

Service burden

David Dahm
Health & Life
DavidD@healthandlife.com.au



Profit and sense

The Australian Taxation Office is over-reacting to how accountants, lawyers and doctors use service trusts. Its guidance on acceptable profit margins for service trusts has been set far too low for these professions.

Owners of a professional practice are allowed by legal precedent to establish a separate service entity away from their practice. This arrangement allows practitioners to protect their personal assets and enjoy income-splitting benefits. For a doctor, a service entity would employ practice infrastructure such as premises, plant and equipment, support staff and branding rights. This service is then bundled and sold to the professional practice for a fee. Medical practitioners can pay up to 60 per cent of their gross income for this type of service.

When the service-entity owner and practitioner are the same person, the ATO requires that a commercial profit be charged. Where this is deemed "excessive", the whole or part of the service fee and/or arrangement may be struck down.

Unfortunately, some large accounting firms have been abusing these arrangements by charging excessive fees. This led to last year's crackdown, with the ATO releasing Taxation Ruling TR 2006/2 – which comes into effect last April – giving guidance on what profit margins for a service trust are likely to gain the attention of the ATO's audit teams.

Debate continues over what is a commercial service fee. I have noted that many advisers have been blindly quoting the ruling. Unwittingly, clients are missing out on legitimate tax and commercial opportunities. At worst, their businesses have been made insolvent and impossible to sell.

Both the ATO's statistics and national benchmarks show overheads are on average 50 per cent of a doctor's turnover, yet the ruling considers a service fee of greater than 40 per cent to be a "high audit risk". If practice overheads are 50 per cent, with the ability to charge a service fee of only 40 per cent, the service entity will run at a loss from day one. The business would be neither viable nor sustainable: how is this commercially realistic? This calls into question why 41 per cent appears to be a tax rort while 40 per cent is acceptable? Is there a court case to support this view? The answer is no.

The insolvency courts would find it laughable if an accountant solely used the ATO's indicative service fee rates. The main test is whether it can be sold. If it cannot, the structure is not commercial.

Owning a medical service trust is a risky business. A case in the New South Wales Supreme Court in 2001, *Alexander v Heise*, showed that an employer is liable for negligence if an untrained receptionist fails to assess a medical emergency. Why would anyone want to own a service trust if it makes little or no money for this kind of risk? Many start-up practices have few patients to begin with. Clearly, the overheads for a start-up or expanding practice will be much greater than 40 per cent of gross fees.

What is an acceptable profit margin? In health care, depending on the nature and type of practice, commercial margins range from 11 per cent to 49.5 per cent. This may be a useful start for a more balanced approach.

David Dahm is chief executive of the practice management and accounting firm Health & Life.