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16 April 2021

Mr Simon Webster
Director - Professional Firms Compliance
Private Groups and High Wealth Individuals
Australian Taxation Office

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

cc:
Tim Dyce, Deputy Commissioner, Private Groups and High Wealth Individuals, ATO
Jade Hawkins, Assistant Commissioner, Private Groups and High Wealth Individuals, ATO
Louise Clarke, Deputy Commissioner, Policy, Analysis and Legislation, ATO
Andrew Orme, Deputy Chief Tax Counsel, Public Advice and Guidance, ATO

Dear Simon

PCG 2021/D2 Allocation of professional firm profits – ATO compliance approach

CPA Australia represents the diverse interests of more than 168,000 members working in over 100 countries and regions supported by 19 offices around the world. We make this submission on behalf of our members and in the broader public interest.

Further to the **joint submission** from CPA Australia, Chartered Accountants Australia and New Zealand, Institute of Public Accountants, the Business Law Section of the Law Council of Australia and the Tax Institute, we make this additional submission to provide further details of our concerns about the current construct of the risk assessment framework proposed in **PCG 2021/D2 Allocation of professional firm profits – ATO compliance approach** (**the draft PCG**). While the submission focuses on our members and experiences in the accounting profession, we believe our comments can be equally applied to arrangements for other types of professional services.

We once again reiterate that CPA Australia, in its role as a peak professional body, was not consulted during the development of the draft PCG, contrary to what is **stated** on the ATO website.

We support the ATO's efforts to address tax avoidance and to apply the anti-avoidance provisions, as appropriate. However, we do not consider that the draft PCG effectively or appropriately targets such taxpayers.

Our primary concerns with the draft PCG are:

- The singling out of a discrete set of taxpayers (i.e. professional services firms and individual professional practitioners (**IPPs**)) with no evidence of widespread tax avoidance or quantified tax revenue losses
- The suggestion that even where an IPP has a legal arrangement in place, they should pay significantly more tax than is legally required simply to avoid the risk of an audit
- The failure of the draft PCG to connect the existing rules (i.e. personal services income (**PSI**) and general anti-avoidance provisions (**Part IVA**)) to the design of the gateways and risk assessment framework
- The lack of both legislation and recent precedential decisions to support the ATO's line of reasoning in the draft PCG
- The classification of many standard, arm's length and commercial arrangements as being moderate to high risk of audit when it is highly unlikely that the ATO would successfully apply Part IVA at the audit's conclusion

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- The ATO's use of generic and indiscriminate "risk assessment factors" as the justification to impose audits on compliant taxpayers
- The failure of the risk assessment framework to:
    - include economic returns to equity holders
    - adjust for arrangements that comply with other relevant laws or rulings (e.g. service entity arrangements)
    - reflect base rate entity company tax rates
    - accommodate the variety of structures used by IPPs, including incorporated practices
    - allow for variance in the level of personal exertion of the IPPs (e.g. part-time IPPs).

We recommend that:

- the Commissioner firstly demonstrates the successful application of Part IVA to IPPs' arrangements including through test cases
- the draft PCG is reconsidered and, at a minimum, is changed to ensure that the risk assessment framework properly identifies IPPs and arrangements with a high level of Part IVA risk
- Taxpayer Alerts continue to be issued as contemporaneously as possible
- an evidence base is established to quantify the level of revenue at risk and justify the approach taken in the draft PCG.

Further details and five worked examples are contained in the Attachment.

We are available to consult on the draft PCG and discuss any queries about this submission. Contact Elinor Kasapidis, Senior Manager Tax Policy, at CPA Australia on 0466 675 194 or **elinor.kasapidis@cpaaustralia.com.au**.

Yours sincerely,

Dr Gary Pflugrath

Executive General Manager, Policy & Advocacy
CPA Australia

Background

The original, now-suspended guidelines (**the suspended guidelines**) were developed as a risk management product for existing arrangements within professional services firms. The suspended guidelines were understood to be focused on the application of Part IVA to structures where the sole or dominant purpose was tax-driven with no real commercial rationale.

Despite our concerns at the time, the profession accepted the suspended guidelines as a way in which professionals could manage their tax compliance risk and obtain a level of certainty from the ATO regarding their arrangements.

We acknowledge that, in practice, the ATO was identifying issues that ran contrary to the intent of the suspended guidelines. We support the ATO's efforts to address such high-risk arrangements.

Scope and target population

The draft PCG targets professional services firms without providing an evidence-based case as to why the ATO will dedicate compliance resources to this particular group of taxpayers rather than others. Conceptually, the draft PCG steps in where the jurisdiction of the PSI rules ends, and therefore should reflect the ATO's compliance approach to the same group of taxpayers, rather than a sub-set thereof.

The draft PCG relies on guidance from the Australian Council of Professions[1] to construct its definition of a "professional" in paragraph 29. Under this definition, professional services can include businesses in building and construction (e.g. builders, plumbers, electricians), finance (e.g. financial advisers, stockbrokers, consultants), property (e.g. real estate agents, conveyancers) and services such as waste removal and funerals.

Therefore, the scope of the draft PCG is potentially very broad – capturing all those who provide services that are subject to some level of education, accreditation and/or regulation.

Paragraph 7 of the draft PCG states:

> "When the business involves the provision of services, we will be concerned with arrangements where the compensation received by the individual is artificially low while related entities benefit (or the individual ultimately benefits), and commercial reasons do not justify the arrangement."

The ATO's recognition that there are a wide range of businesses, including non-professional services, where equity holders contribute to the business through the provision of labour means that the approach in the draft PCG should be designed for, and equally applied to, all such arrangements. While the draft PCG has its origins in the ATO's Private Groups and High Wealth Individuals (**PGH**) strategies in relation to professional firms, its application will be far broader and will potentially capture many small businesses.

While the interaction with the PSI rules is set out in paragraphs 30 to 31, the draft PCG would benefit from an example of a sole practitioner earning personal services income and satisfying at least one of the personal services business (**PSB**) tests to illustrate that the draft PCG would not apply to such situations.

Similarly, the following criteria in paragraph 25 should be better articulated to avoid confusion or uncertainty:

- "the income of the firm is not PSI" – as only individuals can have PSI[2], the meaning and application of this criteria is unclear
- "an IPP is an equity holder, that is, an IPP holds full rights to participate in the voting, management and income of the firm" – in many arrangements, particularly for small and medium sized firms, the IPP will not directly hold equity in the firm and it is instead owned by an associated entity. Is it intended that where the IPP does not hold equity in their own name, the draft PCG will not apply?

Clarity on the ATO's intended scope of the draft PCG, its compliance approach to other types of businesses and the plan for comparable guidelines to be issued for other industries, professions and/or businesses is required. The fact that a plumbing business will be treated differently to a small tax practice by the ATO does not seem equitable nor appropriate.

Where the ATO intends for this to be an exclusive compliance approach with unique tax treatment of arrangements for the professions selected by the ATO, this should be made clear.

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[1] The **Australian Council of Professions** is a non-statutory body comprised of 20 membership organisations, including CPA Australia, and "represents more than 930,000 Australian professionals including engineers, healthcare and computer professionals, veterinarians and accountants." Its membership does not include organisations from the legal, non-accounting financial services or architectural professions, amongst others.

[2] Subsection 84.5(3) Meaning of personal services income *ITAA 1997*

Purpose and approach of the draft PCG

As stated in the joint submission, the draft PCG is primarily a guide to assess the likelihood of the ATO reviewing the affairs of an IPP and his/her firm with a view to applying Part IVA. As such, the context in which the draft PCG has been prepared and the specific risk (i.e. Part IVA) that it seeks to address should be more clearly stated and reflected in the approach.

In its current form, the draft PCG ultimately categorises many ordinary, relatively straightforward and commercial arrangements as moderate or high risk of audit. This is due to the ATO's use of three risk assessment factors that do not have a clear nexus to Part IVA features described in ***PS LA 2005/24 Application of General Anti-Avoidance Rules*** (**PSLA 2005/24**).

The draft PCG does not provide safe harbours, *de minimis* rules or any assurance to many IPPs given the current settings of the scoring model. IPPs who are confident that their structures and distributions would not be subject to Part IVA are likely to disregard the draft PCG. However, we are concerned that others will unnecessarily adjust their arrangements solely to achieve a lower risk score under the draft PCG, potentially to their detriment. Neither response is desirable. Therefore, we suggest that the draft PCG be better calibrated to ensure that IPPs currently paying a correct and legal amount of tax are not driven to increase their tax liabilities merely by the threat of audit.

To this end, the draft PCG needs to encompass a wide range of operating models and modern business practices as well as the different forms taken by firms (e.g. incorporated firms, structures with service trusts, Phillips trusts[3]). It should also recognise that the creation of value by firms and the resulting profit is increasingly generated by intellectual property, processes and product offerings rather than the time or exertion of IPPs. In reality, many directors and partners do not spend significant time with clients providing their professional expertise (i.e. generating billings) but instead work on their business rather than in it – that is, more CEO than accountant.

CPA Australia's My Firm, My Future report[4] provides insights into the changing landscape for accounting practitioners and describes the shift in structure of professional accounting firms. The draft PCG should provide assurance that arrangements that are contemporary, commercial and reflect appropriate economic returns will be at a low risk of audit.

For those assessing themselves using the draft PCG, the process should not be costly or onerous, particularly given the expectation that assessments will be undertaken annually. Members have advised us that undertaking the risk assessment and preparing the associated documentation may add thousands of dollars to business establishment costs and ongoing annual fees.

Gateway 1

Gateway 1 is fundamental as it seeks to identify whether income is validly alienated. Paragraph 40 of the draft PCG imitates the "Part IVA Warning Signs" listed in paragraph 151 of PSLA 2005/24. As such, it is the closest the guidance comes to linking the manner in which profits are allocated to Part IVA.

Paragraph 41 discusses the issue of remuneration and requires that "the IPP actually receives an amount of the profits or income which reflects a reward for their personal efforts or skill". While further guidance is not provided under Gateway 1, paragraphs 88 to 93 of the draft PCG set out the ATO's expectations in establishing an appropriate level of remuneration for the IPP's services provided to the firm.

Once the Gateway 1 requirements are satisfied, subject to the application of the PSI rules, we consider that applying Part IVA to the arrangement would be very difficult, except in the most extreme of situations. Therefore, it is the arrangements that fail Gateway 1 that the draft PCG should seek to identify and address.

Where the commerciality requirements of Gateway 1, including IPP remuneration, and consequently the Part IVA factors, have most likely been satisfied, the function and value of the subsequent risk assessment framework remains unclear.

Gateway 2

The high-risk features listed under Gateway 2 provide a practical guide to identify specific issues that should be considered when risk-assessing the IPP's arrangements.

We support the issuance of Taxpayer Alerts to notify IPPs and their advisers of arrangements that will attract the ATO's attention.

Like Gateway 1, we believe that the ATO should devote compliance resources to arrangements that fail Gateway 2 as they manifest a higher level of risk.

[3] As per *Federal Commissioner of Taxation v. Phillips* **78 ATC 4361**
[4] CPA Australia, 2019. **My Firm, My Future**.

Risk assessment framework

The risk assessment framework introduced in the draft PCG significantly changes the risk profile of an arrangement compared to the suspended guidelines. An arrangement that met the tests under the suspended guidelines (e.g. 50 per cent going to individual and an effective tax rate (**ETR**) of 30 per cent) will now receive a score of nine and is assessed as high risk of an ATO audit.

In the absence of an explanation of how the risk assessment factors and risk score settings have been determined, we find it problematic that the same set of facts results in an arrangement going from low risk under the suspended guidelines to high risk under the draft PCG.

We are concerned that arrangements will be restructured into inefficient, commercially unsound and unnecessary structures so that firm profits are taxed in the IPP's name simply to get a lower risk score, not because it is the correct tax outcome. By artificially inflating IPP incomes it is likely that a greater-than-arm's length salary and wage will be paid to the IPP and profits generated by the business structure will be disproportionately attributed to the IPPs when that income should instead be retained for working capital, business expansion and investment in capital and labour.

A key issue is that the risk assessment framework does not recognise the ability of the business to generate profits in excess of the IPPs' collective and individual contributions, nor the impact of non-IPP related factors (e.g. accelerated depreciation, carry-forward losses, credits and offsets) on effective tax rates. Further, no recognition is given to the fact that many firms have professional non-IPP employees who generate much of the business' profits, nor is there any provision for a commercial return on capital for the investors in the firm. There appears to be an implicit and incorrect presumption that returns generated by the business structure should accrue to the IPPs directly rather than the holders of equity. We highlight the commercial imperative for investors to receive a return on their capital investment.

We also note that the high levels of merger and acquisition activity in the professional services industry demonstrate the value of these business structures and that the fair value of the firm is often independent of the IPPs themselves (i.e. the IPPs of the acquired firm are not necessarily retained and the goodwill calculated as part of the acquisition does not include their participation or expertise)[5].

Further, there is no accommodation for the large variability in profits arising from differences in the profession, firm, location, client base, service and product offerings, specialisations and the capabilities of the IPPs and their staff. There is also no distinction made for partners no longer working in the business or those who are working part-time or at reduced levels. As a result, the scoring is biased against IPPs and firms with the simplest and most conservative of arrangements, which will potentially be classified as moderate or high risk.

When the risk assessment framework is applied to arrangements with arm's length remuneration and profit margins in line with the industry average, our members have observed that it remains highly likely that the risk score results in a moderate or high risk of audit. The risk scores appear to be based on the old professional partnership business model where the IPPs earn all the income of the firm and the settings are calibrated for high-income, high-profit partnerships rather than the majority of medium-income and low to medium-profit professional services businesses. Before partner salaries, 2018 data[6] show profit per partner of $327,000 generating a net profit margin of 35.7 per cent, and when a notional salary of $200,000 per partner is applied, one in four partners make a loss and average firm profitability is approximately 13%.

We note that none of the seven case studies in Appendix 1 of the draft PCG include an incorporated firm and only one with a corporate beneficiary of a trust, which suggests an underlying and incorrect assumption by the ATO that all professional firms operate as sole traders or partnerships. The case studies do not make reference to the amount of equity invested by the IPP and associated entities, nor do they provide an allowance for commercial returns on these amounts.

This is not reflective of modern practices, particularly incorporated firms, and does not factor in the value of the business, its ability to generate profits in excess of the IPPs' contributions (i.e. from its business structure) and the right to retain profits including in associated entities. For example, an incorporated firm where the senior accountants are equity holders receiving arm's length remuneration, where profits are taxed at the 25 per cent company tax rate (i.e. base rate entity) and profits are retained, is still likely to receive a moderate or high risk score.

Fundamentally, the risk assessment framework potentially encourages arrangements where high wages are returned to the IPP and no profits are kept in the business, in order to obtain a low risk score. This is counter-intuitive and commercially unrealistic

[5] Accounting firms change hands regularly including structural shifts such as acquisition by larger firms or divestments into smaller firms. Our members have indicated that an IPP running a small firm earning $200,000 per annum can likely sell her parcel of fees to a third party for $200,000. The acquirer is not purchasing the IPP's personal exertion, nor a job for himself, but rather the goodwill from that parcel of fees. He will be seeking a return of 15 to 25 per cent on his equity investment. Assuming that equity is purchased at fair market value (noting that there are other tax provisions to deal with non-commercial valuations), then resulting profits will be profits of the business, not the IPP and should not be required to be alienated.

[6] Business Fitness, 2018. Executive Summary, **Good Bad Ugly Benchmarking Report & Practice Improvement Guide for Australian Accounting Firms**

with a disproportionate impact on large numbers of IPPs whose small and medium-sized firms generate profit margins (adjusted for IPP remuneration) around the IBISWorld industry average of 23 per cent[7] or lower.

The draft PCG does not explain why arrangements with the following characteristics are considered high risk by the ATO:

- The business has scale
- A significant proportion, and in many cases the vast majority, of the profit is generated from the business structure and not by the efforts of the IPP
- The equity owner/s receive a commercial and reasonable return on their investment
- The balance of the income that is not referable to the return on equity is returned by the IPP
- The IPP has been remunerated at either arm's length rates (i.e. 100 per cent of commercial benchmark) or even over-compensated (i.e. more than 100 per cent of commercial benchmark).

We also question the inclusion of income from service entities and other associated businesses in the risk score calculations. Where these arrangements are in accordance with **IT 276 Payments to service companies: splitting of professional income**, **TR 2006/2 Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements** and the ATO's general **guidance** on service entity arrangements, the purpose of their inclusion in the risk assessment factors is unclear except to inflate the denominator and consequently the risk score. In addition to better defining the term "other associated businesses", the ATO should consider providing firms and IPPs with the option to include or exclude commercial and arm's length arrangements covered by existing guidance, with a comparable adjustment being made available to firms and IPPs without a formal service entity structure.

Ultimately, in addition to the arrangements that have failed the two gateways (e.g. those of most extreme risk, say 1 per cent of arrangements), the risk assessment framework should be designed to identify the arrangements that would sit on the extreme (e.g. 3 per cent might be considered at high risk of audit) and very high (e.g. a further 6 per cent might be considered at moderate risk of audit) end of the risk distribution. We suggest that these would be the types of arrangements that have passed the gateways but appear convoluted and/or indicate a lack of commerciality.

We do not believe that the current design of the risk assessment framework achieves an appropriate distribution and, in fact, will result in many lower risk arrangements being scored as moderate or high risk of ATO audit.

If the draft PCG is progressed, the risk assessment framework should:

- set out an approach for distinguishing between profits generated by the business structure and those generated by the IPPs if arm's length remuneration is considered insufficient by the ATO
- include a factor for commercial returns to equity holders
- accommodate incorporated firm structures
- adjust for differing levels of personal exertion relative to equity shares by IPPs
- recalibrate the risk score settings, including:
    - re-evaluating risk assessment factor 1 against existing data to ensure that the settings appropriately reflect the distribution of profit entitlements returned in the hands of the IPP or permit adjustment factors to accommodate differences in value drivers and operating models
    - recalibrating the risk score so that remuneration of 100% of the commercial benchmark results in a low risk score (i.e. 3 or less) and removing the 200 per cent remuneration percentage as it suggests commercially unrealistic over-compensation is required
    - recalibrating the risk score so that an effective tax rate of 25 per cent or more for base rate entities results in a low risk score
- consider using a weighted score where risk assessment factor 3 (commercial remuneration benchmark) has the largest weight in the risk score.

[7] The average rate of return for accounting practices is 23.7%. Source: IBISWorld, 2021. **Accounting Services in Australia industry statistics**.

Risk assessment factor 1: Proportion of profit entitlement

Risk assessment factor 1 (i.e., the proportion of profits benchmark) applies a one-size-fits-all approach which does not consider the differing profitability of various firms and different types of professions.

The profitability of firms can differ greatly between different firms and/or professions depending on their location, the types of clients and the specialities and capabilities of the IPPs and their staff. Some firms are more reliant on the professional expertise and services provided by the principal IPPs, whereas for others profitability is more dependent on the services and expertise provided by the structure and other IPPs and staff members. Therefore, risk assessment factor 1 is a highly unreliable measure of the appropriate profit allocation to the principal IPPs.

We are also concerned by the inclusion of income from service entities and other associated businesses in applying risk assessment factor 1. By including income from a service entity in the income of the whole firm, this effectively undermines the principles established in *Federal Commissioner of Taxation v. Phillips* **78 ATC 4361** (**Phillips**) which are fully reflected and endorsed in TR 2006/2 and which arguably, should not be over-ridden by the draft PCG.

We consider that where there is compliance with TR 2006/2 and the arrangement is considered commercial and at arm's length, it is no longer necessary to include that income as part of determining whether the IPP has received an appropriate share of the income related to their personal effort. Income from the service entity or other associated business is a return on capital where the IPP (and other entities) have invested money in the service entity to enable it to acquire assets and hold sufficient working capital to provide the administrative services to the practice entity. Such income represents a commercial return on investment and should not be included in the IPP's income as a reward for personal effort.

We also highlight the importance of the risk assessment framework remaining consistent with the principles established in *Taxation, Commissioner of (Cth) v Everett* **80 ATC 4076** (**Everett**). To the extent that assignments are consistent with Everett, these should be scored as low-risk and excluded from the profit proportion measure.

Ultimately, risk-assessing the proportion of profit entitlement returned by the IPP requires a more detailed comparative analysis of the profits generated by the business structure relative to the appropriate level of remuneration of the IPP for their personal exertion with adjustments for the various value drivers and levels of IPP contribution listed in this submission. The denominator should be adjusted for the elements of arrangements that are compliant with existing laws so as to not unnecessarily inflate the risk score.

Risk assessment factor 2: Total effective tax rate

Risk assessment factor 2 (i.e., total effective tax rate) expects an effective tax rate of more than 30 per cent for an arrangement to be scored as low risk. This is very high given that many professional firms will have turnover of less than $50 million per annum (the turnover threshold for the base rate entity company tax rate of 25 per cent) and an IPP must receive taxable income of almost $200,000[8] to achieve a 30 per cent effective tax rate on their individual income. The amount returned by an IPP would have to be even higher if the incorporated firm sought to retain profits for reinvestment purposes with the inappropriate result that the IPP would be over-compensated and the firm would have less access to capital than is commercially sound.

An effective tax rate of 30 per cent is almost impossible to achieve by an incorporated firm paying arm's length remuneration to its IPPs with the result that risk assessment factor 2 discriminates against smaller and/or less profitable firms, base rate entities and lower earning IPPs, including those working part-time. Our members have advised that many suburban and regional firms and part time IPPs will not attain the more than 30 per cent average tax rate required for a low risk score, even if they receive a substantial majority of the firm's profits, including amounts generated by the business structure, not personal exertion.

Further, the effective tax rate of an entity or group of entities can be affected by a range of factors that are well-articulated in the ATO's information on corporate tax transparency[9]. Timing differences, tax depreciation (including temporary full expensing), carried forward losses, loss carry-back, offshore income and foreign tax credits, franking credits, offsets and rebates can all reduce the effective tax rate.

We also note that while risk assessment factor 3 (IPP remuneration) takes into account forms of remuneration such as superannuation and fringe benefits, the effective tax rate calculation does not. This highlights an inconsistency of approach between the measures and suggests, at the very least, tax paid on superannuation and fringe benefits should also be included in risk assessment factor 2.

The effective tax rate, particularly with its current design and risk score calibration, would seem to be a rather clumsy measure by which to assess the likelihood of Part IVA risk. Further work should be undertaken to review the distribution of effective tax rates across the full IPP population, incorporate adjustments as appropriate and consider the full tax base associated with the profits generated by the IPP's personal efforts. At the very least, for firms with turnover below $50 million, the effective tax rate

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[8] The taxable income amount required for an individual effective income tax rate of 30 per cent will increase in future years as Stage 3 personal income tax cuts are introduced.

[9] ATO, 2020. **Tax and report data**, Tax transparency: reporting of entity tax information.

threshold for low risk should be reduced to equal to or greater than 25 per cent, rather than the current setting of above 30 per cent.

Risk assessment factor 3: Commercial benchmark for IPP remuneration

It is our view that where the IPP can demonstrate that their remuneration is equal to or greater than an arm's length amount for the services they provide to the firm, this should be sufficient. This would be consistent with the approach taken in paragraph 150 of TR 2021/D2 which states that Part IVA could apply where a contractor "is paid substantially less than the market value of their work, and the profit made as a result of paying less than a market value salary is distributed to the contractor's relatives or accumulated at a lower rate of tax".

We reiterate that gateway 1 is the fundamental test for assessing the likelihood of Part IVA risk and that the concepts underpinning risk assessment factor 3 are already introduced and addressed in paragraph 41 of the draft PCG.

Given that the draft PCG seeks to identify arrangements where the IPP does not pay individual income tax on income generated by personal effort, this commercial remuneration benchmark is the primary measure that should be used to assess Part IVA risk.

To reduce uncertainty and compliance burden for the ATO and IPPs as to an appropriate methodology and amount, the ATO could publish benchmark remuneration amounts and/or develop remuneration guidelines similar to the **Market valuation for tax purposes** guidelines.

Other issues

Further issues that have been raised by our members include:

1. How does the draft PCG apply to practices that are incorporated and retaining income to invest?
2. What adjustments are made for changes in equity holders and IPPs including entries and exits and part-year periods?
3. The draft PCG suggests that the ATO expects trustees to be able to increase distributions to IPPs. However, this is not always possible (e.g. where there are excluded beneficiaries or fixed interests). How does the draft PCG apply to these situations?

There is a risk that the draft PCG in its current form may be ignored by IPPs or that they will have low confidence in the draft PCG's ability to properly evaluate Part IVA risk, and consequently the likelihood of a successful Part IVA audit.

We also find the manner in which the draft PCG is constructed to be onerous and unclear, creating uncertainty. We believe it would be of greater benefit if the PCG would provide certainty to IPPs with low or no Part IVA risk that the ATO will not apply compliance resources to a review of their arrangements (in a Part IVA context at least).

We have highlighted the inappropriate risk assessment framework results for many incorporated and/or smaller firms and suggest that the ATO considers providing *de minimis* rules, the option to exclude already-compliant arrangements (e.g. arrangements in accordance with TR 2006/2, Phillips and Everett), improved calibration of the risk scores, the inclusion of return on equity factors and refinements to the proposed risk assessment factors.

The draft PCG should not result in the classification of standard and ordinary arrangements as moderate to high risk of audit or drive an unnecessary increase in tax payments by IPPs with no legal basis.

We suggest that the ATO concentrate its resources on identifying arrangements that do not pass the gateways and to continue its work auditing high risk IPPs and firms. Further compliance activity could be considered as part of the tax gap program and results from IPP audits can be used both to inform the ATO's risk models and to develop statistically validated indicators of Part IVA risk as the basis of the "risk assessment factors".

Example 1: IPP with a trust practice structure

A trust invests a total of $1.4 million (being for the acquisition of goodwill (e.g. client lists and brand recognition), plant and working capital) in the equity of a professional services partnership. The trust funds the equity via a combination of its own resources, vendor finance from an outgoing equity owner and bank debt. The partnership has four equity owners and employs 20 professional staff and five administrative staff. The highest paid professional staff member of the partnership has a salary package of $130,000. The trust earns a return on equity of 23.1% which is around the average rate of return for accounting practices[10].

The IPP will receive a risk assessment score of amber (moderate risk of ATO audit) even when more-than-arm's length remuneration is paid to the IPP, the net income attributable to the business structure is not fully distributed to the corporate beneficiary and the return on equity is around the industry average.

Revenue	**4,500,000**
IPP billings[a]	750,000
Other billings[b]	3,750,000
Expenditure	**(2,325,000)**
Salaries paid to professional and administrative employees	(1,650,000)
Overhead costs[c]	(675,000)
Net income of the partnership[d]	**2,175,000**

[a] Gross revenue billed by all IPP's from their personal exertion is $750,000, evenly spread across all IPPs
[b] Each professional employee bills around $185,000
[c] Overhead costs are 15% of revenue with $562,500 attributable to the business structure/staff and $112,500 attributable to the IPPs
[d] $1,537,500 of partnership net income attributable to the business structure/staff and $637,500 attributable to the IPPs

Total partnership net income of the trust as equity holder	**543,750**
Net income relating to the business structure	384,375
Net income relating to professional services provided by the IPP	159,375
Expenses	**(50,000)**
Interest	(30,000)
Other deductions	(20,000)
Net income of the trust	**493,750**
Distribution to IPP[a]	170,000
Distribution to corporate beneficiary[b]	323,750

[a] The remuneration is 130% higher than the equivalent remuneration paid to the highest professional staff member. The IPP pays personal income tax (excluding Medicare levy) of $51,637 on the $170,000 distribution.
[b] The $323,750 represents less than the full profit that is generated by the business structure. The trust has invested $1.4m in the equity and working capital of the business, and the return on investment is 23%.

Risk assessment factor 1

$$Proportion\ of\ profit\ entitlement\ from\ the\ whole\ of\ firm\ group\ returned\ in\ the\ hands\ of\ the\ IPP$$
$$= \frac{distribution\ to\ IPP}{total\ income\ entitlement\ of\ the\ IPP\ and\ associated\ entities} \times 100 = \frac{170{,}000}{493{,}750} \times 100 = 34.4\%$$
$$= Risk\ score\ of\ 5\ (high\ risk)$$

[10] The average rate of return for accounting practices is 23.7%. Source: IBISWorld, 2021. **Accounting Services in Australia industry statistics**.

Risk assessment factor 2

$$Total\ effective\ tax\ rate\ for\ income\ received\ from\ the\ firm\ by\ the\ IPP\ and\ associated\ entities$$
$$= \frac{personal\ income\ tax\ paid\ by\ IPP + corporate\ tax\ paid\ by\ corporate\ beneficiary}{distribution\ to\ IPP + distribution\ to\ corporate\ beneficiary} \times 100$$
$$= \frac{51{,}367 + (323{,}750 \times 0.25)}{170{,}000 + 323{,}750} \times 100 = 26.8\% = Risk\ score\ of\ 4\ (moderate\ risk)$$

Risk assessment factor 3

$$Remuneration\ returned\ in\ the\ hands\ of\ the\ IPP\ as\ a\ percentage\ of\ the\ commercial\ benchmark = 130\%$$
$$= Risk\ score\ of\ 3\ (low\ risk)$$

Risk assessment score

With an aggregate risk score of 12, the IPP is rated amber and is exposed to a moderate risk of ATO audit.

If risk assessment factor 3 is excluded, the aggregate risk score is 9 and the IPP is rated red and exposed to a high risk of ATO audit.

Example 2: IPPs with a corporate practice structure

A small, incorporated professional services firm with two directors (IPPs) who hold equal shares, five professional accountant employees and administrative staff will receive a risk assessment score of amber (moderate risk of ATO audit) when arm's length remuneration is paid, and profits are retained.

The professional services firm uses a corporate structure to protect against professional indemnity claims, build practice goodwill, raise capital, utilise a structure that allows the business to be sold and enable ownership flexibility. The IPPs pay themselves a salary based on commercial benchmarks and the firm's profit margin before tax is 16.7%.

Revenue	**1,500,000**
IPP billings[(a)]	500,000
Employee billings[(b)]	1,000,000
Expenditure	**(1,250,000)**
Salaries paid to IPPs[(c)]	(300,000)
Salaries paid to accountant employees	(450,000)
Other expenses[(d)]	(500,000)
Net income before income tax	**250,000**
Tax[(e)]	(62,500)
Retained profits[(f)]	**187,500**

[(a)] Each IPP bills around $250,000
[(b)] Each accountant employee bills around $200,000
[(c)] Each IPP paid $150,000 salary which is based on arm's length remuneration benchmarks. Personal income tax of $43,567 (excluding Medicare levy) is paid by each director.
[(d)] Includes salaries for administrative and support staff, sales, general and administration expenses
[(e)] Base rate entity, 25% tax rate from 2021-22 income year
[(f)] No dividends are paid and all profits are retained for reinvestment

Risk assessment factor 1

$$Proportion\ of\ profit\ entitlement\ from\ the\ whole\ of\ firm\ group\ returned\ in\ the\ hands\ of\ the\ IPP$$

$$= \frac{salary\ paid\ to\ IPP}{salary\ paid\ to\ IPP + profit\ before\ tax \times ownership\ percentage} \times 100 = \frac{150{,}000}{150{,}000 + 125{,}000} \times 100$$

$$= 54.5\% = Risk\ score\ of\ 4\ (moderate\ risk)$$

Risk assessment factor 2

$$Total\ effective\ tax\ rate\ for\ income\ received\ from\ the\ firm\ by\ the\ IPP\ and\ associated\ entities$$

$$= \frac{personal\ income\ tax\ paid\ by\ IPP + corporate\ tax\ paid\ by\ firm \times ownership\ percentage}{salary\ paid\ to\ IPP + profit\ before\ tax \times ownership\ percentage} \times 100$$

$$= \frac{43{,}567 + (62{,}500 \div 2)}{150{,}000 + 125{,}000} \times 100 = 27.2\% = Risk\ score\ of\ 4\ (moderate\ risk)$$

Risk assessment factor 3

$$Remuneration\ returned\ in\ the\ hands\ of\ the\ IPP\ as\ a\ percentage\ of\ the\ commercial\ benchmark = 100\%$$

$$= Risk\ score\ of\ 4\ (moderate\ risk)$$

Risk assessment score

With an aggregate risk score of 12, both IPPs are rated amber and exposed to a moderate risk of ATO audit.

Example 3: Part-time IPP with a corporate practice structure

This example uses the same fact pattern as Example 2 but now includes three directors who hold equal shares, one of whom is partially retired and works only two days per week and does not generate billings. The part-time IPP will receive a risk assessment score of red (high risk of ATO audit) when arm's length remuneration is paid, and profits are retained.

The directors pay themselves a salary based on commercial benchmarks and the firm's profit margin before tax is 18.8%.

Revenue	**1,600,000**
IPP billings[(a)]	500,000
Accountant employee billings[(b)]	1,100,000
Expenditure	**(1,300,000)**
Salaries paid to IPPs[(c)]	(360,000)
Salaries paid to accountant employees	(450,000)
Other expenses[(d)]	(490,000)
Net income before income tax	**300,000**
Tax[(e)]	(75,000)
Retained profits[(f)]	**225,000**

[(a)] Semi-retired IPP does not generate billings. Two full-time IPPs bill around $250,000 each
[(b)] Each accountant employee bills just over $200,000
[(c)] Semi-retired IPP paid $60,000 salary based on arm's length remuneration benchmarks and pays $11,067 personal income tax (excluding Medicare levy). Two full-time IPPs paid $150,000 arm's length salary.
[(d)] Includes salaries for administrative and support staff, sales, general and administration expenses
[(e)] Base rate entity, 25% tax rate from 2021-22 income year
[(f)] No dividends are paid and all profits are retained for reinvestment

Risk assessment factor 1

$$Proportion\ of\ profit\ entitlement\ from\ the\ whole\ of\ firm\ group\ returned\ in\ the\ hands\ of\ the\ IPP$$
$$= \frac{salary\ paid\ to\ IPP}{salary\ paid\ to\ IPP + profit\ before\ tax \times ownership\ percentage} \times 100 = \frac{60{,}000}{60{,}000 + 100{,}000} \times 100$$
$$= 37.5\% = Risk\ score\ of\ 5\ (high\ risk)$$

Risk assessment factor 2

$$Total\ effective\ tax\ rate\ for\ income\ received\ from\ the\ firm\ by\ the\ IPP\ and\ associated\ entities$$
$$= \frac{personal\ income\ tax\ paid\ by\ IPP + corporate\ tax\ paid\ by\ firm \times ownership\ percentage}{salary\ paid\ to\ IPP + profit\ before\ tax \times ownership\ percentage} \times 100$$
$$= \frac{11{,}067 + (75{,}000 \div 3)}{60{,}000 + 100{,}000} \times 100 = 22.5\% = Risk\ score\ of\ 5\ (high\ risk)$$

Risk assessment factor 3

$$Remuneration\ returned\ in\ the\ hands\ of\ the\ IPP\ as\ a\ percentage\ of\ the\ commercial\ benchmark = 100\%$$
$$= Risk\ score\ of\ 4\ (moderate\ risk)$$

Risk assessment score

With an aggregate risk score of 14, the part-time IPP is rated red and exposed to a high risk of ATO audit.

Example 4: Practice firm owned by family trusts and with service entity

The practice is operated by two IPPs who employ eight professional accountants as staff. The practice is owned in equal shares by two family trusts, and the trust associated with one of the IPPs pays $1 million to acquire shares in the incorporated practice. The acquisition of the shares is funded by a loan at 7 per cent, secured against a property held by the IPP's spouse.

A service entity forms part of the business structure. The service entity fee is less than 30% of the practice entity fee, labour gross mark ups are 10% (under the ATO indicative 30% reduced by 18% to 12% for lack of other operating costs) and net mark-up on costs is 9.3% (under the ATO's 10% ceiling). Likewise, lease is on-charged at cost plus outgoings and equipment hire charged at depreciation plus 7.5% return on assets. Such an arrangement will be considered a low risk service entity that meets ATO guidelines.

Each IPP is paid a salary of $180,000 which is 120 per cent of the commercial remuneration benchmark and 80 per cent of the company profits are paid as dividends with the balance retained for growth.

The IPP will receive a risk assessment score of amber (moderate risk of ATO audit) even when more-than-arm's length remuneration is paid to the IPP and the return on equity is below the industry average.

Practice entity

Revenue	**2,100,000**
IPP billings[a]	600,000
Other billings[b]	1,500,000
Expenditure	**(1,700,000)**
Salaries paid to IPPs[c]	(360,000)
Salaries paid to professional employees[c]	(525,000)
Service entity fee[d]	(470,000)
Other expenses[e]	(345,000)
Profit before income tax	**400,000**
Income tax	100,000
Profit after income tax	**300,000**
Profit margin before tax	19.0%
Profit margin before tax excluding IPP salaries	36.2%

[a] Gross revenue billed by both IPP's from their personal exertion is $600,000, evenly spread between the two IPPs
[b] Each professional employee bills around $187,500
[c] Excludes superannuation and other benefits. The IPP pays personal income tax of $45,592
[d] Includes rent, equipment hire and administrative staff (22.4% of revenue)
[e] Includes superannuation, software, professional indemnity insurance, professional development, sales and marketing, and other costs

Associated family trust

Total net income of the IPP's trust as equity holder	**160,000**
Franked dividends received	120,000
Franking credits	40,000
Expenses	**(80,000)**
Interest	(70,000)
Other deductions	(10,000)
Net income of the trust	**80,000**
Distribution to IPP[a]	0
Distribution to spouse[b]	80,000
Trust return on investment	8.0%

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Risk assessment factor 1

$$\textit{Proportion of profit entitlement from the whole of firm group returned in the hands of the IPP}$$

$$= \frac{\textit{income returned by IPP}}{\textit{total firm income of the IPP and associated entities}} \times 100$$

$$= \frac{180{,}000}{180{,}000 + 80{,}000 + 40{,}000 + 40{,}000} \times 100 = 52.9\% = \textit{Risk score of } 4\ (\textit{moderate risk})$$

Risk assessment factor 2

$$\textit{Total effective tax rate for income received from the firm by the IPP and associated entities}$$

$$= \frac{\textit{total tax paid on firm income by the IPP and associated entities}}{\textit{total firm income of the IPP and associated entities}} \times 100$$

$$= \frac{45{,}592 + 15{,}592 + 10{,}000 + 10{,}000}{180{,}000 + 80{,}000 + 40{,}000 + 40{,}000} \times 100 = 23.9\% = \textit{Risk score of } 5\ (\textit{high risk})$$

Risk assessment factor 3

$$\textit{Remuneration returned in the hands of the IPP as a percentage of the commercial benchmark} = 120\%$$

$$= \textit{Risk score of } 3\ (\textit{low risk})$$

Risk assessment score

With an aggregate risk score of 12, the IPP is rated amber and is exposed to a moderate risk of ATO audit.

If risk assessment factor 3 is excluded, the aggregate risk score is 9 and the IPP is rated red and exposed to a high risk of ATO audit.

Example 5: Sole IPP with a corporate practice structure – different risk profiles depending on whether the draft PCG or TR 2021/D2 is applied

A small, incorporated professional services firm with a single director, the IPP, employs a part-time administrator. The director pays himself a salary based on commercial benchmarks and the firm's profit margin before tax is 16.7%. The firm has over fifty clients and is paid for a result (e.g. preparation and lodgment of tax returns and business activity statements).

Where the income is found to be PSI

Based on TR 2021/D2, the director determines that he earns personal income and satisfies the results test. As a result, the PSI rules do not apply. Due to the preconditions contained in paragraph 25 of the draft PCG, as the income is PSI, the draft PCG also does not apply. Part IVA risk is instead addressed by paragraphs 148 to 150 of TR 2021/D2.

Because the salary and wages paid to the IPP (i.e. the test individual) is commensurate with and for the services provided and that income is returned by the test individual, it is unlikely that the Commissioner would consider the application of Part IVA.

Where the income is found not to be PSI

The income is found not to be PSI and is instead generated by the business structure based on the factors discussed at paragraph 36 of TR 2021/D2[11]. The IPP will receive a risk assessment score of amber (moderate risk of ATO audit) when arm's length remuneration is paid, and profits are retained.

Revenue	**300,000**
IPP billings	300,000
Expenditure	**(200,000)**
Salary paid to IPP[(a)]	(120,000)
Other expenses[(b)]	(80,000)
Net income before income tax	**100,000**
Tax[(c)]	(25,000)
Retained profits[(d)]	**75,000**

[(a)] IPP paid $120,000 salary which is based on arm's length remuneration benchmarks. Personal income tax of $31,867 (excluding Medicare levy) is paid by the IPP.
[(b)] Includes rent, salaries for administrative and support staff, sales, general and administration expenses
[(c)] Base rate entity, 25% tax rate from 2021-22 income year
[(d)] No dividends are paid and all profits are retained for reinvestment

Risk assessment factor 1

$$Proportion\ of\ profit\ entitlement\ from\ the\ whole\ of\ firm\ group\ returned\ in\ the\ hands\ of\ the\ IPP$$
$$= \frac{salary\ paid\ to\ IPP}{salary\ paid\ to\ IPP + profit\ before\ tax \times ownership\ percentage} \times 100 = \frac{120{,}000}{120{,}000 + 100{,}000}$$
$$= 54.5\% = Risk\ score\ of\ 4\ (moderate\ risk)$$

Risk assessment factor 2

$$Total\ effective\ tax\ rate\ for\ income\ received\ from\ the\ firm\ by\ the\ IPP\ and\ associated\ entities$$
$$= \frac{personal\ income\ tax\ paid\ by\ IPP + corporate\ tax\ paid\ by\ firm}{salary\ paid\ to\ IPP + profit\ before\ tax} \times 100 = \frac{31{,}867 + 25{,}000}{120{,}000 + 100{,}000}$$
$$= 25.8\% = Risk\ score\ of\ 4\ (moderate\ risk)$$

Risk assessment factor 3

$$Remuneration\ returned\ in\ the\ hands\ of\ the\ IPP\ as\ a\ percentage\ of\ the\ commercial\ benchmark = 100\%$$
$$= Risk\ score\ of\ 4\ (moderate\ risk)$$

Risk assessment score

With an aggregate risk score of 12, the IPP is rated amber and exposed to a moderate risk of ATO audit.

[11] While this is more likely to be a hypothetical scenario, it is presented to illustrate the different risk profiles that arise between the draft PCG and TR 2021/D2 using the same set of facts.

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