



ATO singles out Professional Practices

Practical Compliance Guidelines

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What we are covering today



Background
Preconditions
and Gateways to
new guidelines



Benchmarks,
scoring system,
model and
examples



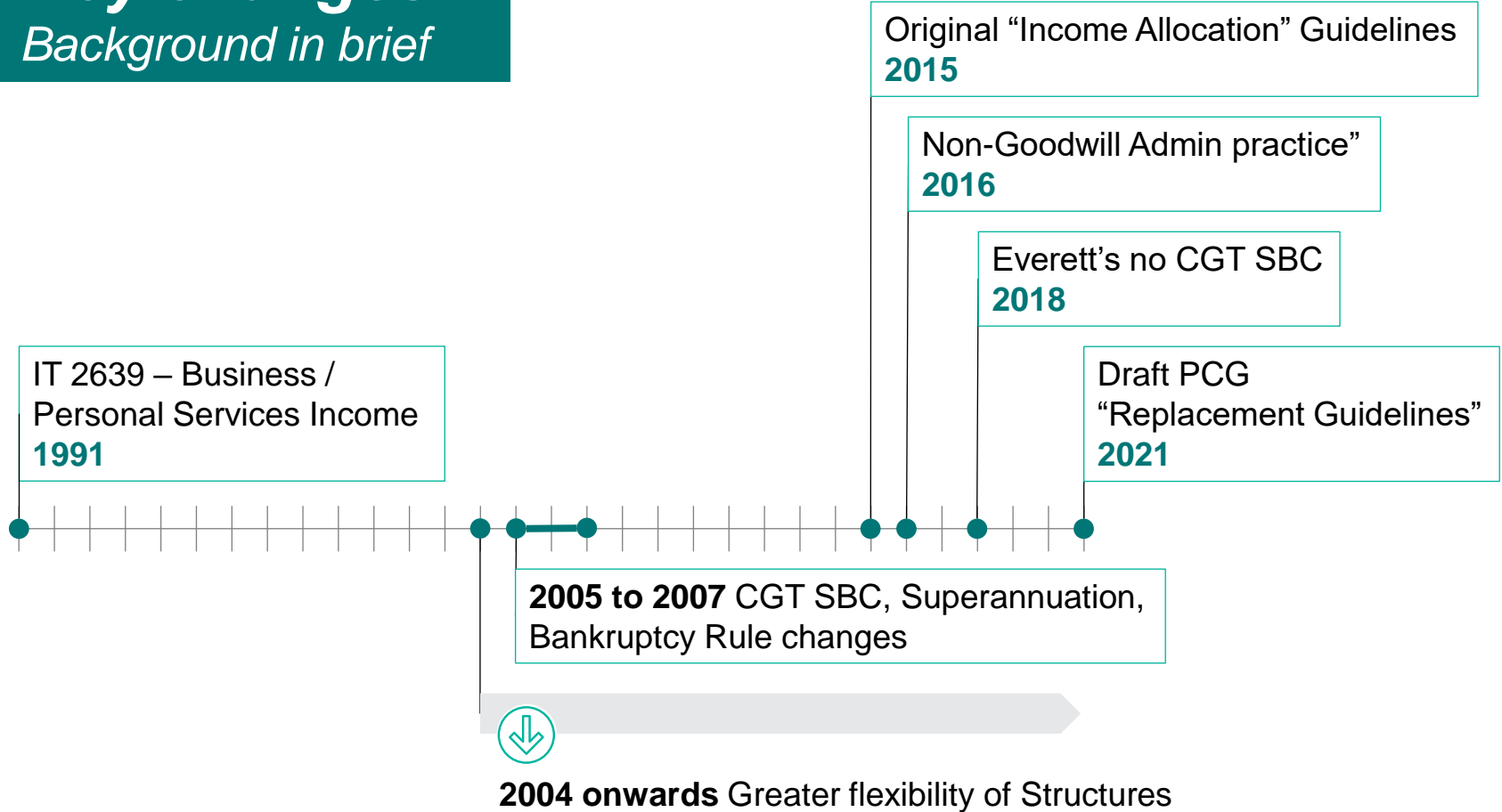
What's being
done



Next steps for
your Practice

Key changes

Background in brief



1991

IT 2639 – Business / Personal Services Income



Business Income or Personal Services Income?

Can split business income

Can not split income from
personal exertion



Two tests

As many employee fee
“Earners” as “Owners”

Easiest test to apply

2007 Service Trust Rules



10% margin
on costs (average)
allowed



**Service
Trust Income**

Relevant for Firm's
"Profit Allocation"
exercise



No change
to allowable
profit margins

2015 Original guidelines



ATO view

- Some part of Professional's Business Income is Personal Exertion
- Unsupported and Discriminatory view

To access original guidelines, needed to have

Business Income

Not PSI, and not Personal Exertion Income, per IT 2639

Legally effective structure

Documentation in shape

2015 Original guidelines

**For 2015 to 2021 years,
3 choices** which could change year on year

**50%
test**

**30%
average tax rate**

**Top employee
level remuneration**

Relatively simple to comply

2016 Non-Goodwill Practices



Admin guidelines
re Non-Goodwill
practices



**Meet relevant
conditions** – in
Firm's Documents



**ATO don't apply
Market Value
Substitution for**

Normal comings
and goings

Merger of practices

2018 CGT SB concessions tightened for Partnerships

No CGT SBC for Everett assignments



Needs a change in Partner – extra SBC condition

Different classes of Partners created

Not impacted

Pre May 2018 restructured

New appointments – post May 2018

Impacted

Existing and non-restructured



Status: draft only – for comment

Draft Practical Compliance Guideline

Allocation of professional firm profits – ATO compliance approach

❶ Relying on this draft Guideline

This Practical Compliance Guideline is a draft for consultation purposes only. When the final Guideline issues, it will have the following preamble:

This Practical Compliance Guideline sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow the approach in good faith, the ATO will not consider you to be in breach of the law in accordance with this approach.

Discriminatory, unsupported,
more complexity

Still in draft form, so may
change

Less flexibility on profit
allocation

Applies for the 2021/2022
year onwards

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Transitional arrangements to 30 June 2023, if needed

Income of the firm is not personal services income	30
Part IVA and this Guideline	32

Draft PCG 2021/D2 – Preconditions Para 25

At least 30 factors in total

IPP (Individual Professional Practitioner) must

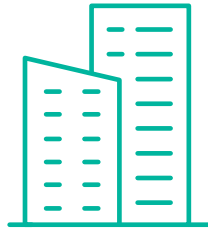
Provide professional services to clients

OR

Actively involved in the management of the firm

Have a legal or beneficial interest in the firm held by IPP and/or associated entities

Be an Equity Holder
Full rights re voting, management and income



The Firm

- No PSI derived
- Be legally effective structure,
- Plus, Gateway 1 and Gateway 2, and other compliance Issues

Equity Partners only

IPP (Individual Professional Practitioner) must

**Legal and beneficial
interest in the firm**

**Equity holder with full rights
re voting, management and income**



Fixed Draw Partners

- From 2022, may need to revisit their rights
- Otherwise outside Draft PCG 2021/D2
- Or can engage the ATO (hard to see as helpful)



Gateway 1 – Commercial Rationale

ATO require:

- the structure must have a “genuine commercial basis”
- the way in which profits are distributed must have a commercial basis
- arrangements must also be appropriately documented
- legal form and documentation must be consistent with the economic substance

Restructure must have a “genuine commercial basis”

Genuine commercial rationale for

All parties involved

AND

Arrangement must
achieve that end



ATO say

- Should reflect the commercial needs of the business
- E.g. likely to enhance, assist or improve income / profits, or
- Commercial benefits asserted are justified.

Key commercial objectives for a Professional Practice



**Attraction
and retention**



**Income and
assets protected**

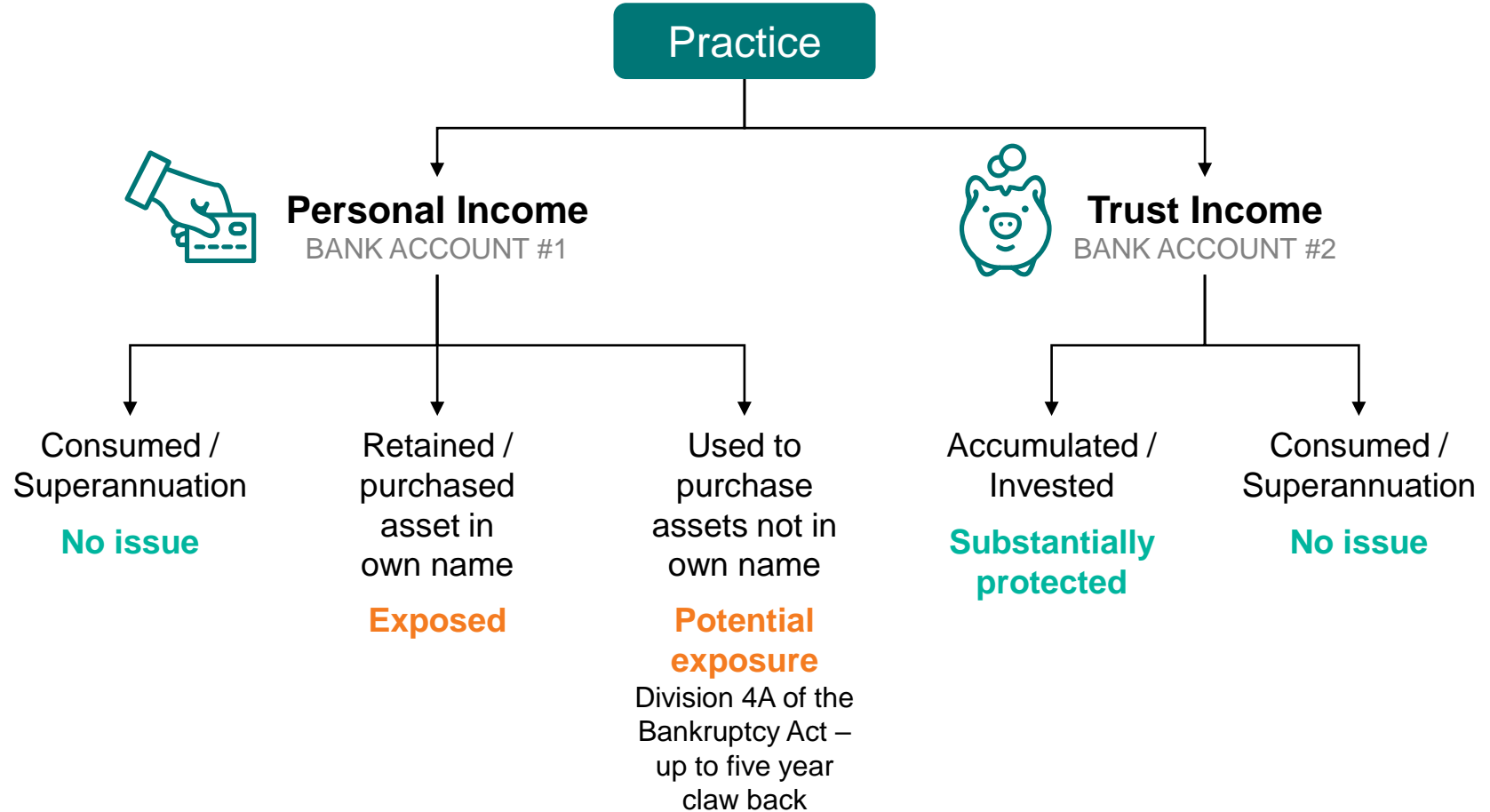


**Distribution
flexibility**



**Ease of
entry / exit**

Asset and Income Protection



Indicators ATO look for

Considerations in Commercial Arrangement to focus on

More complex than is necessary

Includes step(s), or a series of steps, **only purpose to gain a tax advantage**

- Transactions which interpose an entity
- Intra-group or related-party dealings, or
- Involving a circularity of funds or no real money

Tax result of the arrangement at odds with commercial or economic result

- Tax loss claimed for what was previously profitable

Operating on non-commercial terms

- Interest rates above or below market rates, insufficient security, deferment of repayment
- Transactions – not at market rates / value, etc.

Gap between the substance and legal form

Profit distribution



ATO say

- The way profits are distributed must have a commercial basis

Factors listed

Reflects a reward
for their personal
efforts or skill of IPP?

Is IPP remuneration
less than a true
commercial
comparable?

Has the income
been distributed
in substance?

**Who gets and
spends** the
money distributed?

Practical management – stay within the Profit Allocation Guidelines

Documentation



ATO state that

- The arrangement must also be appropriately documented, and
- There must be evidence that the stated commercial purpose was achieved as a result of the arrangement

What ATO look for

Documentation examples



Legal arrangements

- Recognise the correct legal profile i.e. Directors, Principals or Partners?
- Partnership / Shareholders Agreement
- Firm's contractual arrangements particularly capacity of person signing off
- Owners' meeting minutes



Money trail

- Cash flows / bank statements – to correct entities



Other

- Letterhead / Website / Business Cards / Marketing – recognise the correct legal owners
- Offer of Equity – who to?
- Firm's banking and/or insurance records

Form and substance



ATO may look at

- Internal management documents
- Procedures and practices
- Firm's constituent documents

Practical management – align your documentation to stated legal structure

***If Gateway 1 passed,
go to Gateway 2***



Gateway 2 – High-risk features

Features, include:

- financing arrangements relating to non-arm's length transactions
- exploitation of the difference between accounting standards and tax law
- arrangements differ from the Everett and Galland cases
- multiple classes of shares and units held by non-equity holders
- involves an arrangement covered by a Taxpayer Alert

Other compliance issues

Also guidelines do not apply where (not exhaustive)

- cases of non-recognition of net capital gains
- transfer pricing
- misuse of the superannuation system
- promotion of schemes
- failure to lodge returns or late lodgement history
- income injection to loss entities
- avoidance of Division 7A
- application of section 100A
- inappropriate access to low income tax offsets or other benefits,
- non-tax advantages which are dependent on taxable income



Benchmarks, Scoring System

Benchmarks are now called
Risk Assessment Factors

The ATO give you a score
under a traffic light system

*You have to apply **either***

- The first two benchmarks
- or***
- All three benchmarks



Risk assessment factors scoring table

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	> 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%

Traffic light scoring system

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

* Note: The use of the third risk assessment factor is optional as the ATO recognise that it is difficult to determine accurately.

Factor 1 – Proportion of profit entitlement

Risk assessment factors

Income from the whole of firm group will include



**Income from
“main” entity**



**Income from
services entities**



**Income from
other businesses
associated to the firm**

Factor 2 – Effective tax rate

Risk assessment factors



Total tax paid on the professional firm income is the larger of

The tax that would be payable on firm-related amounts (including income and associated deductions) assuming it was the only income with no other sources of income or deductions

OR

The amount being the income tax paid for the year, less the amount which would be payable if firm-related amounts (including income and associated deductions) were disregarded

Total effective tax rate

Referrable to the average rate of tax paid across the entire income from the firm

Factor 3 – *Appropriate remuneration*

Risk assessment factors

Considerations when establishing an appropriate benchmark

- **Employees within the firm who perform commensurate duties** and have commensurate levels of responsibility
- **Employees or principals** in comparable firms
- **Relevant industry benchmarks** for the provision of equivalent or similar services



Adjust remuneration
used to reflect 11
certain factors listed



All components of remuneration to be included i.e. cash, super, fringe benefits and other benefits



Review annually



May be established with an employment agency if all considerations taken into account

Applying risk assessment framework

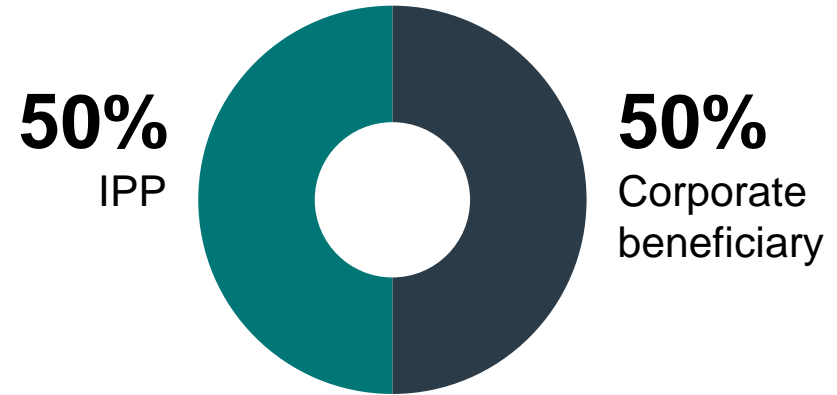
Partner's profit share **\$450,000**
derived by a trust

Service Trust profit share **\$50,000**
derived by separate trust

Assume IPP already on top marginal rate
and company is a base rate entity

Need to establish > 150% of commercial
remuneration under factor 3 to get back
into Green

Effective tax rate of 35% (mid-point
between top MTR and corporate rate)



Factor 1	5	RESULT Amber zone
Factor 2	3	
Total	8	

Applying risk assessment framework

Partner's profit share **\$450,000**
derived by a trust

Service Trust profit share **\$50,000**
derived by separate trust

Assume IPP already on top marginal rate
and company is a base rate entity

50.1%
IPP



49.9%
Corporate
beneficiary

*If split is \$250,001 and \$249,999
instead of equal \$250,000 each*

Factor 1	4	RESULT Green zone
Factor 2	2	
Total	6	

Applying risk assessment framework

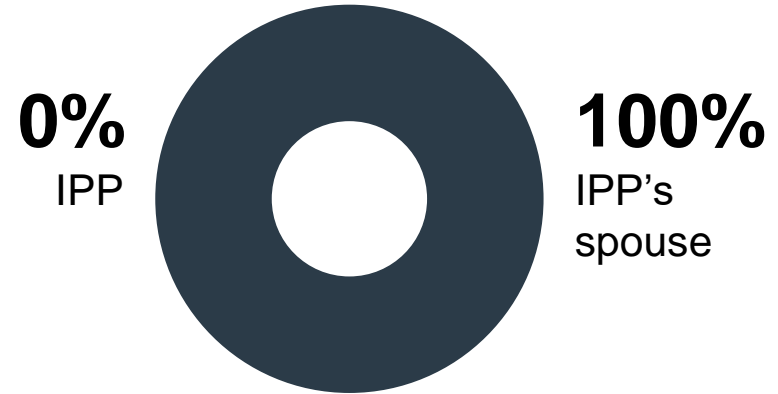
Partner's profit share **\$500,000**
derived by a trust

Service Trust profit share **\$75,000**
derived by separate trust

Assume IPP and spouse have no other income

Same or less tax paid if IPP returned 100%

Need > \$588,660 of taxable income to achieve > 40% effective tax rate (or \$768,161 from 1 July 2024)



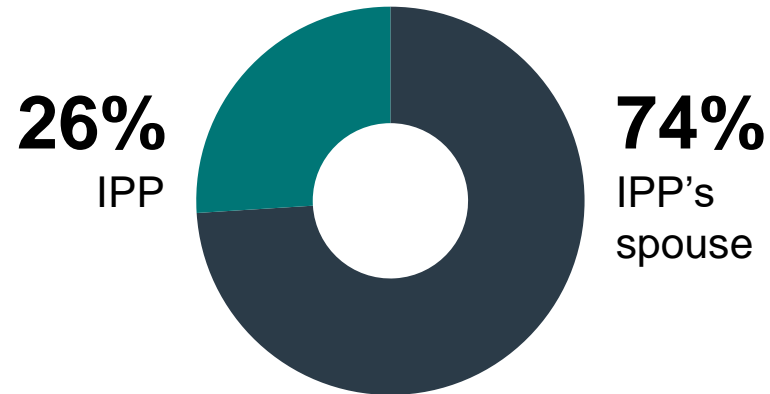
Factor 1	6	RESULT Amber zone
Factor 2	2	
Total	8	

Applying risk assessment framework

Partner's profit share **\$500,000**
derived by a trust

Service Trust profit share **\$75,000**
derived by separate trust

Assume IPP and spouse have no other income



If split is \$150,000 and \$425,000 instead

Factor 1	5	RESULT Green zone
Factor 2	2	
Total	7	

Applying risk assessment framework

Partner's profit share **\$500,000**
derived by a trust

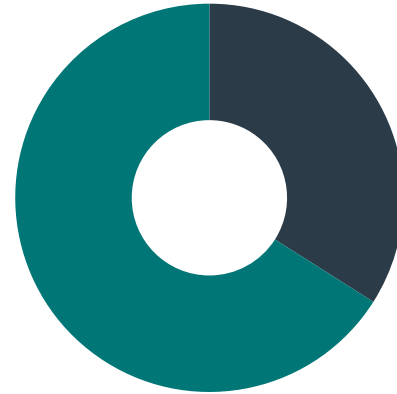
Service Trust profit share **\$100,000**
derived by separate trust

IPP and spouse jointly hold negatively geared rental properties with \$100,000 of losses each

\$300,000 & \$100,000 taxable income but
determine tax rate as if \$400,000 & \$200,000

Effective tax rate of 35.22% despite only
\$128,634 total tax payable (or 21.43%)

67%
IPP



33%
IPP's
spouse

Factor 1	3	RESULT Green zone
Factor 2	2	
Total	5	

Applying risk assessment framework

Partner's profit share **\$500,000**
derived by a trust

Service Trust profit share **\$100,000**
derived by separate trust

IPP and spouse jointly hold negatively geared rental properties with \$100,000 of losses each



If actual tax payable used

Factor 1	3	RESULT Amber zone
Factor 2	5	
Total	8	

Areas of uncertainty



Taxable income or accounting profit?

- ATO will base risk score on tax amounts



Retention of profits in corporate entity and later year franked distributions?

- ATO will look at profit allocation as “snapshot” for the income year



Application of losses

- Corporate losses – Use corporate tax rate
- Unit trust losses – Assume amounts flowed through to unitholders?
- Discretionary trust losses – unknown at the moment



What's being done



Consultation with industry bodies



ATO movement on positions taken in draft PCG



Clarification of ambiguous items

Timeframe for final product?



Pitcher Partners Risk Assessment Tool

PP PARA TOOLKIT

PROFESSIONAL FIRMS

RISK ASSESSMENT FOR IPP

ASSESSMENT FOR: IPP NAME FOR TEST PRACTICE NAME FOR THE INCOME YEAR 30 JUNE 2020

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RISK ASSESSMENT RESULT FOR IPP

<i>Effective tax rate test risk rating (see below)</i>	3
<i>Profit entitlement test risk rating (see below)</i>	5
<i>Appropriate remuneration test risk rating (see below)</i>	2
<i>First two factor risk rating</i>	8
<i>Rating</i>	Amber
<i>All three factor risk rating</i>	10
<i>Rating</i>	Green

Next steps for your Practice

No change for 2021



Transitional rules for some

Structural changes necessary

Fixed draw impact –
retention issue?



Model 2022 outcomes on what is known

Partner / owner expectations

Cash drawing management
from July 2021

Asset protection impact

Tax cost

Q&A

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