THE TAX INSTITUTE

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Dear Simon

Draft Practical Compliance Guideline PCG 2021/D2 — Allocation of professional firm profits – ATO compliance approach

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the draft Practical Compliance Guideline PCG 2021/D2, *Allocation of professional firm profits – ATO compliance approach* (**the draft PCG**).

This separate submission complements a previously lodged joint submission dated 30 March 2021 with CPA Australia, Chartered Accountants Australia and New Zealand, Institute of Public Accountants and the Business Law Section of the Law Council of Australia (together, **the Joint Bodies**). We continue to support the view as represented in the Joint Bodies submission.

The contents of this submission have been developed in close consultation with our special purpose professional firms subcommittee to obtain a breadth of views on issues that impact our broader membership.

We invite the ATO to consider our separate submission and respectfully request that further action is taken to enhance the draft PCG to ensure clear guidance and practical insight is provided to the community. We have set out below a summary of the key issues explored in our submission:

- The scope of the draft PCG and in essence, the allocation of the ATO's compliance resources, specifically on "professional firms";
- The inclusion of specific legislative provisions to assist taxpayers to better understand the taxation law on which the draft PCG is constructed;

- The current technical exclusions from the risk assessment framework including, but not limited to, examples of professional firms running through a common corporate structure, treatment of franking credits and franking tax offsets, the extent of distributions or dividend payment timing mismatches, superannuation contributions and fringe benefits;
- The increased compliance burden and tax liability on IPPs especially in the event that safe harbours are not adopted for evidently low-risk, commercially driven arrangements;
- The inclusion of further guidance on substantiation;
- The inclusion of additional case studies as a means of clearer guidance;
- The further consideration of benefits of inclusion of safe-harbour concessions (on a limited and narrow basis); and
- The insertion of a flow chart to illustrate the operation of the draft PCG and whether the risk assessment framework should apply.

Our detailed submission is contained in **Appendix A** with supporting case studies contained in **Appendix B**.

The Tax Institute is the leading forum for the tax community in Australia. Please refer to **Appendix C** for more about The Tax Institute.

If you would like to discuss any of the above, please contact either Paul Banister or Michelle Ma, Associate Tax Counsel, on (02) 8223 0084.

Yours faithfully,

Peter Godber

President

Appendix A

Detailed comments

1. Scope of the draft PCG

Application to "professional firms"

As raised in the Joint Bodies submission, The Tax Institute requests the ATO provide further information so that we can better understand the rationale of the scope of the draft PCG and the ATO's allocation of compliance resources specifically to "professional firms". The draft PCG defines 'professional firms' as the following:

> "17. ... **Professional firms** include, but are not limited to, those providing services in the accounting, architectural, engineering, financial services, legal and medical professions".[1]

While we acknowledge and respect the ATO's ability to establish its own risk guidelines and parameters, the draft PCG does not provide reasoning for its targeted identification of the services provided by professional firms. For example, it would be helpful if the ATO could explain how the income derived by an accounting or legal firm is different to income derived by a plumbing business or management consulting firm to warrant differential ATO compliance treatment. There is no general principle in taxation law that prescribes differential treatment of the income earned across industries and the distribution (if any) to owners/principals and associates. Furthermore, it would be beneficial for the ATO to clarify whether (and how) the draft PCG applies to non-professional income derived by organisations, for example, project management services provided by a firm whose leaders are members of professional bodies.

All professionals should meet the professional and ethical standards required of all legislation and they are aware they face career limiting sanctions if these are not met. In this light, many practitioners welcomed the Suspended Guidelines as providing a "practical sense check" to confirm that they were "doing the right thing". Similarly, many professional firms themselves appreciated the confidence they obtained by being able to control certain distributions to ensure all of their relevant professionals satisfied the Suspended Guidelines. The structure of the draft PCG precludes firms and their professionals from now attaining such confidence.

The Tax Institute considers that the draft PCG's approach goes beyond what is required to promote good tax compliance and thus involves a very significant risk of being viewed as discriminatory towards "professional firms". The Tax Institute is of the view that there should not be products issued by the ATO which create inconsistent application of tax legislation between market segments.

Distinction between equity partner and non-equity partner

At present, the draft PCG does not appropriately define the terms 'equity partner' and 'non-equity partner'.

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[1] Paragraph 17 of the draft PCG.

Furthermore, the draft PCG seeks to create a differential treatment between an 'equity partner' and a 'non-equity partner' without acknowledging the fact that 'non-equity partners' or 'fixed draw partners' are indeed jointly and severally liable for debts of a partnership; an indemnification is not equivalent to full protection from the risks of joint and several liability. We consider this differentiated treatment created by the relevant "high-risk features" as unreasonable and unnecessary. We submit that those partners who suffer the same exposure to business risks as equity partners should not be unreasonably prejudiced. It should be noted that in some industries, a significant portion of partners are on some degree of fixed share income. For example, it is reported that two-thirds of the country's biggest legal partnerships have at least 30% of their partners on salaried arrangements.[2] To exclude these 'non-equity' partners from the draft PCG reduces the utility of the guidance significantly.

2. Overarching technical considerations

Part IVA

The draft PCG seeks to provide a framework to assess the likelihood of the ATO reviewing the affairs of an individual professional practitioner (**IPP**) and the relevant firm with a view to applying the general anti-avoidance provisions (**Part IVA**) in the *Income Tax Assessment Act 1936* (**ITAA 1936**). However, the Tax Institute is of the view that the draft PCG does not seek to address the specific legislative provisions that may apply but merely provides some indication as to the audit risk that IPPs may face.

As observed in the Joint Bodies submission, Gateways 1 and 2 and the risk assessment framework are not necessarily constructed to align with Part IVA provisions. Rather, the draft PCG uses broad, unadjusted measures as representative factors for Part IVA risk. The risk scores do not appropriately reflect the nuance and specificity required to properly assess the rating of Part IVA risk. We believe that the draft PCG should expressly identify the applicable specific anti-avoidance provisions which apply to enable the ATO's intention to be understood and considered by IPPs and their firms.

Personal services income regime

The alienation of personal services income (**PSI**) rules in Part 2-42 of the *Income Tax Assessment Act 1997* (**ITAA 1997**) are complex and generally not well understood. It can be difficult to determine whether income relates to personal services of an individual or if it is generated from a firm's business structure, particularly for small-sized professional firms.

We are of the view that it is important to expressly outline how this draft PCG interacts with the PSI regime to ensure that taxpayers can confidently self-assess their risk profile and avoid unnecessary complexity and confusion. The Tax Institute considers there should be further clarity in relation to the ATO's intention within Paragraph 30:

> "30. This Guideline only applies where an IPP has received an amount of income from a practice which generates its income from a business carried on in a business structure that is not subject to the PSI regime."

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[2] For example, refer to Wootton, H. and Pelly, M. (2020, Jun 25). Salary arrangements take shine off law firm partnerships. *Australian Financial Review*. Retrieved from: https://www.afr.com/companies/professional-services/salary-arrangements-take-shine-off-law-firm-partnerships-20200623-p555fo.

One interpretation is that the ATO's intention is for this paragraph to apply only where income is actually attributed to an individual under the PSI regime. We consider this position unreasonable. We would suggest the following additional statement to Paragraph 30: "In other words, where the PSI regime applies to attribute income to an individual, or where the entity is carrying on a personal services business and no attribution arises, this Guideline will not apply."

It is our view that, aside from Part IVA considerations, the PSI regime is a prescriptive code dealing with PSI as otherwise captured by those provisions, and the draft PCG should not create overlap where a taxpayer has otherwise satisfied the requirements to be a personal services business. The PSI regime excludes professional firms in certain instances and therefore it is clear the draft PCG would apply in these instances. We specifically draw your attention to the accounting firm example provided in the PSI provisions which recognises a common commercial scenario and concludes that under those particular circumstances, "none of the firm's ordinary income or statutory income is Jim's [as an IPP] because it is produced mainly by the firm's business structure, and not mainly as a reward for Jim's personal efforts or skills".[3]

Transitional arrangements

When the draft PCG is finalised, it is proposed to apply from 1 July 2021 and the Suspended Guidelines will continue to have effect until 30 June 2021 for arrangements entered into prior to 14 December 2017. We note that the ATO is allowing a further transitional grace period until 30 June 2023 for IPPs which take the required steps to modify their arrangements to be lower risk. Effectively, this would defer the commencement date until 1 July 2023 (i.e., the 2023–24 income year) for those arrangements entered into prior to 14 December 2017 and which have a higher risk rating under the draft PCG.

We request that the ATO provide further guidance and clarity on whether the transitional grace period will apply on a firm wide basis or on an IPP basis.

For example, for a firm that entered into an arrangement prior to 14 December 2017 that satisfied the Suspended Guidelines and then admitted new IPPs to the firm after that date – we seek the ATO's clarification whether the transitional rule applies only to the IPPs in the firm as at 14 December 2017 or whether it applies on a firm wide basis?

3. Issues and complexities resulting from exclusions from the draft PCG

We provide our view of various technical exclusions from the draft PCG that should be addressed to ensure clearer guidance for the relevant taxpayers.

Professional firm operating through a corporate structure

- The draft PCG does not provide guidance, by way of examples or case studies, of the common scenario of a professional firm operating through a corporate structure and does not address arrangements such as profit distributions made via dividends. We suggest the inclusion of examples of this common practice structure prior to the finalisation of the draft PCG.
- For illustrative purposes, please refer to **Appendix B**: Case study 3 - Small-sized engineering firm and Case study 5 - Sale of equity in professional services entity.

[3] Refer to section 84-5(1) of the ITAA 1997, Example 3.

Treatment of franked income

- The draft PCG is silent on the treatment of franking credits and franking tax offsets for the purposes of determining the remuneration received by the IPP (risk assessment factor 1) and the effective tax rate (risk assessment factor 2). Where an IPP receives their allocated profit as a franked dividend, the tax payable by the IPP in their income tax assessment would be reduced by the franking tax offset. We consider that the franking offset should be treated as a recognition of the tax prepaid by the firm on behalf of the IPP (or other recipient) of the dividend. The amount of tax paid by the firm should be included in the determination of the effective tax rate of the IPP.
- We request that prior to the finalisation of the draft PCG, the ATO clarify whether franking credits and franking tax offsets are to be considered for the purposes of the risk assessment factors.

Accounting standards and taxation treatment of distributions or dividends

- The draft PCG does not provide guidance on mismatches arising due to differences between profit measured from a commercial standpoint and tax rules. This can impact the extent of distributions or dividend payment timing mismatches. For example, which would be the correct year for the profit entitlement to be considered for the risk assessment where a firm's profits for a certain year are paid as a dividend in the following year? What is the position for trust distributions affected by timing differences from year to year? We request that the ATO provide further clarity on this common practical scenario.

Superannuation contributions and superfund tax paid

- The draft PCG does not provide guidance on whether superannuation contributions and superannuation fund tax paid should be taken into consideration when determining the remuneration received by the IPP (risk assessment factor 1) and the effective tax rate (risk assessment factor 2). We note that the inclusion of superannuation is addressed in the determination of appropriate remuneration (risk assessment factor 3).
- We suggest that the ATO address these matters as it would be a relatively common scenario for IPPs to direct pre-tax income to a superannuation fund, either on a compulsory or voluntary basis. It would also be necessary for the ATO to confirm whether the treatment of superannuation guarantee charge contributions would be different to salary sacrifice contributions, for these purposes.
- Furthermore, we observe that the ATO should consider additional taxes that the IPP would encounter for example, Division 293 tax on superannuation contributions and whether this would be taken into account for the calculation of the effective tax rate.

Fringe benefits

- The draft PCG is silent on the treatment of fringe benefits received by IPPs when determining the remuneration received by the IPP and the effective tax rate. We note that it provides for fringe benefits to be included in the determination of appropriate remuneration.
- We consider that further clarification is needed in circumstances where fringe benefits are provided to IPPs in professional firms operated by entities other than partnerships. For example, under the calculation methodology outlined in the draft PCG, the effective tax rate of the IPP (and their associates), would be lower where fringe benefits are received in place of salary as the methodology in risk assessment factor 2 does not factor in the fringe benefit nor the FBT actually paid by the employer. However, where the FBT is paid by the employer, the effective tax rate would likely be higher (given the FBT rate).

- The ATO may also wish to provide further guidance for IPPs in partnership arrangements where the provision of non-deductible benefits, such as car parking would not impact on the determine of remuneration received by the IPP and the effective tax rate.

Other issues

- The draft PCG does not account for certain contemporary working arrangements such as part-time partners or those who take sabbatical.
- It is unclear how the ATO will approach compliance in 'outlier' years or periods of abnormal activity. In this regard, the ATO should clarify its intention regarding the allocation of resources in circumstances for example, where an entity which would ordinarily have a low-risk rating (green zone) instead has a high-risk rating (red zone) for a limited period. The rating may be affected by special circumstances such as operational issues, trading conditions, unusual economic circumstances, matters outside the control of the taxpayer, including issues affecting personal health and well-being, natural disasters such as a bushfire, cyclone, drought, flood, or pandemic.

The Tax Institute requests that the ATO clarify the approach on the issues raised above and seek to resolve any inconsistences in interpretation or guidance in the draft PCG. Additional information to address the identified gaps will ensure there is better understanding and compliance with the finalised PCG.

4. Risk Assessment Framework

Based on discussions with our members, the consensus view is that the tax calculation methodology in determining the remuneration received by the IPP (risk assessment factor 1) and the effective tax rate (risk assessment factor 2) is too complex, is silent on numerous key aspects including potential arbitrary setting of thresholds and scoring and, in this regard, could be improved. It is broadly acknowledged that the draft PCG is substantially different from the Suspended Guidelines and, in some respects, causes increased burden on IPPs.

For example, under the draft PCG's risk assessment factor 1, a score of 50% gives a rating of 5 which previously would have been a lower rating of 3 or 4. No justification is apparent for this change in rating despite IPPs also needing to satisfy Gateways 1 and 2 for the draft PCG.

Moreover, the proposed scoring system and gateways, while intended to help better identify tax risks, appears less targeted and thus more likely to increase the number of IPPs that are more than low risk. This increased audit scope will inevitably boost the cost to revenue and compliance costs for taxpayers with no obvious benefit.

Rates and thresholds

Factors including whether the firm is structured through a corporate entity, or there is the presence of a corporate beneficiary, and/or whether income earned is business income or passive income of the respective entity would impact the appropriateness of the rates and thresholds for the total effective tax rate.

The effective tax rate thresholds do not factor in the legislated reductions in corporate and individual tax rates. It is observed that corporate beneficiaries which predominantly derive passive income will be taxed at 30%, whereas a base rate entity (**BRE**) which has predominantly derived business income will have a 26% tax rate for the 2020-21 income year.

Further, changes to personal tax rates and tax scales have also been legislated through to 2024 leading to a reduction in average tax rates. If tax rates are reducing, consideration of what benchmarks are acceptable should also change.

The use of effective tax rates to determine risk also appears to unfairly target IPPs in lower income practices where due to commercial and socio-economic factors the income achieved is lower (resulting in lower effective tax rates).

The draft PCG does not appear to appropriately account for the existence of the lower tax rates and accordingly the proposed differential risk ratings have the effect of negating the Government policy of tax reduction for small to medium businesses and individuals.

If this is the ATO's intention, we ask that clarity is provided in this regard.

We believe that additional consideration should be given as to whether the allocated points are truly achieving the correct outcomes, both in relation to the rates themselves, but also in relation to the ranges, for example in risk assessment factor 2, the >20% to 25% range should be ≥20% to <25% and then ≥25% to <30%. In this way, hitting a threshold will achieve the lower scores (in that case 5 and 4 points respectively).

Proportion of profit entitlement – the importance of firm structure

There is particular concern in regard to the inclusion of income from a service entity and its associated businesses to the firm. In essence, the approach of the draft PCG by the inclusion of income from a service entity as part of income from the whole of firm group contradicts and renders useless the established principles in the case of *Federal Commissioner of Taxation v. Phillips* (1978) 8 ATR 783 which have been accepted and endorsed by the Commissioner in Taxation Ruling TR 2006/2 *Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements*.

Therefore, where the service arrangement between associated entities of the relevant kind is constructed in reliance on TR 2006/2, and the arrangement is considered commercial and at arm's length, the relevant provisions under the public ruling (here, section 8-1 of the ITAA 1997 and Part IVA), the ATO should apply the law in the way set out in the ruling to the draft PCG. TR 2006/2 and the ATO's guide to service entity arrangements contain safe harbour indicative margins that service type entities might charge and the business case to justify the structure.

We believe that the draft PCG should more appropriately address income derived through service trusts.

Furthermore, where a structure solely involves a 'simple' partnership with a service entity, there should be a safe harbour to prevent the need for such structure from having to apply this draft PCG, we provide further comments below (for illustrative purposes, please refer to **Appendix B**: Case study 1 – Medium-sized legal partnership and Case study 2 – Small-sized engineering firm).

Increased tax liability for professionals across a broad range of firms

We consider that compliance with the draft PCG is likely to result in a higher tax liability and excessive red tape for professionals. As raised in the Joint Bodies' submission, we observe that there has been a significant shift in the risk scoring of arrangements between the suspended guidelines and the draft PCG. The draft PCG's tax calculation methodology is far more complex than the suspended guidelines and may be difficult to apply in practice. We would encourage the ATO to explain the rationale for the shift or, at least, provide reference to the application of Part IVA provisions such that the approach can be better understood and implemented in a co-operative and comprehensive manner.

Challenges of commercial benchmarking

We understand that a core reason for the draft PCG being issued is ATO concerns that IPPs are not receiving sufficient income/remuneration in their hands (but instead part of that income is being received by associates of the IPP). Where an IPP receives market value remuneration (irrespective of the form), then it is difficult to see how they should be classified as other than low risk. Despite this, under the draft PCG, the receipt of a market value remuneration would score a 4 under the third risk assessment factor, which does not seem commensurate with a low risk (and see for example our Case Studies 3 and 5 in Appendix B for these concerning outcomes).

The draft PCG acknowledges the difficulty that may be encountered by an IPP in determining accurately the use of the third risk assessment factor, the assessment of the appropriate remuneration benchmark, as in many instances there may not be an immediately comparable rate of remuneration.

In the Suspended Guidelines, the ability to benchmark against the highest quartile of non-IPP employees provided a useful and easier to apply tool for practitioners than what is set out in the draft PCG. In light of the potential challenges noted above in satisfying the requirements of Paragraphs 89-91 of the draft PCG, consideration should be given to a shortcut method to apply risk assessment factor 3. For example, if an IPP receives a particular percentage (for example 115% or 120%) of the remuneration of the upper quartile of 'non partner' employees, they should receive a low score under risk assessment factor 3. This would simplify the ability to apply risk assessment factor 3 and also provide a risk assessment rating more commensurate with the ATO concerns.

We would encourage the ATO to engage in further consultation in this regard.

5. Recommendations and pathways

Further guidance on status & substantiation requirements of the draft PCG

We acknowledge the purpose of this draft PCG is to make it clear how the ATO will allocate its compliance resources to particular cases. In this regard, we are of the opinion that the draft PCG should address or better address the following points:

- The PCG is not a statement of how the law applies to professional service firms;
- The PCG is not precluding taxpayers from structuring their arrangements or affairs in any particular manner; and
- A certain risk rating is not definitive in how the Tax Laws may be applied to a taxpayer's circumstances.

These points of clarity are needed for both taxpayers and ATO officers alike to ensure the product and its purpose are understood.

We further recommend that the current wording of the draft PCG be softened in its tone, particularly in relation to the ATO's use of formal powers for information gathering and where "cases may proceed directly to audit" if an IPP sits in the high-risk rating (red zone).

Additionally, given the draft PCG is not a legal interpretive document, it is our view that the draft PCG should clearly state the ATO's expectation in relation to substantiation where a taxpayer is rated moderate-risk rating (amber zone) or high-risk rating (red zone). The draft PCG should state the type, and minimum extent of documentation taxpayers should be able to produce to demonstrate that their position remains acceptable although they may have otherwise self-assessed as moderate-risk rating (amber zone) or high-risk rating (red zone) under the numerical formulas. The ATO should conduct further consultation on what should be considered acceptable in this regard.

Proposed safe harbours

The Tax Institute is of the view that the ATO should consider the inclusion of options for safe harbour eligibility for certain businesses or arrangements without the need for eligible taxpayers to work through the gateways or risk framework. This would not only provide assurance to complying firms and their IPPs in low-risk arrangements but also benefit the ATO in terms of effective allocation of compliance resources to focus on moderate/high risk arrangements. In any event, the ATO will be able to "generally conduct some form of compliance activity to further test the tax outcomes" of arrangements." [4]

We would suggest that the following businesses or arrangements should be considered for safe harbour concessions (non-exhaustive list):

- An arrangement that passes Gateway 1 and the total profit entitlement of the IPP (including all associates) is less than or equal to $180,000 (refer to flow chart);
- The amount of profit entitlement distributed to non-IPPs is less than 35%;
- A 'vanilla' structure involving a partnership with an associated service trust entity. The partnership income is distributed to the IPPs as individuals and the service trust arrangements are consistent with Taxation Ruling TR 2006/2 *Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements*. (For illustrative purposes, please refer to **Appendix B**: Case study 1 – Medium-sized legal partnership and Case study 2 – Small-sized engineering firm).

Case studies

The Tax Institute puts forward additional case studies in **Appendix B** to improve the ATO's risk-based approach to IPPs and how their professional firms allocate profits. These case studies aim to demonstrate a variety of business structures and practical arrangements and are intended to provide further guidance to the tax community. In certain circumstances, the case study identifies a gap or addresses our concerns on behalf of our members relating to potential discrimination against certain types of structures based on size, socio-economic class etc.

We request that the ATO considers the proposed scenarios in **Appendix B** and uses this as an opportunity to clarify any uncertainties raised or current gaps existing in the draft PCG. Our case studies include:

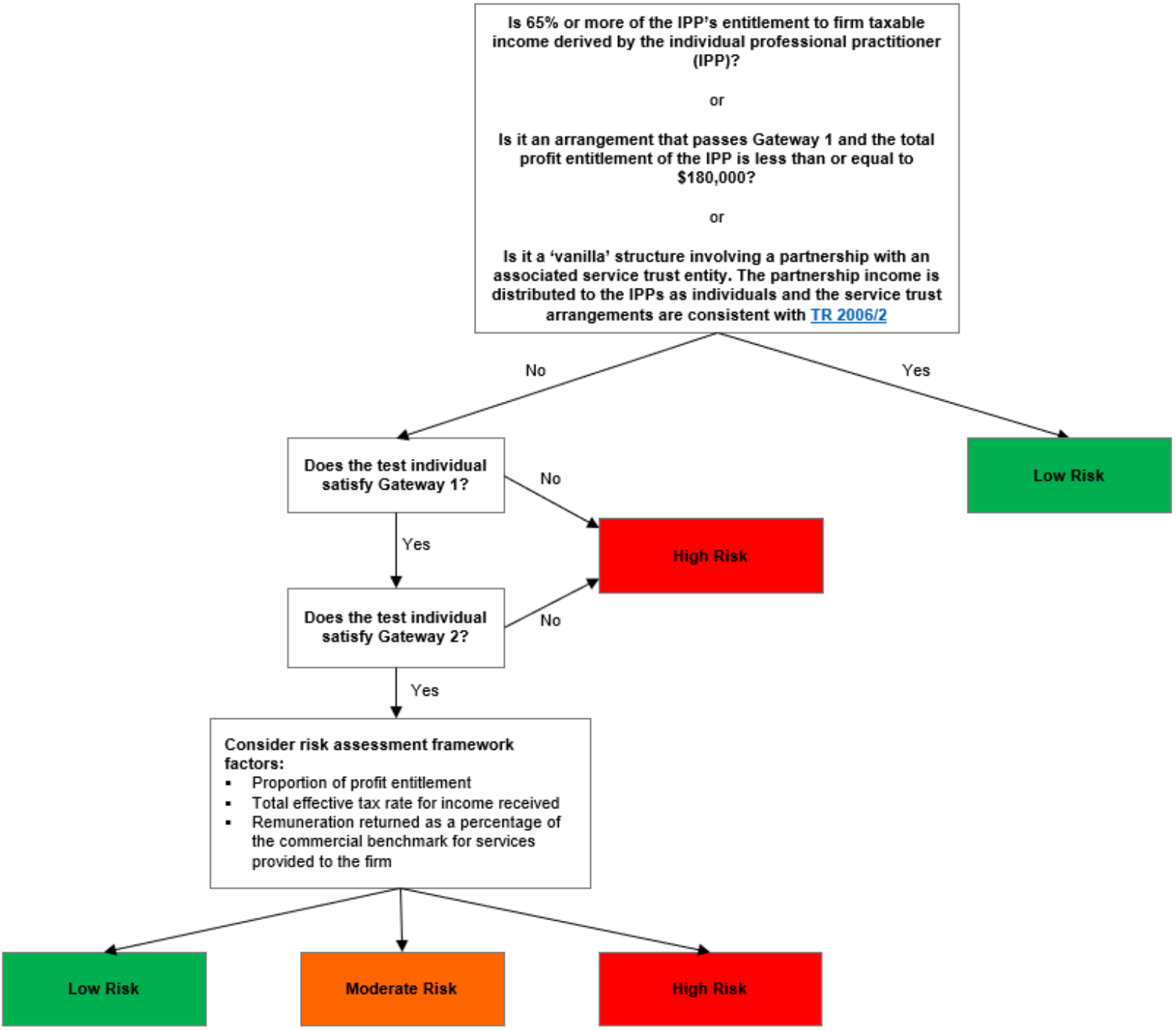
1. Medium-sized legal partnership with a service trust entity
2. Small-sized accounting firm
3. Small-sized engineering firm
4. Unit Trust
5. Sale of equity in professional services entity

[4] Paragraph 66 of the draft PCG.

Proposed flow chart

To assist taxpayers to better comprehend, navigate and apply the PCG, The Tax Institute is of the view that an inclusion of a flow chart would be very beneficial.

The proposed flow chart depicted on the page following demonstrates the operation of the draft PCG and it can be used to determine whether the risk assessment framework should apply.



Appendix B

Case studies

The Tax Institute puts forward various case studies (on a non-exhaustive basis) for your consideration which address scenarios that would assist self-assessment of an arrangement and application of the risk scoring method as prescribed by the draft PCG.

The following scenarios demonstrate a variety of business structures and practical arrangements and are intended to give further guidance to the broader community.

1. Case study 1 - Medium-sized legal partnership

Background information

Jessica is a partner in a professional firm that operates as a partnership. The firm offers legal services and has a total of 20 partners and 100 staff.

There are two categories of partners who receive their partnership distribution as follows:

- 9 Non-equity partners – who receive a minimum distribution of profit plus an entitlement to a small share of any excess profit (if the firm exceeds its budgets) plus a potential partner bonus (for exceeding personal targets).
- 11 Equity partners – who have full exposure to profits and losses plus a potential partner bonus for exceeding personal targets. Jessica is an equity partner.

All partners are entitled to vote and participate in management, but equity partners have a larger percentage voting entitlement. There have been no Everett assignments.

The partnership has an associated services trust to which each of the partners nominates an entity to be the beneficiary (such a spouse or a family trust or themselves).

The services trust engages administrative staff, provides premises and facilities to the partnership. It charges a fee to the partnership which includes a 10% mark-up on its costs. As the firm is subject to legal practitioner rules, all 60 employed legal practitioners are employed by the partnership, only 40 administrative staff and paralegals are employed by the service trust.

On a yearly basis, the service trust distributes approximately $120,000 to each equity partner (or their nominated entity) and approximately $50,000 to each non-equity partner. In normal years, the service trust distribution amounts to equity partners are around 20% of the partner's overall profit entitlement from the firm and 15% for the non-equity partners. However, the percentage will vary (particularly for equity partners) based on variations in partnership profits. In particularly bad years the percentage distributed via the services trust could be higher than 30% (as the income earned by the service trust is generally relatively stable, whereas partnership profits vary).

There are no arrangements in place to create any artificial differences between taxable income and accounting income.

Risk assessment & Comments

The arrangement appears to be commercially driven and does not display any high-risk features. Even though the non-equity partners do not have "full" rights to participate in voting, management, and income of the partnership, they are genuine partners in the business and should be covered by the draft PCG.

The partnership income is distributed to the partners as individuals and the service trust arrangements are commercially based and relatively modest. On this basis, the arrangement should be regarded as low risk without needing to go through the tests in Gateway 2.

It should be noted that even in this low-risk scenario, anomalies could arise by applying the Risk assessment scoring table.

- In a reasonable year, an equity partner could earn $600,000 individually from the partnership plus $120,000 distributed through the service trust. As over 75% of the profit entitlement is received by the partner individually, this would score a "2" for the first factor. The individual partner would pay $240,667 tax, and assuming the service trust income was distributed to a non-working spouse a further $29,467 would be paid on this income. This gives an effective tax rate of 37%, giving a score of 2 for the second factor. The aggregate score of 4 against the first two factors places the partner's arrangement in low-risk rating (green zone).
- However, in a poor performing year (in the partnership), an equity partner could receive a very low profit share (for example $100,000) although the amount distributed through the service trust would be expected to be relatively stable ($120,000). Only 45% of the firm income would go to the partner individually resulting in a score of 5 for the first factor. The total tax of $22,967 plus $29,467 gives an effective tax rate of only 24% giving a score of 5 for the second factor. The aggregate score of 10 against the first two factors places the partner's arrangement as high-risk (red zone) despite there being no actual change in the arrangements but instead, a variation of commercial factors. Even using the third factor places the partner in the high-risk rating as the partnership distribution to the equity partner in a downturn is significantly lower than a commensurate employee would be expected to be paid. This illustrates how the use of the matrix can give anomalous outcomes and how the use of the matrix is inappropriate in low-income circumstances.

2. Case study 2 - Small-sized accounting firm

Background information

Casey and Mitchell are two IPPs in a partnership which provides accounting services in a low socio-economic area. The partnership has an associated services trust which provides premises, equipment, and administrative staff. Both partners each nominate their non-working spouse to be a beneficiary of the trust.

The associated services trust charges the partnership a 10% mark-up on its costs each year. In 2022, the trust pays a total of $100,000 in costs and wages to the administrative staff, charging the firm partnership a total of $110,000 and distributing $5,000 profit to each partner's nominated beneficiary.

In the same year, the partnership generated $200,000 in income from client fees, resulting in a partnership profit of $90,000 with $45,000 distributed to both partners.

Risk assessment

1. Risk assessment factor 1 - proportion of profit entitlement returned in the hands of each IPP is 90%, which provides each IPP with a score of 2.
2. Risk assessment factor 2 - tax payable of $5,092 out of $50,000 total profit provides each IPP with a score of 6.
3. Risk assessment factor 3 –it is likely each IPP is making significantly less than a commercial benchmark resulting in a score of 6.

The aggregate score of 8 against the first two factors places each IPP's arrangement in the moderate-risk rating (amber zone), including the third factor would place the arrangement in the high risk category.

Comments

- The commercial fact that the partners in this small practice are doing it tough and not making much income for themselves should not mean that they are in a higher risk category.
- We consider that it would not be an efficient use of ATO compliance resources to conduct further investigation into an arrangement such as this purely based on the moderate to high-risk assessment.
- In this regard, we would suggest the final PCG provides a safe harbour that an arrangement will be considered low risk if the arrangement passes Gateway 1 and the total profit entitlement of the IPP is less than or equal to $180,000.

3. Case study 3 - Small-sized engineering firm

Background information

Bob is an engineer in a small regional engineering firm. He has worked in the practice for a few years and last year was paid a market salary of $100,000.

The engineering practice is conducted via a company.

Bob is offered the opportunity to buy into the practice. He sets up a discretionary trust to acquire shares in the engineering company. The acquisition is from an unrelated vendor and takes place on arm's length terms.

During the first year after becoming an IPP, Bob receives a salary of $110,000 (which is believed to be market value remuneration) and his family trust receives dividends of $51,800 (with $18,200 of franking credits).

The family trust distributes the dividends by way of 75% to Bob's spouse, Mary, and 25% to his adult daughter, Kiri. All distributions genuinely flow to those individuals.

Risk assessment:

1. Risk assessment factor 1 - $110,000 of $180,000 results in 61% of the IPP's profit entitlement from the firm being returned by the IPP personally, resulting in a score of 3.
2. Risk assessment factor 2 – The calculation of total effective tax rate is approximately 18%, which provides the IPP with a score of 6.
3. Risk assessment factor 3 – Bob's remuneration received is assumed to be market remuneration, which provides him with a score of 4.

The aggregated score against the first two factors is 9, or against all three factors, 13 placing Bob in the high-risk category.

Comments:

- To get to a low-risk rating (green zone), Bob would likely need to receive >75% of the overall entitlements, which would be around 36% of the dividends in addition to his salary. Given that Bob is already paid an arms length salary for his services and his family trust has bought in to this business by paying an arms length price for the shares, it is unclear why the arrangement should be considered high risk.

- This is another example of how risk assessment factor 2 gives anomalous outcomes where total entitlement to the firm income is below $180,000.
- The ATO should consider whether the risk assessment achieves the desired or intended outcome. We note that the inclusion of a safe harbour would assist in resolving any inconsistent or undesired outcomes.

4. Case study 4 - Unit Trust

Background information

The AB Unit Trust currently carries on a professional services business that started 4 years earlier when the principals came together.

Alex and Bernadeene are the principals who founded the business and both work in the business with varying duties and responsibilities.

Alex's family trust has the rights to 60% of income, capital and voting in the AB Unit Trust. Bernadeene's family trust has the rights to 40% of income, capital and voting in the AB Unit Trust.

Alex and Bernadeene do not draw a salary or wage as their agreement when they commenced business was to split profits based on their relative value to the business (by way of revenue generated). Alex and Bernadeene assess their profit share entitlements annually, but the percentages have not changed since commencement.

Alex and Bernadeene wish to introduce Cara, a key long-term staff member to the business by issuing a C Class unit in the AB Unit Trust.

For asset protection purposes, Cara wishes to acquire the C Class units in the AB Unit Trust with her family discretionary trust.

In recognition of past performance and what Cara brings to the business, Alex and Bernadeene are intending to issue the C Class unit to Cara's family trust for nominal consideration.

The rights attached to the C Class unit are:

- a fixed annual income distribution of $200,000;
- no right to capital on a winding up; and
- normal voting rights apart from in relation to incurring of capital expenditure greater than $100,000 (in which there is no right to vote).

The arm's length remuneration of a person like Cara in a business similar to that operated by the AB Unit Trust is $150,000 to $250,000 plus superannuation.

Risk assessment

1. Gateway 1 - appears to be satisfied. There is little to suggest that there is no commercial rationale for this structure.
2. Gateway 2 – the only high-risk factor is the differing unit class. The rights attached to the C Class unit are akin to a 'salaried partner' or 'non-equity' partner in a traditional partnership model. For that reason, and with voting rights other than for extraordinary expenditure (which would be financed by Alex and Bernadeene), this should not be seen as 'high risk'.

Comments

The ATO should clarify expressly that Gateways 1 and 2 are met by the practice.

5. Case study 5 - Sale of equity in professional services entity

Samantha is a Senior Manager who buys into an existing professional services practice under the following circumstances:

- Professional services firm is operated by a company.
- Samantha's salary is $200,000.
- Samantha is to buy 20% of the firm and become a director.
- Samantha is not associated with the firm's other directors or shareholders.
- Net profit of the firm before tax and after directors' salaries is $2m and this profit is the basis of the valuation for the purpose of setting a purchase price.
- The purchase price is 4 x pre-tax earnings giving a valuation of $1.6m for 20% which is the purchase price.
- Samantha's family company (owned by a family trust) funds the $1.6m acquisition price and acquires the shares.
- Post-acquisition, Samantha continues to draw a salary of $200,000 as her role remains unchanged, apart from becoming a director.
- The firm makes a profit of $2m before tax ($1.48m after tax) and pays a dividend of $1m to shareholders.
- Samantha's family company share of the dividend is $270,270 ($200,000 grossed up to include franking credit of $70,270).
- Samantha's company has a tax liability of $81,081 less the imputation credits of $70,270, being $10,811 on the dividend assuming the only income received by the company is passive dividend income.
- Depending on how the ATO treats a franked dividend and franking credit, total tax paid will be calculated as:
    - $60,667 on the salary of $200,000;
    - Either $10,811 on the dividend of $200,000, or $$81,081 on $270,270;
    - Total tax is either $71,478 on $400,000 (17.87%) or $141,748 on $470,270 (30.14%);
- The IPP's risk score on the first two factors will be 11 if the franking credit is disregarded and 8 if the franking credit is included as income, making the IPP either moderate-risk or high-risk.
- Assume the IPP is receiving 100% of market salary, therefore the third risk factor is 4 which still puts the IPP in either the moderate-risk or high-risk category when compared against all three factors.
- This is notwithstanding the purchase price has been funded from an entity other than the IPP, the salary received by the IPP is the salary that was used to calculate the net profit that was used to determine the purchase price of the shares in the professional practice entity and the purchase was negotiated between unrelated parties.

An alternative to this scenario is the acquiring company funds the purchase price by third party debt and applies the dividend received to meet its repayment obligations. Again, this is an arm's length transaction and the return on capital is required to meet repayment obligations to the third-party lender.

Appendix C

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge, and learning.

We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.