', despite assertions to the contrary by the Tax Office.

Legal implications of a change in a prior general administrative practice

6.118 As stated previously, if the Tax Office has changed a general administrative practice for service entities, the Tax Office would be legally bound to consider the application of section 284-215 of TAA 1953[40] in all the service entity audits it has conducted. This section (and its predecessor) have, since the early 1990s, prevented the Tax Office from levying an administrative penalty on a taxpayer where they have made a return which agrees with the Tax Office's previous general administrative practice.

6.119 Such a change in practice would also mean that, from 1 January 2006, the Tax Office would be legally unable to charge interest on underpaid tax to such a taxpayer under section 361-5 of the TAA 1953. Section 361-5 gives this protection where a taxpayer has relied on the relevant practice.

6.120 The Inspector-General notes that, while these legislative protections for penalties and interest are not worded in exactly the same way, they have a similar effect.

6.121 From 1 January 2006, such a change in practice will not of itself mean that the Tax Office is legally obliged to forego the payment of primary tax for years preceding the change. From this date, section 358-10 of the TAA 1953 allows the Tax Office not to pursue the payment of primary tax for previous years (and therefore also has the effect of providing legal protection for taxpayers against the payment of this tax), but only where the change has been made *by a public ruling*. The Inspector-General notes that section 358-10 was enacted following the RoSA review which was conducted by Treasury in 2004. This review recommended that the law should be amended so that where the Tax Office changes a longstanding practice to the detriment of taxpayers that change should take effect from a future date. This was so as to allow affected taxpayers reasonable time to become aware of, and act upon, the change.[41] Section 358-10 legally allows the Commissioner to confine the future application of a changed Tax Office practice to situations where that change is made by the issue of a public ruling.

6.122 There is a view that, when enacted, section 358-10 was not extended to cases where the change is made by means of something other than a public ruling because the RoSA changes to the laws on rulings were not designed to proscribe every aspect of tax administration, including the circumstances in which the Tax Office will raise amended assessments. Under this view, principles of good administration (particularly the principle of fairness) , rather than any express provision in the law, should bring about the result that the Tax Office does not pursue the payment of primary tax in situations where it has changed a general administrative practice by means other than the issue of a public ruling.

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40 Section 226V of the ITAA 1936 for years of income prior to 2000/01.

41 The Treasury, *Report on Aspects of Income Tax Self Assessmen*t, August 2004, Commonwealth of Australia recommendation 2.6 at page 13.

6.123 The Tax Office considers that section 358-10 gives legislative effect to a policy which it has had in effect since 1992. This policy was that where the ATO had contributed to taxpayers adopting a certain practice in lodging their tax returns any ruling less favourable to taxpayers which directly overruled that practice would usually only have a future application.[42]

6.124 The administrative consequences which the current wording of section 358-10 have given rise to are illustrated when considering what effect the section has if, as a result of this review, the Tax Office accepts that it has changed its prior general administrative practice on service entity arrangements. In this case, under current Tax Office practice, it appears that section 358-10 has no application. This is despite the fact that a public ruling (TR 2006/2) has been issued after the date of effect of section 358-10 (being 1 January 2006) and that this ruling has been accompanied by appendices to the ruling and a guidance booklet which appear to give effect to a change in a general administrative practice.

6.125 The reasons for this are as follows.

6.126 Firstly, the Commissioner's change in practice on service entity arrangements has actually been set out in two sets of documents — that is, in both a ruling and a booklet. Only the former of these documents partly takes the form of a binding ruling. Section 358-10 only gives protection against primary tax for previous years for changes made by a *public ruling*. Therefore the changes in ATO practice that are only referred to in the booklet and which are the most significant changes in practice which have occurred — being the changes to how the level of deductible service entity fees should be calculated — will not attract the operation of section 358-10. Similarly, the changes in administrative practice which are referred to in the non-binding appendices section of the ruling will also not attract the operation of section 358-10. Despite these changes in practice, taxpayers will therefore not be legally protected under section 358-10 for the payment of primary tax for previous years.

6.127 Secondly, it is arguable that the Commissioner's change in practice on service entities has occurred prior to the issue of TR 2006/2 and its accompanying booklet. The Tax Office has asserted that this change may have occurred earlier than the release of TR 2006/2 date as an alternative argument as to why any change in general administrative practice should not affect current service entity audits which it is conducting. If this view of the Tax Office is correct, then section 358-10 again does not operate. This is because section 358-10 only gives protection against primary tax where the change has been made *by* a public ruling. It would therefore not operate in a case such as this where the change in administrative practice has been made prior to the issue of the relevant ruling and/or any accompanying non–binding material and the ruling and/or accompanying material then simply confirms this change.[43]

6.128 These comments lead to the following key finding.

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42 This policy was stated in paragraph 16 of TR 92/20.

43 The Commissioner has confirmed this interpretation of section 358-10 publicly at a tax administration forum held in April 2006.

KEY FINDING 6.8

Taxpayers only have express legislative protection against the payment of primary tax for previous years where a change in a longstanding practice of the Tax Office has been made by a public ruling. There is no express protection where the change has been made by other means (such as the issue of non-binding Tax Office guidance) or where the change has been made prior to the issue of a public ruling and the ruling confirms the relevant change.

In contrast, the legislative protection which is given to taxpayers for the application of penalties and interest for prior years in cases where a longstanding practice is changed does not depend on whether the change has been made by a public ruling. In the case of interest, taxpayers need only have relied on the relevant longstanding practice, while in the case of penalties taxpayers need only have made a return which agrees with the relevant practice.

Extent to which the Tax Office has considered the issue of a change in administrative practice in service entity audits

6.129 The Tax Office's view that it has not changed a general administrative practice with respect to service entity arrangements has meant that it has not taken this change into account in levying any of the penalties, interest and primary tax it has imposed in prior year audits of service entity arrangements.

6.130 The Inspector-General's fieldwork on these audits has established that this issue has not been referred to in any of the Tax Office's internal paperwork prepared for these audits, including that prepared for the internal technical committee which reviews the amount of any penalty. This is despite the fact that taxpayers in these audits raised this issue as being a ground for the legal remission of penalties and as a ground for the administrative remission of both primary tax and interest (in accordance with TR 92/20).

6.131 The Inspector-General considers that the failure to take this matter into account in setting either the level of penalties or the amount of additional tax and interest payable amounts to a serious systemic issue which should be immediately addressed by the Tax Office.

6.132 These comments lead to the following key finding.

KEY FINDING 6.9

The Tax Office's view that it has not changed a general administrative practice with respect to service entity arrangements has meant that it has not taken this change into account in levying any of the penalties, interest and primary tax it has imposed in prior year audits of service entity arrangements.

Tax Office administrative practices and guidelines on the meaning of the term 'general administrative practice' and its effect on the determination of penalties, interest and primary tax

6.133 The only internal reference material or processes which the Tax Office has for its staff when they are considering whether primary tax should not be collected because the

taxpayer has relied on a prior general administrative practice of the Tax Office is contained in TR 2006/10 which was issued in final form in October 2006. However, this ruling only deals with the situation where a change in a previous Tax Office practice has been made by the release of a binding public ruling. It does not cover the situation where a change in practice is made by other means, such as by the issue of a non-binding Tax Office publication.

6.134 Until March 2006, the Tax Office also had no such internal reference material for its staff to refer to when considering whether a penalty should not be applied because there has been a change in a general administrative practice. This was despite the fact that this ground for the non-application of any penalty has been part of the law since the early 1990s. This situation has been remedied by the issue of PS LA 2006/2 which was issued during the course of this review.

6.135 Furthermore, until 1 August 2006, the Tax Office had no such reference material for its staff to refer to when considering whether a change in a general administrative practice would lead to a remission of interest. This situation has also been remedied during the course of this review by the issue of PS LA 2006/8. This practice statement deals with shortfall interest (being the interest that accrues for the period between when tax should originally have been paid and when the Tax Office issues an amended assessment to the taxpayer in respect of that tax). It covers the situation where this shortfall interest has arisen as a result of a taxpayer relying on a general administrative practice of the Tax Office either before or after 1 January 2006 and contains a number of statements on the meaning of the term 'general administrative practice'.

6.136 The practice statement states that where a taxpayer has followed a general administrative practice of the Tax Office in good faith prior to 1 January 2006, that practice is incorrect or misleading and the taxpayer makes a mistake as a result, any shortfall interest charge that applies in the period up to 21 days after the Commissioner notifies the correct position to the taxpayer will be remitted in full.[44]

6.137 The Inspector-General considers that the comments in PS LA 2006/2, PS LA 2006/8 and TR 2006/10 are a positive step in the right direction. However, he considers that more needs to be done to provide Tax Office staff with guidance on the meaning and application of the term 'general administrative practice' in the context of both the application of penalties, the remission of interest and the imposition of primary tax. The Inspector-General considers that comments in all three documents are too brief. They do not contain any practical examples of cases where a general administrative practice may exist but has not been set out in an ATO Practice Statement. In the case of TR 2006/10 the Tax Office's comments are also too limited in that they do not cover the situation where a change in a prior Tax Office practice is made but not by means of the issue of a binding ruling.

6.138 The Inspector-General considers that the lack of overall comprehensive guidance for Tax Office staff on the meaning of the term 'general administrative practice' and the effect that a change in such a practice will have on the remission of penalties, primary tax and interest needs to be urgently addressed.

6.139 The Inspector-General also notes that the Tax Office's interpretation of the term 'general administrative practice' and the circumstances in which such a practice will have changed were also major themes of his previous review of the Tax Office's practices for the

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44 PS LA 2006/8 at paragraph 107.

remission of the general interest charge (GIC) for groups of taxpayers. Despite the concerns raised by the Inspector-General, the Tax Office has still not promulgated sufficient guidance to its own officers on the meaning and effect of this term.

6.140 The Inspector-General believes that it is a fundamental principle of good tax administration that the Tax Office should not, as a general rule, pursue the payment of primary tax in situations where it has changed a general administrative practice. In his view, this principle operates regardless of the means by which the relevant change is made (that is, it does not matter whether or not the relevant change has been made by a formal public ruling).

6.141 This principle is founded on the view that in a self assessment environment it is not fair to require taxpayers to retrospectively pay tax for a previous year where they originally calculated their tax liability for the relevant year in accordance with a general Tax Office practice which existed and was widely known at the relevant time.

6.142 In the case of service entities, the Tax Office has effectively sidestepped the application of this principle. It has done so by asserting that it has not in fact made any change in its general administrative practice. It continues to make this assertion despite the overwhelming evidence which has been gathered during the course of this review that it has changed its general administrative practice in this area.

6.143 The Tax Office has then further sidestepped this principle of good administration by contending that, in any event, it only legally needs to consider this principle in the case where it has made a change in its general administrative practice by issuing a public ruling.

6.144 This principle and the overall concepts and protections of general administrative practice are only available if the Tax Office agrees that the practice existed and that it has been changed. The application and effectiveness of the general administrative practice provisions therefore rely on the Tax Office behaving fairly, objectively and being willing to admit that it has contributed to a behaviour that it seeks to change. However, the Inspector-General has noted in other reports that the Tax Office can be reluctant to admit fault, can have a tendency to defensiveness, and on occasion displays a 'win at all costs' mentality.

6.145 The Inspector-General therefore concludes that there is a systemic weakness in relying on Tax Office fairness and objectivity to provide access to the principles, protections and provisions of a changed general administrative practice.

6.146 The Inspector-General will consider this systemic issue further in the course of his final report on all three cases studies which form part of his overall review of the Tax Office's ability to deal with complex tax issues. However, as a first step towards addressing this systemic issue, the Inspector-General has made two recommendations in this review on this issue. The first is that before any compliance enforcement activity, the Tax Office should test how well it has met its obligations to provide adequate and contemporary guidance to taxpayers on the relevant issue (Key Recommendation 1). The second recommendation is Key Recommendation 6 which is set out below.

6.147 The above comments lead to the following key finding and key recommendation:

KEY FINDING 6.10

The Tax Office has no specific internal reference material for its staff to refer to or processes to follow when considering whether additional tax should not be applied because the Tax Office has changed a general administrative practice and the relevant change has been made in a way which does not involve the issue of a binding public ruling.

Until October 2006, the Tax Office also had no such reference material or processes for its staff to refer in the case where a change in a general administrative practice was made by the issue of a public ruling. The guidance it has now issued on this matter only applies however for periods after 1 January 2006.

The Tax Office had no reference material or processes for its staff to refer to when considering whether a change in a general administrative practice would lead to the non-application of a penalty until March 2006. In the case of the remission of interest, there was no such material or processes until August 2006. The guidance it has now issued on both these matters applies for periods both before and after 1 January 2006.

The guidance which the Tax Office has issued on all of the above matters is too brief and does not contain any practical examples of cases where a general administrative practice may exist but has not been set out in an ATO Practice Statement.

KEY RECOMMENDATION 6

The Tax Office should issue comprehensive guidance to its staff, in the form of a practice statement which is made publicly available, on the meaning of the term 'general administrative practice' and on the implications with regard to penalties, interest and primary tax which arise if the Tax Office has changed such a practice. This guidance should also provide practical examples and should be subject to public consultation prior to being issued.

Compensating adjustments

6.148 Submissions have also stated that, in audits on service arrangements, the Tax Office is asserting that it is entitled to apply double taxation. This double taxation is said to arise because the Tax Office is asserting that the entity which has paid the fee is to be denied an income tax deduction for that fee and also that the same fee is still assessable as income in the hands of the service entity (or by the beneficiaries of that entity).

6.149 These submissions state that the Tax Office claims that there is no specific power in the ITAA 1936 or elsewhere for the Tax Office to make a compensating tax adjustment in these circumstances (that is, to reduce tax on the fee income that has been paid by the beneficiaries of the service entity.) These submissions however note that the Tax Office accepts that if the service entity arrangement is struck down by the anti-avoidance provision (Part IVA) it does have the specific power to make such compensating adjustments.

6.150 Submissions to this review stated that by taking the stance that it only has the power to make compensating adjustments where Part IVA applies the Tax Office is forcing taxpayers who wish to settle a service entity dispute to effectively admit that the arrangement is struck down by Part IVA even where the circumstances may not warrant such a conclusion. These submissions assert that the Tax Office should not be seeking to exert

pressure on such taxpayers by relying on an ability to levy double tax in this situation. Instead the Tax Office should be seeking to penalise such taxpayers, where appropriate, only in accordance with either the administrative penalty regime or the regime that applies for tax prosecutions.

6.151 The Tax Office has responded to these assertions by stating that settlements will generally give recognition for taxes already paid by associates without making any findings or inferences about Part IVA. These comments do not address the assertions made in submissions that the Tax Office's practices force taxpayers to effectively rather than to actually admit that their arrangement is struck down by Part IVA.

6.152 The Inspector-General notes that the subject of compensating adjustments is not addressed in either the final ruling or booklet on service entities.

6.153 The Inspector-General considers that taxpayers should not be effectively forced to admit that Part IVA applies to their tax situation solely for the purposes of obtaining a compensatory adjustment which is otherwise fair. If the Tax Office believes that it cannot adequately address this issue through its current general administrative power then it should recommend to the Government that the relevant law should be changed so that any such effective admissions no longer become necessary.

6.154 The above comments lead to the following key finding:

KEY FINDING 6.11

The subject of compensating adjustments is not addressed in either the final ruling or booklet on service entities. The Tax Office is, in practice, forcing taxpayers who wish to settle a service entity dispute to effectively admit that the arrangement is struck down by Part IVA even where the circumstances may not warrant such a conclusion.

CHAPTER 7: INSPECTOR-GENERALS' FINDINGS — ISSUES AROUND COMMUNICATION OF THE TAX OFFICE'S VIEW

7.1 This chapter sets out the Inspector-General's findings in relation to the Tax Office's communication processes for service entity arrangements.

Absence of a comprehensive statement or set of statements of the Tax Office's view on service entity arrangements for the period from 1978 to 2005

7.2 The principal concern raised in submissions to this review on the Tax Office's communication processes for service entities was that the Tax Office did not express it views on these arrangements in any formal, detailed consolidated statement or set of statements until mid 2005.

7.3 This review has confirmed that until mid 2005 the Tax Office's view of service entity arrangements could only be gleaned by referring to a number of different Tax Office statements. These statements included:

- a short non-binding tax ruling (IT 276);
- an assessing manual;
- speeches made by tax officers in 1994 and 1998;
- the Commissioner's 2001 Annual Report;
- a number of speeches made by the Commissioner since 2002;
- minutes of various liaison group meetings (such as the National Tax Liaison Group); and
- the Commissioner's Annual Compliance Program.

7.4 Three of these statements (being the three tax officer speeches in 1994 and 1998) were not made public by the Tax Office.

7.5 The issue and subsequent finalisation of the ruling and accompanying booklet on service entities has largely addressed this concern about the absence of a set of consolidated statements by the Tax Office on service entity arrangements.

7.6 These comments lead to the following key finding.

KEY FINDING 7.1

The Tax Office did not express a complete view on service entity arrangements in any formal detailed consolidated statement or set of statements until mid 2005. A finalised, detailed and consolidated set of statements on these arrangements was issued in April 2006.

Should the Tax Office have issued a Taxpayer Alert on service entity arrangements prior to the issue of the draft ruling and booklet?

7.7 A number of submissions have suggested that the Tax Office, rather than referring to its concerns on service entity arrangements in the period from 2001 to 2005 via speeches, liaison group minutes and annual reports should have made those concerns known to taxpayers generally via the issue of a specific Taxpayer Alert on this topic. These submissions state that this alert should have been issued as soon as these concerns were known.

7.8 The Inspector-General's fieldwork for this review has confirmed that the Tax Office did consider the issue of such an alert as early as 2002. However, no such alert was issued. The Tax Office has advised the Inspector-General that preparation of such an alert was not considered a priority because the Tax Office already had a view on service arrangements (as set out in IT 276). Furthermore, the Tax Office has advised that it considers that such an alert would have served little or no purpose as the use of service arrangements was widespread and the Tax Office's concerns with non-commercial arrangements had already been well published.

7.9 These Tax Office comments ignore the fact that the communication mechanisms which the Tax Office used to make its concerns on service arrangements known to the community (that is, its annual report, speeches and liaison group minutes) are principally directed to an audience which consist of tax advisers or those with a professional interest in tax matters rather than taxpayers generally. Taxpayer Alerts, by contrast, are a communication mechanism which the Tax Office specifically employs to reach a taxpayer market. When drafted, there are internal Tax Office requirements that they be accompanied by both a draft ATO media release and a briefing for Federal Parliamentarians.[45]

7.10 The process of publishing a Taxpayer Alert also gives rise to a formal internal Tax Office requirement to publish an ATO view on the relevant matter as a high priority.[46] Had this requirement been activated, it is possible that the draft ruling and booklet on service entity arrangements could have been issued far sooner than they were.

7.11 The Inspector-General considers that, in view of the widespread use of service entity arrangements by taxpayers, the Tax Office should have issued a Taxpayer Alert or a similar document[47] on its concerns with these arrangements and that this document should have been issued by no later than May 1999, which is one month after it produced an analysis of the results of its 1998 survey of a number of legal and accounting firms.

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45 These requirements are contained in ATO Practice Statement Law Administration PS LA 2005/13 at paragraph 22(ii).

46 ibid at paragraph 22 (iv).

47 The formal Taxpayer Alert system was not introduced until December 2001.

7.12 The Tax Office's response as to why it failed to issue this alert strongly suggests that it does not fully appreciate that communicating with tax advisers does not equate to communicating with taxpayers.

7.13 The above comments lead to the following key finding and key recommendation.

KEY FINDING 7.2

The Tax Office did not issue a Taxpayer Alert or a similar document on its concerns with service entity arrangements at the time when in 1999 it first identified concerns with these arrangements.

KEY RECOMMENDATION 7

The Tax Office should ensure that when it is dealing with a compliance issue that affects a significant segment of the taxpayer population it employs appropriate communication processes to ensure that its concerns on this compliance issue are made known to that population directly and as soon as possible. The Tax Office should not seek to rely on communicating these concerns only in publications or speeches to limited audiences.

Concerns about the content, completeness and clarity of the final service entities ruling and booklet

Content of final ruling and booklet

7.14 A number of submissions to this review raised concerns about the content of the final ruling and booklet in the sense that neither document was said to reflect an accurate statement of the relevant law. As indicated previously, the Inspector-General is not empowered to comments on these concerns.

7.15 However, submissions also raised concerns on:

- whether these documents had been developed on an objective basis;
- whether these documents were needed at all;
- whether these documents were sufficiently complete and clear; and
- the extent to which taxpayers would be protected against retrospective taxation in the future if they follow these documents.

7.16 These matters are all administrative in nature and are matters which can be the subject of review and comment by the Inspector-General.

7.17 Each of these matters is examined below.

Objectivity of the Tax Office's view on service entity arrangements as expressed in the final ruling and booklet

7.18 As noted in a previous chapter, the Tax Office has stated that the final ruling and booklet are together its principal strategy for combating the compliance issues it has found in relation to service entity arrangements.

7.19 The Inspector-General notes that this kind of strategy runs the risk that the terms of the ruling and guidance will not represent an objective Tax Office view of the relevant law, but rather a view of what the Tax Office would like the revenue law to be for revenue collection purposes.

7.20 A number of submissions to this review asserted that the draft booklet on service entities was revenue-biased. Public comments on the final ruling and booklet have not focussed on this aspect, however. At least one professional body that was involved in the consultation processes for the ruling has even been quoted as saying that the new rates for service fees set out in the final booklet are 'quite reasonable and easy to live with'.[48]

7.21 From the Inspector-General's fieldwork for this review, there appears to be at least one feature of possible revenue-bias in the final ruling and booklet on service entities. This is that these documents do not deal with the situation where all or part of the professional firm's practice is conducted not by a partnership but by a practice trust. The Inspector-General notes that the Tax Office has audited at least one firm which employed such a structure and that the result was that no tax adjustments were made in relation to the service fees charged in prior years. This was principally because most of the service fees were being paid from one trust to another trust with the same beneficiaries. In this situation, no additional tax payment arose because if the deduction for the fee in one trust was adjusted to a lower amount a corresponding amount of income would need to be removed from the second trust. This meant that any additional tax payable by the first trust as a result of this adjustment would be matched by and cancelled by a corresponding decrease in the tax payable on the relevant fee by the second trust.

7.22 The Inspector-General notes that in some public rulings (especially those which deal with GST[49]) the Tax Office does include examples of structures which prevent an adverse tax result. The Inspector-General considers that the practice trust structure for professional firm should therefore have been the subject of comment by the Tax Office in its final guidance on service entities.

7.23 During the course of this review, the Tax Office has stated that it did not provide comments on this kind of practice structure in its guidance material on service entities because it is not in the business of providing advice to taxpayers about how to structure their affairs. The Inspector-General notes that this comment raises issues about how the Tax Office defines its role of providing advice to taxpayers on the application of the law. This matter may be the subject of further examination in future reviews by the Inspector-General.

7.24 Subject to the above comment, the Inspector-General believes that the statements made by tax advisers and professional bodies on the final ruling and booklet suggest that the Tax Office has not compromised the objectivity of the view it has expressed in these final documents.

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48 See *The Australian Financial Review* of 21 April 2006 at page 15.

49 See, for example, the going concern ruling GSTR 2002/5 at paragraphs 137 to 140.

Should the ruling and booklet have been issued at all?

7.25 Some stakeholders argued that there was no need for the Tax Office to have issued either a new ruling and/or booklet. Stakeholders who held this view mainly argued that a new ruling was not necessary as IT 276 was a sufficient statement of the Tax Office's view.

7.26 Other submissions were not concerned about the Tax Office communicating its view on service entities via a new ruling but did not think that the issue of the accompanying booklet with comparable and indicative mark-up rates was warranted. This was because each service entity arrangement needs to be judged in the light of its own facts and it is not therefore appropriate to formulate rules of general application in this area.

7.27 A number of submissions also asserted that the issue of a booklet which sets out maximum mark-up rates for service entity fees and a maximum amount of 30 per cent of the firm's profit that can be made by a service entity may actually hinder taxpayer compliance with the law on service entities. This is because these mark-up rates may encourage taxpayers to use these rates or to ensure that 30 per cent of their firm's profits are derived by their service entity even though their individual firm's circumstances do not justify such results.

7.28 The Inspector-General notes that the majority of submissions were in favour of the Tax Office updating its view on service entity arrangements and setting out 'safe harbour' mark-up rates for such arrangements. He therefore believes that it was appropriate for the Tax Office to have issued these documents and for these documents to have contained 'safe harbour' rates.

7.29 These comments lead to the following key finding.

KEY FINDING 7.3

It was appropriate for the Tax Office to have issued a ruling and detailed guidance booklet for service entities.

Concerns about the completeness and clarity of the final ruling and booklet

7.30 Other concerns raised by stakeholders about the completeness, clarity or appropriateness of the final ruling and booklet on service entities, include the following:

- The examples provided in the final booklet (other than those provided for the medical profession) are simplistic as they deal with situations where an entity provides only one type of service (for example, labour hire, the provision of property or recruitment services) while in reality most service entities provide a complete package of services to the main business. A number of submissions suggested that the Tax Office should have used as a case study the actual facts of the *Phillips* case as this was still a common form of service entity arrangement.

- The final booklet does not adequately explain the manner in which the Tax Office will apply the 30 per cent profit cap for the purposes of determining whether a service arrangement will be audited. The booklet does not indicate, for example, whether this cap will apply to medical practitioners, does not indicate how the 30 per cent cap will

apply in a year when the professional firm operates at a loss and does not fully indicate how the profit is to be determined (for example, whether it is to be before or after interest).

- The final booklet does not adequately explain how the 30 per cent indicative gross mark-up rate for labour hire is equivalent to a 10 per cent net mark-up method and how the minimum 18 per cent of operating costs requirement applies. Some taxpayers consider that the wording of the booklet suggests that the 30 per cent gross mark-up on costs method coupled with a requirement for 18 per cent of operating costs being in the service entity equates to a 12 per cent (not 10 per cent) net mark-up.

- The final booklet provides detailed guidance on service arrangements only for lawyers, accountants and medical practitioners. Other taxpayer groups which have service arrangements (such as dentists and pharmacists) have not been dealt with in detail in the ruling and booklet[50] and these taxpayers are not certain how the Tax Office's view will affect their circumstances.

- The documentation requirements in the final booklet are too onerous and impractical.

- The ruling and booklet do not deal with a situation where the current partners in a professional firm have inherited a service entity arrangement which they themselves did not establish (this being a common occurrence, particularly with larger accounting practices).

- The final ruling and booklet keep IT 276 on foot and 'supplement' it with the new final ruling. Submissions assert that IT 276 should have been amalgamated with the final ruling so that taxpayers do not have to consult three separate Tax Office documents to gain a complete understanding of the Tax Office's view on service entities. These submissions note that such an amalgamation would be in accordance with the ease of access and clarity criteria for rulings that were set out in Treasury's 2004 report on *Review of Aspects of the Income Tax Self Assessment*[51] (the RoSA review).

7.31 The Inspector-General considers that the above concerns are valid. During the course of this review he advised the Tax Office that the first six of these concerns could be addressed by the Tax Office developing a process for capturing these concerns.

7.32 The Inspector-General notes in this regard that during this review at the NTLG meeting held on 21 June 2006 the Tax Office invited feedback on the booklet from the professional bodies and advised that is has now set up a dedicated email address to receive such feedback.

7.33 Furthermore, in response to the Inspector-General's concerns about the lack of an overall feedback process on all final public rulings, the Tax Office has now established a web-based electronic feedback process for all public rulings and determinations it has issued since 1 January 2006. This process is therefore available for the service entities ruling.

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50 It is noted that one example in the booklet refers to an arrangements conduced by a chemist but this example, which relates to rental arrangements for commercial premises, is not specific to chemists only.

51 The Treasury, *Report on Aspects of Income Tax Self Assessmen*t, August 2004, Commonwealth of Australia.

7.34 The Inspector-General considers that the concern about the continuing existence of IT 276 should be addressed by the Tax Office simply withdrawing this ruling.

7.35 These comments lead to the following key findings.

KEY FINDING 7.4

In response to the Inspector-General's concerns about the lack of an overall feedback process on all final public rulings the Tax Office has now established a web-based electronic feedback process for all public rulings and determinations it has issued since 1 January 2006. This process is therefore available for the service entities ruling.

KEY FINDING 7.5

The Tax Office should withdraw IT 276.

Concerns about whether the final ruling and booklet provide adequate protection for taxpayers who follow them

7.36 Submissions have noted that the final form of the ruling and booklet on service entities contain only a relatively small portion which is in the form of legally binding advice. Legally binding advice will protect taxpayers against the payment of tax, penalties and interest if they follow it.

7.37 These submissions note that the greater part of the ruling and booklet (including those parts which contain the Tax Office's comparable and indicative mark-up rates and the Tax Office's technical analysis of the law on service entities) only takes the form of advice which is administratively binding on the Tax Office. In material provided to the Inspector-General during this review the Tax Office has confirmed that such advice will only protect taxpayers against the payment of penalties and interest (but not against the payment of additional tax) if they follow it. Furthermore, these protections only arise as a result of the Tax Office's administrative practice. They are not protections which the Tax Office is legally bound to grant.

7.38 These submissions note that the principles underlying the RoSA review (especially those which extend the kinds of matters which can be the subject of a ruling to matters involving ultimate conclusions of fact) appear to suggest that the Tax Office should, wherever possible, provide its advice in the form of a legally binding ruling, in the interests of providing taxpayers with greater certainty in a self assessment system.

7.39 Submissions have further noted that the binding part of the final ruling on service trusts does not contain any examples, which appears to conflict with a recommendation made in the RoSA report.

7.40 The Inspector-General agrees with these submissions and considers that the Tax Office should give effect to the principles underlying the RoSA review by ensuring that all guidance which is of a significant nature and which applies to a substantial segment of the taxpayer population is, to the maximum extent possible, embodied in the form of guidance which is legally binding.

7.41 These comments lead to the following key finding and key recommendation:

KEY FINDING 7.6

The greater part of the ruling and booklet on service entities (including those parts which contain the Tax Office's comparable and indicative mark-up rates and the Tax Office's technical analysis of the law on service entities) only takes the form of advice which is administratively binding on the Tax Office.

KEY RECOMMENDATION 8

The Tax Office should, in the interest of providing maximum certainty to taxpayers in a self assessment environment, ensure that all guidance which is of a significant nature and which applies to a substantial segment of the taxpayer population is, to the maximum extent possible, embodied in the form of guidance which is legally binding on the Tax Office.

Other communication issues

Lack of clear and /or timely communication by the Tax Office of key aspects of its approaches to service entities

7.42 Submissions have also asserted that the Tax Office did not properly communicate two key aspects of its approach to service trusts at, or prior to, the time of issue of the draft ruling and booklet on service entity arrangements. These submissions assert that the failure to properly notify affected taxpayers of these key features of its approach at this time caused unnecessary angst, uncertainty and, in some cases, unnecessary additional costs.

7.43 The first of these key features concerns the criteria the Tax Office decided to employ to identify high risk audit cases.

7.44 In the draft booklet issued in June 2005, the Tax Office said that a taxpayer had to meet only two criteria to be considered a high risk audit case that was to be subject to retrospective audit action. The two criteria were that the service fees had to be over $1 million and that those fees had to represent more than 50 per cent of the gross income of the professional firm. This statement in the booklet confirmed a statement which the Commissioner had made to a Senate Committee about four weeks prior to the booklet being issued.[52]

7.45 However, on 3 November 2005, the Commissioner announced at another Senate Committee hearing that a third requirement would be added for a case to be considered a high risk case. This new requirement was that the profit of the service entity had to be more than 50 per cent of the combined profits of the service entity and professional firm.[53] The Tax Office did not communicate this new key criterion to taxpayers until it confirmed the change in the final version of the service entity booklet. This booklet was however issued some months after this statement to the Senate Committee.

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52 The statement was made at the Senate Economics Legislation Committee hearing of 2 June 2005 (see page E165 of the hearing transcript).

53 Senate Estimates Committee hearing, transcript of 3 November 2005 at page E51.

7.46 Submissions assert that this new third criterion that would be used to identify high risk cases should have been settled by the Tax Office prior to both the issue of the draft booklet on service arrangements and the Commissioner's June 2005 statement on this issue. These submissions further claim that even if this criterion was not settled by this time it should have been communicated to taxpayers as soon as it was settled and that this communication should have taken the form of either a media release and/or by way of an erratum to the draft booklet. An immediate communication of this change at least in the form of a media release was considered to be appropriate in view of the significance of this new criterion to the relevant taxpayer population and the fact that the initial two criteria for high risk audit cases had originally been firstly referred to by the Commissioner at a Senate Committee hearing and then subsequently announced in a media release.[54]

7.47 The second key feature of the Tax Office's approach to service entities which submissions claim was not clearly communicated to taxpayers concerns the date of effect of the Tax Office's new approaches to service entities.

7.48 This 'date of effect' involved the granting of a 12 months period of grace to taxpayers before the Tax Office would commence audits of their service arrangements.

7.49 Submissions assert that by the time when the draft booklet was issued in June 2005 the Tax Office did not make it clear when this 12 months period would commence. As a result many taxpayers assumed that it would commence on the date of issue of issue of the draft booklet. As the booklet was issued on 29 June 2005 that is, just prior to the end of the financial year, these submissions assert that many taxpayers assumed that the 12 months rule meant that audits would first apply for the year ended 30 June 2006. This meant that taxpayers had only one day (that is, until 30 June 2005) to ensure that their service arrangements complied with the Tax Office's stated view.

7.50 Submissions assert that the Tax Office only first made it clear to a group of tax professionals that its 12 months rule would apply from the date of issue of the final ruling and booklet and that taxpayers would have the benefit of a full 12 months to restructure their affairs in comments provided to a liaison group meeting held on 26 August 2005.[55] The comments of the 26 August 2005 meeting were subsequently published on the Tax Office's website in February 2006 as part of the minutes of the relevant meeting. The comments were not embodied in a formal Tax Office communication document directed to all affected taxpayers until they were embodied in the final booklet that was published in April 2006.

7.51 Submissions assert that the precise terms of the Commissioner's intended date of effect of his new approaches to service entities should have been settled by the time of issue of the draft ruling and draft booklet on service entities and should have been clearly spelt out in those documents.

7.52 These submissions also note that as soon as the Tax Office determined the actual terms of this 12 months period of grace it should have immediately taken steps to notify taxpayers of these terms by way of a press release. An immediate communication in this manner was considered to be appropriate in view of the significance of this 12 months period

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54 Australian Taxation Office, Draft Guidance on Service Trusts, Media Release Nat 2005-42, 29 June 2005.

55 The meeting was that of the Small to Medium Enterprises Sub-committee of the National Tax Liaison Group, held on 26 August, 2005. The minutes of this meeting are available on the Tax Office's website at www.ato.gov.au.

to all taxpayers with service entities and because this 12 months period had originally been referred to by the Commissioner in a Senate Committee hearing[56] and then subsequently announced in a media release.[57]

7.53 The Inspector-General agrees with these submissions. He further notes that the Tax Office's failure to clarify the terms of its proposed 12 months period of grace leaves it open to the accusation that it was deliberately creating uncertainty so as to exert compliance pressures on taxpayers with service entity arrangements.

7.54 The Inspector-General considers that taxpayers are entitled to receive, at the time of issue of any draft Tax Office guidance, a very clear indication from the Tax Office of the intended date of effect of that guidance. Clear statements of intended dates of effect provide taxpayers with greater certainty as to the likely effect of the guidance on their past, present and future activity so that they may fully consider what steps they need to take in respect of that guidance and when they should take those steps. Unclear statements of dates of effect can cause taxpayers unnecessary anxiety and can lead them to incurring additional costs (such as seeking professional advice and/or restructuring their arrangements) which may either not be necessary or which may not be necessary until a future date.

7.55 The Inspector-General notes that the Tax Office's internal Rulings Manual specifically states that all draft public rulings (including determinations) are to contain a date of effect. However this manual is silent on the need for this date of effect to be absolutely clear and on whether Tax Office guidance which does not take the form of a ruling is to contain a date of effect clause.

7.56 The above comments leads to the following key finding and recommendation:

KEY FINDING 7.7

The Tax Office did not properly communicate at, or prior to, the time of issue of the draft ruling and booklet on service entity arrangements either:

- the criteria it would employ to identify high risk service entity cases that were to be subject to audit; and
- the date of effect of its proposed approach to service entities.

KEY RECOMMENDATION 9

The Tax Office should ensure that when any form of draft guidance is issued to taxpayers, that draft always contains a very clear statement of the intended date of effect of that guidance. This requirement should be set out in a Tax Office practice statement or other internal document which provides guidance to its staff.

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56 The 12 months period was referred to by the Commissioner at the Senate Economics Legislation Committee hearing of 2 June 2005 (see page E165 of the hearing transcript).

57 Australian Taxation Office, Draft Guidance on Service Trusts, Media Release Nat 2005-42, 29 June 2005.

APPENDIX 1: TERMS OF REFERENCE AND CONDUCT OF THE REVIEW

TERMS OF REFERENCE

A.1.1 On 31 October 2005 the Inspector-General announced the terms of reference for his review of the Tax Office's ability to identify and deal with major, complex issues within reasonable timeframes. The terms of reference for this review were as follows:

> Within each and across all the following three case studies the Inspector-General will identify issues which, when addressed, will improve the Tax Office's handling of major, complex issues into the future:
>
> - Research and development syndication arrangements;
> - Living Away From Home Allowances (LAFHAs);
> - Service entity arrangements.
>
> Each case study will focus on:
>
> (a) the timeframes to identify and deal with the issue;
>
> (b) the nature and cause of those timeframes, and if they were reasonable in the circumstances;
>
> (c) the extent and cause of uncertainty to affected taxpayers, including any initial Tax Office guidance or representations;
>
> (d) the Tax Office's approaches to the issue, the reasons for them, and if they were reasonable in the circumstances, including:
>
> (i) its compliance, legal and resolution approaches; and
>
> (ii) its communications with members of the community; and
>
> (e) the adverse impacts and costs that the Tax Office's approaches and timeframes may have had on businesses and other areas of the community.

CONDUCT OF REVIEW

A.1.2 The Inspector-General advertised the review on his website, www.igt.gov.au from 31 October 2005. The review was also reported in the press and in specialist accounting and legal publications.

A.1.3 Written submissions to the review were taken from members of the public and a number of organisations.

A.1.4 Members of the review team also met with taxpayers, members of the accounting and legal profession, and representatives of various professional bodies representing lawyers, accountants and medical practitioners.

A.1.5 The Commissioner of Taxation was asked to provide information and documents relevant to the review. Visits were made to a number of branches of the Tax Office and to the Tax Office's National Office in Canberra to examine relevant files and interview relevant Tax Office staff.

A.1.6 The review also took into account a number of other inquiries relevant to this review.

A.1.7 This review was essentially completed by the end of August 2006. However, the Tax Office did not provide substantive responses to any of the recommendations made in the review until some three months later, that is, on 1 December 2006.

A.1.8 Recommendations from the review were first provided to the Tax Office in writing on August 25, 2006 and were then discussed at a meeting held between the Inspector-General and members of his staff and a Second Commissioner and other tax officers in mid-September 2006. One month after this meeting the Tax Office provided a letter containing comments on the report signed by the relevant Second Commissioner. Attached to this letter from the Second Commissioner was a copy of the draft report with further detailed Tax Office comments. However, neither of these documents contained any response to any of the recommendations of the review. The letter from the Second Commissioner stated that, although by that stage some six weeks had elapsed since the provision of the draft report and associated recommendations to the Tax Office, that:

> … the Commissioner has not been available to be briefed on the draft report. This reply does not therefore incorporate his views and no comment is made on the draft recommendations.

A.1.9 It was only after the lapse of a further one and a half month period that the Tax Office's substantive comments on recommendations from the review were provided to the Inspector-General.

A.1.10 The Tax Office has provided no explanation to the Inspector-General of the reasons for this three month delay in providing its substantive responses to the recommendations from this review.

A.1.11 The Tax Office's comments on this Appendix are set out in the letter which is reproduced below.

Mr David Vos AM
Inspector-General of Taxation
GPO Box 551
Sydney NSW 2001

Dear David

I refer to your e-mail of 13 December 2006 to the Commissioner of Taxation.

Your e-mail included a draft of Appendix A to your report on your review of the Tax Office handling of service entity arrangements. The appendix includes comments on delays by the Tax Office in responding to the report.

The Commissioner received your final draft report on 25 October 2006 and we provided a substantive response to the draft report on 1 December 2006, some 9 days after the expiry of the 28 day period in which we aim to respond, in accordance with the protocol between our two agencies.

While earlier versions of the report were similar, they were not identical to the final report (for instance, a couple of earlier recommendations had been dropped).

In addition, over the course of the review, the Tax Office made a large volume of information available to your officers. It was unclear if the information we had provided had been considered but rejected in preparing the final draft report. We accordingly felt it necessary to go through the report closely and provide detailed comments. This took a little time and I regret that we could not meet the 28 day goal.

We look forward to continuing to work closely with you in trying to improve Australia's tax administration.

Yours sincerely

Jennie Granger
Second Commissioner

21 December 2006

PO BOX 900 CIVIC SQUARE ACT 2608 AUSTRALIA
ADDRESS
+61 (0)2 6216 1111
TELEPHONE
+61 (0)2 6216 2743
FACSIMILE

APPENDIX 2: COMMISSIONER'S SUBMISSION IN RESPONSE TO THE REVIEW

A.2.1 The Tax Office's response to the review consists of three letters, an attachment to one of these letters which contains responses to the recommendations of the review and a second attachment which contains detailed comments on certain paragraphs in the review.

A.2.2 The first of the Tax Office's letters contains its comments on Appendix 1. This letter is reproduced at the end of Appendix 1.

A.2.3 The Tax Office's responses to the recommendations of the review are set out in Chapter 2.

A.2.4 The other two letters and the attachment which contains the Tax Office's detailed comments on certain paragraphs of the review are set out below.

Mr David Vos AM
Inspector General of Taxation
GPO Box 551
SYDNEY NSW 2001

Dear Mr Vos

Thank you for the opportunity to comment on your report into the Tax Office's management of the service arrangement issue. I do apologise for the delay in responding.

As foreshadowed at the meeting between your Office and the Tax Office on 13 September and as discussed in my telephone call to you on 1 December 2006, we could not find a lot to agree with in the report. We therefore find ourselves disagreeing with many of the recommendations.

I am enclosing a detailed response to the recommendations in Attachment A.

We also find ourselves taking a different position on many of the other issues and findings in the body of the report. Attachment B is a copy of the report which contains our detailed comments on these issues.

Attachments A and B were e-mailed to your office on 1 December 2006.

Much of Attachment B is a repeat of material which the Tax Office has previously provided to your office.

I apologise again for the delay.

Yours sincerely

Jennie Granger
Second Commissioner

7 December 2006

PO BOX 900 CIVIC SQUARE ACT 2608 AUSTRALIA
ADDRESS
+61 (0)2 6216 1111
TELEPHONE
+61 (0)2 6216 2743
FACSIMILE

Mr David Vos AM
Inspector-General of Taxation
GPO Box 551
SYDNEY NSW 2001

David

Dear Mr Vos

I refer to your e-mail of 13 December 2006 regarding your report on the handling of the service trust issue.

Please accept Ms Granger's reply as my formal response to your report.

I have also asked Ms Granger to provide you with a response, on my behalf, on the comments you make in your appendix A.

Yours sincerely

Michael D'Ascenzo

Michael D'Ascenzo
Commissioner of Taxation

21 December 2006

PO BOX 900 CIVIC SQUARE ACT 2608 AUSTRALIA
ADDRESS

+61 (0)2 6216 1111
TELEPHONE

+61 (0)2 6216 2743
FACSIMILE

A.2.5 Detailed Tax Office comments on matters raised by the Inspector-General are:

Paragraph 3.8

A.2.6 The Commissioner argued that the whole of the fees were incurred for purposes that were not deductible. In particular, they were incurred to make the unit trust viable to achieve income splitting with family members. Alternatively, the Commissioner argued that the fee to the extent it represented a profit to the unit trust was not incurred for a deductible purpose. The amount not allowable was argued to fail the statutory requirement of having been necessarily incurred in gaining or producing assessable income.

Paragraph 3.10

A.2.7 A vital aspect of the decision by Justice Waddell was a finding of fact that the evidence led by the taxpayer established that the rates were realistic and not in excess of commercial rates.

Paragraph 3.18

A.2.8 In 1981, at a joint seminar, Deputy Commissioner Brian Nolan stated that the anti-avoidance rules in the newly enacted Part IVA would not apply to a service trust arrangement if the mark up was commercially realistic: Justinian (20) November 1981 pp 10-13.

Paragraph 3.22

A.2.9 Assessing manuals were instructions to staff. The manual did not specify the circumstances in which fees were or were not considered deductible. In circumstances identified in the manual, staff were instructed to refer returns to a specialist assessor.

A.2.10 In addition to referring to particular threshold rates, the manual also provided that arrangements should not be inconsistent with ordinary business dealings, for example the fees should not be demonstrably out of line with the commercial value of the services rendered. Arrangements that were inconsistent with such ordinary business dealings were also to be referred to a specialist assessor.

Paragraph 3.24 – dot point 2

A.2.11 The paper also noted there was in fact no rule of thumb and mark ups had to be determined on a case by case basis. Individual arrangements may be challenged if they were not commercially realistic or where there was inadequate or inappropriate documentation.

A.2.12 Michael Fox from Hall Chadwick Accountants also presented at this conference. Referring to Peter O'Donohue's prior presentation, he said:

> The other observations he has passed on, together with the Tax Office views in published rulings can only emphasise the need to calculate the service entity charges properly. Quotes should be obtained from an 'alternate supplier' to help justify the actual charges.

A.2.13 Michael Fox also published an article on this theme entitled 'Fracturing a Fairy Tale' in the February 1995 TIA journal.

A.2.14 This external recognition of the ATO position should have been reflected in the report.

Paragraph 3.25

A.2.15 Taxation Determination TD 94/45 further explained that taxpayers who wish to know the current ATO position should refer to Tax Office documents such as Taxation Rulings and Determinations or seek a private binding ruling. A Ruling or Determination that is less favourable to taxpayers than the position adopted in an Assessing Handbook need not, in terms of the date of effect guidelines in TR 92/20, have only a future application.

Paragraph 3.26

A.2.16 These opinions also stated that service trust arrangements are only acceptable for income tax purposes provided that the activities of these trusts are considered commercially realistic and the mark-up on the cost of providing the services is reasonable.

Paragraph 3.29

A.2.17 At the same conference, Michael McLaren from William Buck accountants also presented a paper in which he reviewed the history and state of the service trust issue and concluded that: 'The key message is: Check the mark-ups in the market place.' This external recognition of the ATO position should have been reflected in the report.

Paragraph 3.31

A.2.18 The paper further explained that acceptance of service entity arrangements is on the basis that there is a commercial arrangement in place. Individual cases may be subject to scrutiny and will be challenged if they are not commercially realistic. What is commercially realistic will depend on the facts and circumstances of each case and it will be on the basis of evidence presented as to prevailing market rates that decisions will be made as to whether a particular charge is commercial or not. The reference to 'Phillips case guidelines' does not mean a blanket acceptance of the actual rates that were adopted by the taxpayer in that case, but refers to a more general concept that the arrangement be commercially realistic.

Paragraph 3.37

A.2.19 No comments or feedback were provided by NTLG members in response to this request for input.

Paragraph 3.40

A.2.20 Tax Office activity had also been widely communicated across the tax profession. The views expressed by the Tax Office, and Tax Office activity relating to service entity arrangements, were the subject of a number of presentations and articles by tax practitioners over many years. These comments reflected the Tax Office's messages that there were no standard mark-ups, and that commerciality was the important touchstone.

A.2.21 A paper was presented to the TIA's 2002 North Queensland conference by David Marks, Barrister, which urged delegates 'Do not simply rely on the mark-ups used in the Phillips case'. This theme was reprised in Mr Marks's paper in the April 2002 TIA journal entitled 'Service Arrangements: everything has its season'.

A.2.22 In October 2002 Ken Schurgott from Thomson-Playford Solicitors presented to the TIA's Sydney conference and stated: 'The question must always be asked whether the mark-up is commercially realistic. There is no standard mark-up.'

A.2.23 In March 2003 David Marks, Barrister also addressed the TIA's South Australian conference and advised them: 'Review the commerciality of the service costs from time to time. Do not simply rely on the mark-ups used in the Phillips case.' Mr Marks reprised this theme in his article in the TIA journal in August 2003.

A.2.24 Robert Richards advised the readers of the Law Society Journal in April 2003 that the charges need to be 'commercially realistic'.

A.2.25 Gil Levy, the President of the TIA cautioned his members to 'have a fresh look at their service trusts' in May 2003.

A.2.26 Tony Greco advised Taxpayers Australia members in August 2003 that 'The ATO requires that the charges be commercially realistic and up-to-date'.

A.2.27 Also in August 2003, the Weekly Tax Bulletin reminded subscribers that: 'Amounts above 'realistic commercial rates' for a comparable service from an unrelated party are likely to be denied deductibility'.

A.2.28 Law Institute members were advised in September 2003 by Dr Srechko Kontelj that: 'it does not follow that cost plus 50 per cent will be accepted by the commissioner in every instance. The commissioner will adopt a case-by-case basis to assess the commerciality of particular arrangements.'

A.2.29 In November 2003, the ICAA Tax Manager advised members in her column in the CA Charter magazine that they should 'Also bear in mind that the commerciality of an arrangement can change over time in accordance with market forces, and a periodic review might be appropriate.'

A.2.30 Law Society members were advised by Wayne Lonegan and Julie Planinic in the December 2003 Law Society Journal that 'commercial rates (that is, consistent with those charged by unrelated parties providing similar services)' were required to avoid ATO scrutiny.

A.2.31 CPA Australia's magazine 'In the Black' advised members in November 2004 that 'The Commissioner's approach to this issue inevitably involves benchmarking service entity profits against profits generated by organisations providing labour on an arms' length basis to the market generally.' It also set out four general health indicators for compliant service trusts.

Paragraph 3.44

A.2.32 This period of audit activity provided material for a subsequent review of the Tax Office's position on service arrangements. The methodology decided on was consistent with general budgeting and planning approaches to cost setting. It is a standard business analysis tool. Also, the approach taken did not adopt the full functional analysis and arm's length methodologies that apply for transfer pricing purposes. The methodologies had also been used by taxpayers in supporting the commerciality of their arrangements.

Paragraph 3.46

A.2.33 At the September 2002 meeting of the NTLG, the professional bodies suggested that Tax Office guidelines or opinions on service entity arrangements would benefit from being developed in consultation with the professional bodies. The Tax Office explained that it did

not have an understanding at that time of how widespread features of the kind that were of concern were evident in contemporary service entity arrangements. The Tax Office welcomed the professional bodies' views about whether there has been a shift from the typical Phillips case service trust arrangement and, if so, what has driven such a shift. In seeking to identify service trust arrangements which vary from the arrangement reflected in the Phillips case, the Tax Office would likewise welcome the professional bodies' input to assist in developing appropriate strategies. The help of the professional bodies was sought to identify what particular features may be relevant, and to what extent arrangements were commercial. The Commissioner noted that a small number of cases have been identified to date. The Tax Office would form an opinion on particular cases and publish its views.

A.2.34 At the March 2003 meeting of the NTLG, the professional bodies requested the Tax Office to clearly outline what arrangements are acceptable to provide a safe harbour for taxpayers who follow them. The questionnaires were developed over several months and suggestions were invited from key NTLG members. A number of professional bodies further requested that they publish the draft questionnaires for comment by members before being finalised and sent. The information gathered through this survey was essential in meeting this request.

Paragraph 3.47

A.2.35 No decision was made in December 2002 to issue additional guidance. The idea of publishing further material was at this stage only being canvassed in a paper prepared by Tax Office staff for consideration in the development of an appropriate Tax Office response to developments with service entity arrangements.

Paragraph 3.50 – dot point 1

A.2.36 The Tax Office does not consider that there is any evidence in support of this assertion.

Paragraph 3.53

A.2.37 The draft figures were based on preliminary statistical extrapolation from samples. Extrapolation techniques were later refined to take into account statistical bias in the original samples.

Paragraph 3.54

A.2.38 Public rulings provide the ATO view on an interpretative issue and provide a date of effect for the ruling and statement regarding the nature of the protection that it provides. A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

A.2.39 If a taxpayer relies on a ruling, the Tax Office must apply the law to that taxpayer in the way set out in the ruling (or in a way that is more favourable for the taxpayer if the Tax Office is satisfied that the ruling is incorrect and disadvantages the taxpayer, and the Tax Office is not prevented from doing so by a time limit imposed by the law). A taxpayer will be protected from having to pay any under-paid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to the taxpayer. The service entity arrangement is not exceptional in this regard. It states that the ruling applies to years of income commencing both before and after its date of

issue, and that it does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the final Ruling. Material dealing with other aspects of our administration, including audits, are dealt with in the accompanying guide.

A.2.40 Rulings do not deal generally with matters relating to audit and other administrative, compliance or educational activities because they are not issues of interpretation.

Paragraph 3.59

A.2.41 The draft guide did not make the use of any particular approach mandatory. Discussion of these approaches was to provide taxpayers practical information on how they can review their arrangements. The approaches are consistent with common business practices used when budgeting and pricing decisions are made.

Paragraph 3.64

A.2.42 The conclusion is incorrect and contrary to the considerable evidence available which demonstrates that both the Tax Office and tax practitioner assessments of what the Tax Office required was current and commercially benchmarked mark-up rates.

Paragraph 3.67

A.2.43 The guide explains that if the indicative rates are used, and no greater than 30 per cent of the combined profits of the professional firm and service entity (or service entities) is earned by the service entity (or service entities), there is little risk of an audit being commenced because of the amount of the deduction claimed. There may be other reasons for a case to be selected for review or audit.

A.2.44 If a deduction claimed for service fees is adjusted following an audit, we will allow a deduction based on what we consider the appropriate commercial benchmark rate in the circumstances to be.

Paragraph 4.4

A.2.45 This chapter sets out submissions that have been made to the Inspector-General by parties other than the Tax Office. We do not propose to comment on these submissions. However, it should be noted that the Tax Office does not agree with many of the assertions made in these submissions, and this is reflected in our comments in other parts of the report.

Paragraph 5.3

A.2.46 Service entity arrangements did not have project status in 1996. In 1996, the Legal and Accounting Project started with preliminary sampling of 1996 income tax returns. The objectives of the project included:

- gaining greater understanding, knowledge, information and intelligence about the larger accounting and legal firms and their partners,
- identifying any tax avoidance arrangements,
- identifying firms which may be high risk.

A.2.47 There was no mention of service entity arrangements in 1996, and they had not been identified as a distinct compliance issue by then.

Paragraph 5.6

A.2.48 Officers in the Large Business Line canvassed the possibility of a public ruling or practice statement in December 2002 when reporting the results of the Phillips Scan and in a treatment strategy that was drafted in March 2003. No decision was made on a ruling at this time as audit and TCN resources were still focused on completing the two lead audits. Instead, Large Business was asked to proceed with another recommendation in the treatment strategy to undertake a wider industry survey to better define the risk. Questionnaires were issued to 56 firms in June 2003. The questionnaires were developed over several months and suggestions were invited from key NTLG members. Results from this survey were not available until December 2003.

A.2.49 The Tax Office stated at the September 2002 NTLG meeting that it had not planned to issue a ruling, but that it was interested to know whether the NTLG believed a ruling was necessary and, if so, what areas the Tax Office should address. Given the limited understanding of how widespread the undesirable features of service arrangements were, the Commissioner welcomed the professional bodies' input to assist the Tax Office in developing appropriate strategies to deal with its concerns. By the NTLG meeting in March 2003 no input had been received from NTLG members as to the merits or otherwise of a ruling, nor what areas should be addressed

A.2.50 The NTLG Minutes of the March 2003 meeting explain that after completion of audits and enquiries across a range of the Phillips type vehicles used by professional firms, the Tax Office said it anticipated issuing a discussion paper and/or a public ruling setting out the Tax Office view on the way forward. The internal Tax Office material does not provide any evidence of a decision having been made at that time.

A.2.51 Tax Office records show that a decision was made in late 2003 to issue a public ruling. Public notification of that decision was given in the Tax Office's public rulings program in January 2004.

Paragraph 5.7

A.2.52 The 1998 survey was sent to 10 firms in the Large Business market. It was broad ranging in nature and the analysis was necessarily at a high level. The focus of the survey was to understand the reasons for the tax performance of the firms involved. It was not a survey specifically about service entity arrangements or to provide any detailed analysis of these arrangements. Examination of the financial results for the firms indicated that profit levels were lower than expected and that income splitting via Everett assignments and Phillips arrangements could be a potential cause for concern. There was a potential risk around the pricing in service entity arrangements. The survey did not provide any basis on which to conclude that either the use of service entity arrangements was a significant issue, or that there was an issue about the commerciality of service entity fees. At this stage, concern regarding the commerciality of pricing in these arrangements was purely speculative.

A.2.53 The survey helped the Tax Office target issues (for example, work in progress, Everett assignments, Phillips arrangements) and high risk taxpayers. However, it could not have provided the Tax Office with enough detailed information needed to determine whether arrangements were subject to reasonable challenge and that IT 276 needed to be

revisited. Further inquiries were required to ascertain this. There was no reasonable basis upon which to review IT 276 at this stage or on which to provide general advice on the commerciality or otherwise of contemporary arrangements. Any questions regarding the commerciality of arrangements were not able to be answered until the results of the leading audits and the June 2003 questionnaires were available.

Paragraph 5.9

A.2.54 The Tax Office was relying on a number of audits to test its ability to challenge unacceptable service entity arrangements. The work carried out and the results achieved gave confidence that service entity arrangements could be legitimately challenged. At this stage, a broad public education campaign became appropriate. Until then, there was no basis on which the Tax Office could make a justifiable decision that any public guidance beyond that already provided in IT 276 could be given on how service fees should be calculated.

Paragraph 5.12

A.2.55 The Tax Office has limited resources and constantly makes business decisions on the most efficient and effective application of its resources. We must balance our resources across the entirety of the tax system. Appropriate administration depends on factors that include the nature and extent of observed and potential risk, tax law issues involved, and strategies for their effective treatment and resolution.

A.2.56 The Tax Office must make choices on a daily basis on which issues to pursue and in which way to pursue them. These decisions are made having regard to information available at the time. Reasonable judgments can differ on these decisions, especially with the benefit of hindsight. Decisions on the Tax Office's program are also made having regard to matters including the Commissioner's statutory obligations and sound risk management practices.

A.2.57 Concerns with service entity arrangements emerged only out of work focussing more broadly on compliance risks in the legal and accounting professions. There was no evidence, and no reasonable basis on which to believe, that significant compliance risks existed in other professions. The appropriateness of investing additional time and resources on extending the scope of the review is open to question.

A.2.58 Having decided to test compliance issues with service entity arrangements in the legal and accounting professions, undertaking additional analysis in other professions at this stage was not a sensible use of Tax Office time or resources. This risk in the identified professions already established the need to undertake targeted audit activity to establish whether or not deductions claimed in contemporary related party arrangements were in compliance with law. Moreover, the underlying compliance risk under review was the tax performance of the legal and accounting professions, rather than tax compliance of service entity arrangements as such.

A.2.59 The merits of judgments made, and the correctness of administrative decisions and agency business choices that the Tax Office makes, are matters within the statutory responsibility and competence of the Commissioner. The Tax Office will work with the Inspector-General on any improvements that can be made on our risk identification and assessment processes leading up to these decisions in light of any systemic tax administration issues that relate to the concerns identified.

Paragraph 5.13

A.2.60 The use or prevalence of these arrangements in other industries does not indicate the extent to which these arrangements may involve a potential compliance risk if at all. Such an association would be speculative and inappropriate. The legal and accounting profession were selected because of concerns regarding industry tax performance, and not because of the use of service entity arrangements as such. Industry tax performance in other professions was not under review. The Inspector-General's approach presupposes that service entity arrangements were the identified compliance risk at the time. There was no reasonable basis at the time to expand compliance focus on arrangements outside of the legal and accounting professions. Addressing technical and compliance issues with service entity arrangements, including the commerciality of fees, was part of the treatment strategy for risk in the legal and accounting profession, rather than the underlying risk itself.

Paragraph 5.15

A.2.61 By April 1999, the Tax Office had no reliable information on which a finding could be made about the extent or prevalence of arrangements that were considered to involve unacceptable features or to represent significant compliance risks in the legal and accounting professions, or more generally. The 1998 survey provided some support that a potential compliance risk may exist. However, the analysis was high level and focussed on economic results. It did not identify any information in support of whether contemporary service entity arrangements were reasonably exposed to legal challenge or the basis of such a challenge. There was no reasonable or defensible basis on which to responsibly assert or act on a premise that there was widespread or significant degree of non-compliance with the law in claiming deductions for fees incurred in related-party service entity arrangements.

A.2.62 The Tax Office has responded in a measured way to the nature of concerns being raised about service entity arrangements. On relevant occasions, especially in presentations and articles widely circulated in the tax profession, Tax Office staff explained that arrangements had to be commercially realistic and that there were no acceptable generic levels for mark ups. This was consistent with the Tax Office's existing position set out in IT 276, which material from the accounting and legal profession shows was well understood.

A.2.63 Based on early intelligence, several arrangements were selected for audit. Findings made in the course of audit activity contributed significantly to our understanding of the nature of contemporary arrangements and their associated compliance risks. The conduct and results of these audits, together with additional intelligence work undertaken, allowed the Tax Office to supplement its existing views in a manner relevant to contemporary arrangements. The work also allowed the Tax Office to form a view on the basis in law on which these arrangements were open to question.

A.2.64 Without an understanding of this kind and at this level of detail, the Tax Office was not in a position to provide any additional detailed public guidance beyond the advice already provided in IT 276. Moreover, the Tax Office would have been open to criticism for overplaying its hand in questioning contemporary arrangements without having either understanding of the circumstances of these arrangements or satisfying itself of the legal grounds for doing so.

A.2.65 As noted in earlier comments, the decision to issue additional guidance had not been made in December 2002.

Paragraph 5.17 — dot point 1

A.2.66 This paper did not provide detailed guidelines of the kind or extent now contained in the booklet. It did not provide guidelines on actual mark-ups, or acceptable levels of fees more generally. The paper referred to the underlying requirement that fees be commercially realistic, and identified a number of issues and practical points to consider.

Paragraph 5.17 — dot point 2

A.2.67 Taxation Ruling TR 1999/1 addresses the operation of the international transfer pricing rules contained Division 13 of Part III of the Income *Tax Assessment Act 1936*, and the Associated Enterprises Articles in Australia's various double taxation agreements. Where the transfer pricing rules apply, consideration paid or received is taken to be an arm's length amount. The ruling deals with various approaches to the calculation of arm's length amounts for these purposes.

A.2.68 The deductibility of fees under domestic service entity arrangements is not covered by transfer pricing rules. Before the Tax Office was in a position to refer to methodologies also used for transfer pricing purposes, contemporary arrangements needed to first be shown to involve fees and charges that were grossly excessive, disproportionate to the services provided or that the arrangements were not commercially realistic. Until this is first established, a deduction under a service entity arrangement is not subject to adjustment. This matter is not dealt with in TR 1999/1. Moreover, the amount to which a deduction will be adjusted requires a determination of the purpose or purposes for which the expense was incurred and the extent to which it was incurred for deductible purposes. This does not require a determination of the arm's length amount. Fees paid under comparable commercial arrangements are relevant but not determinative of this issue.

A.2.69 A decision to rely on commonly used business analysis methods like comparable prices and comparable profits for working out acceptable service entity arrangements, as well as the subsequent question of the level of acceptable fees, were not able to be made without considerable further legal and practical analysis of contemporary arrangements and extensive consultation.

Paragraph 5.18

A.2.70 It was only in the course of these audits that the precise nature of the issue, and the necessary supporting economic data emerged. This had not been established by 1999. The mere existence of the material identified does not indicate its applicability or suitability for the purposes currently in issue, or the degree of modification that may be required for its use on service entity arrangement issues.

A.2.71 The characterisation of contemporary arrangements as labour-hire arrangements followed from detailed active compliance work. Moreover, this characterisation departed from the types of arrangements dealt with in TR 1999/1. Further survey work identified that contemporary service entities arrangements also covered other services including equipment hire, expenses payments, rent, and debt collection. Without developing this understanding first, any public guidance would have been premature and at risk of being irrelevant to arrangements actually in place.

Paragraph 5.19

A.2.72 The Tax Office issued public guidance material of general application in IT 276 which was publicly released in 1983. The nature of that advice was not specific to the circumstances of any particular arrangement. The extent to which generic advice could be given on such questions of fact, and the nature and detail of such advice, required a detailed understanding of contemporary arrangements. More detailed guidance, covering matters including the actual level of acceptable fees and charges, requires consideration of the circumstances of contemporary arrangements and the formation of a view on questions of fact. It has been customary practice in tax administration to give administratively or legally binding advice on questions of fact only in respect of particular arrangements. General public advice has been limited to the principles on which such questions are decided. In recognition of the community's need for this kind of detailed advice for service entity arrangements, because of the unusual nature of the legal and compliance issues involved, the Tax Office decided on the innovative approach of providing guidance which included advice on comparable market rates for certain set arrangement types and internal indicative rates used for audit selection purposes.

A.2.73 The ability of the Tax Office to challenge service entity arrangements in terms of their commerciality was tested and validated in the course of audit work. The release of additional public guidance was unwarranted until we were in a position to be satisfied that such challenges were reasonable, administrable, and could withstand legal dispute.

A.2.74 In the absence of the work undertaken in the course of these audits, any public statements going further than IT 276 would have attracted serious criticism by tax professionals as unwarranted and unsupportable which we would have had difficulty in responding to.

A.2.75 It is also our experience that service entity arrangements are extremely varied, including in terms of their structure, conduct and the scope and type of services and benefits provided. The further guidance provided by the Tax Office in the ruling and booklet is modelled on conventional service entity arrangements, with some additional discussion of an alternative type of medical practice arrangement in response to requests made during consultation. Detailed public guidance has been correlated with the features and services prevalent in contemporary arrangements. This focus and understanding came in part from the detailed work carried out in the course of leading audits and detailed surveys. Our understanding will continue to be revised as commercial considerations evolve.

A.2.76 We also note the Inspector-General's concern at paragraph 5.120 of this report that consultation with individual industries should have occurred earlier in the drafting process and that any public advice was a work in progress until specific industry circumstances were taken into account.

Paragraph 5.20

A.2.77 The decision to issue further public guidance was made in late 2003: see earlier comments.

Paragraph 5.28

A.2.78 It does not follow that undertaking further risk assessment would have prompted a decision at that time to issue further public guidance on the issue. The risk assessment that had been undertaken had already identified the potential compliance risk and a treatment

strategy was already being worked on. The decision to issue further public guidance followed from further work undertaken in the course of audit activity and required the formation of administrative and technical views. This work had been decided on as the next necessary step and this decision was made without the need for further risk assessment. Also, the original compliance risk which was under review was the tax performance of the legal and accounting professions, and was not service entity arrangements as such.

Paragraph 5.32

A.2.79 The Inspector-General seems to refer to comments made by individual officers which were not concluded views of the Large Business Line. The sharing of views, and developing proposals, is an ordinary and essential element in the development of the Tax Office's position on compliance issues. The Tax Office does not accept that there was any dissent that delayed the issue of public guidance. No decision had been made to issue further public guidance by this time, let alone whether such further guidance was appropriate and the content of any such guidance. It is inappropriate to regard such discussions as a cause of delay in issuing further public guidance. During this period, the appropriate treatment strategy for the potential compliance risks associated with service entity arrangements were being developed. This is not in the nature of dissent. The issue was subsequently discussed between senior officers in 2001, and instructions were given to Large Business to proceed with individual audits on the most serious cases.

Paragraph 5.36

A.2.80 The Tax Office does not accept that there was a delay in the process for the reason identified. The decision to issue further public guidance was made in late 2003. Before that time, project resources were applied on the individual audits being undertaken. The decision to issue further public guidance followed from the work undertaken in the course of these audits. Consideration followed on the most appropriate form for such guidance. The matter was immediately escalated to the Public Rulings Panel for consideration.

Paragraph 5.46

A.2.81 The Public Rulings Panel, which comprises both Tax Office and external members, first considered an early version of the draft ruling in December 2003. Further versions of the draft ruling were considered by the Panel in February and March 2004 taking into account comments and feedback by Panel members. As drafting of the ruling commenced in November 2003, and as it was first considered by the Panel in December 2003, Panel consideration of the draft ruling in February and March 2004 is not considered to represent any period of unreasonable delay. After that time, further review and development of the draft ruling and booklet was driven through the NTLG consultation process. The Panel process was not a cause of delay during this further time.

Paragraph 5.50

A.2.82 Work on the draft booklet commenced in the Large Business Line. It was transferred to the Small Business Line when general responsibility for the issue was transferred to Small Business. Suitable material for wider NTLG consultation was not available until an acceptable version of the draft ruling was prepared with advice from the Public Rulings Panel. An iterative process is likely to be more efficient and effective in garnering feedback from the various review processes adopted for this product.

A.2.83 The decision to issue additional guidance in the form of a booklet followed from feedback received during the NTLG consultation process. As the booklet was prepared in response to this feedback, work on the booklet could not have commenced at the start of the NTLG consultation process. At the commencement of the process, the Tax Office had only intended to publish further public guidance to the extent contained in the draft ruling. Some of the material had been originally prepared in early versions of the draft ruling. However, it was removed on advice from the Public Rulings Panel.

Paragraph 5.53

A.2.84 The inference drawn here does not follow from the statement extracted above. The view quoted reflects concerns about the impact that safe-harbours could have on compliance behaviour rather than a view that service arrangements are unacceptable per se. These concerns are consistent with those raised in the external submissions outlined at paragraph 7.27 of this report. The extract also refers to the compliance issue being the characterisation of the commercial benefits in those arrangements that are unacceptable, not to the arrangements being unacceptable per se. The characterisation of the commercial benefits, their relationship with the fee charged and the deductible/non-deductible purposes remain the key considerations.

Paragraph 5.54

A.2.85 The Tax Office considers this assertion to be unfounded. Disagreement between Tax Office staff and NTLG members was on the issue of appropriate pricing, and not on the legitimacy of service entity arrangements as such.

A.2.86 On this point, the letter actually stated:

> 'the draft ruling fails to recognise the importance of service entity arrangements as a legitimate commercial structure in this highly litigious environment.'

Paragraph 5.56

A.2.87 Responsibility was transferred to the Small Business Line because the bulk of affected taxpayers were in the Small Business market. It was not transferred because of the alleged concerns about the management of the project.

Paragraph 5.60 – Key finding 5.4

A.2.88 This finding is not accepted in light of the material set out in earlier Tax Office comments.

Paragraph 5.60 – Key finding 5.5

A.2.89 The Tax Office accepts that it is possible for decisions to involve other consultative groups like the NTLG, in addition to the Public Rulings Panel, can be made in a more timely manner. Such additional consultation is unusual, and its use for the service entity arrangements ruling reflects the unusual nature of the issues involved and the compliance treatment strategy relied on. The need for additional practical guidance in the form of the booklet emerged after NTLG consultation commenced on the draft ruling: see further Tax Office comment at paragraph 5.50. This additional practical guidance dealt with questions of ordinary business judgment rather than questions of tax law and its application.

Paragraph 5.61

A.2.90 The provision of public guidance is well understood to be a core task for the Tax Office, one to which the Tax Office, including Large Business, devote a considerable amount of resources.

A.2.91 However, at the time available resources were focussed on the conduct of audits to validate the nature and extent of the risk. Our experience from these audits informed the development of the ruling. When consultation processes indicated the demand for more detailed practical guidance, this was not opposed by Large Business or any other part of the Tax Office. We do not consider that Large Business acted in a way that displays any serious misunderstanding about the Tax Office's obligations.

Paragraph 5.66 – Key finding 5.6

A.2.92 Senior Tax Office personnel had regard to the adequacy of the Tax Office's existing guidance on service entity arrangements. This guidance was principally contained in IT 276. A decision was made in late 2003 to supplement this ruling which resulted in the publication of TR 2006/2. In light of concerns raised over the adequacy of the material, and the need for additional practical guidance, the Tax Office decided to also produce the booklet. The Tax Office was responsive to feedback which identified the need for this additional advice. The booklet was an innovative approach to providing practical guidance dealing with matters well beyond interpretative advice.

Paragraph 5.68

A.2.93 The Tax Office agreed to allow additional time for comments to be received on aspects of the ruling and booklet. The release of the final ruling was also delayed at the request of professional bodies which preferred that the ruling and booklet be published together. The ruling itself was ready for publication in December 2005.

Paragraph 5.73

A.2.94 The Tax Office does not accept that the period has been correctly identified: see previous comment at paragraph 3.47.

Paragraph 5.74

A.2.95 The Tax Office does not accept that the period has been correctly identified: see previous comment at paragraph 5.36.

Paragraph 5.75

A.2.96 The Tax Office does not accept that the period was caused by or reflects additional time spent by the Public Rulings Panel on reviewing the ruling: see previous comment after paragraph 5.46.

Paragraph 5.76

A.2.97 The Tax Office has already revised its consultation processes and has announced that future consultation will generally not involve confidential processes. There may be instances where confidential consultation will still be necessary or where preliminary consultation with select groups may be required before the Tax Office is in a confident position to publish material suitable for broader public consultation.

Paragraph 5.85

A.2.98 For the reasons explained in earlier comments, the Tax Office does not consider that there has been a five year delay. The Tax Office does not consider that the content of the ruling and booklet could have been developed based on a sound and effective approach within two years of April 1999, in part because the Tax Office does not agree that the compliance risk could be clearly identified at that time. However, the Tax Office agree that the timeliness of publishing the ruling and booklet could have been improved on, and that a two year period from December 2003 would have been reasonable.

A.2.99 The Tax Office does not accept that the circumstances existed in April 1999 to warrant the development of the ruling or booklet at that time. IT 276 was in place throughout the period under review. The Tax Office's strategy, arrived at early in 2002, was first of all to take with audit action and thereafter to conduct a review of the ruling and, if warranted, to undertake a public education campaign, of which the public guidance and especially the booklet is a major part.

Paragraph 5.92

A.2.100 For the two years in question, comparable percentages for taxation determinations, which are a shorter form of public ruling, were 80 per cent and 40 per cent respectively. The percentages mentioned above represent the aggregate result for the 2005 and 2006 income years rather than for each year.

Paragraph 5.94

A.2.101 The Tax Office has had established processes in place for at least the past seven years to continually review (usually monthly) the timeliness of rulings.

Paragraph 5.97

A.2.102 The preparation of a public ruling may be decided on as a suitable product for the purposes of responding to a compliance issue. However, not all issues are addressed by the preparation of a public ruling. The period prior to a decision to prepare a public ruling is relevant in the context of the holistic resolution of a compliance issue. Once the matter is classified as a priority technical issue (PTI), time spent is monitored as part of PTI reporting processes. However, it is not appropriate to include that time as part of the measurement of the public ruling process itself. It would not provide relevant management information for the purpose of monitoring performance of that particular process which commences with the decision to prepare a public ruling and including the topic on the public rulings program.

Paragraph 5.98

A.2.103 Tax Office standards on public rulings are explained in detail on our website at www.ato.gov.au as well as being published each month as part of the introduction to the ATO's Public Rulings Program which is also published on the website. While relevant to the timeliness of resolution of compliance issues, the time before a decision to issue a public ruling is made is not relevant to the measurement of timeliness of the public ruling process itself.

Paragraph 5.103

A.2.104 In many cases, the retrospective application of Tax Office advice provides taxpayers with administrative or legal protection. For example, in relation to service entity

arrangements, retrospective application of the guidance will provide taxpayers with certain protections where they fall within the terms of the guidance, even though the arrangement might otherwise be subject to audit adjustment on the basis of IT 276.

A.2.105 In any event, we do not consider that the ruling and booklet are a departure from the views expressed in IT 276; they are merely expanding on the guidance already available.

Paragraph 5.111

A.2.106 In the view of the Tax Office there were some unique features about the service entities issue which meant that it cannot be regarded as a good example of how the PTI/public ruling process usually works. The requirements in reaching a robust compliance outcome on service entity arrangements are considered to be unique in nature and do not provide any indication of systemic problems with prioritisation of public rulings. The treatment of service entity arrangements is an exception to the ordinary conduct of the public rulings program. This is because of the nature of the particular issue involving questions of identifying and quantifying commercially realistic fees.

A.2.107 The resolution of the technical issues, and the preparation of the supplemental ruling on service entity arrangements was not the cause of any delay. These matters were resolved in a reasonable timeframe. Moreover, the Tax Office had already published IT 276 which dealt with the tax law issues. The acute issue in relation to service entity arrangements was stakeholder expectations that the Tax Office provide additional detailed practical guidance on commercial questions.

Paragraph 5.117

A.2.108 As noted earlier, the Tax Office's interpretation of the law, and expectations regarding compliance, were widely known and well understood in the tax community. This is evidenced by the number of articles written by tax practitioners in widely distributed professional journals and presentations given at major tax industry conferences. The matter was also raised at the NTLG. The people represented by members of the NTLG, and the professional associations who published and conducted conferences which dealt with the Tax Office's position on service entity arrangements, account for over 95 per cent of all businesses across every industry in Australia. We observe that taxpayers do take the advice of their tax practitioners in matters like service entity arrangements. It is considered an appropriate strategy to raise systemic tax issues through consultative forums of representative tax professionals.

Paragraph 5.119

A.2.109 The approach on the acceptability of particular rates has been to identify the most common types of services provided in conventional service entity arrangements and to provide comparable and indicative rates for each of these types of services. These rates are attributable to the type of service provided rather than the particular industry of a taxpayer's main business.

A.2.110 The booklet explains that higher rates can be acceptable, and the commerciality of an arrangement can be demonstrated on any reasonable basis. Arrangements other than conventional service entity arrangements were outside of the scope of the identified compliance risk and were outside of the scope of the draft booklet.

A.2.111 Conventional service entity arrangements in the medical and other professions were already covered by the booklet. Representatives of the medical profession sought additional advice on service entity arrangements which were comparable to a different commercial service model used in the medical profession and which were outside of the scope of the booklet.

A.2.112 It is reasonable to expect that there are a multitude of arrangements across the community that are not in the nature of conventional service entity arrangements. To provide detailed guidance, as the booklet has done for conventional service entity arrangements, on all these possible arrangements in a single product or project is demonstrably impractical and unmanageable, especially in the absence of an identified compliance risk relating to these other arrangements and industries.

A.2.113 Nevertheless, the Tax Office was responsive to stakeholder concerns that emerged in the course of consultation and undertook further work to provide advice on medical practice arrangements. This advice confirms that medical practice arrangements comparable to arm's length commercial arrangements in the medical profession are at a low risk of audit. This follows from the general approach in the booklet on reviewing the commerciality of arrangements.

A.2.114 Given that commercial arrangements change over time, it misunderstands the nature of the issue to expect that there is a 'final' position in relation to commercial rates. An assessment of the commerciality of an arrangement will require consideration of contemporary comparable arm's lengths dealings. This changes over time. The same is true of industry specific commercial arrangements. The Tax Office has provided detailed practical guidance for conventional service arrangements, applicable to all taxpayers and industries, as it is based on the service being provided. The commerciality of other arrangements can be established with evidence of contemporary comparable arm's lengths dealings. Other professions did not approach the Tax Office during the public consultation period with requests for other industry models to be dealt with in the booklet.

Paragraph 5.123

A.2.115 The Tax Office has during the time of this review announced changes to its consultation processes that attend to these concerns.

A.2.116 The Tax Office notes that commercially sensitive information about particular acceptable rates was only made available late in the confidential consultation period shortly before the public release of the draft booklet. The shortness of this time, together with the draft nature of the booklet being released, and the 12 months review period provided, makes it unlikely for any substantial advantage to have arisen.

Paragraph 5.126

A.2.117 The Tax Office has already revised its consultation processes and has announced that future consultation will generally not involve confidential processes. There may be instances where confidential consultation will still be necessary or where preliminary consultation with select groups may be required before the Tax Office is in a confident position to publish material suitable for broader public consultation.

A.2.118 The Tax Office accepts the consultation with tax specialists could have occurred at the same time as public consultation and this could have shortened the overall period of review.

Paragraph 5.138

A.2.119 The Deputy Commissioner Small Business signed off on the second version of the draft ruling.

Paragraph 5.143

A.2.120 The decision to prepare the booklet was not caused by a change in key decision makers on the issue. It was prompted by feedback received during consultation on the proposed draft ruling. Drafting of the booklet was commenced by staff in Large Business with Tax Counsel Network assistance.

Paragraph 5.144

A.2.121 The level of key decision makers and degree of direct involvement of senior staff depends on the degree and nature of the risk, technical issues and treatment strategy involved. Senior officer involvement on the issue was commensurate with these factors.

Paragraph 5.145

A.2.122 In the course of discussions, a number of contentions were put to the Tax Office, which were accepted at face value for the purpose of discussion, and to develop the form and nature of the Tax Office's treatment of the issue. Further information gathering was carried out which raised concerns about the acceptability of the original contention. The Tax Office has apologised for the misunderstanding caused.

Paragraph 5.149

A.2.123 A high level meeting with one of the professional bodies involved in the NTLG consultation process took place on 21 September 2005, following the September 2005 NTLG meeting. At this 21 September meeting safe harbour rates were discussed, including discussion of a percentage of practitioner billings method for the medical profession. Details on this were contained in a subsequent letter from the professional body dated 5 October 2005. Our initial enquiries with representatives of the medical profession in October 2005 were designed to corroborate this data, in addition to addressing issues raised in their submissions on the drafts and subsequent documentation.

Paragraph 6.2 – dot point 1

A.2.124 Ruling IT 276 relevantly states the Tax Office position to be:

> 4. Given the view of the facts which the court adopted, that is, a re-arrangement of business affairs for commercial reasons and realistic charges not in excess of commercial rates, the decision to allow a deduction must be accepted as reasonable. Accordingly, the decision is not seen as requiring any alteration to existing policy concerning payments of this nature.
>
> 5. The case demonstrates the practical difficulties, of reducing or disallowing claims for deductions where the payments are marginally above commercial rates. Fisher J. in his judgment commented that, if a payment allegedly for services was grossly excessive, the presumption would arise that it was made for some other purpose. He also referred to the necessity to be able to identify and quantify the consideration applicable to any advantage unconnected with business activity. The decision indicates the need for a close examination of all relevant facts before deductions are allowed in cases of this kind.

A.2.125 Meeting this commerciality requirement does not of itself make the expenses deductible. All other requirements for deductibility will also have to be meet in addition to the specific issue about the fees being realistic and not in excess of commercial rates. For example, the services must be relevant and incidental to the conduct of the business, they must be on revenue account, and must not be capital, private or domestic in nature. Other provisions of the law may also be pertinent in particular cases, for example, the application of prepayment rules.

Paragraph 6.2 – dot point 2

A.2.126 The position was that arrangements in excess of those particular mark up rates would be open to scrutiny. However, they would also be open to scrutiny if the arrangements were not commercially realistic.

Paragraph 6.3

A.2.127 The administrative question of how the law will be applied involves the circumstances in which a deduction is likely to be questioned by the Tax Office, rather than how the deductible amount of service fees will be calculated.

Paragraph 6.4

A.2.128 This is not correct. The Tax Office always has accepted, and continues to accept the principles set out in Phillips and IT 276. The second statement can be correct in individual cases, as it is a question of fact. It was never accepted as a statement applicable in all cases. It is our experience that contemporary arrangements tend to involve materially different circumstances. It has always been possible for taxpayers to make claims in excess of the guidelines, depending on their particular circumstances.

A.2.129 It should also be noted that these documents released as drafts for comment and were not final views of the Tax Office.

Paragraph 6.5

A.2.130 The following material shows that the Tax Office did not hold the view ascribed to it above:

A.2.131 Draft Taxation Ruling TR 2005/D5 stated:

> 7. Whilst the Commissioner accepts the correctness of the decision in *Phillips*, 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 ITAA 1997.
>
> 8. If the benefits passing to the taxpayer under a *Phillips* service arrangement are connected to the conduct of the taxpayer's income earning activities or business and, having regard to the benefits delivered, the service fees and charges are commercially realistic then the presumption will be that the service fees and charges are a real and genuine cost of earning the taxpayer's income and the cost of that alone (*Phillips* at ATR 791; at ATC 4368).
>
> 9. Where, however, the benefits passing to the taxpayer under a service arrangement do not reveal an obvious connection with the conduct of the taxpayer's income earning activities or business and/or where the service fees and charges do not constitute a commercially

> realistic charge for the benefits delivered, then the service arrangement alone may not suffice, without more, to characterise the expenditure. In these circumstances there is no objective commercial connection between the outgoing and the taxpayer's income earning activities or business. Consequently it may be necessary to undertake a broader examination of all of the circumstances surrounding the expenditure to determine what the expenditure was for ('a broader examination'). Depending on the circumstances of the particular case, this may include an examination of the taxpayer's subjective purpose, motive or intention in incurring the expenditure.

A.2.132 Statements on the Tax Office's view of the law are contained in the ruling (and a preliminary view for consultative purposes was in the draft ruling). The draft booklet and final booklet deal with practical administration and are not the source for a view on the law.

A.2.133 The draft booklet in fact stated:

> The fact that the fees charged exceed commercially realistic rates is not of itself conclusive that all or part of the fees are not deductible. However, the greater the divergence is, the greater the likelihood becomes of a conclusion that other benefits are being sought, for example, the diversion of income. In this case, all or part of the fees will be non-deductible.
>
> A good rule of thumb for determining whether the service fees and charges are commercially realistic is to ask yourself whether an independent person in your circumstances would engage the service entity to provide the same or similar property or services on the same (or substantially similar) terms to those you have entered into with the service entity. The law does not require exact equivalence provided the charges are commercially reasonable.

Paragraph 6.6

A.2.134 The booklet explained that service fees charged at the rates mentioned would be accepted as being commercially realistic. As explained in the previous Tax Office comment, higher fees can also be deductible.

Paragraph 6.7

A.2.135 The draft booklet dealt with rates for service fees below which they would be accepted as commercially realistic. This did not mean that only fees which matched an arm's length price would be accepted as being deductible. What it meant was that there might not be an objective connection between the expenditure and the income earning activity, and a broader inquiry into the purpose of the expenditure may be required. The material extracted above shows this position. Higher service fees could be deductible, but could be open to question. This is consistent with Phillips and IT 276.

A.2.136 Also, the methodology used applies standard business analysis methods that are used for ordinary business budgeting and pricing purposes.

Paragraph 6.8

A.2.137 The position adopted in active compliance activity and decisions made during this time are also consistent with the decision in Phillips, IT 276, and the final ruling and booklet. Differences between the draft and final ruling are limited to style, choice expression, and would not have led to different results. Some more detailed guidance was included on interpretative matters about the circumstances in which service fees would be open to

question. These differences are not points of distinction which would have led to different decisions and results in these cases.

Paragraph 6.9

A.2.138 Taxation Ruling TR 2006/2 relevantly states:

> 6. While the Commissioner accepts the correctness of the decision in *Phillips*, 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 section 8-1 of the ITAA 1997.
>
> 7. The question of whether expenditure made under a service arrangement is deductible depends on what the expenditure was calculated to achieve from a practical and business point of view. This is a question of fact.
>
> **Where the service arrangement provides an objective commercial explanation for the expenditure**
>
> 8. Ordinarily, expenditure incurred in obtaining the supply of goods or services from another party under a contract will be characterised by reference to the contractual benefits passing to the taxpayer under the contract and the relationship that those benefits have to the taxpayer's income earning activities or business.
>
> 9. This means that where the benefits conferred by a service arrangement provide an objective commercial explanation for the whole of the expenditure made under the service arrangement, then the service arrangement alone will suffice to characterise the expenditure as expenditure that satisfies the positive limbs of section 8-1 of the ITAA 1997. (See paragraph 12 for situations where there may not be an objective commercial explanation for the whole of the expenditure.)
>
> **Where the service arrangement does not provide an objective commercial explanation for the expenditure**
>
> 10. Where, however, the benefits passing to the taxpayer under a service arrangement do not provide an objective commercial explanation for the whole of the expenditure then the service arrangement alone will not suffice, without more, to characterise the expenditure. In that case a broader examination of all of the circumstances surrounding the expenditure will be required to determine what the expenditure was for ('a broader examination'). Depending on the circumstances of the particular case, this may include an examination of the relationship between the taxpayer and the service entity, the manner in which the taxpayer and the service entity have dealt with each other and the taxpayer's subjective purpose, motive or intention in incurring the expenditure.
>
> 11. A service arrangement may not suffice to provide an objective commercial explanation for the whole of the expenditure if:
>
> (a) the service fees and charges are disproportionate or grossly excessive [1] in relation to the benefits conferred by the service arrangement;
>
> (b) the service fees and charges guarantee the service entity a certain profit outcome without reasonable commercial explanation; or

(c) the service fees and charges generate profits in the service entity without any clear evidence that the service entity has added any value or performed any substantive functions. For example, this might occur where there is no clear separation between the service entity's business activities and those of the taxpayer. [2]

[1] It should be noted that whether a payment is grossly excessive will depend on the circumstances of the service arrangement. The nature of the connection between the parties is of particular relevance in this context.

[2] This should not be taken to be an exhaustive list, nor are the situations described necessarily separate or distinct from each other.

Paragraph 6.10

A.2.139 As explained by the Inspector-General in the following paragraph, statements in the booklet provide practical guidance on comparable market rates, and indicative rates below which an arrangement will be at little risk of audit. The rates in the booklet do not represent rates that are or are not deductible as such.

Paragraph 6.11

A.2.140 The booklet explains that service fees not disproportionate or grossly in excess of these rates will be accepted (if the arrangement has the characteristics described, and the services have a relevant connection with your business). The comparable market rate is not identified as the low audit risk threshold.

Paragraph 6.13

A.2.141 IT 276 has consistently represented the Commissioner's view of the law and has been applied consistently throughout this period. Whilst a draft ruling was issued for comment, there is no evidence that the Tax Office 'did in practice' adopt a new view of the law. All audits were conducted in accordance with IT 276.

Paragraph 6.15

A.2.142 As explained in earlier Tax Office comments, we do not agree with this finding.

Paragraph 6.29

A.2.143 The Tax Office does not accept that the material contained in the Assessing Manuals could be reasonably used or relied on in the way identified by the Inspector-General. In addition to the reasons set out above for this view, the Tax Office considers that:

- Selective reference to the rates given in the Assessing Manual disregards material that arrangements would also be open to review if they were inconsistent with ordinary business dealings, for example, the consideration paid for the services is demonstrably out of line with the commercial value of the services rendered.

- It is patently unreasonable to rely on grossly outdated information for the purposes of satisfying the relevant issue whether services fees grossly exceed commercial comparable rates. Setting prices by adopting outdated information is also uncommercial conduct.

Paragraph 6.30

A.2.144 These materials were not inconsistent with the Tax Office's position in IT 276 (and was also not inconsistent with the material in the assessing manuals). They provide additional information about our concerns and attention to the issue. They consistently referred to the requirement that arrangements be commercially realistic, and signalled that we were seeing arrangements where this was questionable.

A.2.145 As identified in Chapter 5, speeches and articles by tax professional establish that the Tax Office's position was well understood and based on IT 276.

Paragraph 6.31

A.2.146 Awareness and conformance with IT 276 is considered to have been a reasonable expectation of taxpayers who chose to enter into service entity arrangements. Moreover, selective reliance on outdated material contained on the Tax Office's internal Assessing Manual, and which had been publicly advised as not able to be relied on, is considered to be patently inappropriate. This is especially so in circumstances where the deductibility of fees was open to question in accordance with IT 276.

Paragraph 6.32

A.2.147 The period of consultation reflects the nature of the issue involved. The length of time this took is no indication whether or not there was a change of view. Rather, it reflects the work and extensive consultation undertaken in providing practical guidance at a level of detail not previously provided on how taxpayers should work out whether their arrangements involves commercially realistic or grossly excessive fees. As this advice has been provided for the first time, it does not involve a change in view. The Inspector-General has already noted that the final ruling does not display a change in the Tax Office's position.

Paragraph 6.36

A.2.148 As explained in comments made in earlier chapters of the report, the Tax Office does not agree that there has been a delay in issuing advice. The Tax Office is obliged to administer the law and taxpayers are obliged to comply with the law. The Tax Office's view on the law was set out in IT 276. Deductions could be claimed in accordance with the requirements of the law, and taxpayers could have regard to the Tax Office's advice in IT 276 in doing so. The law, and the principles applicable to the application of the law have not changed. The Tax Office's administration of the law has been consistent with case law, and IT 276.

A.2.149 In our compliance work, on having formed a view that service fees were grossly excessive, based on the principles in Phillips and IT 276, the next question is to work out what amount would be deductible. This is established on ordinary commercial principles and is not a question on the interpretation or application peculiar to tax law. The booklet is based on these ordinary business principles. The Tax Office does not accept that this situation can be construed as applying the booklet retrospectively. The booklet simply sets out these principles in response to feedback during the consultation period that taxpayers who used service trusts needed detailed advice on commercial pricing of services that they provide.

A.2.150 The ruling and booklet do not require service fees to be calculated using any particular method. Our approach to reviewing arrangements is to look at the result of the method used, rather than to challenge the use of any particular method.

A.2.151 Our compliance approach has been to allow most taxpayers 12 months, to 30 April 2007, to review their arrangements. They will be at little risk of audit if their arrangements are in line with the information provided in booklet by the end of the review period. We have limited our current audit program to the highest risk cases, based on the size of the deduction, the materiality of the arrangement to the business, and the potential extent to which the arrangement may be a sign of unacceptable tax planning. It is only these cases which have not been given the benefit of the review period. We believe businesses that make claims of this size and materiality could reasonably be expected to comply with the law without the need to rely on the additional information in Taxation Ruling TR 2006/2 and the booklet. We consider this approach is based on sound risk assessment principles and, contrary to completely disregarding earlier non-compliance, satisfies the Tax Office's obligations under the tax law and the *Financial Management and Accountability Act 1997*.

Paragraph 6.37

A.2.152 Our current active compliance work involves a review of the conduct of the arrangement, which looks at factors going beyond the particular mark up rates used for labour hire. In cases where an adjustment has been made, there have been features in addition to the level, or commerciality, of the mark up used including:

- the cost base used for mark up purposes;
- the absence of staff, premises or equipment for the service entity to conducts its own business;
- activities and costs of the conduct of the service entity's own business being carried out by staff of the professional firm, or who had been on-hired and charged to the professional firm;
- provision of services other than labour hire and equipment hire;
- mark ups and profits made on back to back arrangements between third party service providers and the professional firm where the service entity is merely a conduit, for example equipment hire, rental of premises, and payment of third party invoices;
- inadequate documentation or records;
- conduct and pricing not consistent with service agreements; and
- dealing between the service entity and firm reflected only in year end journal entries.

These concerns are in addition to questions about the commerciality of the mark ups involved, and these factors also raise serious issues about the applicability of the rates used in these arrangements.

Paragraph 6.38

A.2.153 The Tax Office considers that the cases where an adjustment has been made involve arrangements where the fees are considered to be grossly excessive or otherwise meet the conditions identified above. Whether fees are grossly excessive depends on the facts of the arrangement, and regard is not limited to the particular mark ups used.

Paragraph 6.42

A.2.154 The Tax Office notes that the situations described above deal with a reassessment of an effective life or change in commercial rate. The law specifically provides for the Tax Office to statutorily provide a determination of effective life which taxpayers may choose to adopt. This is not comparable with the law on service entity arrangements which is covered by the general deductions rules and the body of law applicable to these rules.

A.2.155 The Tax Office is of the view that there was no prevailing advice on commercially comparable rates for service entity arrangements prior to the release of the booklet. Any misconception about the applicability of the rates set out in the Assessing Manual was conclusively dealt with in 1994 with the release of TR 1994/45 and the release of an addendum to TR 1992/20. In any event, the Assessing Manuals were not issued as advice on deductible service fees. The information is also outdated and it cannot be reasonably asserted to remain relevant or applicable to the question of commerciality.

Paragraph 6.51

A.2.156 The media release for the draft booklet explained that the Tax Office would look at cases where fees were over $1 million and represented over 50 per cent of the gross fees earned by the professional firm. The media release explained that our analysis showed that over 90 per cent of cases were below this threshold. This was the effect of the test. The media release does not state that the threshold was set in order to limit the number of cases to a maximum of 10 per cent of legal and accounting firms.

A.2.157 The media release dealt with the draft booklet which did not include the third condition referred to. The net profit condition was included in the final booklet following further consultation.

Paragraph 6.52

A.2.158 It follows from other Tax Office comments made in this report that we do not agree with these assertions.

Paragraph 6.53

A.2.159 The criteria are based on reasonable, objective and appropriate grounds that have regard to fair and effective treatment of compliance risk and non compliant behaviour.

Paragraph 6.56

A.2.160 The targeting of serious compliance issues that involve questions of whether the services were in fact provided is not conditional on the size of the service fee. Fees below $1 million can be assessed as a compliance risk where the arrangement is non-genuine and such arrangements remains subject to our current audit program. The threshold based test does not apply to these cases. In any event, the size of the deduction claimed is a legitimate factor in risk assessment and compliance treatment. Cases with service fees below $1 million other than these non-genuine arrangements are not considered to represent highest risk in terms of the commerciality of the arrangement.

Paragraph 6.60

A.2.161 The Tax Office considers that the three-step test provides a suitably targeted approach to identify the range of cases that would remain subject to our current audit

program. As explained in the booklet, the tests look at the size of the deduction, the materiality of the arrangement to the business, and the potential extent to which the arrangement may be a sign of unacceptable tax planning. We believe businesses that make claims of this size and materiality could reasonably be expected to comply with the law without the need to rely on the additional information in Taxation Ruling TR 2006/2 and this guide.

Paragraph 6.62

A.2.162 The Tax Office considers that this would not provide taxpayers with any clarity or certainty whether their arrangement was at risk of being audited or whether they had until 30 April 2007 to review their arrangement and bring it in line with the information provided in the booklet. Providing taxpayers with certainty that they were covered by the review period requires the nomination of fixed thresholds as we have done.

A.2.163 Also, breaching the thresholds does not necessarily result in the commencement of an audit. The threshold test identifies a pool of cases that remain subject to our current audit program, and which are therefore at risk of being audited. Before commencing an audit we confirm whether or not the threshold test has been breached, and we undertake a review of the circumstances of the arrangement.

A.2.164 The work undertaken during this review allows the Tax Office to form a view whether or not an audit should be commenced on the taxpayer. The matters identified above are of the kind that the Tax Office has regard to in deciding whether or not to commence an audit. The collection of information that addresses these points is carried out in the course of a review. An overall assessment is made, having regard to the information gathered during the review, and the individual facts and circumstances of the particular case, whether or not an audit should be commenced.

A.2.165 The threshold test in the booklet, and the factors that this test takes into account, are used for the purpose of establishing the pool of cases subject to our current audit program. The threshold test in the booklet is not the basis on which a decision to commence an audit is made.

Paragraph 6.63

A.2.166 In fact, the Tax Office was asking for more information about which aspects of a taxpayer's compliance history the Inspector-General would regard as relevant. On this point, the Tax Office noted that the compliance risk covered more that non-genuine arrangements that the Inspector-General considered to be the only risk to be targeted.

Paragraph 6.64

A.2.167 As explained in earlier comments, we do not agree with this finding.

Paragraph 6.71

A.2.168 As explained in earlier comments, work carried out in the initial stages focuses on whether the taxpayer is within scope of the current audit program or has the benefit of the Tax Office's undertaking on giving a period for arrangements to be reviewed.

A.2.169 Also, the information gathered at this stage, as identified by the Inspector-General in the above paragraph, is not limited to obtaining material relating to the size of the fee. The

financial statements allow a preliminary view to be formed on the application of the threshold test, together with a preliminary financial analysis of the operations of the professional firm and service entity. Information requested at this preliminary stage is kept at a minimum needed in order to minimise disruption and cost to the taxpayer.

A.2.170 The additional material referred to is of the kind requested if the preliminary review proceeds any further.

Paragraph 6.73

A.2.171 In most cases, there is adequate prima facie evidence that the arrangement exists. At issue is the entitlement to the deduction to the extent claimed.

A.2.172 Because of the administrative and compliance costs associated with the conduct of an audit, we conduct preliminary reviews for the purpose of identifying potential risks. Information is gathered to the extent considered appropriate for this purpose.

Paragraph 6.74

A.2.173 The Tax Office is willing to consider such issues and has considered, and responded to, matters of this kind when they have been raised. However, we may not necessarily agree with the taxpayer on the consequence of these factors. In cases where further compliance action is taken, even after taking these factors into account, we may consider that the circumstances still indicate grossly excessive fees.

Paragraph 6.75

A.2.174 The circumstances were considered, and it was determined that it did not provide an adequate explanation of the commerciality of the fees claimed. The circumstances would be considered in the course of the review as part of the overall circumstances of this case. The circumstance alone was not appropriate grounds on which to decide to not even commence a review.

Paragraph 6.76

A.2.175 The Tax Office does not accept that our conduct has been in breach of the Taxpayers' Charter. The individual circumstances of arrangements have always been taken into account, and our approach in each case is modified to reflect these circumstances.

Paragraph 6.84

A.2.176 The Tax Office does not agree. Advice is not simply ignored but it is true that the applicability of advice to an arrangement may be considered during an audit. In doing so the Commissioner considers a number of factors including:

- the advice was non-binding;
- the advice was not given to that partnership or firm;
- details of activities had been given to support the request of the Commissioner for the very general advice provided; and
- the advice applied only in respect of commercially realistic activities.

A.2.177 (The next two paragraphs of Tax Office's comments on this paragraph have not been published owing to concerns about taxpayers' privacy. The Tax Office has however previously communicated, in a general fashion, a number of the assertions which it makes in these paragraphs. A number of these general assertions have been set out elsewhere in this report — see for example the assertions referred to in paragraph 3.35 in the body of the Inspector-General's report).

A.2.178 More generally, the appropriateness of a particular level of mark-up depends on the circumstances of the case. Mark ups in reliance on Phillips '50/15 rates' need to reflect the facts in that case that supported the commerciality of those mark ups. At no time have we 'walked away' from the rates. We have always said it is a question of fact and the arrangement had to be commercially realistic. Cases where we have not allowed '50/15' claims have involved cases were we were satisfied that the mark ups was patently inappropriate in the individual circumstances of the case, and the circumstances were materially different from those in Phillips.

A.2.179 (The next paragraph of the Tax Office's comments on this paragraph have not been published owing to concerns about taxpayers' privacy.)

Paragraph 6.87

A.2.180 The Tax Office does not accept that it has 'walked away' from the previous advice. These advices, which were not in the form of rulings or other binding advice, were isolated in nature and could not be taken to represent an administrative practice on the part of the Tax Office. (The remainder of this paragraph has not been published owing to concerns about taxpayer's privacy).

Paragraph 6.101

A.2.181 The Tax Office does not accept there is a contradiction between the comments on the term 'general administrative practice' in both TR 2006/10 and the explanatory memorandum to TLAB (No. 2).

Paragraph 6.107

A.2.182 More specifically, it involves determining question of facts about what is commercial in the circumstances of a particular arrangement.

Paragraph 6.109

A.2.183 The Tax Office also considers that, if there was a previous general administrative practice (which is not accepted), that practice was withdrawn with the release of TD 1994/45 and the associated addendum to TR 1992/20.

Paragraph 6.110

A.2.184 Material in the assessing manuals from 1985 about a question of fact patently has no validity or relevance to that question of fact decades later. Especially since reliance on the material was officially rejected in 1994. The material has to be understood in the context of what the material addresses, ie the question of fact whether fees are commercially realistic. It is patently clear that the material in the assessing manuals can have no relevance to that question in recent years.

Paragraph 6.112

A.2.185 The Tax Office is concerned by the view that internal Tax Office risk assessment methodologies could be taken to constitute general administrative practices concerning the interpretation and application of the taxation laws. The Tax Office is of the view that general administrative practices relate to matters affecting the determination of tax liability and does not relate to Tax Office audit practices. As presently relevant, a tax shortfall must arise because of reasonable reliance in good faith on such a practice. This does not cover practices concerning the way in which the Tax Office goes about auditing cases. Whether or not a case will or will not be audited, or its risk of being audited, are not matters that can cause the tax shortfall to arise.

Paragaph 6.114

A.2.186 This accords with the Tax Office's understanding of general administrative practices. However, the Tax Office does not accept that there was a prevailing general administrative practice accepting the calculation of tax using a particular method or particular rate for service fees prior to the release of the booklet.

Paragraph 6.115

A.2.187 The Tax Office is unclear what the source of any such general administrative practice would be, other than potentially the comments made in the 2001 Annual Report. These comments are consistent with previous public comments made by the Tax Office.

Paragraph 6.116

A.2.188 The Tax Office submits that each of these factors referred to above has an explanation which does not require a view to be formed that there has been a change in general administrative practice.

Paragraph 6.117

A.2.189 As explained in earlier Tax Office comments, we do not accept that there has been a change in a general administrative practice.

Paragraph 6.126

A.2.190 We note the Inspector-General's view in paragraph 6.12 that the Tax Office's view on the law on service entities is the same view of the law which it had in 1978. The change that the Inspector-General asserts is not set out in two sets of documents, being TR 2006/2 and the booklet. The change that the Inspector-General asserts, which is not accepted by the Tax Office as having occurred, only related to the practical guidance material in the booklet.

Paragraph 6.132

A.2.191 Although the Tax Office does not accept that it has changed a general administrative practice, prior advices were taken into account in arriving at penalties in appropriate cases. Moreover, as the Tax Office is of the view that there has been no change in general administrative practice, it follows that the existence of such a change would not be taken into account, and cannot be evidence of a systemic issue that there has been a failure to take this into account.

Paragraph 6.150

A.2.192 The Tax Office does not consider that is accurate to describe the circumstance that arises in relation to service entity arrangements as the imposition of double taxation. The law, and the Tax Office's administration of the law, does not operate to assess income from service fees twice.

A.2.193 In an unacceptable service entity arrangement, fees are claimed as deductions by a professional firm or other business in excess of the amount deductible at law. Nevertheless, the fee charged by the service entity remains assessable income at law. The assessability of income to a recipient is not dependant on the deductibility of the expense to the payer.

A.2.194 Nevertheless, the Tax Office understands the economic mismatch that arises in cases where excessive fees have been charged and has taken steps available to it to provide relief. This has been achieved through the exercise of Tax Office's general administrative power in the course of reaching settlements of the issue with taxpayers, by giving recognition in the settled amount for tax already paid by associates of the partner in a professional firm in respect of the partners' tax adjustment due to the non deductible fee.

A.2.195 The Tax Office does not accept that the settlement of these cases has forced taxpayers to either 'actually' or 'practically' admit that their arrangement is struck down by Part IVA. While Part IVA may have potential application in individual cases, the non-deductibility of service fee essentially involves the application of the ordinary deduction rules.

Paragraph 6.153

A.2.196 The Commissioner does not have power to make 'compensating adjustments' under the general deduction provision in section 8-1 although he does under Part IVA. Accordingly, when negotiating settlements, the Commissioner may have regard to the possibility that Part IVA might apply and that compensating adjustments might be available to parties other than the taxpayer. This approach is beneficial to taxpayers.

A.2.197 However, that is not what ordinarily happens in relation to service fees.

A.2.198 We note first that the Tax Office does not consider that it is accurate to say that there is the imposition of double taxation in these cases. The law, and the Tax Office's administration of the law, does not operate to assess income from service fees twice.

A.2.199 In an unacceptable service entity arrangement, deductions are reduced or denied in the hands of the firm or business, but the fee charged by the service entity remains assessable income at law for the service entity. The assessability of income to a recipient is not dependant on the deductibility of the expense to the payer.

A.2.200 Nevertheless, the Tax Office understands the economic mismatch that arises in cases where excessive fees have been charged and has taken steps available to it to provide relief. This has been achieved through the exercise of Tax Office's general administrative power, by giving recognition in a settlement for tax already paid by a shareholder or beneficiary of the relevant service entity in respect of the partner's tax adjustment due to the deduction for service fees being disallowed.

A.2.201 The suggestion that taxpayers have been 'forced to admit' to the application of Part IVA is not an accurately reflect what has occurred.

Paragraph 7.2

A.2.202 The prevailing Tax Office view was published in IT 276. This ruling was exhaustive of our interpretative views on the issue. The ruling emphasised the factual nature of the issue and that cases needed to be looked at on their own facts. Additional communication on the issue reflected the emerging nature of the risks and issues in relation to service entity arrangements.

Paragraph 7.11

A.2.203 There was no document similar to a Taxpayer Alert in 1999 which could have been used to publish concerns about the use of service entity arrangements.

Paragraph 7.56

A.2.204 The criteria which were proposed in the draft booklet reflected the Tax Office's tentative positions at the time. These were released for the purposes of public consultation, and changes were made in response to feedback and submissions received, and the time spent in the consultation process.

APPENDIX 3: TAX OFFICE'S VIEW ON WHAT IS A SERVICE ARRANGEMENT

A.3.1 This appendix contains an extract from the Tax Office publication *'Your service entity arrangements'* which was first published in April 2006.[58]

01 WHAT IS A SERVICE ARRANGEMENT?

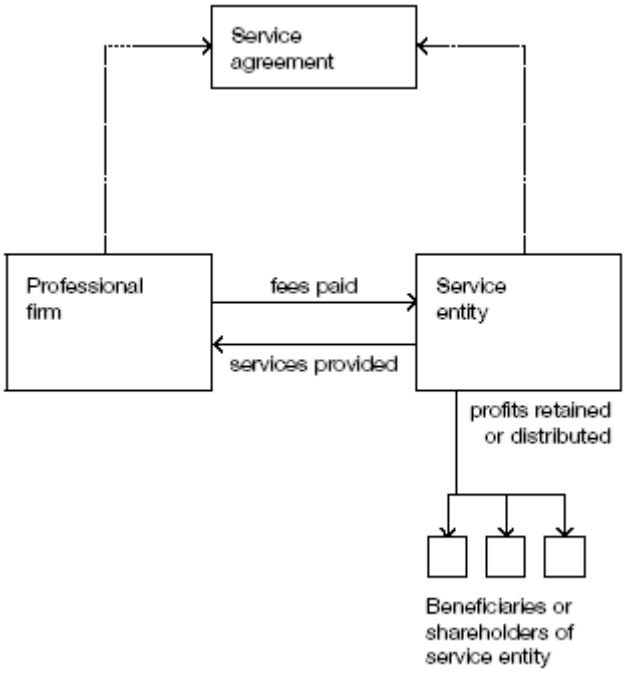
In this guide we refer to a trust or company as the service entity.

A service arrangement will generally show all or most of the following features:

- The taxpayer (and this could be a sole proprietor, a partner in a professional partnership or a company) carries on a business or professional practice in a field such as accountancy, law, medicine or pharmacy.
- There is a trust that is controlled, or a company that is owned or controlled, by the taxpayer or the taxpayer and associates.
- The taxpayer, alone or in partnership, enters into an agreement with the service entity for the taxpayer to pay certain fees and charges in return for the service entity providing certain services. These services could include staff hire, recruitment, clerical and administrative services, provision of premises, plant or equipment, or a combination of services.
- Typically, the service fees and charges are calculated by way of a mark-up on some or all of the costs of the service entity (although a fixed charge may be agreed on by the parties up-front).
- The taxpayer (or professional partnership) claims a deduction for the service fees and charges as expenditure it has incurred in the conduct of its business.
- The service arrangement either gives rise to profits in the service entity, for both accounting and tax purposes, or would give rise to profits in the service entity except for remuneration or service fees paid to associates of the taxpayer or the taxpayer's partners.
- The profits derived by the service entity are either retained by the service entity (usually where the service entity is a company) or distributed (directly or indirectly) to the taxpayer (or partners in the case of a partnership) and/or to associates of the taxpayer (and associates of the partners in the case of a partnership).

58 Australian Taxation Office, *Your service entity arrangements*, guidebook published in April 2006, available on the Tax Office's website at www.ato.gov.au.

Example: A typical service entity arrangement



In our experience, conventional service arrangements are typically entered into by lawyers and accountants, although we have also seen service arrangements involving other professionals, such as medical practitioners and pharmacists. The professional practices that use service arrangements range from large practices to small, micro and individual practitioners.

There are service arrangements that differ significantly from the conventional arrangements described above.

APPENDIX 4: EXTRACT FROM TAX OFFICE'S TRUSTS ASSESSING MANUAL

A.4.1 Paragraphs 4.13.1 to 4.13.4 of Chapter 13 of the Tax Offices' Trust Assessing Manual are reproduced below. These paragraphs (with the exception of the paragraphs shaded in grey) were published by CCH Australia Limited in October 1985.[59]

CHAPTER 13 TRUST ASSESSING MANUAL

SPECIALIST DUTIES

Determination of Certain claims prior to Assessment

4.13.1 In most offices specialist areas have been established to deal with the following cases. Where applicable returns are to be forwarded to those areas for assessment.

Management, Service and Administration Trusts

4.13.2 These trusts are formed to provide services to a professional practice or business. The arrangement is acceptable for income tax purposes provided that the activities are considered commercially realistic and the mark up on the cost of providing the services is reasonable.

The income (in the case of the recipient) or the claim for expenditure (in the case of the payer) will be described variously as:

a. management fees;

b. administration fees;

c. service fees;

d. consulting fees;

e. debt factoring commissions etc.

Claims are examined in the light of the Phillips Case (refer to F.C. of T. v Phillips 78 ATC 4361, 8 ATR 783) which established guidelines for net fees with mark-ups approximating 50% on wages claimed in providing the service and 15% of other expenses.

Returns identified with any of the following features should be referred to a specialist assessor prior to assessment:

a. A service trust with a mark-up on the costs of providing the service of more than 50% on wages, 15% on expenses with a tolerance of 15% or $5,000 whichever is the greater.

59 CCH Australia Limited, *Australian Taxation Office Assessing Handbook – Trust Volume 4*, October 1985.

b. The service trust shows a claim for salary and corresponding superannuation contributions in respect of a principal i.e. an employee who is obviously not at arm's length with the entity requiring the provision of the services.

c. The arrangement is inconsistent with ordinary business dealing e.g. the consideration paid for the services is demonstrably out of line with the commercial value of the services rendered. Rent received appears excessive having regard to the location, nature and cost of the property and improvements thereon would be a specific example of an unsatisfactory arrangement.

Perth office

1. An existing trust return is not examined in the specialist area. All trust assessors are responsible for ensuring that mark-ups are acceptable. If the guidelines are exceeded, they are referred to the specialist area.

2. All first year trusts with fees received are referred to the specialist area.

3. Fees paid - Where a claim for fees paid was accepted in the prior year, the current year may be accepted, provided it falls within the guidelines. Where the prior year claim was adjusted or the current year is the first year of a claim for fees paid, the return is to be referred to a specialist assessor in Sec B.

Brisbane Office

All trust assessors are responsible for ensuring mark-ups are acceptable and adjusting them if not. Each year's return is accepted on its merits unless a prior year's query has issued establishing an acceptable mark-up.

Calculation of Mark-ups

4.13.3 The calculation is to be confined to the management fees (or as otherwise described) and related expenditure. Where income from other sources is also present, such as rental or leasing fees, such income and the associated expenses are to be excluded from the application of the guidelines.

Where applicable, that extraneous activity is to be examined in the light of its economic reality.

Perth office

Example 1

Application of the Phillips case guidelines on mark-ups charged.

Management fees received			$20,000
Less expenses:			
Wages	$9,000		
Other expenses	5,000		14,000
		Net Income	$6,000

Calculation:

$9,000 wages plus 50% mark-up	$13,500
$5,000 other expenses 15% mark-up	5,750
	$19,250

Add:

Tolerange of $5,000 or 15% of $19,250 whichever is greater	$5,000
	$24,250

As the total fees received ($20,000) is less than $24,250 the claim is acceptable.

Example 2

Application of the Phillips case guidelines where rental income is derived.

Management fees		$30,000
Rental income		2,000
		$32,000
Less expenses:		
Wages	$15,000	
Other expenses	3,000	
Rental expenses	1,000	19,000
		$13,000

Calculation:

$15,000 wages plus 50% mark-up	$22,500
$3,000 other expenses plus mark-up	3,450
	$25,950

Add:

Tolerance of $5,000 or 15% of $25,950 whichever is greater	$5,000
	$30,950

As the total management fees received ($30,000) are less than $30,950 the claim is acceptable.

NOTE: Rental income and expenses are not taken into account when determining the allowable mark-up. The commerciality of the rent charged should be reviewed if it is considered excessive.

Management, Service and Administration Companies and Trusts - Administration Salaries and Superannuation Contributions

4.13.4 Where practitioners have sought to provide their administration salary arrangements through a Phillips like service trust (or company) principally for superannuation purposes and provided;

(1) the salaries paid by the service trust as administration salaries to the professional practitioners do not exceed the amount considered reasonable in the context of an administration arrangement;

(2) there is no mark-up on the amount paid by the professional practice to the service trust in respect of the administration salaries and superannuation contributions; and

(3) all the arrangements are bona-fide; then the arrangements may be accepted.

Substituted Accounting Period

4.13.5 New applications and returns covering transition or terminating periods are referred to the SAP assessor.

All applications for leave to adopt a substituted accounting period must be dealt with in conjunction with the returns file (if any) and submitted (after obtaining all relevant information and income details to enable the appropriate alternative adjustments to be determined) to the supervisor for approval.

APPENDIX 5: TIMELINE OF KEY EVENTS IN TAX OFFICE'S APPROACH TO SERVICE ENTITY ARRANGEMENTS

Date	Event	Comment
1978	*F C of T v Phillips*	The Full Federal Court affirms that fees paid to a related service entity are deductible provided they are commercially realistic.
1978	IT 276 issued to Tax Office staff	The Commissioner stated that the decision in *Phillips* was not seen as requiring any alteration to existing policy concerning payments of this nature.
1981	IT 25 issued to Tax Office staff	Paragraph 12 of this ruling noted that in a considerable number of cases service arrangements had been entered into by medical practitioners and that these arrangements generally complied with the official guidelines in this area and had been approved by the Tax Office's branch offices. Made available to the public in 1984.
1981	General anti-avoidance rules introduced (Part IVA)	
1981	Comments made at a seminar by Deputy Commissioner of Taxation Mr Nolan	Deputy Commissioner of Taxation Mr Nolan stated that Part IVA would not apply to service trusts if the mark-up was commercially realistic. If a taxpayer was in doubt they should seek a ruling from the Commissioner.
1983	IT 276 issued to public under *Freedom of Information Act 1982*	IT 276 made publicly available in September 1983.
1985	Trust Assessing Manual published by CCH Australia Limited	Assessing manuals were used within the Tax Office to give its assessors a guide to both the procedural and technical aspects of assessing income tax returns.
1985/6	Introduction of self assessment	The Tax Office does not review income tax returns for individuals, partnerships and trusts when assessing income tax returns.
1986	Address by Commissioner to Taxation Institute of Australia (TIA) Queensland Division's Annual Tax Convention	The Commissioner stated that 'the operation of a service company or trust where the charges are commercially realistic does not attract the operation of section 260.
1988-89	IT 2494, IT2503 and IT2531 issued	These rulings all refer to service entity arrangements. IT 2503 confirms that the comments in IT 25 still applied.
1990 and 1991	Opinions issued to major accounting firm	These opinions confirmed that mark-ups of proposed service fees were acceptable and that these mark-ups could be applied to clients of the firm as well as to the firm itself. These mark-ups were consistent with those in the Tax Office's previous trust assessing manual.
1991	*Fletcher v FCT* handed down	This is a High Court decision on the deductibility of expenses generally. The Tax Office has stated to the Inspector-General that it considers that this case dealt with the question of purpose which was central to the *Phillips* decision. The Tax Office did not however refer to the impact of this case on service entities in any ruling until the issue of the draft ruling on service entities in May 2005.
Mar 1994	Paper delivered by tax officer (Peter O'Donohue) to TIA SA Annual Convention	This paper is titled *'The ATO perspective on Phillips'* and indicates that the Commissioner was not specifically targeting service trust arrangements in the audit program at that time. However, the paper states that fees in excess of commercially realistic levels detected in the course of an audit would be looked at. The paper also states that the ATO does not endorse any particular percentage as a suitable level for mark-ups.
May 1994	Tax Office issued Taxation Determination TD 94/45, together with an addendum to Taxation Ruling TR 92/20	TD 94/45 states that in the Tax Office's view, Tax Office Assessing Handbooks cannot be relied on as evidence of the Tax Office's position. Taxpayers who wish to know the current ATO position should refer to Tax Office documents such as Taxation Rulings and Determinations or seek a private binding ruling.
1996	Tax Office's Service Industry Team in Large Business commences a scoping/data mining review of the accounting and legal profession	*Phillips* case service arrangements are one issue identified out of this review.

Date	Event	Comment
1998	Management of the accounting & legal project is brought within the Aggressive Tax Planning area of the Tax Office	Project assistance was largely from staff working in the Tax Office's Large Business Area.
May 1998	Tax Office sends questionnaires to 10 legal and accounting firms covering the periods from 1 July 1995 to 31 March 1998	Letters are sent to major accounting associations advising those bodies of the review. The key areas for review were wider than service entities.
May 1998	Paper delivered by tax officer (Stuart Forsyth) to Taxation Institute of Australia Queensland State Convention	The paper is titled *'Professional income structures and personal service income'* The paper noted that some taxpayers believe that a rule of thumb exists that a 50 per cent mark-up on wages and 15 per cent mark-up on all other costs will always be accepted by the ATO. However, the Tax Office considers that all cases have to be determined on their own facts.
Nov 1998	Paper delivered by tax officer (Chandra Sharma) to TIA Sunrise Seminar, South Australian Division	The paper is titled *'Service Entities (Trusts/Companies) The Commissioner's Perspective'.*
Apr 1999	Tax Office prepares an analysis on the results of its work on service entities to date	
Oct-Nov 1999	Tax Office notifies two large accounting firms of its intention to audit a number of issues, including *Phillips* service arrangements	This followed on from responses to the May 1998 questionnaires, where service entity arrangements, among other items, were identified as an issue which should be audited by the Tax Office to ascertain the commerciality of service fee pricing and the extent of the use of service entities for income alienation.
Jan-Feb 2000	Fieldwork commenced in relation to audits on two large accounting firms	
29 Feb 2000	Strategy paper developed by LB area in conjunction with ATP area to undertake 14 audits of LB accounting & legal firms partners who were participating in *Phillips* and *Everett* type arrangements	
Mar-Oct 2000	Three internal Tax Office meetings are held about *Phillips* and *Everett* arrangements. ATO participants include LB, OCTC and ATP representatives and a number of external consultants	
Feb 2000-Dec 2002	Field phase in relation to audits on two large accounting firms, culminating in the issue of position papers.	The field phase consisted of several meetings between the Tax Office audit teams and the accounting firms, the issue and response to numerous information requests / questionnaires, and preparation/issue of position papers.
Feb 2001	OCTC and LB representatives meet to discuss application of Part IVA to *Phillips* and *Everett* arrangements	
Mar 2001	LB prepare an internal minute outlining four possible strategies for dealing with *Phillips* and *Everett* arrangements, indicating that it prefers the strategy of the Commissioner announcing that *Phillips* arrangements are no longer acceptable and that OCTC's preferred view is to litigate on a case by case basis.	The four strategies are: 1. The Commissioner publicly announces that *Phillips/Everett* type arrangements are no longer acceptable to the Commissioner. Part of this strategy would involve the Commissioner seeking independent counsel advice on whether Part IVA applies to *Phillips* and *Everett* arrangements. If counsel decides Part IVA applies, IT 276 and related rulings are withdrawn. 2. Litigating *Phillip* and *Everett* arrangements on a case by case basis. 3. Do nothing. 4. Seek legislative change. The minute indicates that the 'do nothing' option is imprudent and that legislative change, while the most preferred option, would be difficult to implement because: a. the complexity of the issue would cause drafting issues; b. it would be difficult to get on the agenda with legislative resources that were at the time devoted to business tax reform; and c. the government would expect the Commissioner to first fully test his powers under Part IVA.

Date	Event	Comment
Nov 2001	Tax Office issues 2001 Annual Report	At page 54 the Commissioner noted that the Tax Office was reviewing some accounting and legal firms and these investigations uncovered that one arrangement used to minimise tax was payments by the partnership to service trusts. The Commissioner noted that: 'In accordance with Taxation Ruling IT 276, payments to service trusts which are commercially realistic will not be challenged. We have concerns in some cases under examination whether the service trust arrangements are commercial and effective for tax purposes.'
Mar 2002	Internal ATO workshop to discuss service trusts cases under audit	At this workshop the Tax Office made a decision to look at the pricing structures of the two cases under audit and to see if the service fees paid were commercially realistic. The Tax Office decides to engage an ATO economist to establish what are current commercial rates for independent businesses carrying on similar activities to service trusts (occurs during 2002-2003).
Apr 2002	Proposal to issue a short tax determination that arbitrary mark-ups for service arrangements are not acceptable and that services provided must be provided at commercially justified rates	The proposal was made in an email by a Deputy Chief Tax Counsel.
Apr 2002	Article published in Institute of Chartered Accountants magazine (CA Charter) by a tax officer (Kevin Fitzpatrick)	The article noted concerns that service arrangements were being used in a manner seemingly beyond the scope of the decision in the *Phillips* case. Referring to a particular case, concerns were said to include the reasonableness of the mark-ups.
29 Jul 2002	Commissioner makes speech to Financial Review- Leaders' Luncheon	The topic of the speech was *'Issues Confronting Australia's Tax System'*. In this speech he stated that *Phillips* case authorised the use of service trusts to provide administrative services to professional partnerships but that lately the Tax Office had seen cases where the arrangements have varied significantly from those reflected in the *Phillips* case. He also stated that the Tax Office was not seeking to re-open the *Phillips* decision but was examining whether the cases have moved beyond what was accepted in the *Phillips* case as explicable on commercial grounds.
5 Sep 2002	NTLG Meeting	The professional bodies raised the issue of service entity arrangements at the NTLG meeting held in September 2002 and in particular the question of reasonable rates. This flowed from the Commissioner of Taxation's address at the Leaders' Luncheon on 29 July 2002. Industry association members of the NTLG indicated that any Tax Office guidelines which may impact on professional firms would benefit from being developed in consultation with professional bodies. The Tax Office indicated that a ruling was not in planning, but feedback was sought on this and other appropriate strategies to deal with concerns about service entity arrangements.
Nov 2002	Position papers presented to two accounting firms being audited	
Dec 2002	*Phillips* Scan Report	As a consequence of serious questions about whether the service fees paid by legal and accounting partnerships were at commercially realistic rates and that audit findings were confirming the concerns set out in the earlier Legal and Accounting Sector Project Plans (1998), the Tax Office decides to review the whole legal and accounting industry on a project basis with a focus on commercial profit outcomes. This review resulted in the *Phillips* Scan Report and led to the Tax Office commencing further work to identify cases where they considered there was a high risk that service trust arrangements were not being implemented in accordance with the law
Dec 2002	The Tax Office decides to issue public guidance on service entities	

Date	Event	Comment
Mar 2003	NTLG meeting	The Tax-Office prepared minutes of the meeting note that, despite a request at the September 2002 NTLG meeting, no response had been provided to the Tax Office concerning appropriate strategies to deal with concerns about service entity arrangements. The minutes state that the Tax Office advised that review of service arrangements in the legal and accounting sectors would continue and that, on completion, it anticipated issuing a discussion paper and/or public ruling setting out the Tax Office view on the way forward. The minutes also state that the professional bodies' assistance was sought in developing strategies and that features of service arrangements the Tax Office was seeing raised issues as to whether the service fees were commercially realistic. A table is attached to these minutes detailing some of the differences between the service arrangements in *Phillips* and arrangements more recently encountered.
Jun 2003	Commissioner makes speech to the NIA in Perth WA	The topic of the speech was *'Future Directions in Tax Administration (A Relationship of Mutual Dependency)'.* The Commissioner presented a table which summarised some of the differences between the *Phillips* case and what was appearing in current arrangements. He foreshadowed the issue of 40-50 questionnaires to accounting and legal firms who had been selected based on an analysis of the proportion of net profit in the service entity as compared to the net profit in the partnership. The speech was reported on pages 1 and 4 of the *Australian Financial Review.*
Jun 2003	Tax Office sends questionnaires referred to by the Commissioner to 56 accounting and legal firms	These firms were a sample of legal and accounting firms identified by the *Phillips* Scan of 2002. Draft questionnaires are issued to professional bodies which were members of the NTLG and their comments sought. No comments or input is received by the Tax Office. The covering letter to the questionnaire advised that the firms are not subject to audit. Responses are received over the following six months.
Oct 2003	Tax Office Steering Committee formed and first meeting held	Objectives of the meeting were: (i) to recommend a practice statement or ruling; (ii) to consider further audit work; (iii) to discuss questionnaire results; (iv) to consider development of a go-forward strategy for executive approval No clear decision is made at this time on whether the Tax Office view would issue as a practice statement or a draft public ruling
Oct 2003	Public Rulings Panel decision is made that the Tax Office view on service entity arrangements should be expressed in a ruling and not a practice statement	TCN view was that guidance should be in the form of a practice statement while the view of the business area was that a public ruling was preferable, given its potential to have a greater impact on compliance for the target population
Oct 2003	Drafting of ruling commences	
Nov 2003	Minute issued by Office of Chief Tax Counsel placing a restriction on advice issuing on service arrangements	The Minute was issued to Tax Office staff restricting the issue of advice in relation to the deductibility of expenses for any cases with similar features to *Phillips* service trust arrangements. The ATO has advised that this Minute was not intended to prevent business as usual in relation to the provision of advice but to ensure consistency of advice.
Dec 2003	Public Rulings Panel meeting	The initial draft public ruling was discussed at this meeting.
Dec 2003	Settlement agreement executed for one of accounting firms subject to audit	
Dec 2003	NTLG meeting	The NTLG was invited to form a subgroup to consult with the Tax Office in development of the draft ruling. This consultation process took more than 12 months.
Feb 2004	Public Rulings Panel meeting	A revised and more advanced draft of the ruling is discussed, which includes economic issues.

Date	Event	Comment
Mar 2004	NTLG meeting	The minutes of the meeting confirmed that a NTLG subgroup was to be formed to consult with the Tax Office on the proposed public ruling on service entity arrangements. Additionally, the Tax Office advised that it was continuing to analyse the responses received from the questionnaire process.
Mar 2004	Public Rulings Panel meeting	Further revisions are made to the draft ruling especially to address concerns about an undue emphasis on transfer pricing
May 2004	Public Rulings Panel approves release of draft ruling to NTLG subgroup on a confidential basis	
May 2004	Draft public ruling circulated to NTLG subgroup	
May 2004	ATO prepares report on results of questionnaires	The report lists questionnaire results and analysis and ATO actions to be taken following survey results, including the selection of a pool of potential audit cases
Jul 2004	Settlement agreement finalised for second accounting firm subject to audit	
Aug 2004	Tax Office's Compliance Program for 2004-05 is released	At page 20 of this Program the Tax Office advised that in the small to medium enterprises section service trust arrangements within the legal and accounting profession continued to be of concern and that a number of firms' arrangements are being examined. The Program stated that this activity would be supported by an educational program following the issue of a public ruling supplementing IT 276. At page 20 of this Program the Program stated that for large business the Tax Office audited a number of firms last year and is now examining these arrangements across a wider group of legal and accounting firms.
Sep 2004	NTLG meeting	The minutes confirm that a submission on the draft ruling had been received by participating members of the NTLG subgroup. The meeting was advised that two workshops had been scheduled with NTLG members to discuss the issues raised in the submissions.
8 & 10 Sep 2004	Two NTLG subgroup workshops are held	
21 Sep 2004	NTLG members participating in the subgroup raise concerns about the content of the draft ruling and the conduct of confidential discussions in a letter to the Commissioner	
Late 2004	Management of service entity arrangements within the Tax Office is transferred from the Large Business area of the Tax Office to the Small Business area of the Tax Office	
30 Sept 2004	Draft ruling is revised and resubmitted to the Public Rulings Panel. Commissioner has decided to issue a separate compliance booklet.	
13 Oct 2004	Commissioner provides reply to the NTLG members in response to consultation process concerns	The Commissioner gives assurance that copies of the draft booklet and draft ruling would be released to NTLG members for further consultation prior to public release.
21 Oct 2004	Second Commissioner-Law revises the ruling	
15 Dec 2004	A draft ruling and draft compliance booklet are issued to the NTLG subgroup for comments by Feb 2005	
Feb-Mar 2005	Draft ruling and booklet are further revised by a Second Commissioner-Law and the Deputy Commissioner, Small Business	These revisions followed consideration of submissions received from the NTLG subgroup.
17 Mar 2005	OCTC area of the Tax Office prepares a report on how to deal with audit cases in hand in terms of position papers and settlements	The report indicates a preference for a draft voluntary disclosure package to issue with ruling and booklet.

Date	Event	Comment
Mar 2005	NTLG meeting	The professional bodies sought release of the draft ruling, but were advised that the ruling would need to be referred to the next meeting of the Public Rulings Panel for approval to release. NTLG members sought information about a further round of consultation but the Commissioner did not commit to this.
30 Mar 2005	Public Rulings Panel meeting	The draft ruling is considered by the panel. On 6 April the Second Commissioner clears the draft ruling for release.
4 May 2005	Publication of draft ruling on service entity arrangements — TR 2005/D5	
25 May 2005	Advance release of draft booklet to NTLG members	
2 Jun 2005	Commissioner indicates to a Senate Economic Committee (SEC) that the Tax Office would not audit prior years where the service fees were less than $1 million and less than 50 per cent of the gross fees of the professional firm	
29 Jun 2005	Issue to the public of draft booklet on service entity arrangements	The booklet confirms that the Tax Office would not audit prior years where the service fees were less than $1 million and represented less than 50 per cent of the gross fees of the professional firm.
29 July 2005	Submissions received on draft ruling and draft booklet	A compendium of submissions and ATO responses is subsequently prepared.
Aug 2005	ATPF meeting	The Tax Office advised the meeting that it would recommence auditing non-high risk service entity cases from July 2006.
Aug 2005	NTLG SME subcommittee meeting	The Tax Office advised the meeting that taxpayers would have a full 12 months period of grace from the date of issue of the final ruling to restructure their affairs.
21 Sep 2005	Meeting between Institute of Chartered Accountants (ICAA) and Tax Office senior executives	The meeting was to discuss progress on the ruling and guidance booklet. At this meeting the Commissioner agrees to introduce a third criterion for auditing prior year service entity arrangements, namely that the profits of the service entity were more than 50 per cent of the combined profits of the service entity and professional firm.
Oct 2005	Public Rulings Panel meeting	The panel's recommendations are taken into account in revising the draft ruling.
Oct 2005	Tax Office has phone hook up with NTLG members and others on draft booklet figures	The purpose of the hook-up was to discuss the figures, referred to in the draft booklet as publicly available, on which the Tax Office arrived at its acceptable margins and levels of profitability for labour hire services.
Oct 2005	ICAA submits several papers to the Tax Office	
Oct 2005	Regular consultation with the Australian Medical Association (AMA) commences. AMA submits papers to the Tax Office	
Oct/Nov 2005	Consultant Economist engaged	
Nov 2005-Mar 2006	Consultant Economist reports	Various reports are received from the consultant economist, including the suitability of benchmarking on a net or gross mark-up basis, comparative benchmarks for certain services, and commentary on the Tax Office's econometric work.
3 Nov 2005	Commissioner makes statement to Senate Estimates Committee that a new third requirement would be added for service entity arrangements to be considered a high risk case	The new third requirement was that the profit of the service entity had to be more than 50 per cent of the combined profits of the service entity and professional firm. This criterion was added to the original two criteria for high risk audit cases. These original criteria were that the service fees had to be more than $1 million and that these fees had to represent more than 50 per cent of the gross income of the professional firm.
12 Dec 2005	NTLG meeting	NTLG members requested that the Tax Office hold back the ruling so that it be issued together with the guidance booklet.
Dec 2005	Second Commissioner- Law approves the ruling	
Jan 06	New Tax Office rulings regime implemented	New regime is the result of Treasury's 2004 Review of Aspects of Income Tax Self Assessment (RoSA)

Date	Event	Comment
17 Feb 2006	Tax Office holds meeting with several general practitioners in Melbourne	The meeting was organised by the AMA at the request of the Tax Office. The meeting sought to independently verify information tendered in submissions concerning the medical profession.
Feb 2006	Further representations from ICAA	
Feb 2006	Minutes of NTLG's SME subcommittee are published	The minutes indicate that taxpayers would have a full 12 months period of grace from the date of issue of the final ruling to restructure their affairs.
Mar-Apr 2006	ATO has further consultation with AMA regarding booklet rates	
April 2006	Issue to the public of final ruling on service entity arrangements (TR 2006/2) and accompanying booklet (*Your service entity arrangements*)	

APPENDIX 6: BIBLIOGRAPHY

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APPENDIX 7: ABBREVIATIONS

AMA	Australian Medical Association Limited
ANAO	Australian National Audit Office
AR	Annual Report
ATO	Australian Taxation Office
ATP	Aggressive Tax Planning
ATPF	ATO — Tax Practitioner Forum
Commissioner	Commissioner of Taxation
EBA	Employee Benefit Arrangement
FCT	Federal Commissioner of Taxation
GIC	General Interest Charge
GST	Goods and Services Tax
ICAA	Institute of Chartered Accountants
IGT Act	*Inspector-General of Taxation Act 2003*
Inspector-General	Inspector-General of Taxation
IT	Income Tax Ruling
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
LB	Large Business
MMTEI	Mass Marketed Tax Effective Investment
NTLG	National Tax Liaison Group
OCTC	Office of Chief Tax Counsel
PS	Practice Statement
PS LA	Practice Statement Law Administration
PTI	Priority Technical Issue
ROSA	Review of Aspects of Self Assessment
SB	Small Business
SME	Small to medium size enterprise
TAA 1953	*Taxation Administration Act 1953*
TCN	Tax Counsel Network
TD	Taxation Determination
TIA	Taxation Institute of Australia
TLAB	Tax Law Amendment Bill
Tax Office	Australian Taxation Office
TR	Taxation Ruling