

16 April 2020

Mr James O'Halloran
Deputy Commissioner, JobKeeper Implementation
Australian Taxation Office

Via email: james.o'halloran@ato.gov.au

Dear James

CORONAVIRUS ECONOMIC RESPONSE PACKAGE (PAYMENTS AND BENEFITS) RULES 2020 – DEALING WITH SERVICE ENTITIES BY LEGISLATIVE INSTRUMENT AND GUIDANCE

CPA Australia represents the diverse interests of more than 166,000 members working in over 100 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest.

We welcome the range of measures taken by the Federal Government to provide financial support to entities to assist with the economic impacts of COVID-19. In particular, the JobKeeper wage subsidy has great potential to help businesses survive the economic downturn and maintain their relationships with their employees.

However, we are concerned that the decline in turnover test as currently contained in the *Coronavirus Economic Response Package (Payments and Benefits) Rules 2020 (the Rules)* will mean that many businesses and their employees who operate using service entities will not have access to JobKeeper payments despite the business being significantly impacted by COVID-19.

The use of a service entity is typical for economic groups. It allows for the consolidation of various administrative functions within an economic group for administrative ease. The use of a service entity provides an ability to protect key assets used in a business from liability claims against the main operating entities in the group which deal with third parties.

In the Attachment, we present the issues and submit suggested solutions for your consideration. We request your consideration of:

- A legislative instrument for service entities (as a class of entities)
- A legislative instrument for tax consolidated groups (as a class of entities), and
- ATO guidance on the application of the contrived scheme rules for service entities.

We are working collaboratively across the professional associations and this issue will be raised in joint communications that will be submitted shortly.

We are available for further discussion of any of these items at your convenience. Please contact Elinor Kasapidis, Tax Policy Adviser, at elinor.kasapidis@cpaustralia.com.au or 03 9606 9666, or Alexis Kokkinos, Chair of CPA Australia's Taxation Centre of Excellence at alexis.kokkinos@pitcher.com.au or 03 8610 5170.

Yours sincerely



Dr Gary Pflugrath CPA

**Executive General Manager, Policy and Advocacy
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CC:

Kirsten Fish, acting Second Commissioner, Law Design and Practice, ATO
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Encl.

1. It is common that economic groups (whether consolidated for tax purposes or not) are structured in a way where all, or substantially all, of the employees in the group are employed in a single entity known as a 'service entity'. These service entities generally provide recruitment, clerical, administrative and other services, as well as premises and other plant, property and equipment, to the broader group. The service entity is typically remunerated through fees it charges to related parties on a cost-plus basis.
2. The use of a service entity is typical for economic groups from an administrative perspective. That is, rather than have employees in five separate entities in the group (and thus run five different payrolls), the service entity is used to employ all the employees of the five business entities. Accordingly, it allows for the consolidation of various administrative functions within an economic group for administrative ease (e.g. only requiring one entity to manage the payroll tax, WorkCover and superannuation guarantee obligations). The use of a service entity provides an ability to protect key assets used in a business from liability claims against the main operating entities in the group which deal with third parties.

Issues with the decline in turnover test for groups with service entities

3. For entities that have adopted a service entity in their group structure, the current decline in turnover test in section 8 of the Rules arguably, is not fit-for-purpose as it may not accurately determine whether a business should have access to the JobKeeper payments.
4. The third-party revenue derived by the economic group would not typically be derived by an entity that employs any staff (i.e. it will have no eligible employees under the Rules). The turnover of the service entity which has employees may not have suffered at all if it continues to employ staff and provide services to the operating entities in the group (i.e. as it is reimbursed on a cost-plus basis).
5. The service entity is left in a "Catch-22" situation where if it continues to employ staff and pay their wages it may not suffer a decline in turnover on a stand-alone basis, as it will earn a similar level of fees from the associated operating entities under the existing service arrangements. This would add further financial pressure on operating entities who are suffering from a decline in turnover.
6. Ultimately, this may cause the group to make some employees redundant where those employees are no longer required to be employed with respect to the related operating entities in the group. This may result in the service entity potentially then passing the decline in turnover test due to the level of job cuts made as less service fees are being charged under the service arrangement. Therefore, the current Rules may reward those employers that make cuts to employee numbers (rather than those businesses that try to retain their staff).
7. This may result in many groups who may otherwise have been intended to benefit under the JobKeeper scheme, to seek to renegotiate their existing service arrangements with the service entity. We are concerned that such arrangements may lead to the risk of section 19 of the *Coronavirus Economic Response Package (Payments and Benefits) Act 2020 (the Act)* applying (relating to contrived schemes).
8. Therefore, we suggest that the decline in turnover test will potentially operate in a manner that is contrary to policy where a service entity employs staff and does not derive any third-party turnover.
9. The current decline in turnover test may not be appropriately considering groups that are structured with service entities and thus, we request that the Commissioner of Taxation (the Commissioner) seeks to address this issue via one of the following methods.

Suggested solutions

10. To assist businesses affected by COVID-19 to retain their staff, we suggest the following solutions for entities that use service entities.

Legislative instrument for service entities (as a class of entities)

11. The Commissioner can create an alternative test under subsection 8(6) of the Rules that applies to service entities, and which would apply to entities whose business predominantly consists of providing labour, administrative services and use of assets to entities that are associates¹ or members of the same family group².
12. We believe that where an operating business has suffered a decline in income, the service entity should be able to take into account the decline in turnover of the operating entity (on a proportionate basis, generally based on activities usually conducted by the employee in that business of that operating entity) to determine access to JobKeeper payments.
13. By way of example, Services Co employs 5 staff at a cost of \$1,000,000. Services Co provides services to two businesses, 75 per cent to A Co and 25 per cent to B Co. Services Co usually marks-up its cost by 5 per cent (i.e. annual charge of \$1,050,000. Assume A Co has suffered a decline in turnover of 50 per cent and B Co has suffered a decline of 10 per cent. The relative decline in turnover (weighted) would be equal to 40 per cent (i.e. 50% x 75% plus 10% x 25%).
14. In this case, as the decline in turnover of the related entities would have decreased by 40 per cent, the services entity could be taken to satisfy the alternative test.
15. We note that the above is only an example and a different test could easily be adapted by the Commissioner.

Legislative instrument for tax consolidated groups (as a class of entities)

16. For groups where a service entity employs staff, the Commissioner could also adopt an alternative decline in turnover test which looks at the service entity's turnover on an aggregated or tax consolidated basis so that the service entity could qualify based on the reduction in the tax consolidated group's third-party revenue. This would be an alternative test to the one outlined above (i.e. it would only deal with those service entities within a tax consolidated group).
17. Taking the previous example, assume all entities are within the same tax consolidated group. Under the single entity rule, the intra-group charges would be ignored. If the overall group has suffered a 30 per cent decline in turnover, the services trust would therefore satisfy this alternative test.

ATO guidance on the application of the contrived scheme rules for service entities

18. Finally, we believe it is critical for the Commissioner to provide guidance which sets out when and to what extent groups may alter existing service arrangements as a result of COVID-19 in a way that will permit them to retain ongoing staff and not breach the rule in section 19 of the Act relating to contrived schemes.

¹ As per section 318 of the *Income Tax Assessment Act 1936* ("ITAA 1936")

² As per Schedule 2F to the ITAA 1936.

19. For example:
- 19.1. Where the operating entity has had a decline in turnover, it should be appropriate for the service entity to be able to discount or waive some of its fees on the basis that its counterparty under the service agreement is suffering financial or economic distress due to COVID-19 and requires assistance. It would not make commercial sense to insist on the same level of fees in such circumstances (as third-party arrangements would be renegotiated in such cases). To the extent that the service fee is adjusted in a similar proportion to the decline in turnover of the other entity, we believe that this should be acceptable. Any relief provided by a service entity by way of reduced fees is in line with what is being presently requested of landlords and banks who have been asked to provide tenants and borrowers with relief over the coming months.
 - 19.2. Where a service arrangement is based on a cost-plus basis where the service entity charges a fee for labour equal to the employee's remuneration plus a mark-up, it may be acceptable for the service arrangement to be varied where the employee has been stood down or being asked to work reduced hours.
 - 19.3. It should be appropriate to reduce a service fee paid in relation to the use of certain assets and premises where the operating business' actual use of those assets or premises has significantly reduced. For example, where the operating business is based in an office the employees are all required to work from home, the use of office space and equipment has significantly declined such that paying the same level of service fees is no longer appropriate even though the service entity makes the premises and equipment legally available for use by the related party. There could be other appropriate examples such as where a restaurant changes its operations to only provide take-away or delivery and is no longer able to use the dining space made available to it by the service entity.
20. We suggest that temporary variations to service agreements leading to a service entity's decline in turnover is justifiable in the current economic climate. Accordingly, to the extent that a service arrangement is modified in line with the above rules, we consider that this should be regarded as acceptable without section 19 applying.
21. We therefore request an urgent statement by the ATO on the application of section 19 that includes reference to the above modifications to service arrangements being deemed acceptable.