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This newsletter deals with corporate insolvency, the deductibility of fees paid to a service entity and business migration.

COMMERCIAL LAW

INTRODUCTION TO CORPORATE INSOLVENCY

When a company has cash flow problems or net asset deficiencies, and is approaching insolvency or is insolvent, it is imperative that directors closely monitor their position and take active steps to avoid insolvent trading by continuing to incur debts for which they may become personally liable if the company is ultimately placed in liquidation. Creditors with defaulting customers or drawn out payments should also review the position to avoid payments being clawed back and left as an unsecured creditor with little prospect of recovery.

If a company is approaching or is insolvent, the following mechanisms may be put in place:

1. *Turnaround Management*

This is an informal arrangement that will usually involve an industry expert or chartered accountant being engaged to evaluate the operations of the business. Such persons will then make recommendations, implement changes or restructure the business. Where necessary, there may be a recapitalising or arranging of funding or sale/closure of unprofitable elements of the business. The role of such persons varies from a short-term consultant to long-term roles involving board participation, profit sharing or introduction of joint venture partners.

Turnaround management will often be useful where a company has grown too quickly or has a good core business but with cash draining or unprofitable elements.

2. *Administration*

Administration allows a cleanup of unsecured debts owed by the company by placing a moratorium over the company for a period of time (which protects the company from any litigation). The directors will resolve to appoint an administrator and will thereafter for the period of the moratorium, relinquish control of the management of the company.

The administrator may, if warranted, trade on in the business. The administrator will otherwise examine the business operations, report to creditors and either recommend a proposal for a payment or partial payment of debts (usually funded by directors/ shareholders) over an agreed period.

If accepted by creditors, the Deed of Company Arrangement will be administered by the administrator binding all unsecured creditors. The operation of the business thereafter returns to the directors.

If on the other hand, after investigation, liquidation is recommended and approved by creditors, the company will go into liquidation.

3. *Receivership*

A receiver and manager are generally appointed by a secured creditor pursuant to a Deed of Charge over the company and its

assets. The aim of the receiver is to cause the creditor to be repaid its outstanding debt/s. The charge may have been over the fixed and/or floating assets of the company.

The receiver and manager can trade on or sell the assets as long as they are not sold at an undervalue. A receiver can also be appointed over specific assets (e.g. in relation to a matter that I am presently acting in, a large parcel of wine owned by investors with a view to reconciling the wine and returning it back to investors). Receivership may also be suitable for disputes involving business or partnership assets or specific goods such as a racehorse.

4. *Liquidation*

When all else fails, the company can be wound up and a liquidator appointed. The liquidator will close down the operations of the business, sell the company's assets and deal with all competing claims.

The sale of assets may be as a total package, or on an item-by-item basis. What money is realised will be applied in payment of the liquidator's costs and disbursements and thereafter be distributed to employees and unsecured creditors in the order of priority as set out in the Corporations Act.

The liquidator also has extensive powers to recover money, including monies paid to creditors in preference to other creditors and from directors personally who allowed the company to trade. A liquidator may conduct inquiries, including public examination in a court of any relevant person and the delivery up of relevant documents.

At the end of the process the company will be deregistered.

In a future article, I will outline where it all starts for creditors - the Statutory Demand - a fast, effective and cheap tool for debt recovery where no genuine dispute exists as to the debt. Failure to comply with a statutory demand within 21 days is a deemed act of insolvency and places the company at risk of being placed in liquidation.

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TAXATION LAW

DEDUCTIBILITY OF FEES PAID TO SERVICE ENTITY

Following the decision of the Full Federal Court in *FCT* v *Phillips* (1978) 36 FLR 399, many professional practices established what are known as "Phillips type service arrangements". In accordance with the Full Federal Court decision, deductions are claimed by the professional practice for service fees paid to the service entity, usually based on a set mark up of the cost to the service entity. For example, in *Phillips* case, wages were marked up by up to 50%.

The release by the Australian Taxation Office ("ATO") of Taxation Ruling TR2005/D5 on 4 May 2005 and the subsequent release by the ATO on 29 June 2005 of a Draft Booklet "Service arrangements – how you can review whether the payments made under your service arrangement are commercially realistic and reasonably connected to your business" (in the link above, scroll down to "Service Arrangements") clearly indicates that "Phillips type service arrangements" are on the ATO's radar (despite being off the ATO's radar for sometime). Of practical importance is that TR2005/D5 states the ATO will not accept deductibility of the service fees in question simply because the mark ups in *Phillips* case have been used or mark ups have been used on the some pre-determined basis.

The good news is that the ATO accepts the correctness of the decision in *Phillips*. This means if the expenditure paid to a service entity is "commercially realistic" and the services obtained provide commercial benefits that are reasonably connected to the

taxpayer's business, then the service fees paid should be deductible in full under Section 8-1 of the *Tax Act 1997*. The general anti-avoidance provision of the *Tax Act 1997*, Part IVA, should have no role to play.

The real question raised by TR2005/D5 is what will the ATO consider to be a "commercially realistic" fee. A "commercially realistic" fee is generally a fee that is negotiated with an independent person for substantially similar services.

From the Draft Booklet, it appears that the ATO requires a "transfer pricing" type benchmarking analysis to satisfy it that the service fees negotiated are "commercially realistic". As a practical matter, it is likely that the benchmarking exercise will be costly and beyond the expertise of most small or medium enterprises.

In lieu of a benchmarking analysis, the Draft Booklet contains "safe harbour rules" that will be accepted by the ATO as being "commercially realistic". The "safe harbour rules", in relation to "labour hire", refers to mark ups of between 3.5% to 5% on the direct and indirect operating costs associated with "on hiring". As a general comment, one has to wonder why anyone would bother carrying on a business with a mark up of between 3.5% to 5% of operating costs.

The ATO has indicated that they will accept most present service entity arrangements up to 30 June 2006. Only those service arrangements where the service fees are over $1m and represent over 50% of the gross fee earned by the professional practice are stated to be at risk prior to 30 June 2006.

If a "Phillips type service arrangement" is to continue past 30 June 2006, a taxpayer has to consider what evidence can be supplied to the ATO to justify the commercial benefit to the business and the commerciality of the fee (if investigated by the ATO). There is little doubt that the ATO expects evidence to substantiate such commercial benefits and to demonstrate that the service fees are "commercially realistic".

However, there is another alternative to consider. Some professional organisations have the ability to use a company to carry on business with trustees of discretionary trusts holding the shares in such companies. Other professional practices may be able to be carried on by the trustees of discretionary trusts in partnership.

Of course, any consideration of transferring a professional practice to a company or to a partnership of trustees of discretionary trusts needs to take into account:

- capital gains tax ("CGT") consequences and, in particular, the availability of CGT concessions;
- the application of the anti-avoidance provisions of the *Tax Act 1997*;
- stamp duty consequences; and
- payroll tax consequences.

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CHRIS PERRY'S ROLE AS A BUSINESS MIGRATION AGENT

As a business migration agent, I can service all and any needs you may have for you, your family members, employees, business associates or consultants with respect to the requirements and grant of Australian temporary and permanent residency visas and citizenship.

This may involve explaining your sponsorship obligations when contemplating the engagement of overseas employees or engaging an employee in Australia who is currently sponsored by a different company.

Visas are determined by delegated authority arising from the Migration Act and Regulations supported by policy advice

manuals interpreted and administered by case officers. Once criteria are met the visa must be granted. There exist, however, many grey areas requiring the exercise of discretion.

My role is to advise you of the criteria and draft submissions with supporting documentation to enable the discretion to be exercised in your favour allowing visas to be granted. Timing can be critical. Supporting documentation can be voluminous. Often an initial conference and advice is warranted as to what needs to be compiled with and a client will set about gathering relevant documentation.

I can assist in directing how employment references need to be drafted, arranging medical examinations, character clearance applications and then drafting detailed submissions, which are lodged with the Department of Immigration. The applicants are often overseas requiring ongoing liaising and sometimes translation of documents.

With the support of clear and concise applications and submissions, I have found that processing times are expedited and with good interaction with case officers this allows for visas to be granted without ongoing requests for information and consequential delays.

The visas I commonly advise and assist with are:

(a) *temporary sponsored business long stay visas* - this allows for Australian companies to sponsor an employee to remain in Australia for work for periods of between 3 months and 4 years;

(b) *employee nomination scheme permanent residency visas* - where an Australian company has a need for an employee for a period exceeding 3 years;

(c) *business owner visas* - this may be an independent or state sponsored visa for experienced business persons wishing to establish a business in Australia. It is a 2-stage process initially for a temporary visa and after a period of time a permanent residency visa;

(d) *business investor visas* - where a party has an established successful business record overseas and has accumulated sufficient assets, permanent residency will be granted where the overseas party is prepared to invest a stipulated sum in Australian Treasury Bonds for a period of time;

(e) *independent points tested visas* - this allows adults with good English, education and work experience to be awarded points with a view to meeting a pass mark for the grant of Australian permanent residency based on their perceived contribution to the Australian society and workforce;

(f) *spouse visas* - designed for de facto or partners wishing to or who have married or are a defacto partner of an Australian and wish to reside permanently with their partner in Australia.

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