TERMS OF ENGAGEMENT

# General template

## CPA Australia has created this checklist for the allocation of professional firm profits in response to PCG 2021/4 that you can use for you and your clients.

## The following version control information has been included to assist you monitor changes to the template to ensure you are using the latest version.

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**PCG 2021/4: Allocation of professional firm profits – Checklist**

The ATO published their revised guideline on the allocation of professional firm profits on 16 December 2021 with the guidelines applying from 1 July 2022 in the form of PCG 2021/4 (**PCG**). The guideline sets out the ATO's compliance approach to the allocation of profits or income from professional firms in the assessable income of the individual professional practitioner (**IPP**). It is not interpretive guidance like a Taxation Ruling.

The ATO has developed the PCG to enable an IPP to:

* Determine the risk level regarding their profit allocation arrangement based on a risk assessment framework;
* Determine level of engagement an IPP can expect from the ATO based on this risk assessment;
* Decide whether to contact the ATO to discuss the IPP’s self-assessment of the arrangement if it is determined to be high risk; or
* Support application for binding advice if it is sought from the ATO.

An IPP is only eligible to use the PCG for these purposes where it passes two Gateways:

* Gateway 1: There is sound commercial rationale for entering into and operating the arrangement or structure (see para 39-46 of the PCG, and below); and
* Gateway 2: There must not be certain high-risk features (see para 47-59 of the PCG).

The main reason to apply the PCG is to assess whether the IPP has a low-risk rating, or how to restructure such that the IPP has a low-risk rating. This is because the ATO set out in the PCG that if an IPP’s circumstance align with the low-risk rating as set out in the PCG, the ATO would generally not conduct compliance activity to test the tax outcomes of the arrangement.

The ATO expects an IPP to annually assess its eligibility to apply the PCG and have this documented. Any changes to the IPP’s business or arrangement should also be documented in the context of an IPP’s ability to apply the PCG.

This checklist is prepared to assist your consideration as to whether the PCG applies and determine the risk rating of an IPP and their arrangement. It could form part of the documentation required by the ATO but is not a complete or comprehensive set of documentation which will satisfy the ATO in the event of a review/audit. You should be guided by the PCG in preparing such documentation but should include the following:

1. The nature of the arrangement
2. How Gateway 1 applies to the arrangement
3. How Gateway 2 does not apply to the arrangement
4. How each risk factor is calculated
5. The total risk score and risk zone
6. Further action to be taken, if applicable.

The PCG is limited to risks associated with allocation of profits to IPPs within professional firms. It does not cover other tax issues such as Division 7A.

For pre-existing arrangements that pass the above gateways, the ATO’s 2015 suspended guidelines *Assessing the risk: allocation of profits within professional firms* apply from 1 July 2017 to 30 June 2022. Taxpayers whose arrangements were low risk under the suspended guidelines but have a higher risk rating under the [PCG](https://iknow.cch.com.au/resolve-citation/XAMTG1_HANDLE%20io3460671sl1312660229) can continue to apply the suspended guidelines until 30 June 2024.

**About the author**

This checklist was prepared by Hall Chadwick (NSW) Pty Ltd on behalf of CPA Australia. Direct extracts from the ATO’s PCG 2021/4 have been used in preparing this checklist.

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| 1. Does the PCG apply to your arrangement?  | Yes | No |
| The PCG will only apply to your arrangement if all of the following criteria are met:1. An individual professional practitioner (IPP) provides professional services to clients of the firm or is actively involved in the management of the firm and, in either case, the IPP and/or associated entities have a legal or beneficial interest in the firm;
2. The income of the firm is not subject to personal services income (PSI) rules;
3. The firm operates by way of a legally-effective structure, for example, partnership, trusts and/or companies; and
4. The IPP is an equity holder, directly or through an associated entity

If the answer is yes to all of the above, the PCG can potentially apply to your arrangement. Continue to question 2.If an answer to any of the above questions is no, the PCG does not apply to your arrangement, and it will not be protected by the terms of the PCG.  |  |  |
| 2. Does your arrangement satisfy Gateway 1: Commercial rationale  | Yes | No |
| Gateway 1 considers whether the arrangement and the way in which it operates are commercially driven. The ATO recommends the answers to the below be documented:1. Is there a genuine commercial rationale for the arrangement for all parties involved? Does the arrangement achieve that end?
2. Is there evidence that the stated commercial purpose was achieved as a result of the arrangement? For example, where “asset protection” is the commercial purpose, the arrangement must improve asset protection.
3. Where the arrangement is not straightforward or commercial, is there a commercial rationale for this?
4. Is the legal form and documentation of the arrangement consistent with its economic substance and how the firm operates in practice?
5. When the arrangement is considered in its entirety, are there non-tax related practical changes in addition to a change in tax performance?
6. Is there a genuine commercial basis for the way in which profits are distributed between the IPP and related parties, especially in the form of remuneration paid? Relevant considerations are:
	1. The IPP actually receives an amount of profits/income which reflects a reward for their personal efforts or skill and reflects an appropriate return for the services they provide;
	2. The income of the IPP in a given period is linked to their personal performance in that period;
	3. The income to the IPP has been distributed in substance to the IPP, and the income of the related party has also been distributed in substance to that related party
	4. The IPP ultimately benefits from the distribution of income to associated entities where the distribution to the related party is referable to the personal efforts or skills of the IPP
	5. The remuneration to the IPP is commercial and comparable to arm’s length payments
	6. There are no loan accounts relevant to the arrangement;
	7. The related party receiving profits has control of the cash distributed to them, and has use and enjoyment of the cash, and this is not predominantly for the IPP’s use and enjoyment.

If the answers to the above is yes, the PCG can potentially apply. Continue to question 3.If the answers are no, the PCG may not apply to your arrangement, and it may not be protected by the terms of the PCG.  |  |  |
| 3. Does your arrangement satisfy Gateway 2: High Risk features  | Yes | No |
| Where an arrangement demonstrates high-risk features, the PCG does not apply. High risk features includes any arrangement covered by a Taxpayer Alert. Does your IPP arrangement have the following high-risk features?1. Financing arrangements relating to non-arm’s length transactions. The ATO does not accept there is a commercial purpose when an associated entity of an IPP utilises finance to acquire an existing portion of the IPP’s equity interest in a professional firm. Financing arrangements involving associated entities that give rise to tax benefits are considered high risk.

Example: An IPP disposes of a portion of their interest in a professional firm to an associated discretionary trust which borrows money from a bank to pay for the transaction. The borrowing is secured and guaranteed by the IPP as an individual. The trust obtains a deduction for the interest paid on the borrowing. The IPP uses the money received from the trust for the interest in the firm to pay off mortgage debt on their primary residence. The effect of this financing arrangement is to convert non-deductible debt to deductible debt through the use of a non-arm's length transaction.1. Exploitation of the difference between accounting standards and tax law, which results in income assessed to individuals or businesses that pay little or no tax while allowing others to enjoy economic benefits. Work in progress and employee leave provisions is not a high-risk feature under this factor.

Example: An IPP may utilise the different treatment between accounting and tax for amortising an intangible asset (for example, the assigned portion of the IPP's interest in the firm). Pursuant to accounting standards, the intangible asset should be tested for impairment or amortisation each year. Where the book cost exceeds the net realisable value, the asset should be impaired. The impairment or amortisation is a non-cash accounting expense and does not give rise to a tax deduction. This will likely generate a situation where there is a difference (not otherwise being a temporary difference) between the taxable income, the accounting income and the cash available for distribution resulting in the ability to distribute the taxable income to certain entities, with the cash being distributed by other means to other entities.1. Arrangements where a partner assigns a portion of a partnership interest that is materially different in principle from *Everett* and *Galland*. In *Everett* and *Galland*, the courts held a partner could reduce income tax on profits from a partnership by assigning an interest (or part of an interest) in a partnership to another entity that is subject to a lower tax rate. The Commissioner considers the following arrangements to be materially different in principle to *Everett* and *Galland* where a partner assigns a portion of their partnership interest:
* arrangements purporting to admit an individual as a partner, where the individual is not an owner or equity holder in the partnership, and
* arrangements where the IPP's relationship has characteristics indicating their relationship with the partnership is akin to a contractor or employee.

Factors that may indicate there has been a departure from *Everett* and *Galland* include but are not limited to:* indemnification of non-owner/non-equity holders by equity partners against any professional liability in respect of actions against the partnership
* a fixed draw or salary, particularly where there is limited or no exposure (without indemnification) to the risks and benefits associated with the performance of the partnership as to the payment of that draw or salary, and
* a lack of rights to full participation in management and the benefits of the partnership, relative to other partners.

Example: An individual is made a non-equity partner in a professional firm. The non-equity partner is not required to make a capital contribution, has a fixed draw component of $130,000, and has no right to vote or participate in the management of the firm. The non-equity partner undertakes an Everett assignment of their income to their family discretionary trust. The ATO does not consider this arrangement to be in line with the principles in Everett and Galland. In these circumstances, this Guideline does not apply.1. Multiple classes of shares and units held by non-equity holders. The ATO considers the issuing of multiple classes of shares in a company or units in a unit trust in a professional firm, without the accompanying voting rights, to be a high-risk feature due to the potential for alienation of income by professionals that are non-owner or non-equity holders in a structure. Further, the discretionary nature of these shares or units is usually linked to the personal performance of the non-owner or non-equity holder in order to receive any distribution or dividends.

Example:  A dividend access share arrangement which pays dividends, at the discretion of the directors of the firm, to the dividend access shareholders or unit holders (who are associated entities of a professional who is not an owner or equity holder). The entitlement to receive any distribution or dividends is linked to the personal performance of the non-owner/non-equity holder.If the answer is no to all of the above, the PCG can potentially apply. Continue to question 4.If the answer is yes to any of the above, the PCG would not apply and the ATO expects the IPP to engage with them via ProfessionalPdts@ato.gov.au.We recommend that you seek specialist tax advisory services prior to contacting the ATO where your arrangement is not within the green zone or has risk factors. The high-risk features listed above are not exhaustive and the ATO may update this and amend PCG 2021/4 as the ATO becomes aware of further high-risk arrangements. Please check the latest PCG for changes. You should also maintain awareness of Taxpayer Alerts that are relevant to this PCG. |  |  |
| 4. Risk assessment  | Yes | No |
| The following table sets out the score for each risk assessment factor

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| --- |
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| **Risk assessment factor** | **Score** |
|   | **1** | **2** | **3** | **4** | **5** | **6** |
| **(1) Proportion of profit entitlement from the whole of firm 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 for income received from the firm by the IPP and associated entities****(excludes levies such as Medicare)** | >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% |

Please refer to paragraph 82 onwards in the PCG for examples and more details in calculating each of the 3 risk factors. An IPP can self-assess their profit allocation arrangement using * Risk assessment factor 1 and 2 only, or
* All 3 risk assessment factors

The following table sets out the risk rating depending on whether you risk assess against two factors or all three factors in the table above:

|  |  |  |  |
| --- | --- | --- | --- |
| Risk zone | Risk level | Aggregate score against first two factors | Aggregate of all three factors\* |
| Green | Low risk | ≤7 | ≤10 |
| Amber | Moderate risk | 8 | 11 & 12 |
| Red | High risk | ≥9 | ≥13 |

 In making an assessment of each risk assessment factor and the overall risk assessment: * IPPs working part time should adjust their profit allocation to a full-time equivalent to self-assess their level of risk as part of risk assessment factor 2.
* All components of remuneration are to be included in the risk assessment, including cash, superannuation, fringe benefits and any other non-cash benefits
* Where fringe benefits tax is paid by the firm, the tax paid will be included in calculating the risk assessment factor
* The ATO recognises there may be a number of other relevant factors pertaining to individual arrangements which will affect an IPP's self-assessed risk rating. These may include timing differences, retention of income within a firm in a particular year for commercial purposes, access to tax concessions and provisions including accelerated depreciation and instant asset write-off, and other extraordinary business factors. Where extraordinary factors exist, an IPP may wish to engage with the ATO to discuss its circumstances.
* The first two risk assessment factors may be used (instead of all three) where it is impractical to accurately determine an appropriate commercial remuneration against which to benchmark. To be considered low risk (green zone), in that circumstance, the aggregate score for those two factors must be seven or less.
* Where an IPP returns 100% of the profit, there is no need to assess against the other risk factors. The arrangement is low risk because none of the income is diverted to other entities.

The Appendix of the PCG provides seven case studies on how to calculate and come to a risk zone. If you have completed your risk zone calculations, go to question 5 |  |  |
| 5. Green Zone under PCG 2021/4 | Yes | No |
| After performing the risk assessment, **is your IPP and its arrangement within the green zone?** If yes, no further action is required and you can expect the ATO would not apply compliance resources to the arrangement allocating profits, unless there are exceptional circumstances such as:* The ATO not being satisfied with the self-assessment of risk
* There are high-risk features
* There is a change in the arrangement causing a shift towards the border of compliance
* The broader arrangement present a compliance risk (e.g. Division 7A)
* The arrangement is part of a broader set of circumstances being reviewed
* Changes to the arrangement is not appropriately treated or disclosed.

Where there is no material change, the ATO will generally only apply compliance resources to:* Confirm risk zone calculations
* Confirm the absence of risk factors
* Provide binding advice if requested

You should document the answers to the above and the risk assessment factor and risk zone calculations to document your IPP is within the green zone. If your arrangement is not in the green zone, go to Question 6 |  |  |
| 6. Amber or Red Zone under PCG 2021/4 | Yes | No |
| If you consider that the risk rating does not reflect the actual underlying risk, you should engage with the ATO to discuss your circumstances by emailing ProfessionalPdts@ato.gov.au. We recommend that you seek specialist tax advisory services prior to contacting the ATO where your arrangement is not within the green zone or has risk factors.Where your IPP and its arrangement are not within the green zone, you may need to modify the arrangement to prospectively come within the green zone. Taxpayers with pre-existing arrangements are able to continue to rely on the suspended Assessing the risk: allocation of profits within professional firms guidelines (Suspended Guidelines) (published on ato.gov.au in 2015) for the years ending 30 June 2018, 30 June 2019, 30 June 2020, 30 June 2021 and 30 June 2022, as long as their arrangement:* complies with those Suspended Guidelines
* is commercially driven, and
* does not exhibit any of the high-risk features in Gateway 2.

In recognition that certain IPP's arrangements considered low risk under the Suspended Guidelines may have a higher risk rating under this Guideline, the ATO allows a transitional period for those IPPs to continue to apply the Suspended Guidelines to their arrangements until 30 June 2024.You may inform the ATO of your intention to transition your arrangement to a lower risk zone at any time and engage the ATO in good faith by emailing ProfessionalPdts@ato.gov.au, and the engagement will be on a ‘without prejudice’ basis. If you still have concerns in relation to transitioning your arrangements on a prospective basis, you should engage with the ATO by emailing ProfessionalPdts@ato.gov.au. In such cases, the ATO would expect relevant details, including:* existing profit allocation arrangements
* proposed profit allocation arrangements and their compliance with the PCG, and
* how the transition will be executed and any tax consequences associated with the transition.
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