THE TAX INSTITUTE

30 May 2018

Mr Will Day
Deputy Commissioner
Private Groups & High Wealth Individuals
Australian Taxation Office
PO Box 9977
CIVIC SQUARE ACT 2608

By email: william.day@ato.gov.au

Dear Will,

Allocation of profits in professional firms

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the issues currently being considered by the ATO professional Firms Working Group and in particular, the withdrawal of the *Assessing the Risk: Allocation of profits within professional firms guidelines* (**Guidelines**) on 14 December 2017.

In The Tax Institute's view:

- The Guidelines have operated well in the majority of cases where the core issue was the allocation of profits;
- The reasons given for the withdrawal of the Guidelines is due to what we submit are issues not core to the matters the benchmarks in the Guidelines are intended to apply to;
- These non-core issues can either be resolved by applying other relevant tax provisions already in the law or should be the subject of a separate piece of guidance.

Furthermore, uncertainty for taxpayers persists while the Guidelines remain withdrawn without replacement. Therefore, it is key that this uncertainty be resolved as soon as possible and preferably by 30 June 2018.

Review of the withdrawn Guidelines

The stated purpose of the Guidelines is to:

> "…explain how the Australian Taxation Office (ATO) will assess the risk of Part IVA applying to the allocation of profits from a professional firm carried on through a partnership, trust or company, where the income of the firm is not personal services income[1]".

The Guidelines apply to 'relevant arrangements within professional firms including, but not limited to, those providing services in the accounting, architectural, engineering, financial services, legal and medical professions[2].'

The Guidelines were intended to apply to all the 'professions' (eg law, accounting, architecture etc) to the extent that the governing / relevant professional bodies or statutory regulations permitted the carrying on of a business by an entity other than the individual professional practitioner (**IPP**).

When the Guidelines were developed, it was agreed between relevant stakeholders and the ATO that the Guidelines were simply guidelines to be used by the ATO to identify 'high risk' and 'low risk' taxpayers in respect of allocation of profits in professional firms. It was well understood the Guidelines could not address all possible legal structures and therefore the Guidelines should focus solely on the issue of allocation of profits within professional firms. Stakeholders agreed that this guidance could not be released in the form of a (binding) ruling given there was no legislative support or case law supporting the application of Part IVA of the *Income Tax Assessment Act 1936* (Cth) (**1936 Act**) to require that a certain amount of income should be allocated to an IPP and declared in the IPP's return.

Per the Guidelines themselves:

> "Taxpayers will be rated as LOW RISK (sic), and will not be subject to compliance action on this issue, where their circumstances indicate they meet **one** of the following guidelines regarding income from the firm, income being salary, distribution of partnership or trust profit, distributions from associated service entities, dividends from associated entities or any combination of these. **However, where compliance issues other than the alienation of income issues discussed within these guidelines are evident taxpayers will be rated as higher risk**." [Emphasis added]

On this basis, if one of the benchmarks is satisfied, the risk of the taxpayer being subject to review or audit should be reduced.

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[1] Refer to the second paragraph of the Guidelines.

[2] The Guidelines note later under the heading 'Further general guidance on the Benchmarks' that the guidelines do not apply to all professionals or to any non-professionals and goes on to refer to the reason for this as being how the structure of practices in certain 'thought related' professions comes about. This is confusing.

In The Tax Institute's view, the Guidelines have so far operated well in the majority of ordinary cases anticipated to fall within the application of the Guidelines.

Discussions with the ATO

The current discussions with the ATO regarding the Guidelines are focused on the numerous issues listed below that are either not relevant to determining profit allocation in a professional practice or not particular to a professional practice. These include:

- financing arrangements;
- trust law accounting/tax differences;
- CGT Small Business concessions;
- Self-Managed Superannuation Fund Investments;
- business sales; and
- disposal of a partnership interest.

These concerns raised by the ATO in respect of the operation and application of the Guidelines are broadly centred around tax issues common to all taxpayers and are not particular to professional firms. While such factors may contribute to determining whether a taxpayer may be regarded as higher risk (per the Guidelines themselves as noted above), these are compliance issues that are not related to the issue of the allocation of profits within professional firms.

Since their introduction, members' experience is that the Guidelines have broadly been accepted and actually encouraged and resulted in practical compliance with the requirements of the Guidelines to ensure they do not risk facing an ATO review in relation to their professional profit allocation.

Focus of the current review

In order for the current review to progress, the focus of the current ATO review needs to be squarely on whether the Guidelines still deal with the issue of the allocation of profits in professional firms. In our view, the issues identified by the ATO are not core to the issue of 'allocation of profits' and can either be resolved by applying other relevant tax provisions already in the law or should be the subject of a separate piece of guidance.

Given the amount of effort put in to have developed a practical, workable set of Guidelines in the first place, The Tax Institute cautions against simply discarding the current Guidelines and starting again. Rather, any changes required to the Guidelines should be minimal to preserve the workable solution that took so long to arrive at in the first place.

The Guidelines should not be used to address:

- structures or restructuring transactions that are unusual or out of the ordinary; or
- general tax issues that are not specific to dealing with the allocation of profits in professional firms.

In this regard, any review of the existing Guidelines should be well considered and limited to the original purpose of the Guidelines. Issues relating to structures on the periphery or tax issues unrelated to the allocation of profits should be dealt with separately.

Issues List

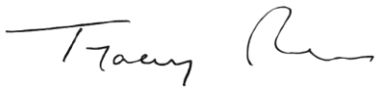
While we consider that the review of the Guidelines should only focus on issues relevant to the allocation of profits in professional firms per our comments above, we provide our comments in the Appendix on the issues contained in the Issues List provided to the ATO Professional Firms Working Group in early April.

Conclusion

The Tax Institute believes that the Guidelines in their current form have achieved a high degree of compliance by the professions and should not be unnecessarily disturbed by trying to broaden the application of the Guidelines to issues unrelated to the allocation of profits within professional firms. They serve their purpose well of identifying 'high risk' and 'low risk' taxpayers in respect of the allocation of profits in professional firms. It is well-accepted that the Guidelines are not a sanction for non-compliance with other parts of the tax legislation. Extraneous issues arising that may affect the taxation of profits from professional firms should be dealt with separately.

If you would like to discuss any of the above, please contact either myself or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours faithfully,



Tracey Rens
President

APPENDIX – Issues List

1. ***Issue 1 – potential application of Part IVA to restructures/arrangements of equity holdings in a professional firm with one or more of the following features:***

a) Financing arrangements relating to non-arm's length transactions

What does the ATO mean by a 'non-arm's length transaction'? In any event, we consider that there should be a carve out for transactions at fair market value, otherwise all related party transactions may unnecessarily be caught.

We note this issue affects other businesses, not just professional practices. If there is a particular concern the ATO has, that issue should form part of a broader review outside of the review of the Guidelines.

b) Amortisation leading to differences between tax and accounting income

If the ATO is concerned with the amortisation of goodwill arising on the restructure of a professional practice which gives rise to differing tax and accounting outcomes, this issue arises as a result of using a trust in the structure. It is not related to the allocation of profits in a professional firm and is likely to arise in any business structure that uses a discretionary trust.

To the extent that the amortisation is predominantly driven to gain a tax benefit, then Part IVA will address this. To the extent that the trust deed specifically requires the amortisation of an asset or the application of generally accepted accounting principles/accounting standards in Australia require the asset to be amortised or impaired tested, this requirement should not have any bearing on the principles outlined in the Guidelines.

c) Multiple assignments/disposals of an equity interest

It is understood that multiple assignments/disposals of an equity interest in a partnership is used as a way to access the Small Business CGT concessions. If so, this is a wider issue rather than an issue specific to a professional practice.

We suggest the ATO work this issue through to the actual outcomes before flagging this as problematic. Per the case study provided to the ATO Working Group in April, the end result is that simply more money is put into superannuation, not less assessable income. This does not appear to be an outcome of itself the ATO should be concerned with from a Part IVA perspective.

d) Assignments/disposals of an equity interest to a self-managed superannuation fund

This is a superannuation fund issue and an issue not specific to professional practices. This issue is likely already dealt with under the myriad of superannuation rules (such as the Sole Purpose Test and the In-House Asset rule that deal with non-permitted SMSF investments).

e) Assignments by non-equity principals

It is unclear what asset would be assigned in these circumstances. A non-equity (fixed draw) partner would have an interest in the partnership typically limited to a right to receive a fixed amount of income. That partner could hold that interest as trustee, by way of nomination or declaration of a trust over that interest, rather than there being an 'assignment' of income.

f) Assignments where the arrangement is not on 'all fours' with the principles of *Everett*[3] and *Galland*[4].

In *Income Tax Ruling IT 2330*, the ATO held the view at paragraph 19 that neither section 260 nor Part IVA of the 1936 Act would apply to a 'no strings' attached assignment of partnership interests of the same nature as the interest assigned in *Everett*. With the introduction of the Guidelines, from 1 July 2015 this view was determined to no longer apply to a 'no strings attached' disposition of a partnership interest that was on 'all fours' with the facts in *Everett* and in fact Part IVA could apply to such an assignment in appropriate cases.

The original test required the assignment of the partnership interest to be 'of the same nature' as the assignment in *Everett*. Requiring the assignment to be on 'all fours' with *Everett* is, in our view, a narrowing of the test. In any event, this test is problematic as it only covers one type of transaction, being an assignment of a partnership interest.

In our view, the test for determining whether Part IVA could apply to a transaction should be whether or not the assignment of the partnership interest occurs at market value, not whether the transaction is on all fours with the assignment in *Everett*. We suggest this on the basis that the Commissioner has demonstrated that he is more concerned with Everett assignments made for market value consideration (where subsequent to the transfer, the trust assigned the partnership income rights refinances[5]) than Everett assignments for no valuable consideration[6]. We would have

[3] *FCT v Everett* 80 ATC 4076

[4] *FCT v Galland* 86 ATC 4885

[5] In this case, a partner assigns their income rights to a trust for market value. A debt is created between the trust and the partner and booked and market value in the accounts. The trust refinances the debt (by borrowing from a bank for which the interest payments are deductible) and repays the partner who may then pay off a home loan (for which interest payments are not deductible). In this case, the Commissioner considers that a tax benefit arises for the trust due to the interest deductions arising following the Everett assignment.

[6] In this case, no consideration or inadequate consideration is provided for the Everett assignment, so that no transaction is recognised in the accounts. Market value is deemed to apply for CGT purposes with CGT consequences following.

thought the Commissioner would have been more concerned with the latter and would prefer to see an assignment for valuable consideration at market value.

2. *Issue 2 Application of Part IVA to restructures of professional firms after the introduction of the Guidelines in 2015 and their ongoing operation*

a) Restructures of professional firms

To apply Part IVA to a simple restructure where transactions take place at market value, in the most basic case the likely 'tax benefit' would be that the person who disposed of the asset (possibly for a capital gain), would no longer derive assessable income from holding that asset. This outcome is no different to that which arises to any taxpayer who sells an income producing asset to a related party.

This outcome has been held not to be problematic as long ago as Purcell's case[7] and also in a professional practice context in *Everett* and *Galland's* case. This approach also gives rise to different treatment (and therefore a further difficulty) for:

- newly established practices;
- newly appointed "partners/IPPs", and;
- existing practices/partners restructuring.

b) Ongoing operation of the structure

If the Commissioner's premise is accepted, being that some part of business income needs to be derived personally by a professional, then the Guidelines regarding profit allocation at least provide some certainty between what would be regarded as 'low risk' and 'high risk' taxpayers in relation to their profit allocation.

While it is open to the Commissioner to apply Part IVA in the circumstances where he considers the profit allocation of business income from a professional firm is inappropriate, there is currently no case law precedent to support this. A case of this nature succeeding may overturn the practical outcomes currently being achieved by the application of the Guidelines.

3. *Issue 3 – ATO view Products*

To the extent that both the Guidelines and other ATO view products also apply to the allocation of profits by a professional firm, the Guidelines should clearly state that all ATO guidance products relevant to a particular situation should be satisfied before a taxpayer is able to avail themselves of the Guidelines. For example, the *Your service entity arrangements* publication (**Service entity guidance**) also applies to service entity arrangements. Therefore, a taxpayer must have regard to both the relevant applicable benchmark in the Guidelines as well as the Service entity guidance to determine the appropriate amount of profit allocation that can be made to the service entity.

[7] *DFC of T v Purcell* (1921) 29 CLR 464

4. *Issue 4 – Non-equity partners, hybrid partners and partners who transition from being employees to equity partners*

Non-equity partners are typically entitled to a fixed draw amount of practice profits, but are also jointly and severally liable as partners. However, we are unclear what the ATO's concerns are in relation to non-equity partners and the applicability of ATO view products.

It is not clear what is meant by the reference to 'hybrid partners' or partners who transition from employees to equity partners (typically, an employee of the partnership who becomes a partner in the partnership usually becomes a non-equity partner first). We require further explanation of what the ATO's concerns are here before we are able to comment.

5. *Issue 5 – Professional Practice Structures isolated to only having partners with all assets and employees held in a separate service entity*

The primary guidance for what is a permissible structure for a professional practice structure is drawn from its governing professional body, or relevant legislation (eg the *Legal Profession Acts* for lawyers). If there are no restrictions, then commercially it may make sense for the partners to be isolated in one entity and other things, such as employees and assets to be contained in a separate entity.

For example, law firms usually have all the professional employees (ie lawyers) in the same entity as the partners (ie the IPPs). Only non-professional staff (such as administrative support staff) would usually be allocated to the service entity. In this regard, there should be no issue for law firms.

Accounting firms typically have a much more diverse set of requirements to follow including:

- Partners in the firm undertaking statutory audit are usually appointed in their personal capacity, though this appointment can be undertaken though a corporate structure;
- Partners in the firm are usually appointed in their personal capacity to an insolvency;
- Financial planning (AFS Licences) may be held through a corporate structure;
- Tax Agent registration can be held by individual partners as well as the firm;
- Requirements of the accounting professional bodies in relation to permitted structures.

If an accounting firm complies with any of the above, and has a practice structure that is legally effective, then prima facie there should be no issue with the firm having its employees in a separate entity to the partners. This may make good commercial sense, particularly if a partner is sued, as the partners only are jointly and severally

liable. The claim may be then limited to the partnership entity, whereas a separate entity containing the employees and infrastructure could potentially continue to carry on the 'business'.

6. *Issue 6 – Form and substance of the suspended Guidelines*

The source of the four points raised as 'concerns' by the ATO is unclear. These concerns seem to focus on the form and substance of the suspended Guidelines with a particular focus on the benchmarks contained in the Guidelines.

In The Tax Institute's view these concerns are largely unfounded. The reasons for our view are set out below:

- Concerns raised by a number of parties (including taxpayers and the ATO) demonstrate a misinterpretation of the purpose of the Guidelines;

- The benchmarks are specifically designed for and actually do cater for the differences within professional firms. They are not, nor were they intended to be, a 'one size fits all', but in fact are the converse in that firms of all sizes can fit within the Guidelines;

- The first benchmark (the 'equivalent remuneration' test) caters for firms of all sizes and in all different locations as it looks to the firm's highest remunerated employees to ascertain within the actual commercial setting (of the firm itself), the relevant benchmark of the highest paid employees. The Commissioner's premise for the concern raised is that some part of the practice business income must be derived by an IPP personally. While we do not agree with this premise, if this premise is accepted, then this benchmark is the most suitable measure to look at rather than considering what the IPP would otherwise receive as an employee of the practice (being the highest level of firm remuneration) to ascertain what part of the business profit may relate to personal exertion of the IPP;

- The '50% entitlement' test is a simple test that is easily applied and is efficient in terms of ensuring compliance and providing certainty. In fact, to achieve practical compliance with the guidelines (as well as a certain level of firm control of partners/IPP affairs), a number of firms ensure through their practice structures that 50% of the business income is derived by the IPP personally, limiting profit allocation away from the IPP to 50% only;

- The 30% tax rate test was introduced to align the taxation of the business profits of professional firms to the corporate tax rate. This test has a simple practical basis in that it:

    - recognises that some firms will retain profits – such as listed as incorporated legal practices; and

- requires the IPP to achieve at least a 30% tax rate. This broadly aligns to around $210,000 gross assessable income from the practice. After $25,000 in superannuation is deducted as well as, say $5000 of other personal tax deductions, this leaves an IPP typically deriving, say, $180,000 personally, resulting in an average tax rate of 32%.

- As the three benchmarks are applied at the IPP level, the Guidelines provide three simple measurements allowing flexibility for the IPP to best determine how to comply with the Guidelines. Each benchmark has benefits and drawbacks. For example, the determination of an arm's length equivalent remuneration amount for the personal exertion of an IPP may be difficult given the skills, location of where the services are provided and availability of market/comparable data. The use of the 50% entitlement test may provide a quicker and cheaper alternative.

- We have not seen evidence of the benchmarks being 'widely misquoted as indicators of acceptable risk parameters' in cases that do not involve professional firms. Please provide us with examples of this to evidence this concern and we may be able to assist the ATO to address this concern.

- The Guidelines do not clearly define what a 'professional firm' is, therefore it may be possible for non-professionals to also consider that the Guidelines could apply to them. As noted above, the Guidelines apply to 'relevant arrangements within professional firms including, but not limited to, those providing services in the accounting, architectural, engineering, financial services, legal and medical professions. The Guidelines note later under the heading 'Further general guidance on the Benchmarks' that the guidelines do not apply to all professionals or to non-professionals. The reason provided for this is that 'the structure of professional practices in certain 'thought related' professions (eg accounting, law, medicine) is unique and has been driven by a combination of factors' - which are then listed in the Guidelines. This is confusing and does not make it clear to which taxpayers the Guidelines apply. This should be clarified in the Guidelines.

- The Guidelines require that business income be derived through a legally effective structure. The benchmarks are then intended to be a 'bright line' test such that so long as a taxpayer meets one of them, they should be regarded as 'low risk'.

7. *Issue 7 – CGT Treatment of assignment of a partnership interest on the exit of a partner i.e. CGT Event C2.*

The above assumes that on exit, a partner will abandon or surrender their partnership interest. This appears to be at odds with *Income Tax Ruling IT 2540*, which looks at disposals of an indivisible interest in each and every partnership to ongoing partners, (the 'fractional interest' approach).

In these circumstances, it would appear that CGT Event A1 would typically be relevant, in that there has been a part disposal of an interest in each and every underlying partnership asset. Therefore, we query why CGT Event C2 is contemplated.