



ATO finalises approach to Professional Practices

Practical Compliance Guideline PCG 2021/4

May 2022

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What we are covering today



Background
Preconditions
and Gateways to
new guidelines



Transitional
arrangements



Benchmarks,
scoring system,
model and
examples



Next steps

Setting the scene

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

- The problem**
- Some arrangements led to alienation
 - 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

Suspended guidelines	New and finalised guidelines
<p><i>Assessing the risk – allocation of profits within professional firms</i> issued in 2015</p> <p>These were suspended in Dec 2017</p>	<p>PCG 2021/D2 <i>Allocation of Professional Firm Profits – ATO compliance approach</i> (‘Guidelines’) was issued 1 March 2021</p> <p>PCG 2021/4 published on 16 December 2021 Applies, subject to any transitional arrangements, from 1 July 2022</p>

2015 Original “suspended” guidelines

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

50% test

**30% average
tax rate**

**Top employee
level remuneration**

Both IPP individually
and IPP & associates
collectively

New and finalised guidelines

PCGs represent guidance on how the ATO will allocate its compliance resources according to assessments of risk

Intended to guide the behaviour of taxpayers who wish to operate in a low risk environment

To signal when the ATO considers certain behaviours to be of a higher risk in nature

Not intended to provide interpretation of taxation laws



Risk differentiation approach

Uses 2 'gateways

Has traffic light risk zones for low, moderate and high risk zone



Provide confidence

If circumstances align with low-risk rating, ATO generally will not allocate compliance resources

2-year transitional period that is post the 1 July 2022 start date of the PCG

Transitional arrangements

	Awareness and education		Tailored and targeted engagement of high risk transitional IPPS	
	PRE FY2023	Yr 1 – FY2023	Yr 2 – FY2024	Yr 3 – FY2025
Transitional IPPs				
Low risk IPP arrangements entered before 1 July 2022, rated as low risk under the suspended guidelines and satisfies both gateways	Suspended guidelines in effect	Transitional period 1 July 2022 to 30 June 2024		New PCG guidelines in effect – BAU All IPPs now subject to PCG
Non-transitional IPPs				
High risk IPP arrangements rated as high risk under the suspended guidelines	Suspended guidelines in effect	New PCG guidelines in effect from 1 July 2022 – BAU		
Low / medium / high risk IPP arrangements entered on or after 1 July 2022	Suspended guidelines in effect	New PCG guidelines in effect from 1 July 2022 – BAU		



Overview of PCG 2021/4

Overview

Applies to IPPs that meet two preconditions



Gateway 1

Commercial Rationale



Gateway 2

High-risk features

If preconditions not met, then contact ATO ... or run the risk!

If preconditions met IPP applies ATO's risk framework to self-assess risk rating

Not a safe harbour from ATO examination

If medium / high ATO will generally conduct "some form of compliance activity"
(including more broadly, **Div 7A/100A, losses**)

PCG 2021/4

Preconditions

IPP (Individual Professional Practitioner) must

Provide professional services to clients

OR

Be actively involved in the management of the firm

Have (themselves or by associated entities) **a legal or beneficial interest in the firm**

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



The Firm

- Not subject to PSI rules
- Legally effective structure,
- Plus, Gateway 1 and Gateway 2



Gateway conditions



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

Key commercial objectives for a Professional Practice



**Attraction
and retention**



**Income and
assets protected**



**Distribution
flexibility**



**Ease of
entry / exit**

(including cash, superannuation, fringe benefits and any other non-cash benefits) to reflect the true cost to the business of employing a comparable individual.

104. The assessment of the appropriate remuneration benchmark must be reviewed annually.

105. An acceptable benchmark may be established if the business approached an employment agency and negotiated remuneration based on the considerations outlined in paragraphs 101 and 102 of this Guideline. The remuneration agreed with the employment agency should provide a reasonable benchmark of the true value of hiring a comparable individual.

The ATO's compliance approach

106. We will assess your level of risk pursuant to the criteria set out in this Guideline.

107. We will monitor outcomes for profit allocation arrangements to ensure there is no 'drift' to the limit of the green zone without commercial drivers. For example, where arrangements are in place such that the income from a firm results in 85% of profit entitlement being returned personally by an IPP over a period of time, and the operation of the arrangement changes, resulting in 55% of the profit entitlement being returned personally by the IPP, we may engage with you to determine the commercial rationale of this change, notwithstanding the arrangement may still result in a low risk assessment.

108. After performing your self-assessment, if you consider that the risk rating does not reflect your underlying risk, you should engage with the ATO to discuss your arrangements to ensure they are compliant.

107. We will monitor outcomes for profit allocation arrangements to ensure there is **no 'drift' to the limit of the green zone** without commercial drivers.

compliance

- we become concerned that your broader arrangements present a compliance risk (for example, with Division 7A of Part II)
- your arrangement relates to a broader set of circumstances being reviewed by us
- changes to your arrangement may not have been appropriately treated or disclosed

Where there has been no material change, then we will generally only apply compliance resources to the arrangement to:

- confirm your calculations were done according to this Guideline
- confirm the absence of any exclusionary factors (for example, the high-risk features under Gateway 2)



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

Gateway 2 – High-risk features

The structure must not have any high-risk features, include but not limited to:

- financing arrangements relating to non-arm's length transactions
- exploitation of the difference between accounting standards and tax law
- arrangements that 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



Benchmarks and scoring system



Benchmarks and scoring system

Benchmarks are now called
Risk Assessment Factors

Score produces a risk rating
under a traffic light system

*You have to apply **either***

The first two factors

or

All three factors



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.

Automatic green rating if 100% to IPP

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

Look at total remuneration including fringe benefits, salary & superannuation

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

* Medicare levies and offsets ignored.

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 non-cash benefits



Review annually



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



Examples

Applying risk assessment framework

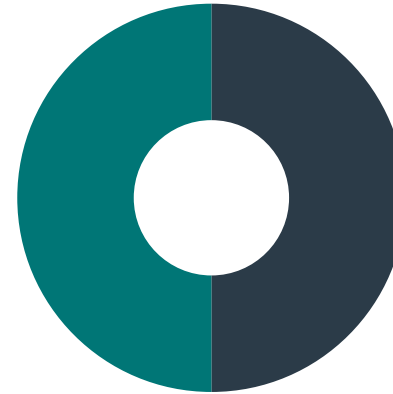
Partner's profit share **\$450,000**
derived by a trust

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

Assume

- IPP already on top marginal rate
- Company is a base rate entity

50%
IPP



50%
Corporate
beneficiary

35% effective tax rate is mid-point of top personal rate and lower corporate rate

Factor 1	4	RESULT Green zone
Factor 2	3	
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 incomes
- Determine effective tax rates as if \$400,000 & \$200,000
- Effective tax rate of 35.22% despite only \$128,634 (or 21.43%) total tax payable



Factor 1	3	RESULT Green zone
Factor 2	2	
Total	5	

Applying risk assessment framework

Super and fringe benefits

Partner's profit share (main practice + service trust + <i>Everett</i>) each derived by a trust	\$400,000
Type 1 Fringe benefits to IPP (taxable value of \$33,651)	\$70,000
Salary sacrificed super using "catch-up rule"	\$130,000
Total remuneration = \$600,000, assume IPP has no other income, 2024-25 year	
<i>Outcome 1</i>	
Profit share to IPP	\$300,000 (50% of total)
Corp. Beneficiary share	\$100,000
Tax	\$173,992
Effective Tax Rate	29.00%
Result	4 + 4 = 8 Amber

\$6,008 extra tax at 20% tax rate differential = \$30,040 extra assessable income

Applying risk assessment framework

Incorporated practices – Outcome 1

	IPP \$100,000 other taxable income	Corporate <i>Base rate entity</i>	Total Sum of IPP + Corporate
Profit share from incorporated firm entity (grossed-up franked dividend) shares held by a trust, firm entity a 30% taxpayer, 2024-25 year	\$300,000 (\$210,000 cash) (\$90,000 credits)	\$300,000 (\$210,000 cash) (\$90,000 credits)	\$600,000 (\$420,000 cash) (\$180,000 credits)
Tax paid	\$96,592	\$75,000 at 25%	\$171,592
Effective Tax Rate			28.60%

\$15,000 excess corporate tax paid
by practice entity does not count
for *Risk Factor 2*

Factor 1	4	RESULT Amber zone
Factor 2	4	
Total	8	

Applying risk assessment framework

Incorporated practices – Outcome 2

	IPP \$100,000 other taxable income	Corporate <i>Not a base rate entity</i>	Total Sum of IPP + Corporate
Profit share from incorporated firm entity (grossed-up franked dividend) shares held by a trust, firm entity a 30% taxpayer, 2024-25 year	\$300,000 (\$210,000 cash) (\$90,000 credits)	\$300,000 (\$210,000 cash) (\$90,000 credits)	\$600,000 (\$420,000 cash) (\$180,000 credits)
Tax paid	\$96,592	\$90,000 at 30%	\$186,592
Effective Tax Rate			31.10%

Factor 1	4	RESULT Green zone
Factor 2	3	
Total	7	

Areas of uncertainty



Taxable income or accounting profit?

- ATO likely to 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



Next steps

Next steps

No change for 2021-22



Transitional rules for some

Structural changes necessary

Fixed draw impact –
retention issue?



Model 2023 outcomes on what is known

Partner / owner expectations

Asset protection impact

Tax cost

Pitcher Partners Risk Assessment Tool



Professional Firms Toolkit Risk Assessment

INDIVIDUAL PROFESSIONAL PRACTITIONER (IPP) REVIEW

IPP Name *

Practice *

Year *

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