



Grant Thornton

An instinct for growth™



Part 1

This four part series provides no-nonsense commentary upon topical issues for professional services firms and the professionals that practice within them.

The series will provide a perspective upon:

- Allocation of Profit
 - A pathway to Greater Certainty
- Structuring a practice
 - Navigating the Maze
- Structuring for equity participants
 - Preserving the Return
- Partner compliance obligations
 - Keeping partners focussed.

Our comments are drawn from the personal experiences of the members of our Professional Services Industry Focus Group either as advisors to the Professional Practices or equity participants in those practices. The comments reflect the reality of the issues facing practices and the equity participants – not mere theory.



In Brief

Commentary by Professionals for Professionals

Allocation of Profit

Assessing the Risk a Pathway to Greater Certainty

Since 1 September this year, many commentaries have been produced around the Tax Office Guidelines on Profit Allocations. The Guideline is focussed upon maintaining the integrity of the tax system with liberal references to the anti-avoidance provisions of Part IVA of the 1936 Act and compliance activity that will enforce these provisions.

Fear may be the reaction of choice for some and those that are not prepared may well be justified in that state of mind. The reality however, is much brighter depending upon the perspective one chooses to take.

What the Tax Office has done is articulate the rules by which they will referee the game. Like many so-called integrity measures a line is drawn in the sand and if you choose to play within the lines then your return is greater certainty and peace of mind. But that need not come at the price of reduced tax efficiency. The Tax Office has established a benchmark of 30% tax on the practice income entitlement of practitioners irrespective of the ownership structure that may be employed. This warrants closer investigation.

1. The Threshold Test

The Tax Office understands indeed, expects that most professionals in practice split income. The concern is not that it is happening but rather that it needs to be measured. The streaming of practice income to a family trust (or other controlled entity) is not of itself a trigger for compliance activity by the Tax Office. The ultimate question is the measure of tax paid. The concern on the part of the Tax Office is that measure can be manipulated by an income allocation strategy that streams income away from the individual professional practitioner in a way that the tax payable is reduced below an acceptable level. The first step in the process is to recognise this essential fact. Once that occurs, the journey begins.

One focus for many years has been the distinction drawn between reward for personal services and income that is generated by the practice infrastructure, that is, professional, non-professional and administrative staff. Traditionally, the existence of business structure income has been critical to the ability to stream or split income. Strictly speaking, income from the personal services of an individual should not be split or alienated. However, the new guidelines provide a proviso to that rule in the context of profit allocation by professional firms where an acceptable rate of tax is paid. The critical point here is that acceptable does not necessarily mean the top marginal rate.



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2. A Practical Perspective on the Application of the Guidelines

To assist in qualifying taxpayers for compliance activity, the Tax Office has put forward what may benignly be referred to as “Safe Harbour” rules. Only one of the rules needs to be satisfied. Hence, in the context of structuring a professional practice and the allocation of income there is some flexibility in the method of allocation of profit against the background of the commercial needs of the practice and the personal objectives of the individual practitioners involved. A nice touch given the focus is integrity and the stick is Part IVA.

The guidelines require one of the following:

- Pay an individual professional practitioner at least as much as the highest paid employee;
- Ensure the individual professional practitioner receives at least 50% of the profit allocation based upon his or her equity entitlement (including of course the equity entitlement of entities controlled by that practitioner e.g. a trust or company); or
- Ensure that the tax rate paid by the individual practitioner and the entities and individuals (e.g. family) related to him is at least 30%.

Application of these rules provides legitimate planning opportunities and moreover, a pathway to greater certainty. That certainty would crystallise in terms of preservation of the desired commercial and tax outcomes from the structure employed at practice level and by individual practitioners.

There is opportunity here to meet compliance obligations whilst quarantining at least some level of practice profits from the top marginal rate. This is not an invitation for wholesale restructuring of professional practices designed to achieve tax efficiency alone, however, the opportunity may be crystallised by proper structuring of equity ownership and the design of simple yet effective distribution strategies.

