Service Entities: Quick Reference Survival Guide for Lawyers

By Daniel Butler (Director) and Bill Leung (Consultant), from DBA Butler Lawyers, www.dbabutler.com.au

Due to the Australian Taxation Office's ('ATO') position in relation to service entities with the release of TR 2006/2 Income Tax: Deductibility of service fees paid to associated service entities: Phillips arrangements and guide 'Your service entity arrangements' in April 2006, this survival guide may prove useful for law firms with service entities.

Questions to consider:

1. Do you have a service entity?
2. If you have a service entity, do you wish to continue it (and not winding it up)?
3. If you don't have a service entity, should you still get one in light of ATO's focus?
4. If you do still want to have a service entity, do you want to know how to operate a service entity within the ATO's guidelines?

If your answer is yes to the above, then you will need to 'know the rules and play it safe'. It must be noted that there is no change to the common law in relation to service entities, but that the ATO's current position will compel legal practices with service entities to 'toe the line'. This quick reference survival guide provides the main issues that you need to consider in operating a service entity successfully into the future.

THE RULING TR 2006/2

The ruling confirms the view of the ATO (see IT 276) that the decision of the Federal Court in 1978 (FC of T v Phillips (1978) 8 ATR 783; 78 ATC 4361) is not authority for the proposition that service fees calculated using the particular mark-ups for labour adopted in that case (50%) will always be deductible.

The ruling also states that it is necessary to consider whether the benefits passing to the taxpayer under a Phillips service arrangement are connected to the conduct of the taxpayer's income earning activities, and having regard to the benefits delivered, the service fees are commercially realistic. In short, the ATO consider that service arrangements are acceptable provided they are entered into for commercial reasons and that the fees charged are not grossly excessive.

It also confirms the ATO's view that it does not accept that asset protection alone can explain service arrangements that use grossly excessive service charges. The ATO can still apply Part IVA (the general tax anti-avoidance provision) if the dominant purpose of entering into a service arrangement was to obtain a tax benefit. This reaffirms the ATO's view that service arrangements must have the requisite commercial connection with the taxpayer's income earning activities or business.

In summary, the ATO confirms there must be a commercially operated service entity responsible for its own functions and risks.

THE GUIDE

There are three service review methods provided in the final guide which the ATO accepts in working out whether a service entity's level of service fees and charges are acceptable:

1. Comparable market prices
2. Comparable profits
3. ATO indicative rates

The comparable market prices and comparable profits methods are used when you want a more extensive review to find out a market benchmark and not rely on the ATO indicative rates. From this market benchmark, you can then check if your service charges are correctly calculated.

The ATO's guide has also revised and expanded its comparable market price rates as compared to its draft ruling in 2005 (see columns 1 and 2 of table). These rates are what the ATO deems as appropriate commercial benchmark rates for service arrangements which have a reasonable commercial connection to a taxpayer's main business. Note the ATO's comparable market rates are net mark-up on costs, ie, looking at the net profit, measured as a net mark-up on total costs (eg, operating profit/total costs). This is contrary to common practice of service entities charging the professional practice for providing these services on a cost plus margin basis.

Table: ATO Indicative Rates Summary

	TR 2005/D5 Draft Guide	TR 2006/2 Final Guide		
			'Ceilings'	
	Net mark-up on costs (maximum)	Net mark-up on costs (maximum)	Net mark-up on costs (maximum)	Gross mark-up on costs (maximum)
Labour hire – Temporary staff	5%	5%	10%	30% of salary & benefits
Labour hire – Permanent staff	3.5%	3.5%		Operating costs absorbed not less than 18% of salary & benefits
Recruitment	5%	5%	10%	N/A
Expense Payments	N/A	5%	10%	N/A
Equipment hire	9%	7.5%	N/A	10%
Rental	Market rates (+ finder fees)	Market rates (+ finder fees)	Market rates (+ finder fees)	

The guide has also introduced a comparable profits approach for calculating indicative rates, called the gross mark-up on costs. Under this approach, you look at the gross profit applying to particular operating costs, measured as a gross mark-up on those costs (eg, gross operating profit/particular operating costs).

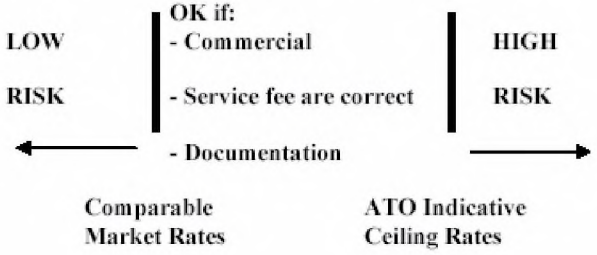
The ATO has also defined its boundary for determining whether service charges are grossly excessive by providing indicative mark-up rates (see columns 3 and 4 of table). These rates are provided to help professional firms determine whether fees paid under service arrangements are acceptable to the ATO and therefore at a low risk of being audited.

Therefore, the ATO has provided a 'ceiling' to its indicative rates for net and gross mark-ups. This means if you choose to use rates within the ceilings, and that the service entity makes no more than 30% of the combined profits of the main business and the service entity, then you will be in the low risk category of an ATO audit. Hence, the 30% 'combined profit' is an additional 'hurdle' that needs to be satisfied in addition to the indicative rate ceilings. In essence, through the 30% of the combined profits rule, the ATO has imposed a 'cap' on the level of profits which can be derived by the service entity from an audit risk viewpoint.

THE RELATIONSHIP BETWEEN ATO INDICATIVE RATES AND ATO AUDIT

If the ATO undertakes an audit of your service entity, it will be based on the comparable market rates, not the indicative rates, ie, what the rates are charged by independent parties in the open market. The ATO needs to be satisfied that the rates you use are in fact commercial benchmark rates. Therefore, operating within the indicative ceilings does not translate to the ATO being satisfied that your rates arrived at are commercial, it only means you have a low risk of being audited.

Illustrating the relationship between ATO indicative rates and ATO audit diagrammatically is as follows:



ATO AUDITS

There is a 12 month period (the ATO states a 'third safeguard') to 'clear-up' current service arrangements that may fall foul of the ATO's requirements (ending 30 April 2007). Where an audit is conducted in this case, the ATO may review earlier income years.

Regardless of the above deadline, the ATO may still conduct audits (including of earlier income years) in 'high risk' cases that meet all of the following tests:

1. The main business claims deductions for service fee expenses of over $1 million.
2. Service fee expenses represent over 50% of the gross fees or business income.
3. The net profit of the service entity represents over 50% of the combined net profit of the businesses involved.

An ATO audit may also be conducted (regardless of

Continued page 52...

Service Entities: Quick Reference Survival Guide for Lawyers cont...

the 30 April 2007 deadline) where there are serious doubts as to whether the services were actually provided by the service entity.

ACTION – TO DO'S:

ATO recommends the following service arrangements should be reviewed prior to 1 May 2007:

- If the service fees do not have regard to the value of the services provided, eg:
  - o The service fees are based on an arbitrary or fixed mark-up with no discernible connection to the value or nature of the services.
  - o The main business has effectively guaranteed the service entity a certain profit with no commercial explanation.
  - o The service entity has charged service fees for private or domestic expenses it has incurred which benefit the main business/associates.
- The service entity has not been clearly separated or distinguished from the business, eg, employees of the service entity 'belong' to the main business.
- Failure to keep adequate records.

In view of the latest changes in relation to service arrangements by the ATO, it is critical that existing and new service arrangements are reviewed and properly documented. In order to prove your business dealings between you and your service entity are commercial and your services charges are not grossly excessive, proper documentation is essential. Some examples of such documentation are:

- the service agreement (we are aware of certain law firms being unable to find these contracts)
- documents showing how you and your service entity work out a pricing structure for services
- tax invoices for service fees charged
- calculations showing how your service fees were arrived at
- lease/rental agreements
- list of personnel employed by the service entity

By having proper documentation, you then have some evidence to add weight in proving:

- the arms length nature of the dealings conducted by your service entity,
- you can justify the pricing structure you have for your service entity, and
- that your service entity is a separate commercial entity (as per ATO preference).

The above is a brief summary only and is no substitute to expert advice for your particular firm.