

# NEWSFLASH BOOKLET

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# PROFESSIONAL PRACTICES

## Service trusts and companies

The ATO has recently released a draft ruling and guidance booklet which are discussed in the next article in this booklet. This article examines Phillips case which is the major case on the issue. ATO rulings are not law cases are. The guidance booklet in particular is tracking a very narrow view so I have reprinted this article to familiarise readers with an service entity arrangement that has been approved by the courts.

The primary objective of a service entity is to stream some of the income the Professional earns into an entity where it can be distributed to family members in a lower tax bracket. Personal services income such as Medicare fees cannot be distributed to family members. Income from a business structure can. Examples of income from a business structure include sale of goods or the provision of services by just as many or more employees as principles. In the latter case there are many cases, rulings and legislation that set out when a business is of the size that the income stream is considered to be more than primarily from the services of the business owners.

A landmark case in regard to service entities was Phillips case in 1977. Some of the relevant points include:

- 1) The Court found that the fees charged by the service entity were commercially realistic.
- 2) The service entity was set up with the predominant purpose of keeping assets out of the hands of anyone suing the professionals. This is necessary to argue against Part IVA which voids for tax purposes any arrangement with the predominant purpose of minimising tax.
- 3) The service entity took over, all aspects of the practice that were not required to be carried out by a suitably qualified professional and was run by a company whose directors were not professionals in practice or an associate of the professional. This was clearly done in every practical way, such as, a written agreement regarding the provision of services, independent records and issuing of invoices.
- 4) The firm provided accounting and auditing services and had 31 partners and 300 staff.
- 5) None of the partners were directors of the service entity but they were potential beneficiaries of the underlying trust. The partners did not lend the service entity any money.
- 6) Services provided included lending the Professional partnership money, providing clerical staff, office equipment, furniture and share registry services The markup was 50% on wages. (Another acceptable way of determining the charge rate for wages is to collect some information on what the labour hire firms are charging.) Interest on the loan was 10% (commercially realistic in the 70s) and the furniture and equipment was provided at a mark up of 6 to 8% which was considered by the judge to be commercially realistic
- 7) The furniture and equipment that was originally owned by the accounting firm was sold to the service entity at arms length values. Existing staff were terminated and employed by the new service entity.
- 8) The practice didn't try to mark up services where the service company did not value add. For example phone, rent and electricity should only be charged to the practice at the actual cost.

As a result of losing Phillips case the ATO issued IT 276 which states that payments to service trusts that are commercially realistic will not be challenged. The ATO accepts that the service entity is not set up primarily to avoid tax, if there is also an asset protection objective and a cash flow benefit to the practice of not having to purchase equipment. The ruling also states that if the service fees are excessive the presumption will be made that the payments are not just for the provision of the services and will need to be apportioned.

Even when you fit within the commercially realistic guidelines above care should be taken to ensure the service fees are not out of proportion to the income earned. Fletcher v FCT 1991 173 CLR "it is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income but only how much he has spent ..... If however, that consideration reveals that the disproportion between the outgoing and the relevant assessable income is essentially to be explained by reference to the independent pursuit of some other objective and that partly of the outgoing can be characterized by reference to the actual or expected production of assessable income, apportionment of the outgoing between the pursuit of assessable income and the pursuit of that other objective will be necessary."

A service company set up right at the start of the practice's business operations is more reliable than one put in place later.

ATO ruling IT 2494 states that it is not acceptable for the Service Entity to provide cars as a fringe benefit to the practitioners but it does concede that the service entity can purchase cars and lease them to the practice.

Note if the practice is operating as a partnership then it cannot utilise the Fringe Benefit's Tax formula to provide the cars to the partners. This means that in most cases a log book will be required. Note if the service entity leases a vehicle on lease to the practice it cannot justify a mark up as there is no real value add. Further as a lease of a vehicle is not ownership involving the service entity cannot be justified under asset protection or improved cash flow.

IT 2494 also discusses administration entities or service entities, employing the professionals so that they can make employer supported superannuation contributions. The benefit here is that they would be able to claim more than \$5,000 in superannuation contributions without having to reduce the excess by 75% as other self employed taxpayers have to. The ATO accepts this arrangement providing the services the professionals provide to the practice are charged at only the amount that is either paid to the professional or contributed to superannuation for him or her, there should be no mark up. Further the actual salary, if any, received should be commensurable with the work performed.

## Update re service entities draft ruling

Many professional practices use service entities to run their office. The advantage being the mark up on services provided to the practice can be distributed to other family members. Asset protection is another benefit if the equipment and premises used in the practice are owned by the service entity

The ATO has released a draft ruling and a guidance booklet on the sort of arrangements they consider acceptable. The guidance booklet discusses in detail what items can be marked up and by how much. There are two main tests. Firstly, is the service entity bona fide? If so is the amount the professional entity is paying for the services commercially realistic.

**Is the Service Entity Bona Fide?:** The services provided must have a commercial purposes and the service entity must operate independently of the professional firm. I quiet accept the points on having separate management and the professionals not working in the service entity but the guidance booklet tries to make quiet a big deal about separate premises. In one of the examples the wages show there are only 4 or 5 staff in the service entity but it is paying \$80,000 a year in rent for separate premises. I think this is over the top, not practical or realistic and not supported by the leading cases on the topic. Though it is important that staff clearly know who they are working for and that the service entity's office area and administration is separated from the professional firm both in action and in the layout. The ATO is threatening to use Part IVA if the service entity does not have a bona fide purpose in the business. It is saying that asset protection is not sufficient justification on its own (TR 2005/D5 para 39). This is in conflict with statements from the decision in Phillips Case.

There also needs to be ample documentation such as contracts and regular invoices.

**Are the Fees Commercially Realistic?:** The rate charged not only has to be similar to what arms length entities are charging for those services or goods but also the net profit on that section of the service entities business must be similar to others in the industry. The Guidance booklet gives the following examples:

1) No markup should be added to items where no value is added – for example if the service entity pays the professional entity's electricity bill they should be simply charged the amount of the bill, that is assuming the staff member paying the bill is already being contracted to the professional firm by the service entity. If that is not the case a fee can be charged for the administration time but not a percentage mark up just an amount based on time spent.

2) Prices charged for casual staff can be similar to labour hire firms but permanent staff (longer than 12 months) must be charged out at a much lower rate. The guidance booklet recommends that the profit made on on hiring temporary staff should only be 5% on top of their wages, superannuation, insurance and their share admin costs and overheads of the service entity. With permanent staff this should only be 3.5% net profit.

Note the 5% & 3.5% is if you went though and dissected all expenses in the Profit and Loss Statement against the income it earned the net profit for each section should only be 5 or 3.5%. I think the ATO would like to confuse tax payers into thinking this is the gross mark up. Examples put the gross margin at around 35% on the wages of the staff member hired out plus their superannuation and Workcover but the booklet clearly places more emphasis on the net profit percentage. As the ATO is looking at the net profit it is important that family members take every cent they are entitled to as wages rather than profit distribution. To maximise this, a diary needs to be kept of hours worked and the hourly rate needs to be commercially realistic. **Note** in

Phillips case the court accepted a mark up of 50% on wages. I have written to the ATO explaining that the net profit margins they quote are less than the benchmarks they use to test whether employment agencies are understating their profit. According to the ATO's contradicting figures if you get the service entities net profit down low enough to fit within the guidelines in the booklet you will trigger an ATO audit for understating your income.

3) Don't double dip. If the professional firm is paying an hourly rate for you to provide them with clerical staff, then the work that staff member does can not in anyway be charged to the professional firm nor can they be attending to the administration of the service entity. The guidance booklet also expects the person attending to the administration of the service entity not to be on hired to the professional firm in anyway.

4) Equipment hire should be marked up at 9% of the depreciation and administration costs of holding the equipment. I have also criticised this in my letter.

5) Rent charged by the service entity for the practice's premises must be market value so if the premises are rented from a third party the amount can not be marked up. If the service entity owns the premises then a market rent or less must be charged.

In its guidance booklet the ATO says it is giving most service entities 12 months to correct their margins. But during that 12 months they will be auditing high risk entities. These are ones where no real services are provided and those that pay over \$1million in service fees and that \$1million represents more than 50% of the gross fees earned by the professional firm.

Generally the guidance booklet tries to suggest that service entities that are not large enough to require several full time staff members just to manage them will not qualify. The size of the entity is just not relevant. I feel the statements made in the guidance booklet will have to be watered down or the professions will fund another test case and based on previous cases they will make a lot of ground. The ATO must realise that by specifically stating in its ruling that it is mainly concerned with Solicitors and Accountants that they will wind up in court if they try to push beyond the current position in case law.

In the current climate clients who are not yet operating a service entity may have to wait and see whether it is worth the set up costs. If the ATO is successful in enforcing the small margins the tax saved may not be worth the extra operating costs. The main area that they are attacking is the on hiring of staff. A simple and cheap solution for a sole practitioner maybe to have his or her spouse own the equipment and premises and simply pay rent to the spouse as well as employing him or her on wages to do the clerical work and keeping a diary of work performed. If the couple are nearing retirement with independent children it may be better to rely on Ryan's case and make a large superannuation contribution for the spouse. If the couple have young children the children are only allowed to receive \$772, each year, in passive income before they are pushed into the maximum tax bracket. If the children over 18 and still financially dependant there may be some advantage in having a trust but this is not necessary if they can work in the business anyway.

References: TR 2005/D5 & ATO Booklet N13085 May, 2005,

Phillips v FCT Supreme Court 1977 original Case,

FCT v Phillips Federal Court 1978 appeal by ATO dismissed.

## **Ryan's Case - Superannuation for employee spouse**

Dr Ryan ran a computer consulting company that employed him and his wife. The court accepted that the company was not set up for tax purposes but that the dominant purpose was for asset protection and because clients generally preferred to consult with companies rather than individuals. Ryan's wife only performed secretarial work for his company. She was paid at commercial rates for the amount of time she spent on company business. This was a relatively small amount but much, much more was contributed to superannuation on her behalf.

The ATO argued that this was simply a scheme to reduce tax and was caught under Part IVA. The court found that the only restriction on the amount of money Dr Ryan could contribute to superannuation for his wife, and claim a full tax deduction was the age base limit. Further the arrangement did not meet the main criteria of a scheme to reduce tax (Part IVA) because if the superannuation contribution had not been made in his wife's name it would have been made in his name, so Dr Ryan's tax situation would remain exactly the same.

I would like to point out that the years the case applied to were before the Alienation of Personal Services Income (APSI) rules were introduced. So the scenario will appear to contradict the law as we now understand

it. The APSI rules did not override any existing law. Therefore the circumstances of this case will apply to you if you manage to avoid being caught by the APSI rules. On the other hand if you are caught by the APSI rules you cannot claim a deduction for superannuation contributions for your spouse unless they perform work that the client is directly charged for. Full details of the APSI rules are available in a booklet on the free publications section of our web site.

## Buying equipment to reduce tax

If the equipment is going to be depreciated under normal circumstances there is not much benefit in buying it at the year end because the depreciation claimable is apportioned over the year and life of the item so the deduction would be minimal.

It would be different if you leased the equipment, elected to be in the Simplified Tax System and made 12 months lease payments in advance. You would get a full deduction for those prepayments.

There are concessions for small purchases. If items are under a threshold they can be written off immediately:

**Non STS Businesses** - \$100 GST exclusive if registered.

**STS Businesses** - \$1,000 (net of GST if claimable) if the item is part of a set the whole set must be under \$1,000.

**Wage Earners** - \$300 (GST Inclusive) but all items that are identical must be added together for the \$300 test. If an item is part of a set the set must be under \$300.

**Rental Properties** - \$300 (GST Inclusive) per owner ie \$600 hot water system of a jointly owned rental property can be written off immediately. Identical items or part of a set must be added together.

Some items purchased in June will get more than just a few days depreciation if they meet certain criteria.

**Non STS Businesses** - that buy a piece of equipment for less than \$1,000 they can write 18.75% of the purchase price off in the year of purchase regardless of when it is bought.

**STS Business** - can write off 15% of any equipment in the year it is purchased if the life expectancy is less than 25 years.

**Wage Earners and Rental Property Owners** – Can claim 18.75% in the first year, on equipment costing less than \$1,000 regardless of when purchase. The threshold for rental property owners is actually \$1,000 per owner.

## Tax concessions for charity auctions and dinners

Fund raising events should have even greater appeal now that payments for goods, entertainment and/or meals, in excess of their value, can be claimed as a tax deduction.

Previously the rule was, if you received some benefit for a contribution you made to a charity it was not considered a donation so no deduction was available for any portion of the amount even if all you received was a pen. The new concessions are directed at charity auctions and gala dinners where the true value of the benefit received is less than \$100 (GST Inclusive), less than 10% of the amount paid and the amount paid exceeds \$250. Of course the event has to be held by a charity that is registered as tax deductible. The deductible portion of the amount contributed is the difference between that and the market value of the benefit actually received. The organisers of such events are required to provide you with the market value of the benefit on their receipt.

## Tax minimisation between spouses

Before entering into an arrangement that effectively shifts income from one partner to the other or deciding whose name in which to buy an income producing asset, check the need for this considering the new tax brackets.

The way for a couple to minimise their overall tax is to arrange their affairs so that they are both in the same tax bracket. They do not need to have the same taxable income. Their combined tax bill will not benefit from any income shifting arrangement if they are already in the same tax bracket. Even if one is at the higher end and the other the lower end.

By the 2007 financial year the government expects that only 2% of the population will be in the maximum tax bracket due to the new tax rates. The 31.5% bracket is so wide that a taxpayer only working part time may well be in the same bracket as his or her spouse who is working full time. For example

2006/07

0-6,000 0%    6,001- 25,000 15%    25,001 – 75,000 30%    75,001 – 150,000 40%    150,001 + 45%

Note the above does not take into account the low income rebate of \$600 which starts to shade out after \$25,000 in taxable income.

You need to have gone well into the next bracket above your low income spouse before any tax arrangement that shifts income to them is worth your while.

## **Who or what should own business premises**

Section 152-40 makes the active asset discount available to assets owned by a non business entity providing they were used in the business of their small business CGT affiliate or another connected entity.

Your Small Business CGT affiliate according to section 152-25 is your spouse or child under 18 years or a person who acts in accordance with your directions. Your partner in a business partnership is not your small business CGT affiliate. Section 152-30 describes a connected entity as one where you control 40% or more of the rights either directly or through control of another entity that has that control.

These definitions are also used to defined whose assets are added to yours for the 5 million dollar asset test to qualify for the CGT small business concessions. So on the one hand being a CGT affiliate or connected entity is good as assets owned by these entities and used in your business can qualify for the active asset discount even though the owner of the asset is not in business. On the other hand to qualify for any of the small business CGT concessions you and your CGT affiliates and connected entities must have less than \$5,000,000 in net assets. Superannuation and personal assets such as homes are not counted, section 152-20 (b).

This is just another one of the many issues that should be taken into account when establishing your business. The trouble is no one really expects to get to the \$5,000,000 threshold so it doesn't get a lot of thought. But the active asset side should always be considered as it is important for asset protection purposes that the assets are owned separately from the business but without losing the small business CGT concessions. Note the CGT concessions do not apply to plant and equipment. In the case of most small businesses the two assets that the CGT concessions are likely to apply to are Goodwill and the premises the business operates from. The Goodwill by definition will always be owned by the same entity as the business so usually it is only the business premises that need to be held in a different entity from the business but still connected with the business so that the active asset concession is available.

So who or what should own the business premises? If you are looking to make the most of the CGT concessions the premises should be owned by you, your CGT affiliate or a connected entity. Owning the building in the name of a child under 18 would result in penalty tax and once they reach 18 they would not be your affiliate so this leaves you, your spouse or an entity you control more than 40% of. A company while qualifying to the CGT concession will not be able to distribute the tax free profits to you without triggering tax at your normal tax bracket. This means the only suitable non human entity to hold the premises in is a trust.

If you want to have flexibility on how the profits are distributed and/or you are concerned that you or your spouse may one day be sued the cost of setting up a discretionary trust is well worth it.

Now the next question is would you be better giving up the CGT discount so that you could hold the premises in your self managed super fund? About 90% of the time, yes. Super funds are only taxed at 10% on capital gains and once they are in the pension stage they are not taxed at all. Careful use of the CGT concessions can reduce the tax to zero as well but there is a risk that you may lose your qualification for the CGT concessions. This is easy enough to do by simply selling the premises more than 12 months after the business has ceased or turning the premises into domestic accommodation or not using the premises in the business right up to and including the day the business is sold. The down side for super is trying to draw more than your reasonable benefit limit out of the fund and the super fund cannot borrow to buy the building. On

the up side having the building in the superannuation fund will exclude it from the \$5,000,000 asset test so that you are more likely to qualify for the CGT concessions on your goodwill. If this has provoked you to change your circumstances, a super fund can buy the business premises from a related entity.

## Back Issues & Booklets

To obtain free back issues of the fortnightly BAN TACS Newsflash or any of the following booklets visit our web site at [www.bantacs.com.au/publications.php](http://www.bantacs.com.au/publications.php). You can also subscribe to our Newsflash reminder.

<i>Alienation of Personal Services Income</i>	<i>Buying a Business</i>	<i>Capital Gains Tax</i>
<i>Claim Your Trip Around Australia</i>	<i>Claimable Loans</i>	<i>Claiming a Motor Vehicle</i>
<i>Death and Taxes</i>	<i>Divorce</i>	<i>Division 35</i>
<i>Defence Forces [Military]</i>	<i>FBT for PBIs</i>	<i>Fringe Benefits Tax</i>
<i>Goods and Services Tax</i>	<i>Home Loans</i>	<i>How Not To Be A Developer</i>
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<i>Wage Earners</i>	<i>With Attitude</i>	<i>Year End Tax Strategies</i>

**Disclaimer:** Please note in many cases the legislation referred to above has only just passed through parliament. The full effect is not clear yet but it is already necessary to make you aware of the ramifications despite the limited commentary available. On the other side of the coin by the time you read this information it may be out of date. The information is presented in summary form and intended only to draw your attention to issues you should further discuss with your accountant. Please do not act on this information without further consultation. We disclaim any responsibility for actions taken on the above without further advice as to your particular circumstances.



# INVESTMENT NETWORKING

FOR YOUR  
BUSINESS AND YOU



some **work** others **network**

**learn how to**

drastically advance **your financial future**

through property and personal investment



**Australian Property Investors Network (APIN)**





# What does APIN offer ?

## Seminars & Workshops

Why is that most people aren't taught how to be rich or happy? We are trained to do most things in our lives, in order to do them well enough to get by. We are taught how to read and write, how to cook, how to drive. We are taught how to do incredibly complex and challenging tasks like designing and building bridges over wide spaces, how to cure diseases, to fly airplanes, yet when it comes to creating personal wealth and happiness, we're left to find out for ourselves.

There's another, more subtle reason why most people don't achieve wealth and happiness. Deep down they don't believe that there is a choice to be made between being rich and being happy. They believe that somehow you can't have both, which is why in the end they don't get either.

The money that slips through your fingers could make you wealthy if spent more wisely.

Our free seminars and information evenings will provide you with leading edge valuable and up to date information. As a bonus you will be able to meet other like minded people who are either starting out on the road to success or are avid investors sharpening their investment knowledge. As a further advantage we encourage you to meet and freely talk with our alliance

partners. These hand picked people both male and female are leaders in their own right, they are also licensed, qualified and independent.

These evenings are fun and informative plus you will have access to lots of support material in the form of e-books, books and cd's on a wide range of topics. Come and learn the many strategies used by successful investors NO SECRETS just sensible plain English techniques that really work in any market at any time.



## Education

It's true what they say "the difference between the rich and poor is what they know and what they do". Property is more than houses and unit investing. Do you know how to buy a property using an option, how about knowing all the ins and outs of being your own "DIY Developer"?

There are many ways to make money in real estate and with the correct tools and strategies you too can play with the best.

TIME x INTENSITY = SUCCESS.

You can't expect to get results in life if you have all the information but fail to apply the principles needed to succeed.

Our programs, e-book, books and home study kits will give you the ability to learn and gather what you need at your own pace in your own time. We encourage you to learn from our expert alliance partners all that you can, so when you are ready to act you will have the education to get into your first investment or do your own JV building renovation makeover.





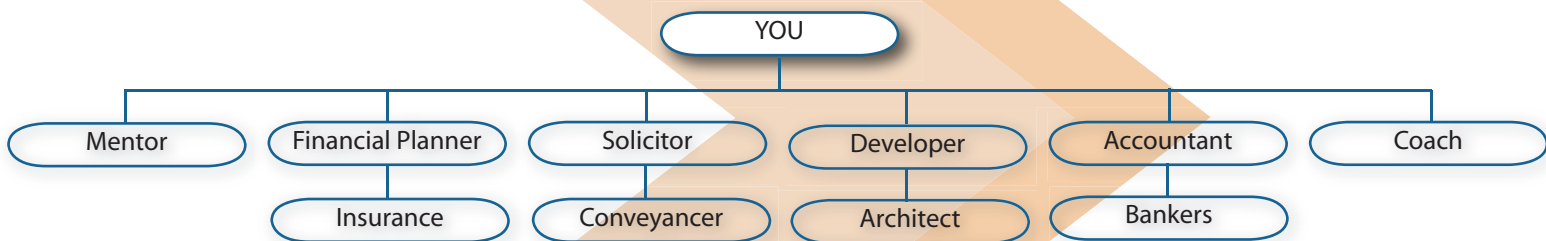
## On going Support

Through APIN's Alliance Partners and Discussion Forums you can fortify your ideas and gain strength by exchanging information. Creating alliances generates business opportunities increasing your network and of course - your cashflow.

We have a mentoring service for those that are not quite ready to take those steps without guidance, extra information and some affirmation. Helping you to create a "safe" environment for your first steps.

## Who is on your team?

When looking at people who are successful, you will notice they have a hand selected group of people to support and advise throughout the journey to success.



## Property Opportunities

Through our Australia wide network we select opportunities that "stack up". We use an independent Research company (Guardian) who are licensed financial planners and real estate agents to use our pre selection due diligence program. From investment properties, development sites, future land subdivisions, building makeovers to even golf course resort projects.

APIN also align ourselves with a select group of builders and developers where we negotiate wholesale purchasing, saving you 10% off the retail price. These opportunities are not available to the public but only members of the APIN site. We can introduce you to the key people who are experts in their fields, saving you thousands of hours of frustration and heartache. Very shortly APIN will also be offering FREE property advertising on our site through resisearch.com who are one of our alliance companies. APIN is fast becoming the most exciting site in Australia.