ALLOCATION OF PROFESSIONAL FIRM PROFITS – WHAT DOES IT MEAN FOR YOU AND YOUR CLIENTS?

ATO – CPA AUSTRALIA WEBINAR
FEBRUARY 2022

PRESENTERS

Christopher Ryan – Acting Assistant Commissioner, ATO

Christopher is acting Assistant Commissioner, Technical Leadership and Advice, within Private Wealth at the ATO and is responsible for leading teams that provide tailored strategic and technical advice. He has held roles in the ATO leading the delivery compliance programs the Tax Avoidance Taskforce and supporting the development of administrative approaches and technical views on trust matters.

Michael Parker – Partner, Hall & Wilcox

Michael's practice focuses on tax disputes, capital gains tax, business sales and acquisitions and restructuring. Michael has been recognised in The Best Lawyers in Australia in Tax Law every year since 2016.

Robert McDowall CPA – Director, Arabon Accountants

As director in a Queensland-based firm, Robert is experienced in working with small and medium enterprises, public companies and not-for-profit organisations. He is a member of CPA Australia's Best Practice Advisory Committee and is a regular guest of CPA Australia.

Elinor Kasapidis – Senior Manager Tax Policy, CPA Australia

Elinor joined CPA Australia after more than 15 years in various executive roles at the ATO and is responsible for CPA Australia's tax policy and advocacy portfolio.

EVENT AGENDA

A walk-through of ATO presentation on PCG 2021/4 Allocation of professional firm profits: the ATO compliance approach

- Background
- Purpose
- Gateways
- Self-assessment
- Transitional arrangements
- Further information
- Resources

ATO PRESENTATION:

PCG 2021/4 ALLOCATION OF PROFESSIONAL FIRM PROFITS: ATO COMPLIANCE APPROACH

Australian Government
Australian Taxation Office

Professional firms

PCG 2021/4 – Allocation of Professional Firm Profits and ATO's risk treatment

Background

It is common for professionals who jointly practice with other individual practitioners, such as lawyers and accountants, to use a variety of arrangements that result in some share of their income being diverted to related parties, such as a spouse or family trust.

WHAT IS THE PROBLEM?

Some of these arrangements led to alienation, or the inappropriate redirection of, the income of an ‘individual professional practitioner’ (‘IPP’) to an associated entity where it has the effect of altering the IPP’s tax liability.

PREVIOUS GUIDELINES

Compliance guidelines relating to the diversion of professional firm profits *Assessing the risk – allocation of profits within professional firms* issued in 2015 to deal with the problem. These guidelines were suspended in Dec 2017 after an ATO review identified evidence they were being misinterpreted (‘Suspended Guidelines’).

After consultation, Practical Compliance Guideline 2021/D2 *Allocation of Professional Firm Profits – ATO compliance approach* (‘Guidelines’) was issued for public consultation on 1 March 2021. The PCG was published on 16 December 2021 as PCG 2021/4 and applies, subject to any transitional arrangements, from 1 July 2022.

Purpose

Practical Compliance Guidelines – General

PCGs represent guidance on how the ATO will allocate its compliance resources according to assessments of risk.
They are intended to guide the behaviour of taxpayers who wish to operate in a low risk environment, as well as to signal when the ATO considers certain behaviours to be of a higher risk in nature.

They are not intended to provide interpretation of taxation laws.

Risk differentiation

The approach assists the ATO to differentiate risk in order to tailor our engagement with IPPs.

This Guideline uses two ‘gateways’ and a risk assessment framework of objective factors to rate IPP arrangements as low (green), moderate (amber) or high (red) risk. Analysis of the facts and circumstances of individual arrangements in the high and moderate risk zones would then be undertaken to determine investment of compliance resources where appropriate.

Provide confidence

If your circumstances align with the low-risk rating set out in this Guideline, we will generally not allocate compliance resources to test the relevant tax outcomes of your arrangement. Additionally, for most IPPs there will be a two year transitional period (post the 1 July 2022 start date of the PCG) where we will work with you to ensure you get it right.

Gateways

The Guideline only applies if the two Gateways are passed.

Where an IPP's circumstances do not pass the two Gateways the risk assessment framework is not available to them.
IPPs that believe they should be low risk can contact us at ProfessionalPdts@ato.gov.au to discuss further.

Gateway 1 – Commercial Rationale

Gateway 1 considers whether there is a genuine commercial rationale for the arrangement and the way the profits are distributed.

There must also be evidence that the stated commercial rationale was achieved as a result of the arrangement. The mere assertion of 'asset protection' is not sufficient, the IPP must be able to show how the arrangement actually improves asset protection.

Gateway 2 – Must not contain certain "High Risk Features"

You must assess whether your arrangement contains any high risk features, such as those covered by a Taxpayer Alert.

We also consider the following as potentially high risk features:

- Financing arrangements relating to non-arm's length transactions
- Exploitation of the difference between accounting standards and tax law
- Arrangements where a partner assigns a portion of a partnership interest that is materially different in principle from *Everett* and *Galland*
- Multiple classes of shares and units held by non-equity shareholders.

Self Assessment

HOW WILL THE PCG PRACTICALLY WORK?

The now Suspended Guidelines required an IPP to pass a single binary test to be low risk (any single test of the three could be passed).

The new Guidelines set out three risk assessment factors which must be considered to determine the IPP's risk zone.

Where the third risk factor is impractical to determine accurately, the IPP may use only the first two risk assessment factors.

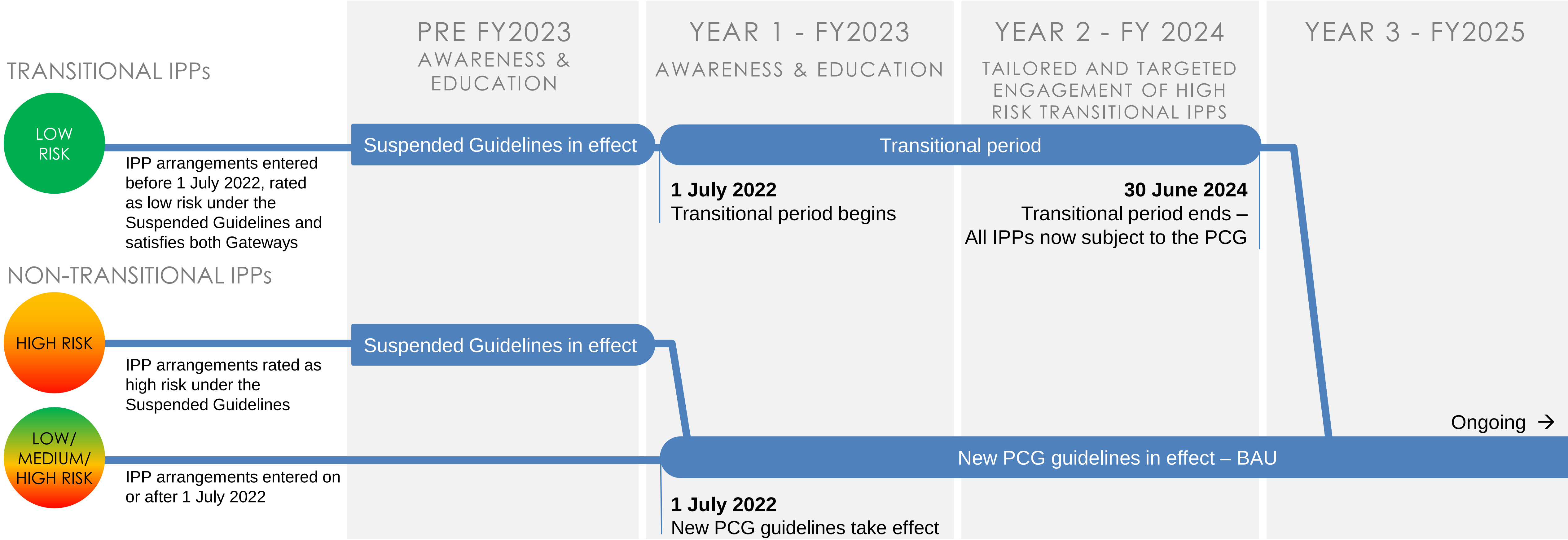
A The PCG provides a risk based approach which requires you to consider the three risk assessment factors (or where relevant, the first two):

RISK ASSESSMENT FACTOR	SCORE (LOWER IS BETTER)					
	1	2	3	4	5	6
1 Proportion of profit entitlement from the whole offirm group returned in the hands of the IPP	> 90%	>75% to ≤ 90%	>60% to ≤ 75%	≥50% to ≤ 60%	>25% to < 50%	≤25%
2 Total effective tax rate forincome received from the firm by the IPP and associated entities	> 40%	>35% to ≤ 40%	≥30% to ≤ 35%	>25% to < 30%	>20% to ≤ 25%	≤20%
3 Remuneration returned in the hands of the IPP as a percentage of the commercial benchmark for the services provided to the firm	> 200%	>150% to ≤ 200%	>100% to ≤ 150%	>90% to ≤ 100%	>70% to ≤ 90%	≤70%

B The scoring of these risk factors determines the risk zone of an IPP and ultimately our compliance approach (subject to transitional arrangements):

RISK ZONE	RISK LEVEL	AGGREGATE SCORING AGAINST	
		1 + 2	1 + 2 + 3
GREEN	Low risk	≤ 7	≤ 10
AMBER	Moderate risk	8	11 & 12
RED	High risk	≥ 9	≥ 13

Transitional Arrangements



KEY CONSIDERATIONS

- The transitional arrangements apply to IPPs who were low risk under the Suspended Guidelines.
- The PCG only applies from the application date for those IPPs who were high risk under the previous guidelines.
- Practically this means that any compliance action is in respect of those IPPs who were high risk under the Suspended Guidelines.
- We expect that most IPPs will only be subject to compliance action (where appropriate) in respect of their 2025 or later income tax returns.
- We will continue to monitor the behaviour of the population during the transitional period.

Further Information

The PCG contains a number of case studies and risk assessment examples which may be useful to your circumstances.

Each case study highlights the risk assessment factor to be considered, practical application of the criterion to the facts and circumstances, as well as the risk score.

We encourage you to read through our Compendium as it addresses many other issues and questions.

Should you have a unique situation that isn't covered by those examples, or the Compendium, we encourage you to contact the ATO at the ProfessionalPdts@ato.gov.au mailbox.

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CPA Australia Member Connect

Connect with the CPA Australia community, and post and reply to professional firm profit allocation threads.

RESOURCES

Read the ATO's web content

- https://www.ato.gov.au/business/income-and-deductions-for-business/in-detail/professional-firms/assessing-the-risk--allocation-of-profits-within-professional-firms/

Check out CPA Australia's professional firms profit allocation checklist and client letter (members only)

- https://www.cpaaustralia.com.au/tools-and-resources/taxation

THANK YOU