The NTAA's Guide to a Service Agreement for a Service Trust (or other Service Entity)

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Law

The law is as stated January 2018.

Service Agreements

What is a Service Agreement?

A service agreement is a contract between a professional practice (the "**Principal**") (which may take the form of a sole practitioner, a trust, a partnership, or a company) and a service provider (the "**service entity**", which is often a "**service trust**") which provides services to the Principal. The service agreement contains the agreed terms by which the service entity will provide the services to the Principal and may cover a range of matters, including the type of services provided, the fees for services and the rights and obligations of the parties. It is important for tax and asset protection reasons that the service arrangement between the service entity and the Principal is properly documented and that the terms and conditions for providing the services are set out in detail.

Generally, a service agreement should cover the following matters:

- The services that may be provided by the service entity as required;
- The commencement date and termination period;
- Any special conditions (if applicable);
- Employment of staff to carry out the services;
- Provision of business premises to the practice;
- Fees and payment methods;
- Warranties;
- Intellectual property rights;
- Limitation of liability provisions;
- Dispute resolution mechanism; and
- Miscellaneous provisions.

What is the difference between an independent contractor and an employee?

This service agreement operates as a 'contract for services', whereby the Principal requests and pays for services provided by the service entity. Essentially, the Principal operates a professional practice and the service entity operates a separate business of providing administration and support services to the Principal. Operating under this service agreement should not result in an employment relationship, as the service entity is an independent entity and not an employee of the Principal. If the service entity acts on behalf of the Principal, it does so in accordance with the terms of the service agreement. In contrast, an employee is employed by the Principal under an employment contract and is subject to the direction and control of the Principal as employer.

Service Trusts

What is a Service Trust?

A service trust is a service entity that is generally set up to provide administrative and support services to a professional practice (i.e., the Principal). Some examples of a professional practice include doctors, dentists, lawyers, accountants and other professionals that operate a practice. The service trust generally provides non-professional services (e.g., clerical, secretarial, administration, book-keeping services), employs non-professional staff, owns or leases the premises for the practice, owns the plant and equipment, and manages the infrastructure required to run the practice.

What are the advantages of a Service Trust?

A service trust arrangement can provide asset protection, where business assets are owned by a separate entity (i.e., the service entity) and provided (together with other services) to the Principal. A greater level of protection therefore exists for those business assets in the event of litigation or liability claims against the Principal.

In addition, service entities are seen as tax-effective vehicles that may enable 'income splitting'. This may be achieved by the service entity incurring expenses which are then on-charged to the professional practice (which are 'marked-up' with a commercial profit component). This results in profits being made by the service entity, which may be distributed to the owners/beneficiaries of the service entity (who are often family members on lower marginal tax rates).

How can I set up a Service Trust?

A service trust can generally be set up as either a discretionary trust or a unit trust depending on the structure of the professional practice. Typically:

- a service trust may be set up as a discretionary trust where the Principal is a sole practitioner, and the Principal's family and other related entities are beneficiaries of the trust; or

- a service trust may be set up as a unit trust (or even a partnership of trusts or a hybrid trust) where the Principal is a partnership of professionals, and the Principal's families (or their own discretionary trusts) are unit holders of the trust.

Note: In some limited circumstances, the service entity may be a company, although this is not as common as there are generally fewer tax benefits.

Whichever form of trust is adopted, it is important that the service trust's deed provides the trustee with adequate powers to operate the trust as a service entity, including powers to:

- undertake the service trust's business;
- classify receipts/outgoings as being on income or capital account; and
- divide any income received into categories for distribution.

Further, the trust deed should have an appropriate definition of income of the trust for tax purposes. NTAA Corporate's trust deeds include the above powers and provisions which would support the running of a service trust.

If your service entity's trust deed does not provide for the above powers and requirements, it may adversely impact the validity of the service entity and/or the service arrangement. If you have not ordered an NTAA Corporate trust deed, we recommend that you seek independent legal advice to ensure that the powers in your trust deed meet the requirements for a service entity.

Do I need a Service Agreement to operate a Service Trust?

Yes. If you are operating a service trust which is required to provide services to the Principal, you will need a detailed service agreement to properly document the arrangement. You will also need further documentation to implement the service arrangement – refer to the section on '*Documentation for the Service Arrangement*' below.

The tax law relating to Service Entities

The use of service entities became prevalent following the decision in *FCT v Phillips* [1978] FCA 28 ("*Phillips' case*") and this form of structuring has been common amongst professional practices for the provision of administration and support services. In *Phillips' case*, the ATO unsuccessfully challenged the deductibility of fees paid by a partnership to a service trust under the former general anti-avoidance provisions in the ITAA 1936. In that case, the mark-ups applied by the service trust to the expenses on-charged to the partnership were found to be realistic and not in excess of a commercial rate for the services provided by the service trust. The service entity arrangement was also meticulously documented and implemented.

Whilst the ATO accepts the correctness of the decision in *Phillips' case*, it will often seek to deny deductions for service charges unless the service entity arrangement is seen as commercial (and broadly reflects the circumstances in *Phillips' case*). The ATO has also released detailed guidance regarding its position on service entities and service arrangements.

Therefore, before implementing a service arrangement, you should carefully read:

- *Taxation Ruling TR 2006/2 Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements* (the "**Ruling**"); and
- The accompanying ATO compliance document "*Your Service Entity Arrangements*" (the "**ATO Guide**"), which details the Commissioner's opinion on the deductibility of service charges paid to associated service entities.

  Specifically, it considers whether or not such fees are deductible under Section 8-1 of the *Income Tax Assessment Act 1997* (Cth) or, alternatively, whether Part IVA applies to deny deductions for incurring such fees. The ATO Guide contains examples of acceptable mark up rates and outlines whether service entity arrangements are at risk of tax audit – refer to the section on '*Calculation of Service Charges*' below.

In considering the deductibility of any service charges/fees, the Commissioner will assess whether the expenditure was incurred for the purpose deriving assessable income, or for some other non-deductible purpose.

Generally, the ATO will focus on the following key areas:

- whether the **administrative burden** of arranging for the services being provided has genuinely passed to the service trust;
- whether the **asset protection benefits** have been achieved by engaging in the service entity arrangement;
- whether **service charges** are calculated on a **commercial basis**, including whether mark-ups applied are realistic and not in excess of a commercial rate for the services provided by the service trust; and
- whether the service entity arrangement is **well documented** and **properly implemented** by the parties.

Simply having a service agreement in place is not sufficient to establish deductibility of the service charge by the Principal practice entity; there needs to be evidence that the parties have actually complied with the terms of the agreement **and** that any service charges have actually been incurred.

In a recent AAT case, *PBKQ v FCT* [2016] AATA 681 ("***PBKQ's case***"), a taxpayer was denied a deduction for an inter-entity service charge (which was 'journalised' in the taxpayers accounts, but not paid) on the basis that insufficient evidence was provided to show that the service charge was **incurred** by the taxpayer in carrying on its business. A 'service agreement' in place was held to have very little evidentiary value, as **the terms of the agreement were not adhered to** during the course of the arrangement.

Documentation for the Service Arrangement

It is important that the service arrangement is properly documented to prove that the arrangement is a genuine one. The ATO released the ATO Guide as a companion document to TR 2006/2 to help professional practices determine whether the charges incurred under a service entity arrangement are deductible for tax purposes. Service charges that are disproportionate or grossly excessive in relation to the benefits provided under the service arrangement will be scrutinised by the ATO.

Generally, taxpayers involved in service entity arrangements will be at a **lower risk of audit** by the ATO if:

- the level of their service charges are **less than or equal to the ATO's 'indicative rates'** for the services described – refer to the section on '*Calculation of Service Charges*' below; and
- **documentation is maintained** that explains how those services are relevant to the conduct of the business.

If your service entity arrangement is not properly documented or followed, you may be at risk of audit by the ATO. In *Phillips' case*, the service entity arrangement was meticulously documented and implemented. In contrast, while a written service agreement existed in *PBKQ's case*, the existence of such an agreement was insufficient where its terms were not strictly followed by the parties.

What evidence do I need to claim a deduction?
To claim deductions for an outgoing in relation to services provided by another related entity, an entity/taxpayer must be able to demonstrate:

- the exact nature of the services purported to be provided;
- that the services have actually been provided; and
- that the outgoing has actually been incurred (i.e., the entity claiming the deduction actually has a presently existing liability or the outgoing has been paid).

Note that a deduction can only be claimed if the expenses would have been deductible had the Principal incurred the expenses directly, rather than via a service agreement with the service entity: refer to *PBKQ's case*.

What documents do I need to evidence the service entity arrangement?
While there is no obligation to create specific business records about dealings with an associated service entity, taxpayers must keep records that explain their transactions for tax purposes. The extent to which records are ordinarily kept can depend on factors like the significance and complexity and materiality of the transaction and the size of the business.

Some of the key documentation that will be relevant in evidencing the services provided under the arrangement, and how the services are priced, include:

- a fully documented and up-to date service agreement;
- documents showing how the Principal and the service entity arrived at a pricing structure for the services provided;
- tax invoices for the service charge under the arrangement, and evidence of payment (*beyond* mere journal entries);
- calculation statements showing how the service charges were calculated from time to time, including documents justifying any mark-ups that have been applied by the service entity;
- detailed profit and loss statements and balance sheets for both the Principal and the service entity;
- for a Principal trading as a partnership, the partnership agreement (as varied when applicable);
- the constituent documents for the service entity (e.g., trust deed establishing the service trust, constitution of the corporate trustee);
- adequate minutes of meetings and resolutions of the service entity on all matters relating to the service trust, including entering into the service agreement, any changes to the agreement, and distributing profits to beneficiaries;
- budgets and business plans for both the business and the service trust;
- a list of personnel employed by the service entities together with relevant duty statements, along with employment contracts, timesheets, other personnel records and reporting guidelines for employees of the service entity;
- relevant insurance contracts; and
- relevant leases and/or rental agreements.

Calculation of Service Charges

All service entity arrangements will be unique and the fees charged should reasonably reflect the specific services rendered by the service entity.

How should service charges be calculated?
It is important to read the Ruling and the ATO Guide in detail to determine how to calculate reasonable service fees. The Commissioner will broadly accept charges calculated by reference to any of the following as they apply to the service:

- **comparable market prices**;
- **comparable profits**; or
- **the ATO's indicative rates**.

If service fees and charges are calculated at higher rates than the ATO's indicative rates, it would be necessary to explain why the fees and charges are higher and how they are connected with earning the business income.

The calculation of the service charge must be **commercially realistic** and:

- must not be disproportionate or "grossly excessive" in relation to the benefits conferred by the service agreement;
- must not guarantee the service entity a certain profit outcome without reasonable commercial explanation;
- must not generate profits in the service entity without any clear evidence the service entity has added any value or performed any substantive functions; and
- there must be a clear separation between the service entity's business activities and those of the taxpayer.

In addition, there must be adequate records evidencing the service trust arrangement and its benefits to the taxpayer. If expenditure is grossly excessive, it may not be wholly deductible on the basis that it was not wholly or entirely incurred for income producing purposes.

Generally, there must be an "objective commercial explanation" for the expenditure or service fees in determining deductibility under the tax legislation. Otherwise, the Commissioner may conduct an audit to determine whether the expenditure was genuinely incurred for the purpose of deriving assessable income or some other non-deductible purpose. The ATO has provided rates which it considers to be the commercial benchmark rates for services typically offered under service arrangements at the following link: https://www.ato.gov.au/Business/Income-and-deductions-for-business/In-detail/Service-entities/Your-service-entity-arrangements/?page=6 (or search for Quick Code ('QC') 18677 on the ATO's website).

Service entities which charge service fees that are substantially higher than market rates may be audited by the ATO. The ATO does accept, however, that market rates may change over time, and service fees may be adjusted in line with these changes. In some instances, the ATO will accept that paying a fee higher than market rate will be justifiable, particularly where:

- rates for a specific industry are higher;
- a different service model applies;
- a specialised/highly skilled service is being provided; or
- the charges reasonably reflect the contribution of the service in generating profits for the business.

What evidence is required to show that a service charge has been incurred?
To demonstrate that a genuine service charge has been incurred, it is important that:

- the services and agreed cost (or method of calculating the cost) of the services are outlined in the Service Agreement;
- a tax invoice is issued by the service entity regularly (e.g., monthly), which appropriately describes the services provided and the terms of payment; and
- the Principal actually pays each invoice within a reasonable period (in accordance with the payment terms).

If the parties wish to settle service charges via an offset agreement, it is not sufficient to product journal entries as evidence of the offset. Instead, the parties should enter into a separate agreement stating that an outstanding service charge shall be offset against any amount owing by the service entity to the Principal.

TAX WARNING – Journal entries not evidence of incurring expense

A mere journal entry will not be sufficient evidence of payment (where no other documentation exists). This means that journal entries themselves, in the absence of any other documentation (i.e., agreement, minutes of meeting, etc) are not considered sufficient evidence to argue that an expense has been incurred. Refer to *Temples Wholesale Flower Supplies Pty Ltd v FCT* [1991] FCA 162 and Taxation Ruling IT 2534.

The basis for rendering charges should be reviewed regularly and this review should be properly documented at the time it is completed.

Practical considerations

The service entity arrangement must be a genuine one and there needs to be evidence that the service entity is actually providing the services to the practice.

Accordingly, it is important that the following is carried out:

- **The service entity must actually provide the services to the practice**, which should entail the following:
  - the lease of the business premises should be in entered into in the name of the service entity, which may be then sub-let to the practice;
  - non-professional staff should be employed and paid by the service entity (employment agreements should be in place);
  - employment costs for non-professional staff, including superannuation, PAYG withholding and WorkCover premiums should be paid by the service entity;
  - operating bank accounts should be opened in the name of the service entity, not the practice;
  - tax invoices to run the service business should be in the name of the service entity (e.g., stationery, printing, seminars, gas and electricity, etc), and the service entity should actually pay any such tax invoices; and
  - all plant, furniture and equipment should be owned by the service entity, and the practice should be charged a monthly invoice for use of these assets.

- **Asset protection must be achieved**. The arrangement must ensure that assets used by the practice (e.g., office equipment, photocopiers, computers) are in the name of the service entity and the assets must be of sufficient value to warrant protection. There must also be a need for asset protection whereby there is a real possibility the practice could be sued. All new assets should be acquired by the service entity.

- **The service entity staff should actually carry out the work**. For example, if the practitioner's spouse is employed by the service entity as a practice manager, the spouse must actually do the work, including signing all cheques and financial records, and maintaining documentation for the business. This should not be carried out by the practitioner.

- **The service entity must carry out its employer obligations**. Service entities employing staff must ensure they meet obligations imposed on employers, including registering for PAYG withholding (and FBT if applicable), obtaining workers' compensation insurance, registering for payroll tax where the level of remuneration exceeds the relevant threshold, and meeting superannuation obligations (e.g., making superannuation guarantee payments, complying with SuperStream rules).

- **Keep the service entity staff and professional staff separate**. It is important to separate the practitioners from the non-professional staff that will be running the service entity. It is advisable that the practitioner is not appointed as a director of the corporate trustee for the service trust, and is not involved in any way in the service entity's business. All bank accounts and invoices should be signed-off only by the non-professional staff and the practitioner's handwriting should not appear on any of these documents.

- **Comply with GST obligations**. Service entities are considered to be 'carrying on an enterprise' and, therefore, are required to be registered for GST where their annual GST turnover is at least $75,000 (or otherwise may voluntarily choose to register for GST, especially if the practice is also registered). Unless the practice and the service trust are grouped for GST purposes, a registered service entity should:
    - charge and remit GST on all taxable supplies made to the practice;
    - claim input tax credits in respect of acquisitions made by the service entity in the course of carrying on its enterprise; and
    - ensure valid tax invoices are issued to the practice to allow it to claim input tax credits where available.

- **Invoices should be issued regularly (e.g., at least monthly)**. It is important that tax invoices (including GST, where registered) are raised by the service entity regularly (e.g., at least monthly). Otherwise, less frequent invoicing may throw the arrangement into question by the ATO.

- **Payments should strictly be made in respect of tax invoices**. Any payments made by the practice to the service entity should only be in respect of a properly issued tax invoice which outlines the services in detail, and which is in accordance with the service agreement. Where possible, the invoices should set out the basis for the fee (e.g., 'cost plus' or fixed) and invoices should be paid on a timely basis in accordance with the payment terms.

- **Review the arrangement on a regular basis**. The service agreement should be reviewed at least once every three years and the service fees reviewed at least annually to ensure that the document still reflects the current service arrangement between the parties.

- **Keep documentary evidence for everything**. The service entity should keep working files and account records to support all payments received by the service entity. Any loans provided by the service entity to the practice should be properly documented in a loan agreement. Minutes of meetings of the service entity should be kept as records of any decisions made, including the decision to enter into the service agreement.

- **Consider the impacts of CGT**. Where the service entity holds CGT assets that are used in the business of the Principal, the availability of the CGT small business concessions should be considered, preferably well before the entity intends to dispose of any such assets.

Can the anti-avoidance provisions still apply?

Yes. The general anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936* may apply to service arrangements, and the Commissioner will assess whether a reasonable person would consider the arrangement exists for the sole or dominant purpose of enabling a taxpayer to obtain a tax benefit. A tax benefit may arise where the taxpayer's taxable income is lower than would have been the case had the relevant 'scheme' not been entered into.

Features of NTAA Corporate's Service Agreement

The following are some of the features of NTAA Corporate's Service Agreement. However, the agreement should be read in full, and in conjunction with the service entity's trust deed and the Principal's other documents, to fully ascertain the relationship between the service entity and the Principal. Note that the agreement has been drafted flexibly (including in relation to the fees to be charged). Nonetheless, it is important to strictly comply with the terms of the agreement and to pay invoices regularly and on time to avoid scrutiny by the ATO. Documenting a service agreement is one of the factors that the ATO will consider, but we cannot guarantee that a service arrangement utilising our Service Agreement will be completely 'safe' from an ATO audit or adjustment.

Note also that the agreement has been drafted for arrangements between related parties, so although it *may* be used for the provision of services to unrelated parties, not all of the clauses may be suitable (and legal advice should be sought to *ensure* that it is suitable for the parties).

- The service entity (the 'Service Provider') may provide a range of services to the Principal on an 'as needs' basis, as described in Schedule 2 – refer clause 2.1.
- The agreement starts from the Commencement Date and terminates upon one party giving 30 days written notice to the other party or as otherwise agreed by the parties – refer clause 2.2.
- The parties may agree on any Special Conditions as described in Schedule 3, and the agreement will be read subject to such Special Conditions – refer clause 2.3.
- The Service Provider shall be the sole employer of any staff employed to carry out the services – refer clause 2.4.
- The Service Provider shall provide the services to the Principal at the Principal's business premises, unless otherwise agreed – refer clause 2.5.
- Schedule 2 of the agreement allows service charges to be calculated either:
    - by on-charging the relevant expenses incurred by the Service Provider plus a mark-up as determined by the Service Provider, provided the mark-up does not exceed the relevant rates set out in the ATO document "Your Service Entity Arrangements" (or as otherwise determined by the ATO from time to time); or
    - by charging such other amounts as agreed by the parties from time to time (this allows the parties to agree to service charges without reference to the ATO's guidance, where appropriate).
- The Service Provider shall invoice the Principal for any services provided, unless otherwise agreed. The Principal must pay the invoice within the payment period specified on the invoice using a payment method acceptable to the Service Provider – refer clause 3.2. Accordingly, the parties need to set up how and when payments for the Services will be made. It is recommended that invoices be issued regularly (e.g., at least monthly) and paid on time so that the arrangement is not thrown into question by the ATO.
- Although the Service Provider has a broad discretion (within acceptable limits) regarding the calculation of the fees (unless otherwise agreed), the Principal can query the calculation of the fees on receiving an invoice (e.g., if the Principal believes the Service Provider's fees are not commercial), and then does not need to pay the invoice until the Service Provider has provided evidence regarding the calculation of the fees (refer clause 3.2(c)). If the Principal is still unsatisfied, it may consider terminating the agreement in accordance with clause 2.2(b).
- The Service Provider warrants that the services shall be provided in a good, proper and workmanlike manner to the standards of care of an experienced contractor supplying the same services – refer clause 4.1.
- The parties agree to protect each other's Intellectual Property Rights – refer clause 6.

- Clause 9 sets out a dispute resolution procedure where there are any disputes between the Principal and the Service Provider (which requires them to use mediation and then arbitration before taking a matter to court).
- The parties may amend the agreement by making a further agreement in writing referring this variation power in subclause 10.10
- The specific details of the parties and their agreement are to be completed in Schedule 1. The services to be provided (as envisaged at the outset, as well as potential services that may be provided in the future), and the fees that may be charged for them, are contained in Schedule 2. Any Special Conditions for a particular service arrangement not already contained in the body of the agreement can be provided in Schedule 3.