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Mr. Simon Webster, Director - Professional Firms Compliance
Private Groups and High Wealth Individuals
Australian Taxation Office

cc:
Tim Dyce, Deputy Commissioner, Private Groups and High Wealth Individuals, ATO
Jade Hawkins, Assistant Commissioner, Private Groups and High Wealth Individuals, ATO

Dear Simon

PCG 2021/D2 Allocation of professional firm profits – ATO compliance approach

The Institute of Public Accountants (IPA) have further considered **draft PCG 2021/D2 Allocation of professional firm profits - ATO compliance approach** (**the draft PCG**). Following on from the joint submission already sent, we wish to make further comments on some more specific issues relevant to our member firms and members.

1. **Risk Parameters** – Small changes in the profit distribution and tax rate can significantly change the compliance risk result and therefore the likelihood of attracting compliance attention from the ATO. The risk rating of an Individual Professional Practitioner (IPP) can move from low to high based on a small change in the profit distribution and tax rate amount.

The risk assessment scoring table and risk zones indicate that provided IPPs receive a proportion of profit entitlement of greater than 50% (say 50.1%) and a total effective tax rate of greater than 30% (say 30.1%), they would be in the green zone. Only a small amount of change to the proportion of profit can move the risk rating into the red zone. Smaller less profitable firms may be disadvantaged as a result. IPP's in firms with higher total income will have a reduced risk rating as income returned by the IPP will be subject to higher marginal rates, therefore bringing the total effective tax rate up. Given that risk rating does may not equate to the existence of any Part IVA factors, the PCG can therefore lead to unnecessary compliance activity and costs.

2. **Corporate structures used by smaller and relatively newly established professional firms** -
We note that the draft PCG contains five examples illustrating how to apply different aspects of
the proposed compliance approach and seven case studies. However, the guideline does not contain any examples of the common scenario of professional firms that are run through a corporate
structure. Inclusion of such examples would then ideally also need to address following factors:

- profit distributions made via dividends and whether franking credits are taken into account in determining remuneration received by IPPs.
- Profit /dividend payment timing mismatches. For example, if the firm's profits for year one are paid to the IPP as a dividend in year two, the question arises as to in which year the profit entitlement should be taken into account for the risk assessment factors.
- Treatment of superannuation (compulsory and voluntary) and fringe benefits, which are common occurrences for IPP's in corporate structures. Clarification of how these benefits are taken into consideration as part of 'risk factor 1-proportion of profit entitlement' and 'risk factor 2 – effective tax rate risk assessment process', would be beneficial.

We would request that prior to finalisation of the draft PCG, examples of this common practice structure are considered, including the issues noted above to form part of an amended PCG risk assessment guidance.

3. **Legal Basis underscoring PCG** - As noted in the Joint Submission by the Accounting bodies, the draft PCG is primarily a guide to assess the likelihood of the ATO reviewing the affairs of an individual professional practitioner (**IPP**) and his/her firm, with a view to applying the general anti-avoidance provisions in the *Income Tax Assessment Act 1936* (**Part IVA**). However, we observe that the exclusionary "Gateways" and risk assessment framework are not necessarily constructed to align with Part IVA factors. Rather, the draft PCG uses broad, unadjusted measures as proxies for Part IVA risk. As a result, the risk scores reflect neither the nuance or specificity required to properly assess the level of risk. Nor does the draft PCG provide either the ATO or the IPP with assurance that arrangements with high-risk scores are, in fact, likely to be those to which Part IVA could be successfully applied.

There is no general principle of taxation law dealing with, or proscribing, the so-called "alienation of income". That is, absent specific statutory provisions such as the personal services income or general anti-avoidance rules, there is no general principle which brings about the result that the income or profit beneficially derived by a partnership, company or trustee of a trust, that has arisen from the personal exertion or skilled labour of an individual, can be regarded as the profit or income of that individual. It does not matter how involved such an individual may be in the activities from which the income is derived by the entity.

Given this situation, it is likely that professional firms may feel coerced into changing their current arrangements even where the IPP can show that they are remunerated on an arm's length basis for the services they provide to the firm.

Is the goal of the PCG to intimidate professional firms into conservative tax outcomes when Part IVA factors are absent?

Profit or income of a professional firm usually comprise different components — reflecting a mixture of income from the efforts, labour and application of skills of the firm's IPPs (that is, personal exertion) and income generated by the business structure including intellectual property. The proportion of profits benchmarked in the risk assessment scoring table, applies a one size fits all approach which does not take into account the differing profitability of various firms and different types of professions. The profitability of firms can differ greatly between different firms and/or professions, depending on their location, the types of clients and the specialties and capabilities of the IPPs and their staff. Some are more reliant on the professional expertise and services provided by the Principle IPPs and for others profitability is more dependent on the services and expertise provided by the structure, other IPPs and staff members.

Not many firms would be willing to engage in litigation and make public their taxation arrangements in the public domain in the process of mounting a defence against a review, if litigation is the only way to fight an amended assessment. For small firms there is a significant power differential at play here, as the vast majority of affected businesses are in no position to want to take on the ATO in defending their existing profit allocation arrangements.

4 **Effective rate of tax** – The effective tax rate thresholds do not factor in the legislated reductions in corporate and individual tax rates. We believe that this will result in a very large number of IPPs across a broad range of firms being classified as moderate or high risk, when their arrangements are highly unlikely to trigger Part IVA. When the original guidance was released in 2015, the corporate tax rate was universally 30%. The reduction in the rate to 25% from 1 July 2021 will result in a score of 5 using risk assessment factor 2, making it much easier to fall in the amber or red zone. This is further exacerbated by the increases in the personal income tax thresholds which now means that for an individual to have an average tax rate of 30%, they need to have earnings of just over $195,000.

Lastly, Part IVA requires the Commissioner to undertake a determination which is administratively burdensome for the ATO to undertake, on a case-by-case basis. The PCG effectively puts the onus on the taxpayer to self-assess and in doing so provides this information to the ATO in response to an information request which could then lead to a review. Part IVA factors being absent, can lead to unnecessary compliance activity and costs. The expectation is that once the PCG is finalised, the ATO is likely to use its formal powers for information gathering to obtain data on how entities have self-assessed their risk rating. The compliance burden that this places on smaller professional firms should also be considered, particularly where the IPP can show that they are remunerated on an arm's length basis for the services they provide to the firm, irrespective of the number that eventuates as a consequence of the risk assessment result rating.

If you would like to discuss our comments, please do not hesitate to contact me.

Yours sincerely

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Institute of Public Accountants

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