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Your service entity arrangements

Check your business is claiming only deductible service fees and charges for your service entity arrangements.

Last updated 17 November 2025

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This guide will help you decide whether the payments you make under your service arrangements are deductible.

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About this guide

This guide will help you decide whether the payments you make under your service arrangements are deductible.

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This guide can be downloaded in Portable Document Format (PDF) Your service entity arrangements (PDF, 188KB).

The role of this guide is to help you decide whether the payments you make under your service arrangements are deductible under income tax law. It does this by providing you with information to help you decide whether the service arrangement is relevant to the conduct of your business and the charges are correctly calculated. By 'correctly calculated', we mean that the payments are not disproportionate or grossly excessive in relation to the benefits conferred by the service arrangement. This guide will assist you in identifying the market price of those services for the purpose of calculating these claims, or you may choose to use the indicative rates provided to position your arrangement into a low risk audit category.

This guide explains how service arrangements can be conducted to minimise the risk of audit. You will be at a low risk of audit if the level of your service fees are less than or equal to the indicative rates for the services described and you keep documents that explain how those services are relevant to the conduct of your business.

Tax laws exist that deal with arrangements that have a tax-avoidance purpose. This guide does not deal with these rules.

For more information about how these rules may apply to service arrangements see Taxation Ruling TR 2006/2 *Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements*.

If, after reading this guide, you do decide to review your service arrangement, you will need to ask yourself:

- how the benefits passing under the service arrangement help you to run your business, and
- whether the service fees and charges you have agreed to pay under the service arrangement are correctly calculated in the light of the benefits passing to your business under the arrangement.

The information in this guide is part of our compliance response to some practices being adopted in claiming deductions. The guide includes:

- the circumstances in which you should review your service arrangement

- the steps you can take to review your service arrangement
- the way in which we identify fees for service as correctly calculated
- the way we identify the risk of being audited in various case studies.

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Introduction

Introduction to using service arrangements.

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Using service arrangements

We understand that it is common for accountants, lawyers and other professionals (particularly those who are required to operate their businesses as individuals or as partnerships) to engage associated entities to provide them with labour hire, recruitment, clerical, administrative and other services (also known as service arrangements). These arrangements can also be used in the broader business community.

We also understand that it is common for professionals to view service arrangements as an effective means of protecting their assets from professional negligence actions and other claims.

Our concern is whether the service fees being claimed are deductible under the income tax law.

If you have a conventional service arrangement where your payments are correctly calculated and the services are reasonably connected to the conduct of your business, then the presumption will be that your service fees and charges are a real and genuine cost of your business and deductible in full.

If your payments are grossly excessive or the services are not reasonably connected to the conduct of your business, then the purpose, and the deductibility, of some or all of your service fees is open to question. We may ask you to explain your entitlement to the

deduction claimed. If we are not satisfied with your explanation, we may disallow some or all of your deduction.

For an authoritative explanation of why this is the case, you should consult taxation rulings IT 276 *Payments to service companies: splitting of professional income* and TR 2006/2 *Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements*.

Tax Office compliance activities

Our concerns about practices being adopted in some service arrangements arose from audits conducted in the legal and accounting sector. These concerns were raised publicly in the Commissioner of Taxation's Annual Report to Parliament for 2000-01, and subsequently in speeches by the Commissioner. After consulting with industry, Taxation Ruling TR 2006/2 was issued to supplement Taxation Ruling IT 276 and provides a more detailed explanation of our views in light of these practices.

Our approach for existing arrangements

We will allow a period of 12 months after the release of this guide for people to review their service arrangements if their circumstances warrant a review. This period ends on **30 April 2007**.

In such cases, we recommend that you commence a review of your arrangements as soon as possible as the implementation of changes can take some time. Reviews that have not been finalised by 30 April 2007 will only be given additional time to comply in exceptional circumstances.

If at the end of this period your service arrangement is generally in line with the information provided in this guide there is little risk that we would audit your arrangements. If at the end of this period your service arrangement is not in line with the information in this guide, and we do commence an audit, our review may include earlier income years.

This guide provides:

- Case studies assessing the risk of audit for service arrangements in place at the end of this review period. It also includes case studies that deal with service arrangements entered into by general medical practitioners.

- Our general indicative rates above which your arrangement may be audited.
- Specific indicative rates relevant to the medical profession.

We will also continue with our current audit program for the highest risk cases. We consider these highest risk cases meet all of the following three tests for a given income year:

- Service fee expenses are over $1 million.
- Service fee expenses represent over 50% of the gross fees or business income earned.
- Net profit of the service entity (or service entities) represents over 50% of the combined net profit of the entities involved.

These tests look at the size of deduction claimed, the materiality of the arrangement to the business, and the potential extent to which the arrangement may be a sign of unacceptable tax planning.

The highest risk cases with the features listed above will not be given 12 months to review their arrangements. We believe businesses that make claims of this size and materiality could reasonably be expected to comply with the law without the need to rely on the additional information in TR 2006/2 and this guide. If we do commence an audit in these cases, our review may include earlier income years.

We will also look at cases under our current audit program where there are serious questions as to whether the services were in fact provided by the service entity.

In terms of our current audit program, when we do start an audit of your service arrangement, it does not mean we think you are dishonest. We acknowledge there may be cases selected for audit based on risk assessment which on further examination turn out to be acceptable.

If you have acted on specific advice from the Tax Office you would generally be excluded from our current audit program, but you may need to review your arrangements for the future. In any examination of these cases we would need to consider the terms of the specific advice and whether there are material factors relevant to the operation of the service arrangements that were not disclosed in connection with the advice.

Our approach after the review period

After the review period, we will manage ongoing tax compliance for service arrangements in accordance with our general risk assessment approaches. Depending on what we see as the ongoing risk, we may include service arrangements in our general compliance program, and conduct market or industry based projects. Our view on tax compliance risk for service arrangements is explained in this guide.

For more information, see:

- Comparable and indicative service fees for certain service arrangements
- Case studies

If we do start an audit of your service arrangement, it does not mean we think you are dishonest. We acknowledge there may be cases selected for audit based on risk assessment which on further examination turn out to be acceptable.

All or part of the fees may still be deductible even if the fees charged exceed market rates. The greater the divergence from those rates, the greater the likelihood becomes that other benefits which do not support a deduction may explain the purpose of the arrangement. In these cases, all or part of the fees will be non-deductible.

Depending on the overall level of risk we see, we would not ordinarily commence an audit unless there is substantial divergence. We provide indicative rates that reflect this divergence.

In this guide we provide data on the level of commercial returns seen for some of the more common functions performed under service arrangements. This represents the best information currently available to the Commissioner. This data would be used by the Commissioner if amendments to assessments are required to adjust excessive expense claims back to economically justifiable amounts. Over time, commercial returns can change for services and the Commissioner will consider up-to-date information in making adjustments.

For more information, see:

- Steps you can take to review your service arrangement
- Comparable and indicative service fees for certain service arrangements

If we conclude that an income tax adjustment and penalties are required, our usual practice is to issue a position paper that gives you the opportunity to comment before any tax and penalties are assessed. Further, where the audit results in an income tax adjustment and/or the imposition of penalties, any such adjustments would be subject to the normal review and appeal processes.

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What is a service arrangement?

Features of a service arrangement and an example of a typical service arrangement.

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In this guide we refer to a trust or company as the service entity.

A service arrangement will generally show all or most of the following features:

- The taxpayer (and this could be a sole proprietor, a partner in a professional partnership or a company) carries on a business or professional practice in a field such as accountancy, law, medicine or pharmacy.
- There is a trust that is controlled, or a company that is owned or controlled, by the taxpayer or the taxpayer and associates. This is the service entity.
- The taxpayer, alone or in partnership, enters into an agreement with the service entity for the taxpayer to pay certain fees and charges in return for the service entity providing certain services. These services could include staff hire, recruitment, clerical and administrative services, provision of premises, plant or equipment, or a combination of services.
- Typically, the service fees and charges are calculated by way of a mark-up on some or all of the costs of the service entity (although a fixed charge may be agreed on by the parties up-front).
- The taxpayer (or professional partnership) claims a deduction for the service fees and charges as expenditure it has incurred in the

conduct of its business.

- The service arrangement either gives rise to profits in the service entity, for both accounting and tax purposes, or would give rise to profits in the service entity except for remuneration or service fees paid to associates of the taxpayer or the taxpayer's partners.
- The profits derived by the service entity are either retained by the service entity (usually where the service entity is a company) or distributed (directly or indirectly) to the taxpayer (or partners in the case of a partnership) and/or to associates of the taxpayer (and associates of the partners in the case of a partnership).

Example: A typical service entity arrangement

Diagram detailing the features of a service arrangement as listed above.

In our experience, conventional service arrangements are typically entered into by lawyers and accountants, although we have also seen service arrangements involving other professionals, such as medical practitioners and pharmacists. The professional practices that use service arrangements range from large practices to small, micro and individual practitioners.

There are service arrangements that differ significantly from the conventional arrangements described above.

Our experience and concerns have been with conventional arrangements which are the focus of this guide. We will continue to respond to concerns we see with these other types of service arrangements as appropriate.

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Should you review your service arrangement?

When we recommend you review your service arrangement and situations when a review may be critical.

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We **recommend** that you review your service arrangement if you:

- are dealing with an associated service entity and you have entered into an arrangement without fully considering whether the benefits passing to your business under the service arrangement will assist you to conduct your income earning activities or business
- have not taken steps to satisfy yourself that the service fees and charges which you have agreed to pay are not disproportionate or grossly excessive in relation to the benefits passing to your business under the service arrangement, and/or
- are not sure whether you have maintained adequate records on the service arrangement and its perceived benefits.

It will be **critical** for you to review your service arrangement if one or more of the following has occurred:

- You have agreed to pay service fees and charges that are disproportionate or grossly excessive in relation to the benefits conferred on your business by the service arrangement, particularly if the profit outcomes in the service entity are high relative to either:
  - the profit outcomes achieved by independent companies engaged in the provision of the same or similar services to the service entity, or
  - the profit outcomes you have achieved given the relative risks you have assumed and functions you have performed.
- You have agreed to pay service fees and charges calculated by the service entity without regard to the value of the services it provides, particularly if:
  - you have agreed to pay service fees and charges using an arbitrary or fixed mark-up on some or all of the costs of the service entity on a basis that has no discernible connection with the value or nature of the services provided
  - you have effectively guaranteed the service entity a certain profit outcome without obvious commercial explanation, or
  - you have agreed to pay service fees and charges calculated by the service entity applying mark-ups to private or domestic expenses it has incurred for the benefit of you or your associates.

- You have not clearly separated or distinguished the business you are carrying on from the business carried on by the service entity, particularly if:
  - there is no evidence that the service entity has added any value to your business
  - there is no evidence that the service entity has performed any substantive functions for your business, or
  - there is no evidence that the services provided were conducted by the service entity.
- You have failed to maintain adequate records that give evidence of the service arrangement and its perceived benefits, particularly if:
  - you cannot substantiate the existence of the arrangement, or
  - the documentation is not consistent with the business services actually provided.
- You have failed to maintain adequate records that give evidence of the service arrangement and its perceived benefits, particularly if:
  - you cannot substantiate the existence of the arrangement, or
  - the documentation is not consistent with the business services actually provided.

If you decide that you need to review your arrangement, we recommend you use the steps outlined in steps you can take to review your service arrangement. You may also find the decision matrix (PDF, 29.6KB) helpful.

Once you have completed your review and considered our interpretation of the relevant law as discussed in taxation rulings IT 276 and TR 2006/2 you may decide that your service arrangement needs to be changed. We provide information about indicative service fees in this guide.

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Steps you can take to review your service arrangement

Steps to help you identify the commercial benefits of your service arrangement.

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The following steps will help you identify the commercial benefits of your service arrangement to your business and, given those benefits, judge whether the service fees and charges are correctly calculated.

Step 1: Can you explain how the service arrangement helps you run your business?

For expenses to be deductible, they need to have a connection to the income earning activities of your business.

A service arrangement is likely to enhance, assist or improve your ability to produce income or make profits if the service entity:

- gives you access to staff, skills or know-how that is relevant to the conduct of your business and which is in fact provided by the service entity
- relieves you of the responsibility for conducting and managing certain functions (for example, recruitment or payroll services)
- relieves you of certain risks (for example, provides you with a fixed or pre-determined cost structure for certain activities), or
- relieves you of certain financial or legal obligations (for example, employer obligations in relation to workers' compensation, payroll tax, superannuation, statutory holidays, long service leave or unfair dismissal).

Your service entity should be able to point to the personnel (for example, staff and management) and resources (for example, materials, equipment and premises) it employs to deliver the contracted services to you at the times and to the quality agreed under the service agreement.

If you conclude that you have not obtained any commercial benefits from the service arrangement and it is clear that there is no connection between the arrangement and the income earning activities of your business, the service fees and charges may not be wholly deductible (see taxation rulings IT 276 and TR 2006/2).

If you have identified the commercial benefits provided by the service arrangement and the necessary connection with the business, go to step 2.

Step 2: Are the service fees and charges correctly calculated?

Once you have identified the necessary business connection and the commercial benefits to your business from the service arrangement, the next step is to review whether the level of service fees and charges are acceptable.

In cases where fees charged are grossly excessive, all or part of the fees may be non-deductible. The greater the divergence away from market rates, the greater the likelihood becomes that other benefits that are not deductible are being claimed.

Review methods

Indicative rates

The simplest method of review is to look at the indicative rates and the case studies. If you come within these, you have a low risk of audit.

However, if you want to carry out a more extensive review to determine a market benchmark from which you can consider whether your charges are correctly calculated, a number of approaches are described below.

Comparable market prices

Comparable market prices can provide a starting point to determine whether your charges are grossly excessive. You do this by comparing your service arrangement with arrangements entered into by independent parties to look at the prices charged for the same or similar property or services by independent suppliers in the open market.

For example, if the service entity is leasing you office space, you might compare the rent the service entity is charging you to the market rent charged between independent parties for similar office space (adjusted for any differences in the terms and conditions on which the respective leases are negotiated or for any other relevant factors).

Similarly, if you are hiring a staff member from the service entity on a long-term basis, you might compare the hire fee the service entity is charging you with either the salary, on-costs (such as superannuation and payroll tax) and administrative expenses you would be likely to incur if you employed the person directly, or the fee charged on comparable long-term commercial arrangements if these are available and ordinarily used in your industry.

If your service arrangement is not delivering you any commercial benefits above and beyond what you could have obtained direct from an unrelated supplier, but your service fees and charges are grossly excessive relative to the market price, then there is a high risk of audit and adjustment.

Comparable profits

Another approach to determine a benchmark from which to see whether your charges are grossly excessive is to look at the profits achieved by independent suppliers who provide the same or similar property or services in the open market.

Net mark-up on costs

Under this approach, you might look at the net profit achieved by independent suppliers who provide the same or similar property or services in the open market, measured as a net mark-up on total costs.

The following table provides information about a number of publicly listed companies providing labour hire and recruitment services.

The financial results for these companies were publicly available from the Australian Securities and Investment Commission (ASIC) and from the companies themselves (via their websites). We were able to take the publicly available information and calculate the operating profits achieved by these companies' labour hire and recruitment activities.

We have considered this information in working out the comparable labour-hire and recruitment rates.

Net mark-up on costs (operating profit ÷ total costs), 2003–05

Net mark-up on cost	2003	2004	2005
Annual average	2.9%	3.5%	3.8%
Overall average	3.4%		
Median	3.8%		
Interquartile range	3.1% to 4.3%		

Note: In this table, operating profit was defined as the profits from labour hire and recruitment activities, before interest, income tax, and goodwill amortisation expenses. Non-labour hire/recruitment expenses were excluded from the calculations. Total cost was defined as the total cost of the labour hire activity, taking into account both direct and indirect costs. The interquartile range represents the middle 50% of the observations or data points.

Gross mark-up on costs

Under this approach, you might look at the gross profit margin that independent suppliers apply to particular operating costs in order to arrive at a benchmark rate for the particular property or services, measured as a gross mark-up on those costs.

Labour hire firms generally determine the charge for staff placed with clients by adding a mark-up to the salaries, and employment on-costs like superannuation, workers' compensation insurance and payroll tax costs incurred by the labour hire firm for those staff members.

Other operating costs incurred by the labour hire firm, such as its own staff costs, marketing, consumables, accommodation, administrative and recruitment costs, are not charged to the client but are instead absorbed by the gross fees earned from customers.

Usually, the gross mark-ups vary with the length of the placement. The mark-ups usually decrease the longer staff are placed with the client. This is because costs involved with the recruitment cycle are incurred less frequently.

An appropriate level of gross profit mark-up and the comparability of a particular arrangement depends on:

- the industry or service involved
- the detail of the pricing model used
- the extent to which expenses are included in the calculation of the service fees and charges compared to those expenses that are not
- the mix between fixed and variable costs, and
- the mix between gross costs and operating expenses.

These factors differ greatly from business to business. For example, a higher gross mark-up rate for labour hire services applied to a narrower base of direct salary only can be equivalent to a lower gross mark-up rate that is applied to a broader base covering salary and other direct and indirect employment costs.

A gross mark-up in a particular case can be shown to be correctly calculated in a number of ways. For example:

- it does not grossly exceed the mark-up in independent arrangements with comparable pricing factors
- it can be a mark-up consistent with business plans or budgets supporting a net profit outcome which does not grossly exceed benchmark net profits, or
- it can be a mark-up for the current year based on the previous year's results, or an average over a number of years, adjusted to provide a net profit outcome which does not grossly exceed benchmark net profits.

Using these methods

Example: Labour-hire arrangement

A labour-hire arrangement typically involves a labour-hire agency employing casual workers on a temporary basis to on-hire to clients on short-term to medium-term placements (see note 1).

Regular labour hire arrangements provide the client with an efficient and cost effective way of accessing a flexible pool of appropriately qualified staff, readily able to help the client cover staff absences and to respond to the fluctuating demands of its

business. They may also provide the client with an opportunity to assess individuals before offering permanent employment.

The agency supplies the assets, staff and know-how required to recruit and match workers to clients and it retains the bulk of the employment risks and responsibilities for the workers. The client has control over how much time the worker is engaged and is able to employ additional labour only when required, resulting in lower overall wage costs compared with a strategy of hiring additional ongoing labour (see note 2).

Notes:

1. A survey of labour hire companies by the Australian Industry Group found that 96.9% of labour hire employees are engaged as casuals – see page 24, Labour Hire Task Force, Final Report, 2001, commissioned by NSW Government, **http://www.industrialrelations.nsw.gov.au//_report.pdf** (accessed 8 April 2005).
2. Laplagne, P., Glover, M. and Fry, T. 2005, *The Growth of Labour Hire Employment in Australia*, Productivity Commission Staff Working Paper, Melbourne, February 2005 (at page 20).

Regular labour hire arrangements of the type described in the example above should be distinguished from labour hire arrangements in which the agency recruits permanent staff specifically for long-term placement with a client who assumes the long-term control and management of the staff.

The sharing of responsibilities, risks and benefits in a permanent recruitment arrangement is different to the regular labour hire arrangement. The fees that would be charged by independent labour hire firms for the particular type of services provided to you gives a reasonable benchmark from which to determine whether your charges are grossly excessive.

If you choose to use a comparable profit approach, you need to take care to be consistent about the cost structure you use to make the profit comparison and make sure the arrangement you use for comparison has the same types of expenses. You should also exclude any non-operating expenses that are not connected to the provision of the particular property or services (for example, interest and royalties).

Similarly, costs that are not genuinely incurred by the service entity in carrying on its business should be disregarded. In some cases, payments made by a service entity to its associates or to associates of the taxpayer may be either excessive or inflated when compared with payments that would have been made to an independent party providing the same services. In these cases, the payments should be excluded from any calculations - at least to the extent of the excess.

You also need to be careful if the service entity provides more than one type of service. A common mistake is to take the same costs into account when making comparisons in relation to two or more types of service - this is often referred to as 'double counting' the costs.

Example: service entity providing 2 services

A service entity is engaged to provide both marketing services and a labour hire service, and a comparable profit approach is used to compare the service arrangement with the same or similar marketing and labour hire arrangements entered into by independent persons. In this situation, the salary and on-costs incurred by the service entity for the marketing staff should only be taken into account in determining a comparable profit outcome for the marketing service. Their salary and on-costs should not be taken into account in determining a comparable profit outcome for the labour hire service.

Information about comparable profit approach

There are several public sources of information that can be used to undertake a comparable profit approach. One source of industry information is the Australian Bureau of Statistics catalogue that reports industry profitability outcomes. Alternatively, information about many companies is publicly available through a range of commercial databases of companies, such as IBISworld, Dunn and Bradstreet and Business Who's Who.

This information can be complemented by the financial results published by the companies themselves (for example, on their websites or as reported by ASIC).

Please carefully consider the reliability of the data and, where necessary, make adjustments to reflect any material differences between two factual situations so you are matching like with like.

If we ask you about your service arrangement, the way you have used such information can help explain the commerciality of your arrangement and the basis for any differences with the indicative rates we have provided.

Commercial arrangements and profits differ between industries and the nature of the services provided. This needs to be recognised in any comparison undertaken. Similarly, commercial arrangements in one industry may not be used in another industry and may not be suitable for comparison purposes.

Example: suitable comparison

Certain practice management arrangements that have come to be used in the medical profession may be appropriate for comparison purposes in the medical profession where a similar range of services is provided by the service entity.

However, they are unlikely to serve as a suitable comparison for the purposes of more conventional service arrangements in other professions. This is because the features and circumstances of these arrangements are substantially different. Refer to case studies on the medical profession.

Step 3: What documentation do you need?

While there is no obligation on you to create specific business records about your dealings with an associated service entity, you must keep records that explain your transactions for tax purposes. The extent to which records are ordinarily kept can depend on factors like the significance and complexity and materiality of the transaction and the size of the business.

Example: records

In large businesses a high standard of planning and governance is usual and consideration of commerciality can be expected to include an economic assessment of the various parts of the business and the value of all major contracts and arrangements.

> Documentation can also be expected to deal with a comprehensive business assessment including allocations of business profits to brand value and goodwill of the firm in working out a fair commercial return on each element of the business, including those elements provided by the service entity.

In our experience, arrangements with related parties generally involve a greater level of potential tax compliance risk. Our attention will be drawn to arrangements with related parties that are not well documented and that do not have the elements usually associated with a commercial activity.

The key documentation that you may already have in relation to your arrangements and that may be relevant in supporting the way you have characterised and priced the benefits of your service arrangement includes:

- the service agreement
- documents showing how you and the service entity arrived at a pricing structure for the services provided
- tax invoices for the service fees charged, and evidence of payment
- calculation statements showing how the service fees were calculated from time to time, including details of how any mark-ups have been applied
- minutes of meetings concerning the service entity
- budgets, business plans, and organisational charts for both your business and the service entity - your service arrangement should be reflected in your planning and budgeting
- detailed profit and loss statements and balance sheets for both your business and the service entity for the current year and two prior years
- if you are a partner in a partnership, your partnership agreement, as varied
- the constituent documents for the service entity (such as the deed establishing the service trust)
- resolutions by the service entity about distributing profits

- a list of personnel employed by the service entities together with relevant duty statements
- employment contracts, timesheets, other personnel records and reporting guidelines for employees of the service entity
- relevant insurance contracts, and
- relevant lease and/or rental agreements.

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Comparable and indicative service fees for certain service arrangements

Market rates that we consider are commercial benchmarks for the typical service arrangements described.

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In this chapter we provide market rates that we consider are commercial benchmarks for the typical service arrangements described. These rates are based on our current findings and commerciality of rates can change over time. We also provide higher indicative rates that reflect a degree of divergence from comparable market rates, above which we consider there to be a level of tax compliance risk that supports an audit.

Individual circumstances will be taken into account where:

- arrangements exceed these indicative rates, or
- the characteristics of the arrangement differ significantly.

You will have the opportunity to explain these circumstances, and why you consider your payments to have an objective commercial explanation before any adjustment is made in relation to your arrangement.

Higher rates can be acceptable

Some reasons that higher rates may be acceptable include:

- industry specific comparable data
- specialised or highly skilled nature of the service provided
- the extent to which services are provided in excess of comparable third party arrangements
- the economic contribution to profits of the main business that is attributable to the activities of the service entity (the activities of on-hired staff are not activities of the service entity), and
- level of business risk associated with the activities of the service entity and the nature of the service model used.

Comparable market rates

Service fees at the following comparable rates for the typical services are considered to be appropriate commercial benchmark rates where the arrangement has the characteristics described. If your arrangement involves fees and charges not disproportionate or grossly in excess of these rates, the expenses will be accepted if the arrangement has the characteristics described, and the services have a relevant connection with your business.

Higher rates may be acceptable if appropriate evidence is provided. We acknowledge that further enquiry can establish that rates higher than those we have found may ultimately be found to be deductible. This is relevant in our approach to risk assessment and audit case selection.

It is not possible to provide general advice on comparable market rates for gross mark-up on cost due to the diversity of circumstances behind different companies' pricing models.

Arrangement	Characteristics	Fees and charges
Labour hire – temporary staff	• The service entity employs staff on a casual basis or on short-term employment contracts, where:	**Comparable rate** • **Net mark-up on costs** – labour hire fees that result in the service entity deriving a net

	– a casual employee is a person not entitled to holiday pay or sick leave, and – a short-term employment contract is an employment contract the duration of which is, or is reasonably expected by the employee, to be less than 12 months. • The service entity on-hires the staff to you for a limited period under a hiring contract that sets out your respective rights and obligations regarding the staff. • You pay a service charge which is calculated as a multiple of the hours worked and an hourly rate specified in the hiring contract. • The service entity meets the costs of premises and equipment it uses and employs its own managers and HR staff (who are not on-hired to you in relation to the service arrangement) who are responsible for recruiting, employing,	mark-up not exceeding 5% on the direct and indirect (note 1) operating costs associated with its on-hiring of the temporary staff.

	administering and on-hiring the temporary staff. • The service entity, and no other entity, meets all the costs associated with carrying on its activities out and only out of the fees it earns. These include rent on its premises, purchase and hire of items of office equipment, costs of its own office management and staff, advertising, hospitality and travel, insurance, legal expenses, leave entitlements, cleaning and maintenance, utilities, and depreciation.	
Labour hire – permanent staff	• The service entity employs staff on a permanent basis or on long-term employment contracts, where – a permanent employee is a person who is entitled to holiday pay or sick leave, and – a long-term employment contract is an employment contract the duration of which is, or is reasonably expected by the	**Comparable rate** • **Net mark-up on costs** - labour hire fees that result in the service entity deriving a net mark-up not exceeding 3.5% on the direct and indirect (note 1) operating costs associated with its on-hiring of the permanent staff.

	employee to be, equal to or greater than 12 months. • The service entity on-hires the staff to you for a nominated period under a hiring contract that sets out your respective rights and obligations regarding the staff. • You pay a service charge which is calculated at a rate specified in the hiring contract. • The service entity meets the costs of premises and equipment and employs its own managers and HR staff (who are not on-hired to you in relation to the service arrangement) who are responsible for recruiting, employing, administering and on-hiring the permanent staff. • The service entity, and no other entity, meets all the costs associated with carrying on its activities out and only out of the fees it earns. These include rent on its premises, purchase and hire of items of office	

	equipment, costs of its own office management and staff, advertising, hospitality and travel, insurance, legal expenses, leave entitlements, cleaning and maintenance, utilities, and depreciation.	
Recruitment	• The service entity undertakes staff search and recruitment activities on your behalf. • You pay the service entity a once-off success fee if you engage a candidate identified by the service entity. • The service entity maintains its own premises and equipment and employs its own managers and recruitment staff who are responsible for undertaking the search and recruitment activities.	**Comparable rate** • **Net mark-up on costs** – recruitment fees that result in the service entity deriving a net mark-up not exceeding 5% on the direct and indirect (note 1) operating costs associated with the recruitment activities.
Expense payments	• The service entity provides bill administration and payment service. • The service does not involve the provision of finance or other financial supply.	**Comparable rate** • **Net mark-up on costs** – a mark-up not exceeding 5% on direct and indirect (note 1) operating costs associated with

	Note: If finance is provided, the appropriate rate will have regard to individual factors including the cost of finance, and source of funds for the service entity and the terms of credit offered to you.	its expense payment activities.
Equipment hire	• The service entity owns the equipment. • The service entity leases the equipment to you on ordinary commercial terms.	**Comparable rate** • **Return on assets** – the hiring fee results in the service entity deriving a return on assets not exceeding 7.5% of the opening written down value of assets used in the hiring activity (note 2).
Rental	• The service entity owns or leases the property. • The service entity leases or subleases the property to you on ordinary commercial terms. • You do not provide any guarantees or undertakings for the service entity's borrowing obligations in relation to the property (if any) or for its obligations under the head lease.	**Comparable rate** • **Comparable market price** – the rent is at market rates (plus finder fees where appropriate).

Notes:

1. Indirect operating costs should be apportioned on a reasonable basis. For example, if the service entity provides both temporary and permanent labour hire services then its indirect operating costs should be allocated between the temporary and permanent hire functions in the same proportion as the temporary and permanent on-hired staff bear to each other.
2. The actual hiring fee charged by the service entity would generally also cover depreciation on the equipment, direct and indirect hiring costs in addition to this return on assets component. That is, the hiring fee will give the indicative return after allowing for these expenses.

Indicative rates

If you use the indicative rates below and no greater than 30% of the combined profits of the professional firm and the service entity (or service entities) is earned by the service entity (or service entities) due to the service arrangement, there is little risk of being audited because of the amount of the deduction claimed.

This is because we believe that the potential compliance risk would generally not justify audit activity where the rates are less than or equal to these indicative rates. This does not mean that we are satisfied that the indicative rates are in fact commercial benchmark rates.

Service fees charged above these levels may result in an audit of the service arrangement as would cases where there is no clear connection between the service arrangement and the earning of income by the business (refer to step 1).

If your arrangement involves fees and charges above these indicative rates and you are audited, you will be asked to explain why the fees and charges are higher and how they are connected with earning your business income. If the payments are considered to be grossly excessive and we adjust your claim, we will allow deductions based on what we consider to be the appropriate commercial benchmark rates in the circumstances. You will, of course, have rights of objection and appeal.

We provide indicative rates at a net mark-up on costs level for labour hire and recruitment services because net mark-ups provide a widely

accepted comparable measure of commerciality that is not dependent on the detail of the particular arrangement. These indicative rates are based on evidence we have found.

Indicative rates for gross mark-up on costs are based on all costs associated with providing the service being wholly met out of the service fee. If a service entity meets all direct and indirect operating costs associated with the activities carried out in providing its services out of the service fees and charges, a gross mark-up on costs at the indicative rate shown is not expected to represent a high compliance risk.

If you choose to rely on a gross mark-up on costs taken from the table in this guide, the type of expenses that are on-charged should be those that are directly attributable to the services or benefits provided. All other expenses of conducting the activities of the service entity should be absorbed or defrayed by the service entity out of the service fees charged. The mark-up rates that we accept from a compliance risk perspective are based on this approach.

Type of service or benefit provided	Fees and charges
Labour hire arrangements • Arrangements that are broadly in line with conventional service arrangements for the provision of labour hire services, that is arrangements that are not fundamentally different to arrangements with the characteristics described in the previous table.	**Indicative rate** (see note 4) • **Gross mark-up on costs** – labour hire fees that result in the service entity deriving a mark-up not exceeding 30% of salary and benefits of the on-hired staff paid by the service entity, provided that all direct and indirect (note 1) operating costs associated with the on-hiring of staff are absorbed by this mark-up. Operating costs would be expected to represent about 18% of salary and benefits (note 2). • **Net mark-up on costs** – labour hire fees that result in the service entity

	deriving a net mark-up not exceeding 10% on the direct and indirect (note 1) operating costs associated with its on-hiring of staff. See also note 3.
Recruitment • Arrangements that are broadly in line with conventional service arrangements for the provision of recruitment services, that is arrangements that are not fundamentally different to arrangements with the characteristics described in the previous table.	**Indicative rate** (see note 4) • **Net mark-up on costs** – labour hire fees that result in the service entity deriving a net mark-up not exceeding 10% on the direct and indirect (note 1) operating costs associated with its recruitment activities. See also note 3.
Expense payments • Arrangements that are broadly in line with conventional service arrangements for the provision of expense payment services, that is arrangements that are not fundamentally different to arrangements with the characteristics described in the previous table. **Note:** If finance is provided, the appropriate rate will have regard to individual factors including the cost of finance, and source of funds for the service entity and the terms of credit offered to you.	**Indicative rate** (see note 4) • Net mark-up on costs – expense payment fees that result in the service entity deriving a net mark-up not exceeding 10% on the direct and indirect (note 1) operating costs associated with its expense payment activities.
Equipment hire • Arrangements that are broadly in line with conventional service arrangements for the	**Indicative rate** (see note 4) • **Gross mark-up on costs** – the hiring fee results in a gross mark-up not exceeding 10% on the cost

provision of equipment hire services, that is arrangements that are not fundamentally different to arrangements with the characteristics described in the previous table.	to the service entity of the equipment with all relevant costs relating to the equipment being met by the service entity.
Rental • Arrangements that are broadly in line with conventional service arrangements for the provision of property rental services, that is arrangements that are not fundamentally different to arrangements with the characteristics described in the previous table.	**Indicative rate** • Comparable market price – the rent is at market rates (plus finder fees where appropriate).

Notes:

1. Indirect operating costs should be apportioned on a reasonable basis. For example, if the service entity and business share premises the rent paid on the premises should be apportioned between the service entity and the business. A reasonable basis of apportioning this cost would be based on the floor area of the premises used.
2. As a guide, it would be expected that such costs would not be less than 18% of the salary and benefits of the on-hired staff. If costs are below this level, we expect for the following year, that the gross mark-up on costs would be proportionally reduced or the proper costs of the service trust would come up to this level (or a combination of both). For each 1% that costs are less than 18% we expect the indicative 30% gross mark-up to be reduced by 1%. Relevant costs include accommodation, payroll tax, recruitment, training, supervision and personnel. For labour hire arrangements, the treatment of expenses in working out this gross mark-up on costs is set out below.
3. When applying this method, it is important that the costs of the service entity do not exceed the costs that are associated with the labour hire service. For example, we may adjust the amount if excessive or inflated costs are charged to the service entity by

related parties. For the purpose of this method, it is not essential for costs that are incurred by the service recipient that are partially attributable to the service entity to be dissected and apportioned to the service entity. Typical costs of this kind include rent, electricity and salary costs incurred by the service recipient where the service entity occupies premises or uses staff of the service recipient in conducting its activities. Any cost apportioned in this way would simply be charged back to the service recipient either at cost or within an acceptable mark-up. There is no additional risk in using this method if these costs have not been fully attributed and this can be overlooked in the interests of practical compliance and sensible administration.

4. These rates may not apply if greater than 30% of the overall profit of the group is earned by the service entity or service entities (see page 14 of this guide). These situations will be considered on a case-by-case basis.

You are at a low risk of audit if you are below these indicative rates and you keep documentation which is adequate to establish that your service arrangement is connected to the income earning activities of your business.

For the purposes of these indicative rates, the treatment of typical expenses for labour hire arrangements is shown below.

Labour hire arrangements

Expense type	On-charge		Absorb cost
	with mark-up	at cost	
Cost absorption pricing Direct salary and other employment costs connected with staff on-hired:	-	-	-
Salary of on-hired staff	-	-	-
Other remuneration costs, for example, superannuation, other benefits, sick leave, annual leave, long service	-	-	

leave, termination payments and other benefit accruals.			
Other employment related costs, for example, payroll tax, workers' compensation premiums, recruitment, training, supervision and personnel costs.	-	-	-
Note: apportioned on a reasonable basis if staff are not wholly on-hired.	-	-	-
All other direct costs	-	-	-
Salary and employment on-costs of service entity staff directly involved in the provision of the benefit or service.	-	-	-
Other direct costs like payroll services, other third party charges (for example, advertising, security checks), incidental expenses and disbursements attributable to the services provided like photocopying, postage, telephone.	-	-	Yes
Operating and financing expenses of the service entity	-	-	-
Costs of conducting the business of the service entity that are not attributable to the provision of the benefit or service under the service arrangement.	-	-	Yes

Note: Typically, labour-hire arrangements involve a mark-up based on the full employment cost of the on-hired staff with all other expenses met out of this mark-up. The treatment of expenses can differ from

this. However, the rate that we accept would be adjusted to take this into account

Calculating the mark-up

Generally, we will rely on the mark-up as calculated in the service entity's accounting records. In some cases, we may ask you to explain the way the mark-up has been calculated and we may adjust the mark-up rate before comparing it to the comparable market rates.

The calculated rate may not be appropriate where:

- it has been worked out on an incorrect basis, for example, the rate would be adjusted if it takes into account expenses not connected with the service provided or it double counts expenses already attributed in the calculation for other services
- expenses of the service trust are inflated
- expenses of providing the service are not paid by the service entity either for the full amount or within a reasonable period of time
- the accounts are not prepared in accordance with applicable accounting standards and generally accepted accounting practices, or
- the arrangement contains contrived features to artificially reduce the mark-up rate.

QC 18677

Case studies

Understand our view of the audit risk presented by the arrangements described in these case studies.

Last updated 17 November 2025

The following case studies provide our view of the audit risk presented by the arrangements described. Our audit program is described in the introduction of this guide. Those taxpayers with service arrangements that are categorised as highest risk will continue to be looked at over the next year as part of our current audit program. Other taxpayers

with service arrangements will have 12 months to review their arrangements, ending on 30 April 2007. The following case studies indicate how service arrangements can be conducted to minimise the risk of audit after this review period ends.

Labour hire activities

1. A labour hire arrangement where the payments are correctly calculated and reasonably connected to the business.

An accounting firm (the firm) provides various accounting and tax advisory services to the public and one of the firm's key costs is staffing. The firm contracts with a related service provider (the provider) to provide temporary professional and clerical staff to undertake short-term placements with the firm, on a needs-only basis.

The provider advertises for and identifies potential staff to be placed with the firm, checks their background and skills, and then checks their suitability with the firm. It is up to the firm to make the final decision as to which individuals, if any, they want to hire. If the firm decides to hire an individual, the provider will engage that person as a temporary employee and on-hire them to the firm in accordance with the hiring contract.

The hiring contract describes the work to be performed and the conditions attaching to the hiring assignment, including the responsibilities of the respective parties for issues such as performance feedback, occupational health and safety and workers' compensation. The service charges are calculated as a multiple of the hours worked and an hourly rate specified in the contract. The hourly rate specified in the contract is based on the salary, wages, and superannuation of the on-hired staff, marked up by 30%.

The provider has separately identifiable premises, for which it pays rent, and it owns computers, computer software, desks and chairs. The provider's payroll and human resource staff are employed as permanent employees and their activities are supervised by a manager who reports to the provider's board. The provider also incurs a range of expenses in undertaking its labour hire activities. For example, it incurs costs associated with advertising for and interviewing temporary staff, undertaking security checks and negotiating hire and employment contracts. The provider does not seek to pass any of

these fixed or operating costs back to the firm - the provider absorbs them out of the service charges it receives under the hiring contract. The provider does not receive any other economic support from the firm.

Case study 1: Operating costs for provider

Income	
Labour hire fees	$1,950,000
Expenses	
Salaries (including superannuation) of hired staff	$1,500,000
On-costs of hired staff	$100,000
Salary and on-costs of staff (non-hired)	$150,000
Depreciation	$15,000
Insurance	$15,000
Advertising	$25,000
Legal fees	$20,000
Rent	$20,000
Light and power	$10,000
Other costs	$5,000
Total costs	$1,860,000
Net income before interest and tax	$90,000
Net mark-up on costs (EBITA ÷ total costs)	4.84%

From an analysis of information available from independent parties in the labour hire industry, it is clear that independent labour hire firms also price these types of services by marking-up salary, and a range of

other expenses related to the individual placed with the client. The percentage mark-up can vary and is usually negotiated with the client, but a 30% mark-up on remuneration of the individual placed is in a range that represents a compliance risk we would not generally consider for audit.

Expenses that are met out of this mark-up on gross costs total $360,000 which represents 24% of salaries of the on-hired staff. We consider that this level of costs is indicative of an arrangement where the provider meets all the costs of providing the service. This provides additional support that the mark-up used is appropriate.

Also, on a net profit basis, an analysis of independent firms providing similar labour hire services reveals that a 4.5 – 5.0% mark-up on direct and indirect costs associated with the labour hire activity is typical. Based on this, the provider's net profit outcomes are not dissimilar to the profits of independent firms providing similar services.

From an operational perspective, it is clear that the arrangement gives the firm an efficient and flexible way to manage its staffing costs in an environment of changing workloads. If the firm does not have capacity to use a person then it is not required to take the placement. Equally, because the staff are employed by the provider on a temporary basis only, the provider is under no obligation to pay them when they are not on a placement.

In these circumstances, it is reasonable to conclude that the benefits delivered by the labour hire arrangement are reasonably connected to the business in the sense that they assist the firm's ability to produce income. It is also reasonable to conclude that the hire charges are not grossly excessive - both in terms of the gross mark-ups charged for the same or similar services by independent suppliers and in terms of the net profit outcomes achieved by independent suppliers.

The firm would be at **low risk** of a tax audit

2. A labour hire arrangement where the deductibility of payments is accepted

In an arrangement similar to case study 1, the provider instead charges fees based on a mark-up of 35% of the salary and benefits of the on-hired staff.

Case study 2: Operating costs for provider

Income	
Labour hire fees	$2,025,000
Expenses	
Salaries (including superannuation) of hired staff	$1,500,000
On-costs of hired staff	$100,000
Salary and on-costs of staff (non-hired)	$150,000
Depreciation	$15,000
Insurance	$15,000
Advertising	$25,000
Legal fees	$20,000
Rent	$20,000
Light and power	$10,000
Other costs	$5,000
Total costs	$1,860,000
Net income before interest and tax	$165,000
Net mark-up on costs (EBITA ÷ total costs)	8.87%

While the gross mark-up rate exceeds what we generally consider acceptable, a tolerable level of tax compliance risk is associated with arrangements that result in mark-up of up to 10% of all costs involved in providing the labour-hire service. Below this level, we consider that it would generally not be appropriate to conduct an audit to establish whether the payments made under the arrangement are grossly excessive in the particular case.

The firm would be at **low risk** of a tax audit.

3. A labour hire arrangement where the deductibility of payments is not accepted

An arrangement is similar to case study 1, but the firm provides its own staff and equipment to the provider to conduct its activities and also meets some of the operating costs of the provider.

Case study 3: Operating costs for provider

Income	
Labour hire fees	$1,950,000
Expenses	
Salaries (including superannuation) of hired staff	$1,500,000
On-costs of hired staff	$100,000
Salary and on-costs of staff (non-hired)	$0
Depreciation	$0
Insurance	$0
Advertising	$25,000
Legal fees	$20,000
Rent	$0
Light and power	$0
Other costs	$0
Total costs	$1,645,000
Net income before interest and tax	$305,000
Net mark-up on costs (EBITA ÷ total costs)	18.54%

While the gross mark-up rate is within the range of what we generally consider acceptable, the provider does not meet all of the costs of

conducting its activities. The costs met by the provider out of the gross mark-up reflect only 9.67% of the salaries and benefits of the on-hired staff and the arrangement results in a net mark-up on costs of 18.54%. We do not consider the claim under this arrangement to have been correctly calculated. It has features and produces results that we consider to exceed a tolerable level of compliance risk.

The firm would be at **high risk** of a tax audit.

4. A labour hire arrangement where the payments are not correctly calculated and may not be reasonably connected to the business

A professional firm (the firm) provides various accounting and tax advisory services to the general public and one of the firm's key costs is staffing. Assume a related service provider (the provider) undertakes a contract to provide the firm's entire professional and clerical staff on permanent placements.

The provider advertises for and identifies potential staff to be placed with the firm, checks their background and skills, and then checks their suitability with the firm. If the firm decides to hire an individual, the provider engages that person as a permanent employee and on-hires them to the firm in accordance with the hiring contract.

The hiring contract does not contain a description of the work to be performed nor the conditions attaching to the placement. For all practical purposes the firm controls and directs the day-to-day activities of the on-hired staff and all performance management issues are handled by the firm. The hiring charge is calculated by the provider marking-up the total employment costs of all its staff by 30% (including the staff on-costs). The provider supports the hire charge by reference to an old survey which documents the mark-ups on salaries charged by labour hire firms for short-term placements.

The provider has separately identifiable premises, for which it pays rent, and it owns computers, computer software, desks and chairs. It is not clear whether the provider's payroll and human resources (HR) staff have been on-hired to the firm. The hiring contract does not refer to the HR staff specifically but their activities are supervised by the firm's partners (free of charge). The provider also incurs a range of expenses in undertaking its labour hire activities. For example, it incurs costs associated with advertising for and interviewing staff,

undertaking security checks and negotiating hire and employment contracts.

Caste study 4: Operating costs for provider

Income	
Labour hire fees	$2,275,000
Expenses	
Salaries (including superannuation) of hired staff	$1,500,000
On-costs of hired staff	$100,000
Salary and on-costs of staff (non-hired)	$150,000
Depreciation	$15,000
Insurance	$15,000
Advertising	$25,000
Legal fees	$20,000
Rent	$20,000
Light and power	$10,000
Other costs	$5,000
Total costs	$1,860,000
Net income before interest and tax	$415,000
Net mark-up on costs (EBITA ÷ total costs)	22.31%

From an analysis of information available from independent parties in the labour hire industry, it appears that the gross mark-ups being applied and the type of costs to which those mark-ups are applied are not consistent with how independent labour hire firms would set prices for a labour hire activity of this nature. In particular, a service provider

would ordinarily be expected to absorb its own staffing costs out of the service fees and charges. In addition, gross labour hire mark-ups for short term labour hire arrangements are not generally considered a sound basis for pricing permanent staff hire arrangements (at least not without some adjustments).

In terms of a net profit analysis, even if it is assumed that the provider is providing services which are similar to those typically provided by independent labour hire firms, a 22.31% net mark-up on direct and indirect costs associated with the labour hire activity is grossly excessive. The net profit outcome achieved in this example is far higher than the net profit outcomes achieved by independent operators.

From an operational perspective, it is not clear that the arrangement relieves the firm of the substantive risks associated with the engagement of staff nor does it provide the firm with any additional flexibility in managing its staffing costs. By agreeing to a hire charge based on the provider applying a mark-up to all of its staffing costs, the firm is effectively liable for all of the on-hired staff's non-productive hours and for all staff recruitment, payroll and personnel costs.

In these circumstances, the labour hire charge appears to be grossly excessive when compared to the commercial benefits passing to the firm under the labour arrangement. The arrangement does not make objective commercial sense in the context of the firm's business operations (particularly if you compare the fees charged by the provider to the salary, on-costs and administrative expenses the firm would have incurred if it had employed the staff directly).

The firm would be at **high risk** of a tax audit.

5. A labour hire arrangement where the payments are not correctly calculated and may not be reasonably connected to the business

A small legal practice uses a related service entity to provide clerical and administrative services. The service entity employs a number of secretaries, including a spouse of one of the partners. The spouse is employed on a salary of $200,000 a year. All the other secretaries are employed on salaries of no more than $35,000 a year.

A cost mark-up comparable with independent labour providers is used in calculating the fees charged by the service entity. However, the

excessive component of the spouse's salary (that is, $165,000) is included in the amount marked up. The salary paid to the spouse does not appear to be correctly calculated and may not be connected to the business.

The firm would be at **high risk** of a tax audit.

Recruitment arrangements

6. A recruitment arrangement where the payments are correctly calculated and are reasonably connected to the business

A professional firm (the firm) enters into an agreement with a related service provider (the provider) to find professional staff suitable for permanent employment by the firm in the firm's business.

The provider undertakes search activities to identify staff who may be suitable for the firm's business. The provider also checks the background, skills and character of the candidates and provides a short-list to the firm with a recommendation for the firm's consideration.

Under the agreement, the provider is paid a once-off fee if the firm employs someone the provider has identified. The fee is equal to six weeks of the employee's starting salary package (the package is negotiated separately). None of the provider's costs are explicitly marked up. The provider is not paid if it cannot find a suitable candidate to the satisfaction of the firm.

The provider has separately identifiable premises for which it pays rent, and it owns computers, computer software, desks and chairs. The provider employs its own permanent staff and their activities are supervised by a manager who reports to the provider's board. The provider also incurs a range of expenses in undertaking its recruitment activities. For example, it incurs costs associated with advertising for and interviewing temporary staff, undertaking security checks and negotiating employment contracts. The provider does not seek to pass any of these fixed or operating costs back to the firm - the provider absorbs them out of the recruitment fees it receives from the firm. The provider does not receive any other economic support from the firm.

The fee paid to the provider is, in effect, a success fee. The provider is not guaranteed a profit from its recruitment activities. The provider's

profitability depends on the provider's ability to locate and engage suitable staff in a cost effective manner. The formula used to calculate the fee is comparable to those charged by independent firms providing substantially similar employee recruitment services.

Case study 6: Operating costs for provider

Income	
Recruitment fees – Based on salary packages for the staff successfully recruited by the provider and employed by the firm totalling $3,860,133.	$445,400
Expenses	
Staff salary and on-costs	$285,000
Depreciation	$15,000
Insurance	$15,000
Advertising	$25,000
Legal fees	$25,000
Rent	$45,000
Utilities	$10,000
Other costs	$5,000
Total costs	$425,000
Net income before interest and tax	$20,400
Net mark-up on costs (EBITA ÷ total costs)	4.8%

On a net profit basis, it seems reasonable to assume that a net mark-up of 4.8% on direct and indirect costs associated with the recruitment activity will yield the provider a net profit outcome that is consistent with the net profit outcomes achieved by independent firms providing similar services.

From an operational perspective, it is clear that the arrangement gives the firm access to specialist recruitment services. It relieves the firm of the responsibility for overseeing the recruitment activities and provides the firm with the certainty of a pre-determined cost structure for its recruitment activities.

In these circumstances, it is reasonable to conclude that the benefits delivered to the firm by the recruitment arrangement are reasonably connected to the business in the sense that they assist the firm's ability to produce income. It is also reasonable to conclude that the recruitment fees are correctly calculated - both in terms of the gross mark-ups charged for the same or similar services by independent suppliers and in terms of the net profit outcomes achieved by independent suppliers.

The firm would be at **low risk** of a tax audit.

7. A recruitment arrangement where the payments are not correctly calculated and may not be reasonably connected to the business

A professional firm (the firm) contracts with a related service provider (the provider) to find professional staff suitable for permanent employment by the firm in the firm's business.

The provider does not undertake the search activities required to identify staff who may be suitable for the firm's business. The provider contracts this function out to a third party recruitment firm (nominated by the firm). The third party recruitment firm charges a fee equal to six weeks of the new recruit's starting salary package (which is negotiated separately). The provider itself maintains a small, one room office and employs a part-time accounts clerk and a part-time secretary.

The recruitment fee charged by the provider is calculated as a 25% mark-up on all of the provider's costs associated with the recruitment activity, including but not limited to the recruitment fee charged by the third-party.

Case study 7: Operating costs for provider

Income

Recruitment fees	$684,250
Expenses	
Third party recruitment fees – Based on salary packages for the staff successfully recruited by the provider and employed by the firm totalling $3,860,133.	$445,400
Staff salary and on-costs	$50,000
Depreciation	$15,000
Insurance	$15,000
Legal fees	$5,000
Rent	$12,000
Utilities	$3,000
Other costs	$2,000
Total costs	$547,400
Net income before interest and tax	$136,850
Net mark-up on costs (EBITA ÷ total costs)	25%

From an analysis of information obtained from independent suppliers in the recruitment industry, a recruitment fee calculated on the basis of a gross mark-up on all of the suppliers' costs does not represent a market price for this kind of service. The effect is to guarantee the provider a profit. Ordinarily, the provider would be expected to absorb some of its expenses out of the recruitment fee.

In terms of a net profit analysis, even if it were assumed that the provider is providing services that are similar to those typically provided by independent recruitment agencies, a 25% net mark-up on direct and indirect costs associated with the recruitment activity appears to be grossly excessive compared against the net profit outcomes achieved by independent recruitment agencies.

From an operational perspective, while the provider has contracted with the third party recruitment firm and, as such, bears some risk on the arrangement, from the firm's perspective it has acted as little more than the firm's paying agent. As such, an independent party providing the same services as the provider would only expect to be able to extract a small fee from the firm above and beyond its own costs and the external recruitment firm's fee.

In these circumstances, the recruitment fee appears to be grossly excessive when compared to the commercial benefits passing to the firm under the recruitment arrangement and the fees may not be reasonably connected to the business.

The firm would be at **high risk** of a tax audit.

Hiring arrangements

8. A hiring arrangement where the payments are correctly calculated and reasonably connected to the business

A related service provider (the provider) enters into an agreement with a law firm (the firm) to rent the firm desktop computers for all staff over a 12 month period.

The agreement, which stipulates that the firm must keep the item insured and in working order, is consistent with other rental agreements in the computer equipment hire industry. The provider employs and supervises a part-time clerk and incurs minor administrative and legal expenses.

The firm pays a rental fee consistent with what other rental companies receive under substantially similar leases involving this type of equipment. The amount of profit the provider makes from the rental is similar to the profit made on the lease of similar assets by others in the business of hiring out equipment.

The firm would be at **low risk** of a tax audit.

9. A hiring arrangement where the payments are not correctly calculated and may not be reasonably connected to the business

A related service provider (the provider) enters into an agreement with a law firm (the firm) to rent the firm a desktop computer for its staff over a 12 month period.

At the same time, the provider enters into a commercial agreement with an external equipment provider (the equipment owner) for the rental of a desktop computer. The agreements are the same in form and substance and, in effect, are back-to-back agreements. Because the provider has no employees, both of these agreements are, in effect, negotiated by members of the firm and no other services are provided as part of the equipment hire arrangement. The actual agreement between the provider and the equipment owner is signed by the directors of the provider. The firm guarantees the provider's obligations under its rental agreement.

The fee charged by the equipment owner is negotiated on commercial terms. The terms and conditions are those generally included in business equipment hire arrangements. The contract price between the provider and the firm is 20% more than the price between the provider and the equipment owner.

The rate negotiated between the equipment owner and the provider is an independent commercial transaction, and represents a market price for the provision of this type of equipment over a 12 month period. While the firm may wish to rent the computer through the provider, there is no obvious commercial reason for the firm to pay an amount over and above that which it could have negotiated directly with the equipment owner. The fee may not be reasonably connected to the business.

The firm would be at **high risk** of a tax audit.

Rental arrangements

10. A rental arrangement where the payments are correctly calculated and reasonably connected to the business

A related service provider (the provider) enters into a lease of commercial premises from an unrelated third party. The provider then subleases half of the space to third parties and half of it to a chemist related to the provider (the business).

The provider's head lease from the head lessor is negotiated on normal commercial terms. Because of the volume of space being leased by the provider, the provider was able to negotiate a lower cost per square metre of floor area than would have been commercially possible if it had only leased the space needed for the sublease to the business.

The sublease from the provider to the business is on ordinary commercial terms for space of that nature and the rental is consistent with the market rent charged by unrelated parties for leases of office space of the same or similar volume. The business is not required to provide any guarantees and/or undertakings to the head lessor for the provider's obligations under the head lease.

The business would be at **low risk** of a tax audit.

11. A rental arrangement where the payments are not correctly calculated and may not be reasonably connected to the business

A related service provider (the provider) enters into a lease of new office space from an unrelated third party (the head lessor). The provider then subleases the office space to an associated firm (the firm).

The provider's head lease from the head lessor is negotiated on normal commercial terms. The sublease from the provider to the firm is on the same terms and conditions as the head lease although the provider charges a rent equal to the rent it pays the head lessor, plus 20%. The firm is also required to provide the head lessor with guarantees and/or undertakings in relation to the provider's obligations under the head lease.

While the firm may wish to rent the premises through the provider, there is no obvious commercial explanation for it agreeing to pay an amount over and above that which it could have negotiated directly with the head lessor. The fee may not be reasonably connected to the business.

The firm would be at **high risk** of a tax audit.

Expense payment arrangements

12. An expense payment arrangement where the payments are correctly calculated and reasonably connected to the business

A related service provider (the provider) pays utility and other expenses to third parties on behalf of the professional firm.

The benefit to the firm of this arrangement is the administrative function the service entity assumes, relieving the firm of the staffing and administrative costs associated with the physical payment of the expenses (for example, writing a cheque or arranging a direct debit to pay the bill).

The service entity is paid a fee calculated by reference to the time spent by service entity staff in carrying out this function. The staff costs are calculated at a rate which is correct for clerical staff and results in an acceptable net mark-up on all costs of providing this service.

The firm would be at **low risk** of a tax audit.

13. An expense payment arrangement where the payments are not correctly calculated and may not be reasonably connected to the business

A related service provider (the provider) pays utility and other expenses to third parties on behalf of the professional firm.

As in the previous example, the benefit to the firm of this arrangement is the administrative function the service entity assumes.

The service entity is paid a fee calculated by reference to the time spent by service entity staff in carrying out this function. The staff costs are calculated at a rate which is correct for clerical staff.

However, the service entity does not employ any staff. The payments are in fact carried out by a family member under the direction of one of the partners of the firm. There will be no commercial benefit to the firm from the arrangement if the service entity cannot demonstrate that it has clerical staff or, if it does have staff, if it cannot demonstrate that the staff has completed work for the firm. The fees may not be reasonably connected to the business.

The firm would be at **high risk** of a tax audit.

14. An expense payment arrangement where the payments are not correctly calculated and may not be reasonably connected to the business

A related service provider (the provider) pays utility and other expenses to third parties on behalf of the professional firm. The provider maintains a bank account and a staff member to make the payments under the arrangement. The firm transfers the required funds into the provider's account as and when payments are required. The service entity is paid a fee calculated at a 15% mark-up of the value of the expenses paid.

As in the previous example, the benefit to the firm of this arrangement is the administrative function the service entity assumes. The benefit is not the provision of the underlying services - the service entity is not in the business of delivering electricity, travel services and office space. Those services are provided by the electricity company and other third party suppliers.

In these circumstances, the service fee does not appear to be correctly calculated and may not be reasonably connected to the business.

The firm would be at **high risk** of a tax audit.

Medical practice arrangements

15. A practice management arrangement where the payments are correctly calculated and reasonably connected to the business

Three general practitioners (GPs) form a service entity to render a comprehensive suite of services to conduct a medical practice. The GPs provide their medical services through the practice. The service entity employs a practice manager, reception staff, clerical support staff and a nurse. It conducts the entire business of the medical practice, including premises, equipment, medical and office systems and supplies, patient records, general administration, marketing, legal and regulatory obligations (excluding the professional obligations personal to the practitioners) and incurs all of the expenses involved in running the practice. The medical practitioners focus solely on providing professional services to patients. Each practitioner pays a service fee that results in the service entity earning 40% of each

practitioner's gross fees from patient consultations and procedures and this is paid on the same basis by each of the doctors out of their separate fees. Arm's length practice management arrangements used in the medical profession are broadly similar to this arrangement.

In these circumstances it is reasonable to conclude that the benefits provided by the practice management company to the doctors is reasonably connected to the business carried on by each doctor, as it clearly supports the doctors' ability to provide medical services to patients and to earn income from clinical activities. Similar commercial arrangements providing a comprehensive suite of services to GPs exist in the medical profession by practice management companies.

Our examination of independent practice management arrangements shows that service fees of up to 40% of gross practice fees are likely to be appropriate regardless of the context and circumstances of a particular arrangement. As the fees in this arrangement are set at 40% we consider that the risk that the fees claimed are not deductible is low and any further examination of the fee level is not appropriate.

The practice would be at **low risk** of a tax audit.

As discussed in step 2, when using this comparable market prices approach it is important to consider any relevant differences between your service arrangement and those between independent enterprises. It is important to compare like with like. For the purposes of considering the commerciality of the service fees paid to the service entity, the nature of the relationship between the practitioners is not considered material (for example, whether they practice as partners or associates).

The service arrangements in the medical profession, which provide a complete suite of services for conducting the medical practice, are significantly different to conventional service arrangements where particular services are provided to a professional practice.

A service arrangement where a fee split of this kind is comparable involves the service entity effectively conducting the business of the medical practice. The service entity takes responsibility for all the expenses of the practice while the doctor is responsible for meeting the costs of indemnity, personal work related transport, and costs incurred in meeting their personal professional obligations. These include training and education, medical registration and membership of professional bodies. The arm's length practice management arrangements involve the practice company conducting the business

of the medical practice. While these arrangements involve a different business model, we consider that they are broadly comparable to those types of arrangements in the medical profession where a complete suite of services is provided for the purpose of considering the commerciality of the fees charged and the level of costs involved in running a medical practice.

We have observed that fees generally vary between 35% and 50% of gross practice fees depending on factors such as the location of the practice, cost structures and the relative bargaining position of the parties. Fees of up to 40% of gross practice fees will not generally be considered sufficient to warrant further examination. However, for fees over 40% you will be expected to be able to explain the reasons for the higher fee. The risk of being audited will increase according to the degree of divergence above 40%.

For rural and sole medical practitioners, costs can represent a higher percentage of revenues, and in these situations we would consider that service fees of up to 45% of gross practice fees would not warrant further examination.

16. A practice management arrangement where the payments are not correctly calculated and may not be reasonably connected to the business

A related service entity rents premises for a GP and employs a receptionist on-hired to the GP. Annual rental is $65,000 and the receptionist's salary is $38,000. The GP's gross fees from the practice for the year total $300,000, out of which the GP meets all other clinical, regulatory and practice and personal professional expenses which come to about $80,000. The service entity charges a service fee of 40% of gross fees earned.

As the service entity only provides limited services (the premises and receptionist), the GP continues to meet the general costs of the practice. This contrasts with the arrangement in the previous example (where the service entity effectively conducted the business of the medical practice by taking responsibility for all the expenses of the practice other than each of the GP's indemnity insurance and personal work related transport costs).

Unless there is evidence of a comparable arm's length arrangement, a share of gross consultation fees is not considered to be a correct basis of charging for these limited services. Charges for these services

should be in line with the approach in this guide for conventional service arrangements providing staff and premises.

The non-commercial nature of this arrangement is reinforced by the high percentage of gross consultation fee used in this case. Both this method and the rate used bear no discernible commercial relationship to the nature or value of the services provided. The income left in the hands of the GP is also considered to be substantially less than the income earned by other GPs, and the relative incomes of the GP and the service entity is not considered commensurate with the contribution to the profit of the medical practice.

The firm would be at **high risk** of a tax audit.

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Summary

A summary of the position you should now be in when reviewing your service arrangement.

Last updated 17 November 2025

After reading the rulings on service arrangements and following the steps outlined in this guide and in the decision matrix, you should be in a better position to review whether your service arrangement has an objective commercial connection with your business activities.

In short, if you can identify how the benefits passing to your business under the service arrangement assist you to conduct your business and you are confident that the service fees and charges are correctly calculated then they are probably deductible.

If, however, you cannot identify any commercial benefits from the service arrangement and/or you are not satisfied that the service fees and charges are correctly calculated then you cannot assume that they will be deductible.

In that case, the deductibility of the service fees and charges may depend on a range of other factors, including:

- the nature of your relationship with the service entity

- the reasons your business had for entering into the service arrangement, and
- the reasonableness of the fees relative to the benefits provided.

If you need any further assistance to resolve the deductibility of your service fees and charges you can contact the Tax Office or apply for a private binding ruling.

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More information

How to find access information and help about the deductibility of service fees paid to associated service entities.

Last updated 30 October 2026

For further information on the deductibility of service fees paid to associated service entities refer to taxation rulings IT 276 and TR 2006/2.

You can also phone our Business enquiries line. Specialist phone services available include:

- the Indigenous Helpline, which is a service for Aboriginal and Torres Strait Islander peoples
- call services for hearing or speech/communication difficulties
- the Translating and Interpreting Service to speak with us in a language other than English
- an overseas enquiries line if you are phoning from outside Australia.

You can send a written enquiry to:

Service Arrangements
Deputy Commissioner (Private Wealth)
Australian Taxation Office
GPO Box 9990
[Name and postcode of your capital city]

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If you follow our information and it turns out to be incorrect, or it is misleading and you make a mistake as a result, we will take that into account when determining what action, if any, we should take.

Some of the information on this website applies to a specific financial year. This is clearly marked. Make sure you have the information for the right year before making decisions based on that information.

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