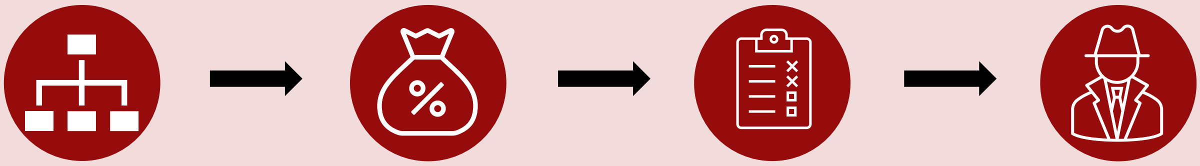
see beyond the numbers

FACT SHEET: Professional firms – ATO compliance approach to allocation of profits

What are the guidelines about?

PCG 2021/4 sets out the ATO's compliance approach to the allocation of profits or income from professional firms in relation to an individual professional practitioner (IPP).



Different business structures used by professional firms

Risk of income from professional services being redirected to other entities, resulting in a significant reduction in tax on these profits

New guidelines provide an objective framework for professionals to self-assess the risk level of their arrangements

Risk level determines the extent to which the ATO will apply their compliance resources to further investigate the arrangement

Who does it apply to?

The guidelines are relevant to "professional firms". A professional firm is **any business structure that provides professional services**, ie. customised, knowledge- based services.

Examples include:

✓ Management consulting	✓ Medicine	✓ Engineering
✓ Financial services	✓ Allied health services	✓ Architecture
✓ Law	✓ Accounting	

Additional conditions for the guidelines to apply are:

- The individual professional practitioner (IPP):
  - provides professional services to clients of the firm; and/or
  - is actively involved in the management of the firm.
- The IPP is an equity holder, directly or through an associated entity.
- The income of the firm is not subject to the Personal Services Income (PSI) rules.

  (the income may be income from personal services, but must not be subject to the PSI attribution rules)

EXAMPLE
Steven is a sole director in a management consulting firm. He provides advice directly to clients as well as employing and managing a team who assist with providing advice and administrative work. The firm's income is not subject to the PSI rules. Steven owns the shares in his company via his discretionary family trust.

Steven is an IPP and equity holder in a professional firm and the guidelines would apply to him.

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How does it work?

Two Gateways ➢ Commercial rationale ➢ No high-risk features	The IPP's circumstances must pass two "gateways" in order for the remainder of the guidelines to apply. If one or both gateways are not passed, the firm or IPP cannot rely on the remainder of the guidelines and Part IVA anti-avoidance rules may be considered by the ATO.
Apply the **risk assessment framework** to self-assess risk level	The guidelines set out a framework for an IPP to assess their risk level using an objective scoring system across three risk factors: ➢ Proportion of profit entitlement from the whole of firm group returned in the hands of the IPP ➢ Effective tax rate ➢ Appropriate remuneration Arrangements are classified as **green** (low risk), **amber** (moderate risk) or **red** (high risk) based on their cumulative score.
Risk level determines **level of ATO compliance attention**	The level of compliance attention from the ATO will depend on the risk level identified.

The ATO notes in the guidelines that it expects IPPs to:

- **assess annually** their eligibility to apply the guidelines;
- **document** their assessment of their eligibility and risk assessment; and
- **review** their eligibility and risk assessment as their business or arrangement changes.

The Gateways

Commercial rationale gateway

To pass this gateway, there must be a genuine commercial rationale for the way the arrangement is structured and for the way profits are distributed.

Indicators that an arrangement *lacks* commercial rationale may include:

- It seems more complex than necessary to achieve the commercial objective (e.g. layers of entities).
- It serves no real purpose other than to gain a tax advantage.
- The tax result appears to be at odds with its commercial or economic result.
- It results in little or no risk, in circumstances where significant risks would normally be expected (e.g. use of limited or non-recourse loans)
- It operates on non-commercial terms or in a non-arm's length manner.
- There is a gap between the substance of what is being achieved and the legal form it takes.

No high-risk features gateway

To pass this gateway, the arrangement must not have high-risk features.

The guideline lists the following specific high-risk features:

High-risk feature	Example
➢ Financing arrangements exist relating to non-arm's length transactions	IPP disposes of part of their interest to an associated discretionary trust. The trust borrows funds from a bank to pay for the transaction and claims a deduction for the interest paid on the loan. The IPP uses the capital proceeds to pay down their home mortgage (non-deductible debt).
➢ Exploitation of the difference between accounting standards and tax law	A firm that manipulates differences in accounting and tax treatment in order to distribute taxable income to certain entities (that may have lower tax rates for example) with the cash being distributed to other entities by other means.
➢ Assignment of a portion of a partner’s partnership interest in a way that is materially different in principle from the Everett and Galland cases (see guidelines for more details)	A non-equity partner in a professional firm makes no capital contribution, has a fixed draw / salary and no right to vote or participate in management of the firm. They assign part of their income to a discretionary trust.
➢ Multiple classes of shares and units, particularly where they create a disconnect between distributions and voting rights	Dividend access shares (held by non-equity holders) that pay dividends at the discretion of the directors of the firm.

Further, any arrangements that are similar to those in a Taxpayer Alert are considered to have high-risk features and will not pass this gateway.

The Risk Assessment Framework

The framework requires an IPP to assess their arrangement against three objective risk assessment factors. A score is calculated, which determines the IPP’s risk zone.

The risk assessment factors

Risk assessment factor	How it is calculated
Factor 1: Proportion of profit entitlement from the whole of firm group returned in the hands of the IPP	$$\text{Proportion of profit entitlement} = \frac{\text{Profit entitlement from the whole of firm group * included in the IPP's assessable income}}{\text{Total amount of income to which the IPP and their associated entities are collectively entitled (whether directly or indirectly)}} \times 100$$ * “whole of firm group” includes service entities and any other associated businesses to the firm.

Factor 2: Total effective tax rate for income received from the firm by the IPP and associated entities	$$\text{Total effective tax rate} = \frac{\text{Total tax paid* by the IPP and associated entities of the IPP on professional firm income}}{\text{Total firm income collectively received}} \times 100$$ * The larger of: (a) the tax that would be payable on firm-related amounts assuming no other income or deductions; or (b) the income tax paid for the year on income including firm-related amounts, less the amount which would be payable if firm-related amounts were disregarded. Any levy based on taxable income (for example, Medicare levy, Medicare levy surcharge or the temporary budget repair levy) is not included in the calculation of the effective tax rate. Note, the total effective tax rate is a reflection of the average rate of tax, not the marginal rate of tax.
Factor 3: Remuneration returned in the hands of the IPP as a percentage of the commercial benchmark for the services provided to the firm	$$\text{Remuneration percentage} = \frac{\text{Remuneration returned in hands of the IPP}}{\text{Commercial benchmark remuneration for the services provided to the firm}} \times 100$$ This reflects the principle that the IPP should receive income from the firm in their own hands which reflects an appropriate return for the services they provide to the firm. Considerations when establishing an appropriate benchmark may include, among other things: ➢ employees within the firm who perform commensurate duties and have commensurate levels of responsibility; ➢ employees or principals in comparable firms; and ➢ relevant industry benchmarks for the provision of equivalent or similar services. Further considerations are listed in the guidelines. Where it is impractical to accurately determine an appropriate commercial benchmark remuneration, this factor may be disregarded (see below).

When applying the risk assessment factors, note that:

- IPPs who work part time or for only part of the year should adjust their profit allocation or remuneration to a full-time equivalent for risk assessment purposes.
- Remuneration includes all components, including cash, superannuation, fringe benefits (including any fringe benefits tax paid by the firm) and any other non-cash benefits.

Extensive examples are included in the PCG which may assist when applying the guidelines.

The scoring table

A score is allocated for each risk assessment factor based on the following table:

Risk assessment factor	Score					
	1	2	3	4	5	6
Factor 1: Proportion of profit entitlement from the whole of firm group returned in the hands of the IPP	More than 90% *	More than 75% to 90%, inclusive	More than 60% to 75%, inclusive	50% or more to 60%, inclusive	More than 25% to less than 50%	25% or less
Factor 2: Total effective tax rate for income received from the firm by the IPP and associated entities	More than 40%	More than 35% to 40%, inclusive	30% or more to 35%, inclusive	More than 25% to less than 30%	More than 20% to 25%, inclusive	20% or less
Factor 3: Remuneration returned in the hands of the IPP as a percentage of the commercial benchmark for the services provided to the firm	More than 200%	More than 150% to 200%, inclusive	More than 100% to 150%, inclusive	More than 90% to 100%, inclusive	More than 70% to 90%, inclusive	70% 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 Risk Zones

The scores from each of the three risk assessment factors are added together to arrive at a cumulative score. 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.

The cumulative score determines which risk zone the IPP falls into.

If **two** risk assessment factors are used:

Score	1	2	3	4	5	6	7	8	9	10	11	12
Risk zone	Green							Amber	Red			
Risk level	Low							Moderate	High			

If **three** risk assessment factors are used:

Score	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24
Risk zone	Green										Amber		Red											
Risk level	Low										Moderate		High											

ATO compliance activity

IPPs can expect the following treatment depending on their risk zone:

Risk zone	ATO treatment
Low risk	Compliance resources will be applied **only if** the ATO is not satisfied the self-assessment is correct or adequately supported; or if specific concerns arise about the arrangement through other compliance reviews or data analysis.
Moderate risk	The ATO are **likely** to conduct further analysis on the facts and circumstances of the arrangement. They **may contact you** to understand the arrangement and resolve any areas of difference.
High risk	The ATO **will** conduct further analysis on the facts and circumstances of the arrangement **as a matter of priority**. If the arrangement remains high risk following further analysis, they **may proceed to audit**.

Relying on the guidelines does not preclude the ATO from considering other compliance issues relevant to the IPP or their associated entities; for example Division 7A, misuse of the superannuation system, income injection to utilise losses, transfer pricing etc.

Date of effect

	Up to 30 June 2017	1 July 2017 – 30 June 2022	1 July 2022 onwards
Existing arrangements	Suspended guidelines apply	IPPs can continue to rely on suspended guidelines (arrangement considered low risk) if their arrangement: ➢ complies with the suspended guidelines; ➢ is commercially driven; and ➢ does not exhibit any of the high-risk factors outlined in the No high-risk features gateway.	If your arrangement was low risk under the suspended guidelines, but has a higher risk rating under PCG 2021/4, you can rely on the suspended guidelines until 30 June 2024. Otherwise, new guidelines apply from 1 July 2022.
New arrangements			New guidelines apply

What to do next

1. **Discuss your circumstances with your tax advisor** to determine whether the guidelines apply to you.
2. **Determine if you are eligible** to rely on the guidelines.
3. **Apply the risk assessment framework** to determine your risk zone.
4. **Document** your eligibility assessment and risk assessment.
5. **Review** your assessment **annually.**
6. If you have unusual circumstances or are in the moderate or high risk zones, you may need to contact the ATO. (Speak to your tax advisor first!)

This fact sheet is informational only and should not be taken as advice. If you have any questions regarding this topic or how it applies to your personal circumstances, please contact Catalyst Financial.