



THE TAX INSTITUTE

16 August 2018

Mr Simon Webster
Director
Professional Firms
Private Groups & High Wealth Individuals
Australian Taxation Office
PO Box 9990
MELBOURNE VIC 3000

By email: simon.webster2@ato.gov.au

Dear Simon,

Allocation of profits in professional firms – Gateway issues

The Tax Institute welcomes the opportunity to make a further submission to the Australian Taxation Office (**ATO**) in relation to the issues currently being considered by the ATO Professional Firms Working Group. Our submission relates to the following three documents (**Draft Guidance**) issued for consultation to the ATO Working Group on 28 June 2018:

- Definition of professionals;
- Commercial Rationale; and
- High Risk Factors.

We have extracted a copy of the Draft Guidance issued by the ATO in relation to the above in the Appendix.

The Tax Institute's own working group met with the ATO on 2 August 2018 to discuss the Draft Guidance. We provide further comments on the Draft Guidance below.

Summary

The Tax Institute considers that the "Assessing the risk: allocation of profits within professional firms" guidance as issued in 2015 should be maintained in the main. Additional information should be included in the guidance in relation to the three 'gateway' issues the ATO has identified as listed above.

Our comments in our submission are designed to assist the ATO with the production of the revised guidance which maintains the three benchmarks (the 'equivalent remuneration' benchmark, the '50% entitlement' benchmark, and the '30% effective tax

rate' benchmark') and builds in guidance for the gateway issues identified for resolution during the consultation process throughout 2018 (ie 'definition of professionals', 'commercial rationale' and 'high risk factors').

Discussion

1. Overall comments

We understand from our discussion with the ATO that the intention is that the proposed revised guidelines are to act as an indication of when compliance resources are likely to be applied by the Commissioner to arrangements involving allocation of profits in professional firms and to what kinds of arrangements.

We consider each piece of Draft Guidance separately below.

2. Definition of professionals

- The current approach risks creating an artificial distinction in the tax treatment between two businesses/taxpayers providing similar services – one being treated as a professional and subject to the guidelines, the other not. For example, an accountant providing business advice to clients compared to a self-style business advisor/business coach, or an architect as compared to an interior designer. The taxpayer that is regarded as a 'professional' will be afforded the protection of the proposed guidelines and will be required to adhere to the parameters set out in the guidelines, and the other will not. Accordingly, different tax outcomes may arise.
- The ATO representatives confirmed during our discussion on 2 August 2018 that it is not intended that different outcomes arise. We have suggested some amended wording to this Draft Guidance to address this issue (refer to the Appendix).
- The term 'professional' is not a defined term for tax law purposes and as such the ATO should not try to define this term, though they may wish to make reference to other resources that do. We refer to the guidance on the Professions Australia website¹ and the Professional Standards Councils² regarding what is a 'profession' and what is a 'professional' by which the ATO may wish to be guided. We note that reference is made to this guidance; however, the points drawn out by the ATO, in particular the second bullet point relating to the sharing of income, is not contained in that guidance.

¹ <http://www.professions.com.au/about-us/what-is-a-professional>

² <https://www.psc.gov.au/what-is-a-profession>

- It is also not clear if all factors need to be present for the individual/firm to be regarded by the ATO as a professional/professional services firm, or whether some factors are sufficient, or if some factors carry more weight than others.

3. Commercial rationale

- The term 'commercial rationale' is a subjective term and should be removed from the guidelines. We would suggest this gateway is replaced with a form and substance requirement. We have set out example wording in the Appendix significantly amending this section.
- There is no requirement under the tax law for an arrangement to be commercially driven to be legitimate. It is not appropriate to introduce such a test into the guidelines. The guidelines are intended to provide practical guidance for compliance, not create further uncertainty which the concept of 'commercial rationale' test introduces.
- The 'commercial rationale' test is also inconsistent with statements in existing ATO guidance (eg paragraph 19 in IT 2121 and paragraph 16 in IT 2330).
- If the ATO's concern is about sham transactions entered into for the purpose of allowing taxpayers to avail themselves of the guidelines, then this matter should be expressed in that manner.
- Should the ATO choose to retain the concept of 'commercial rationale', it is important that the example included in the first bullet point regarding improved income production is not read so as to limit the generality of the term 'commercial rationale'.
- We query the relevance of the fourth bullet point as we consider that how other parties approach the question of structure is only a weak indicator at best of whether the structure commercially suits particular circumstances and is likely to "enhance, assist or improve your ability to produce income or make profits".
- It would be useful if the ATO could include some examples in the guidance of acceptable circumstances for common situations encountered by professional firms, for example the ordinary circumstance of when an individual first becomes a salaried / fixed draw partner and then progresses over time to become an equity partner. This would assist taxpayers to understand what are the extraordinary circumstances to which the ATO is likely to apply compliance resources.

4. High Risk Factors

The concept of excluding high risk taxpayers from the guidelines is a reasonable one. However, the document does not set out sufficient detail to really understand where the Commissioner's concerns stem from. We consider each high risk factor in turn below.

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

- The presence of financing should of itself not be considered a high risk factor. There should be no difference in the outcome whether the finance came from a related party or an unrelated third party. We note the ATO representatives noted in our discussion that the presence of related party financing is regarded as a 'risk' indicator. It would be useful if the ATO could confirm that the presence of unrelated third party financing (eg from a bank) is not regarded by the ATO as a 'risk' indicator.
- In relation to the financing arrangements factor, if the same interest had been sold to an arm's length party, the Individual Professional Practitioner (**IPP**) would expect to receive market value consideration and the purchaser would, if they did not have the funds available, use debt to fund the purchase price. Why is it any different if the same arrangement occurs, but in relation to a transaction between associates? Is the Commissioner suggesting that the IPP should enter into the transaction other than on arm's length terms? Why do we not use existing guidance on interest deductibility for related party refinancing, for example *Re Taxation Appeals [1991] AATA 1; 22 ATR 3001*, where Part IVA was held to apply.

b) Exploitation of difference between accounting standards and taxation law

- In relation to tax and accounting differences, more detail on the supposed exploitation needs to be supplied to enable taxpayers to distinguish between acceptable and unacceptable situations. For example, very large differences between accounting and tax incomes will arise for many practices in relation to the timing of when work in progress (**WIP**) is recognised as income. A worked example would be useful to show an acceptable, and an unacceptable, situation.
- The ATO representatives indicated in our discussion that in fact items such as WIP and employee leave provisions are not meant to be included in this factor.
- It would be useful if examples that relate to standard variations between accounting and tax treatment were included in the guidelines so taxpayers know that when they are doing something that is out of the ordinary, they will not be able to avail themselves of the guidelines.

- Please refer to the Appendix for some suggested amendments to this factor.

c) Arrangements that are materially different in principle from Everett and Galland

- Salaried / fixed draw partners are in essence partners and should in principle not raise concerns with the ATO. Arrangements that involve disguising an individual employee as a 'partner' should really be the only arrangements of concern here.
- On this basis, we have made some significant changes to the wording of this factor in the Appendix to remove the references to the *Everett*³ and *Galland*⁴ cases and draw out the ATO's concern, being the assignment of income by an individual whose relationship to the partnership is more akin to that of a contractor or employee.
- Retaining references to the *Everett* and *Galland* cases are unhelpful in explaining the ATO's main concern here.
- We also note that a number of professional firms can operate through non-partnership structures and therefore are unlikely to be affected by this factor.

d) Multiple assignments/disposals

We understand that this issue as it affects partnerships will likely be dealt with legislatively in accordance with the 2018-19 Federal Budget announcement⁵.

In relation to other entity types, the benefit appears to be that additional superannuation contributions are made, rather than an immediate reduction in a tax liability *per se*. However, no tax difference arises by virtue of the multiple assignments. In addition, the requirement to have a significant individual will likely limit the ability to achieve the purported benefits in any event.

e) Arrangements that misuse the superannuation system including assignments or disposals of interest to associated SMSFs

- If an arrangement complies with the *Superannuation Industry (Supervision) Act 1993* (Cth) and associated regulations, we consider that the ATO should not have any concerns with arrangements involving superannuation funds. Should the arrangements breach these rules in any way, then this would obviously be a relevant concern for the ATO and such arrangements should not be able to avail themselves of the guidelines.

³ *FCT v Everett* 80 ATC 4076

⁴ *FCT v Galland* 86 ATC 4885

⁵ 'Tax Integrity – enhancing the integrity of concessions in relation to partnerships'

- We note that there will be few arrangements that would overcome the related party tests under the In-house asset tests.
- We query the necessity of dealing with this particular issue in the revised guidance.

5. Suggested amended wording for the Draft Guidance

Having made the comments above, we have suggested some wording in the Appendix that could be inserted at the beginning of the Draft Guidance and which may help contextualise the revised guidance the ATO will issue. We have also made amendments to various parts of the Draft Guidance for the ATO's consideration.

We hope this will assist in reflecting the ATO's concerns that have led to the issue of the revised guidance while maintaining alignment with the relevant tax legislation and its proper administration.

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,

A handwritten signature in black ink, appearing to read 'Tracey Rens', with a stylized flourish at the end.

Tracey Rens
President

APPENDIX

Insert at beginning of Draft Guidance

“This Guidance is intended to apply to Individual Professional Practitioners (IPP) who carry on a business either on their own behalf or through other entities that comply with the regulatory requirements that allow the entity to conduct an enterprise providing a professional service⁶.

It should be noted that the ATO has issued rulings and other publications relating to specific professions and/or the conduct of those enterprises. This guidance does not replace those specific publications and should not be used as a substitute for the views expressed in those publications. Similarly, to be covered by these guidelines, an IPP must not fall within the income tax legislative requirements for Personal Services Income (PSI) set out in Part 2-42 of the *Income Tax Assessment Act 1997* (Cth).

This Guidance has been issued for the purposes indicating where the ATO is likely to commit compliance resources in relation to IPPs and their related entities sharing in the profits of professional practices.

Risk Assessment

1. Low Level of risk

The ATO will consider IPP to have a low risk of escalation to audit if the profit derived by the IPP from the conduct of the professional practice meets one of the 3 following benchmarks:

[Insert details of the three existing benchmarks]

This does not mean that all ‘low level of risk’ IPPs will not be reviewed for compliance. Other selection processes may escalate the taxpayer for review depending ATO emphasis in respect to the relevant period. For example, review of rental property income, travel and motor vehicle claims.

2. Higher level of risk leading to review

The following circumstances, will lead to the possibility of further review of an IPP even where one of the three benchmarks above is met:

⁶ The ATO may like to exclude certain professions.

- 1) A transaction or restructure which is in the ATO's view designed to bring the IPP or related entity within a lower risk category but where the IPP or related entities have not dealt with the income tax consequences of disposals or acquisitions of the relevant interests in the Professional Practice.
- 2) The use of a Superannuation Fund to hold an interest in a Professional Practice where a related party of the fund is or was involved in the conduct of the enterprise.
- 3) Financing arrangements for interests in a professional practice where those arrangements seek to replace non-deductible debt with deductible debt in circumstances such as those demonstrated in *Re Taxation Appeals [1991] AATA 1; 22 ATR 3001*.
- 4) Arrangements that seek to specifically exploit differences between accounting and tax treatments such that a tax benefit is derived. Normal differences between tax and accounting treatment such as provisions for employee entitlements or timing related to the realisation of Work on Progress are excluded.

Further details are below.”

[Suggested edits are in **red text** below]

Definition of professionals

The term 'profession' is not defined by tax legislation. We consider that for the purpose of this guidance, the definition of 'profession' provided by Professions Australia is applicable. ~~and is limited to the principles below.~~ **In principle, indicators of a profession are:**

- Those who are required to be accredited and adhere to ethical guidelines in order to enter into and maintain practice in the relevant field.
- ~~There are restrictions on the structures that can be adopted by the practitioners' within that field and/or in relation to the sharing of income from a practice with persons who are not accredited.~~
- Those who are accepted by the public as possessing special knowledge and skills in a widely recognised body of learning, derived from research, education and training at a high level and who are prepared to apply this knowledge and exercise these skills in the interest of others.
- Their behaviour and practice is beyond the personal moral obligations of an individual.

- They uphold a high standard of behaviour in respect to the services provided to the public and in dealing with professional colleagues.

It is recognised that some individuals and businesses that would not be considered professionals based on the above guidance nevertheless provide similar services to those are traditionally regarded as 'professionals' or being a member of a profession. The Allocation of Profits in Professional Firms guidance is intended to apply to these persons as well, such that comparable tax outcomes are achieved by people in comparable circumstances.

~~Commercial Rationale~~ *Form and Substance*

In order for an arrangement to be considered under these guidelines, the arrangement must **meet thresholds relating to its form and substance**. ~~be commercially driven. In assessing the rationale regard~~ **Regard** should be given to the following factors:

- the arrangement is properly legally documented and implemented;
- operating in a manner consistent with the scope and terms of the relevant constituent documents;
- the legal form and documentation are consistent with the economic substance of the arrangement;
- transactions with related parties are undertaken on arm's length terms.

Examples of behaviours which would not satisfy the form and substance thresholds include:

- Service entity arrangements that do not fit within the ATO guidelines on the operation of service entities;
- Distributions of profit that are made in a manner that is not consistent with the legal structure that is in place;
- Profit that is shifted between entities through transactions where arm's length prices are not applied; and
- Restructure transactions where the legal and tax outcomes of the restructure are not recognised by the taxpayer.

~~• there is a genuine commercial rationale for the arrangement and the arrangement achieves that end. For example, the arrangement is likely to enhance, assist or improve your ability to produce income or make profits, and the commercial benefits asserted to be achieved by the arrangement are justified. The arrangements must also be appropriately evidenced. For example, the mere assertion of 'asset protection' alone for an IPP is not sufficient if the arrangement does not actually provide improved asset protection.~~

~~• there are any changes that could be expected to result from the arrangement in the relevant business operations that have not so resulted. That is, there is a~~

~~gap between the substance of what is being achieved under the arrangement (or any part of it) and the legal form it takes.~~

- ~~• the legal form and documentation are consistent with the economic substance of the arrangement. For example, arrangements are not properly legally implemented or operating in a manner contrary to or outside the scope of the relevant constituent documents would not adequately demonstrate a commercial rationale for the arrangement.~~
- ~~• there is evidence of broader accepted market conduct that resembles the arrangement in question. That is, the arrangement (or any part of the arrangement) is aligned with the sort of arrangements ordinarily used to achieve the relevant commercial objective. These arrangements are aligned with commercially established practices in the profession. For example, putting in place a service entity arrangement which complies with the published "Your service entity arrangements" guidance.~~
- ~~• there are any aspects of the arrangement that would not be normally seen between parties dealing at arm's length. 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 do not have the elements usually associated with a commercial activity. These arrangements may also include transactions relating to debt or financing arrangements which may involve a third party where the primary transaction is not undertaken at arm's length.~~

High Risk Factors

You must assess if your arrangement contains any of the high risk features below.

If your arrangement has one or more of the features outlined below you are unable to rely on this guidance, as the features operate outside the scope of this guidance.

The ATO raises concerns regarding a number of arrangements to the public through the release of Taxation Alerts. If you have arrangements which are similar to, or the subject of a Tax Alert you should contact the ATO prior to relying on these guidelines as you may not be able to rely on this guidance.

The features below are not exhaustive and will be subject to further amendments and additions as the ATO becomes aware of further high risk arrangements. The absence of any published guidance on a specific arrangement or a variation on an arrangement does not mean that the ATO accepts or endorses the arrangement or variation, or the underlying tax consequences.

Financing arrangement relating to non-arm's length transaction

Arrangements with related parties generally involve a greater level of potential tax compliance risk. The Commissioner ~~does not accept there is a commercial purpose~~ **is concerned** when an associated entity of the IPP utilises finance to acquire a portion of the IPP's equity interest in a professional firm. **The concerns are centred on situations where there is no material change in the overall financial position of the IPP and their associated entities other than the tax benefit that is obtained by the tax deduction for the interest being paid. Refer for example *Re Taxation Appeals [1991] AATA 1; 22 ATR 3001*, where Part IVA was held to apply. Where the interest charge is between related parties and no material tax benefit arises, the Commissioner's concerns are less and the guidelines would still be able to be relied on. For example, if a commercial rate of interest is paid by a family trust to the IPP from whom the trust acquired the interest in the professional firm, a tax benefit is unlikely to arise and, if that was the case, the Commissioner would not have concerns.**

Exploitation of difference between accounting standards and taxation law

The ATO maintains concerns with arrangements that create artificial differences between taxable income and accounting income. Some arrangements create contrived differences which are exploited to have the income assessed to individuals or businesses that pay little or no tax, while allowing others to enjoy the economic benefits. For example, utilising the different treatment between accounting and tax for amortising an intangible asset.

The ATO recognises that differences between tax and accounting incomes will arise for genuine reasons. Examples include work in progress and employee leave provisions. The concerns are focused on situations where the difference is contrived, such as where a choice of the taxpayer is key to driving the change and the change is not explainable by normal commercial practice or generally accepted accounting principles. The ATO is specifically concerned by situations where taxpayers then take further steps to exploit this difference to achieve a tax benefit, for example streaming of tax income to lower taxed associates or the circumvention of Division 7A.

*Arrangements that **involve individuals assigning income** ~~are materially different in principle from *Everett* and *Galland*~~*

An arrangement that concerns **an individual** ~~a partner~~ who has the appearance of **a** ~~an~~ equity partner (obligations, rights and entitlements) but the ~~partner's~~ **nature of the** relationship with the firm is more akin to that of a contractor or employee.

The following factors **that may feature in an individual's relationship with the partnership that** are considered to be **indicative of such situations:** ~~materially different from the principles established in *Everett*⁷ and *Galland*⁸:~~

⁷ *FCT v Everett* 80 ATC 4076

⁸ *FCT v Galland* 86 ATC 4885

- The individual has no voting rights in the partnership;
 - The individual does not carry the typical risks of a partner (eg risks of recovery of an indemnity);
 - The 'cost' of the individual is treated as an expense to the partnership similar to the expenses of employees of the partnership and is not dependent on the profit performance of the partnership;
 - There is provisioning the accounts of the partnership for liabilities such as long service leave;
 - Other on-costs typically associated with employees (such as PAYG withholding and a liability to payroll tax) are associated with payments made to these individuals.
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- Nil or nominal amount of capital contribution by the partner
 - entitlement to a 'token' number of equity points;
 - indemnification by equity partners against any professional liability in respect of actions against the partnership;
 - the presence of a fixed salary component;
 - the lack of rights to participate fully in the management of the firm

Multiple assignments/disposals

The Commissioner has concerns where an IPP may decide to assign or dispose of his or her interest in the practice in multiple transactions, generating opportunities to manipulate the various superannuation thresholds. These outcomes are only achieved by non-arms' lengths transactions occurring without any commercial justification as to the multiple disposals.

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.

Arrangements that misuse the superannuation system including assignments or disposals of interest to associated SMSFs

The ATO has concerns with transactions where a SMSF associated to an IPP is entitled to receive profit from the practice, or has an equity interest in the practice.

These transactions potentially contravene the superannuation legislation and regulations. Section 66 of the Superannuation Industry (Supervision) Act 1993 (SISA) generally prohibits trustees from intentionally acquiring an asset (other than money) from a related party of the fund.

Amounts received by the SMSF may also constitute non-arm's length income of the fund under section 295-550 of the Income Tax Assessment Act 1997 such that the income is not eligible to be concessionally taxed and is not exempt current pension income.

Further, this arrangement could present superannuation regulatory issues, in particular the requirement that a SMSF is maintained for the purpose set out in section 62 of the SISA.

The presence of a SMSF in the ownership structure of a firm is not a concern in and of itself. What is a concerns is situations where transactions involving the SMSF and the professional firm (including restructure and profit distributions) breach the SISA or superannuation related provisions in the tax law. Such situations would not be covered by these guidelines.