

Service Entity Arrangements: ATO's TR 2006/2

On 20 April 2006, the ATO issued its final ruling TR 2006/2 on service entities and guide 'Your service entity arrangements'. This follows a lengthy and extensive consultation process. We summarise below the latest changes made by the ATO in relation to service entity arrangements.

The Ruling

The ruling confirms the ATO's long standing view 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 view that it does not accept asset protection alone can explain service arrangements that use grossly excessive service charges. 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 entity itself responsible for its own functions and risks. In a number of cases, the service entities were found not to have any separate function.

The Guide

In its final guide, the ATO has also 'refined' its parameters for determining whether service charges are commercially realistic and has provided revised 'safe harbour' mark-up calculation methods.

Note, the ATO's indicative 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).

The guide has also introduced another 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).

Furthermore, the ATO has also provided a 'ceiling' to its indicative rates for net and gross mark-ups. This means if you choose to use the indicative rates within the ceilings, and no greater than 30% of the combined profits of the main business and the service entity is earned by the service entity due to the service arrangement, 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. This does not mean however, that operating within the safe harbour ceilings translates to the ATO being satisfied that your rates arrived at are in fact commercial benchmark rates. As for the medical profession, the ATO accepts a service fee rate of up to 40% of gross practice fees.

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 will 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 expense of over \$1 million.
2. Service fee expenses represent over 50% of the gross fees or business income earned.
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 the 30 April 2007 deadline) where there is 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:
 - The service fees are based on an arbitrary or fixed mark-up with no discernible connection to the value or nature of the services.
 - The main business has effectively guaranteed the service entity a certain profit with no commercial explanation.
 - 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 arrangement by the ATO, it is critical that existing and new service entities are reviewed and properly documented. DBA's Service Agreement, which includes the service agreement, the service entity memo and resolutions, helps to ensure documentation is in place and assists your service entity arrangements to be in accordance with the latest ATO requirements.

Table: ATO Safe Harbours - Indicative Rates Summary

	TR 2005/D5	TR 2006/2		
	Net mark-up on costs (maximum)	Net mark-up on costs (maximum)	Ceilings:	
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 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)	

✂

Order the DBA Service Agreement

'Yes, I want a Service Agreement for \$385 incl GST'.

Signature _____ Name of person ordering _____

Name of Firm _____

Postal address of firm _____ State _____ Postcode _____

Tel _____ Fax _____ Email _____

Don't send any payment. You will be invoiced upon delivery of the documents.

For further Information please contact:

DBA BUTLER PTY LTD, Lawyers, 23 Union Street, South Melbourne Vic 3205
Ph 03 9682 0903 Fax 03 9682 0907 dba@dbabutler.com.au www.dbabutler.com.au

DBA News contains general information only and is no substitute for expert advice. Further, DBA is not licensed under the *Corporations Act 2001* (Cth) to give financial product advice. We therefore disclaim all liability howsoever arising from reliance on any information herein unless you are a client of DBA that has specifically requested our advice.

✓ Superannuation ✓ Tax ✓ Succession Planning