



Service entities and mark-ups... back to the future

BY GARRY PAMMER, CA, BEC, LLB

Historically speaking... Back in the late 1970s, the *Phillips Case* paved the way for what is generally accepted as the standard business structure for most professional practices.

That case actually involved an accounting partnership that claimed deductions for payments made to a service trust for the hire of office furniture and equipment, non-professional staff, provision of share registry services, interest on outstanding amounts and other incidental charges.

The Commissioner of Taxation argued that a significant effect of the arrangement was to *divert income away from the high marginal tax rate accountancy partners to persons interested in the service trust with much lower effective tax rates*. These persons comprised spouses of the partners, dependants, family companies and trusts.

Notwithstanding this argument, the Federal Court upheld those deductions on the basis that *the service fees charged by the service trust were realistic and not grossly excessive relative to commercial market rates*.

Such “Phillips Trusts”, as they were initially known, or service trusts have become extremely widespread throughout all forms of professional practices. Many dental practitioners operate through such business structures where the practice outsources all of its requirements to a service entity - usually a trust. This service trust usually supplies the practice with all its business needs such as premises, equipment, staff, dental and office systems and supplies, general administration, marketing, legal and regulatory. In addition to relief from the associated administrative burdens, such arrangements also created other benefits, such as the protection of assets from claims made against the practice. The structure also allows practice members to “income split” with family members and associates, who are the beneficiaries of the service trust.

So what has changed since the 1970s?

Well, nothing much in terms of the abovementioned principles, but a lot in terms of how those principles are about to be applied by the Tax Office going forward. The service trust landscape has always been dominated by principles concerned with commercially realistic rates for services.

By way of illustration, assume that three partners have established a service trust in respect of their dental practice. Each of their respective spouses are beneficiaries of the trust and have no other income streams. Simplistically, Table 1

level of service fees being charged and their correlation to the actual services provided. Specifically, taxpayers now only have until 30 April 2007 to review existing arrangements and eliminate:

- excessive service fees and charges, particularly where arbitrary or fixed mark-ups are used, bearing no relationship to the value of the service provided or that guarantee the service trust a profit, without apparent commercial justification; and
- situations where there is no clear separation between the service trust’s business activity and those of the dental practice.

Table 1.

Net income of partnership:.....	\$1M
Less: salaries.....	\$750K
Less: superannuation.....	\$100K
Less: service trust.....	\$150K
	<u>(\$1M)</u>
Taxable income of partnership.....	NIL
Taxable income of beneficiaries of service trust.....	\$150K
Tax payable by spouse beneficiaries.....	\$31K

illustrates what the commercial/tax schematic could look like.

Without \$150K of increased charges by reason of the service trust, the practising partners would otherwise pay \$67,500 in tax on \$150K of partnership profit (instead of \$31K paid by their spouses).

A “Tax Office crackdown” makes for sensational headlining but so too should mention of the “Phillips Case mythology”. The dominant question asked by the Federal Court in the 1970s is essentially the same as the question to be asked now, namely, is the above income tax saving generated through a high mark-up rate that is not commercial?

By publishing a ruling on deductibility of service fees (TR 2006/2) and its accompanying Guide Booklet (Your Service Entity Arrangements), the Commissioner of Taxation is crystallising both the timing and focus on long held concerns as to the

So how do you determine a commercial fee and charge?

The Tax Office has been involving economists in dealing with arms length and commerciality issues since the 1980s when its National Office focused on international transfer pricing across various industries including manufacturing, natural resources and pharmaceuticals. Those issues ostensibly involved multinational corporations shifting profit across the border and out of the Australian tax net and into low tax jurisdictions overseas. However, the terminology and concepts in the recent Guide Booklet are similar and focus on what level of profit can legitimately be shifted out of the practice entity and into an associated service entity to be income split.

In its Guide Booklet, the Tax Office provides comparable profit returns, market rates and indicative mark-ups on

Table 2.

Characteristics of services	Comparable market rates (net mark-up on costs)	Indicative rates (gross mark-up on costs)	Indicative rates (net mark-up on costs)
Labour hire - temporary staff	5%	30% (salaries and benefits) NB mark - up to cover direct and indirect operating costs associated with on-hiring	10%
Labour hire - permanent staff	3.5%	30% NB cost coverage as above	10%
Recruitment	5%	N/A	10%
Expense payments (billing and payment services)	5%	N/A	10%
Equipment hire	7.5% NB Net return on assets	10%	N/A
Rental (property leasing)	Market rates	Market rates	Market rates

costs for service trusts with various distinguishing business characteristics. Two approaches in relation to commercially realistic pricing are outlined:

- comparable market price approach: whereby service arrangements are compared with arrangements that would be entered into by independent parties in the open market; and
- comparable profits approach: whereby service trust profits are compared to either “cost plus” or “net” profits achieved by independent suppliers in respect of the provision of the same or similar services.

However, rather than undertake your own domestic equivalent of an international transfer pricing review, the Guide Booklet also sets out indicative rates which it represents to be more generous than the comparable market rates it has identified in its arms length pricing review of various independent businesses.

The comparable market rates and indicative rates are shown in Table 2.

Interestingly, but hardly surprisingly, given today’s market for staff services, the 50% mark-up on labour costs which was adopted in the *Phillips Case* is well outside both the comparable and the indicative labour hire rates.

That is not to say that you must slavishly follow the table rates. Even the Tax Office acknowledges that higher rates are acceptable where, for example, the extent of services provided or business risks assumed by the service trust can be distinguished from the business characteristics set out in the examples provided in the Guide Booklet. However, the attraction of adopting the indicative or “safe harbour” rates is that by doing so you follow the path of least resistance. Namely, if you adopt the “safe harbour” rates, you will be protected against any Tax Office audit activity provided your service trust profits do not exceed 30% of the combined profits of your business group.

So what will my revised business profit structures look like?

Whilst it is trite to say that the decision for every practice depends upon its own facts, it is also markedly true. However, to give a meaningful overview, I will attempt to summarise our experience to date.

Table 3.

	Dentist \$	GP \$
Total Fees	645,000	465,000
Staff Wages & Salaries	195,000 30.23%	85,000 18.28%
Rent	36,000 5.58%	25,000 5.38%
Supplies/Consumables	60,000 9.30%	2,000 0.43%
Interest/Bank Fees	13,000 2.02%	2,000 0.43%
Lab Fees	40,000 6.20%	- -
Equipment Costs	33,000 5.12%	17,000 3.66%
Insurances	5,000 0.78%	10,000 2.15%
Other	20,000 3.10%	50,000 10.75%
Net Profit	\$243,000 37.67%	\$274,000 58.92%

Over the last six months, we’ve conducted a detailed review of the mark-up rates and commerciality of all service entity practices, both dental and medical, that we act for. The results of this review showed that most service entity arrangements (over 80%) were objectively commercial and could continue, but almost 100% of the mark-up rates could potentially be deemed excessive under the new regime.

Our discussions with the Tax Office and clients broadly covered the following circumstances and issues:

- The functions and risks of some of our integrated service arrangements suggested that the published comparable and indicative rates were low;
- whether a benchmark, similar to the accepted medical practice charge of 40% of gross fees, would be issued for dental practices; and
- which clients should undertake a business restructure to better suit their own business model going forward.

The Tax Office was very keen to emphasise reliance on publicly available, industry wide averages if there was any suggestion of divergence from their own published mark-up rates. The Tax Office also made it clear that its general acceptance of a service charge equal to 40% of gross fees derived in the medical profession is not applicable to the dental profession. Whilst there was significant public and private information reviewed in respect of the medical profession, curiously, a similar detailed analysis of the dental industry was not made and, currently, there is no directive or intention to further review the Australian healthcare industry with respect to service entities.

The practical upshot of this experience can best be illustrated by looking at some benchmarking data on two “average” metropolitan dental and medical practices as shown in Table 3.

It can immediately be seen that two

very different business models are apparent across the two professions. The average dental practice is a 40% net profit business, compared with a 60% net profit in the case of a medical practice. As such, it is also immediately apparent that whilst a service fee totalling 40% of total fees provides a commercially acceptable result in the medical practice, a similar service fee charged in the dental practice would create an overall loss.

However, it can also be seen that even conservatively adopting the “safe harbour” rates should mean that any service entity associated with the dental practice will still show a legitimate substantive profit. For example, simply applying the Tax Office’s new 30% mark-up on wages and superannuation reduces the net profit of the dental practice by approximately \$63,000 and the associated service entity will income split the remaining profit, after it has borne any applicable staff associated operating expenses (eg payroll tax, recruitment, training costs, etc).

Where to between now and 30 April 2007?

If you have a service entity as part of your practice structure, the arrangement between the trading and the service entity must be reviewed. This will include reviewing the commercial, administrative and asset protection benefits of running such a structure. If the structure is justifiable in these respects and can therefore continue in its current form, then the service fee mark-ups and agree-

ments must also be reviewed in relation to their own commerciality. If your business model does not suit the revised service entity regime then a restructure should be undertaken having regard to factors such as cost/benefit analysis of set-up costs, ongoing administration, protection of assets, business income estimates, marital status and particulars of other family members and their income estimates, etc.

If you have not already done so, we recommend contacting your accountant or taxation advisor to arrange a time to review your structure. It may not be a big change to your practice overall, but one that you simply have to get right.

DISCLAIMER: This article is designed to provide generic information only and should not be viewed as a recommendation to act. Individuals should seek advice from a qualified advisor to ensure their actions are commensurate with their financial needs and requirements.

Garry Pammer is a Director of Clark & Jacobs, Accounting and Business Advisers, specialising in providing advice to dentists. Advice includes planning for your financial well-being, superannuation, insurance, practice management, computer software and the buying and selling of dental practices. For a free assessment of your financial position and to see how you can achieve your goals, please do not hesitate to call Garry on (02) 9264-1111.
