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LEGAL BRIEF

# Alienation by no means

*A quiet taxation revolution in the making will affect more than just the financial services industry. And there is no turning back*

THE AUSTRALIAN TAXATION OFFICE HAS finally embarked on the mission it set itself five years ago. Where it failed in its bid to make alienation the buzz word that cleaned up the taxation evasive business structure practices that it sees as rife in the industry, it has now embraced a new strategy: the alienation of personal services income test case program.

The test case program is designed to clarify the law and has the support of the tax office's consultative group, comprising representatives of the professional accounting and legal associations.

Before you rest easy, there is no safe harbor simply because you are able to satisfy one of the personal services business tests, and therefore escape the new rules. The tax office's view is more clinical than that, according to Mick Lyons, a senior tax officer who has been living constantly with alienation issues. "The test case program has been designed to test arrangements entered into by personal services businesses [that is, personal services entities that satisfy one or more of the tests in Part 2-42, Income Tax Assessment Act, 1997]. The objective is to test the ability of Part IVA to apply to arrangements that result in the alienation of personal services income, even if the arrangement otherwise satisfies a personal services business test."

Up to 24 cases have already been identified, all with slightly different factual circumstances. There are companies, trusts, partnerships and an array of claimed deductions to associated persons that will be "tax-law tested". The result will affect some in the industry.

If the taxpayers involved are willing to be tested, the tax office will finance the court case for each of them, hopefully before a full bench of the Federal Court. The full range of issues is to be tested even where the client facts allow a personal services business determination. The question being put is, can Part IVA strike out the arrangement?

Other questions, just as important, include: notwithstanding the nature of a spouse's work in a personal services business being principal work, would Part IVA result in the spouse salary being no longer income tax deductible? Is there a reasonable total remuneration limit to the payment of a tax deductible working spouse superannuation contribution? If such a limit exists, the maximum age based deduction limits will no longer be relevant. What will be relevant is the true worth of the spouse as an employee.

Lyons was the tax office protagonist who acted as counter balance to the efforts of the Financial Planning Association (FPA) to bring about a change to the new alienation of personal services income tax

rules. Few recognise how successful the Financial Planning Association was — it achieved a change of the tax laws.

Con Hristoulidis, together with June Smith and members of the FPA board, in a 18-month campaign, convinced the Government that the original alienation laws were simply not fair to the financial services industry. A special carve out was achieved that recognised the unique structure of business relationships. Now the tax office plans to cut away at what the industry won by the most almighty swing of its Part IVA general anti-tax avoidance powers.

It is understandable that Lyons may have been feeling alienated in recent years. The tax office has lost some important cases. The Federal Court did not agree with its arguments in Mochkin or Wells. Neither are the tax office views in the service trust areas progressing to its satisfaction. However, the tax office has scored victories on its anti-tax avoidance powers in the High Court as recently as the May 27, 2004 full bench decision in the Hart case.

At least one test case participant has asked for confirmation that the tax office will pay the legal costs to the High Court. Lyons has made it clear that the test case program will only be funded to the Federal Court. If a taxpayer wishes to make an application for further funding, the tax office will consider it on its merits at the time.

The intention is to get the test case program into the courts quickly. The tax office and each of the 24 taxpayers are to agree on as many facts as possible before the tax office goes through the formal process of issuing amended income tax assessments. The taxpayer is expected to lodge a formal objection within four weeks of the tax assessment, knowing that this will be disallowed. Within a further four weeks, there will be an appeal, which the tax office hopes, with the agreement of the court, will be directed to a full bench of the Federal Court. The test case program may be over by the end of the year. This will allow the tax office to start to review other taxpayers in early 2005.

There is little doubt that the decisions in the test case funding program will have wide ranging implications. For at least one test case program participant, who works in the financial services industry, the challenges will be to show:

- ▶ That all company income belonged to the principal.
- ▶ That profits could not be kept within the company taxed at the company rate.
- ▶ That payments for superannuation for a working spouse were not deductible up to the maximum deductible contribution limit, but up to an amount that reflects a reasonable total remuneration.

The tax office superannuation claims have the potential for a double whammy: if successful, not only will a portion of financial advisers' deductible spouse contributions be rejected, so too will the

# a single event



June Smith, FPA: The original laws were not fair to the industry

contributions they organise for their clients. Whose fault will it be when a client's claim is rejected and there are penalties payable?

The tax office does not expect to win on all of the points, but it also does not expect to lose all of these.

Tax Commissioner Michael Carmody has taken a personal interest in the issue. Last year he said: "Our views on anti-avoidance laws and their application to arrangements involving income splitting and retention of profits are long standing and stem from court cases and rulings from the 1980s.

"Some argue that concepts of employment, business and entrepreneurship have moved on since the 1980s and our views do not cater for these changes. I want to ensure certainty and so I will select cases in consultation with tax and accounting professional representatives in order to get further clarification from the courts on how general anti-avoidance rules apply to these arrangements."

Many would agree that concepts of employment, business and entrepreneurship have moved on since the 1980s. So too has taxation law, which in those days could be found in one book but now sits in

six separate volumes. In those volumes are the new alienation tax laws, including the business determinations principles, but these will not provide a safe harbor.

If they lose, the participants in the test case program have not been offered any immunity from prosecution. They will face back taxes to 2000 with a basic general interest charge. It is not expected that other taxpayers will be so lucky. If, with Federal Court judgments in hand, the tax office starts to audit business across the industry and across Australia, you should be aware that Part IVA assessments usually give rise to penalties of no less than 25% of what the tax office claims were the taxes avoided. When the usual cumulative general interest charge in the range of 12% is added, it is the best investment for the tax office in the country. In these circumstances, it is common that its payment demand exceeds the whole of the income originally earned.

Does this mean you should rush to become a volunteer in the test case program? It is not recommended. Although the tax office will pay for the legal costs, there is a catch. Unless you can secure expert taxation advisers willing to be paid the Commonwealth rate, the tax office will only pay \$400 for your senior counsel. This falls well short of the hourly commercial rates of \$1500 and \$1250 for the tax counsel used by the tax office in its recent win before the High Court in Hart case. To engage tax counsel directly means a cost commitment that is almost four times what the tax office is willing to fund. And the tax office test case funding is GST inclusive. Of the \$400 allowance, the tax office will get one eleventh back.

What does all this mean? For some within the financial services industry it will mean taxation liabilities that, with penalties, and years of back taxes, will wipe them out. For others, it will be business as usual, since the "renewed-but-old" alienation tax rules would never have applied any way. Perhaps you should make clear what category you fall within. Just because you say that you can satisfy the personal services business determinations, this will not protect you. The question is do your arrangements and financial transactions survive a Part IVA assessment?

And, by the way, the same rules will apply to clients.

Even more problematic for clients will be the superannuation issues. RBL determinations, ETP assessments and pension valuations have assumed that the contributions were taxable. For many, there will be no change, even though the tax deduction will be disallowed with penalties. A superannuation contribution made by an employer is a taxable contribution, whether or not the employer is later disallowed the tax deduction.

For those who conduct their review and fall into this area, your only hope is that the tax office will lose more than it wins. **Asset**