Grant Thornton
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Simon Webster
Australian Taxation Office
By Email:
Simon.webster@ato.gov.au

Grant Thornton Australia Limited
Level 17
383 Kent Street
Sydney NSW 2000
Locked Bag Q800
Queen Victoria Building NSW 1230

T +61 2 8297 2400

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Dear Simon

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

We refer to the Australian Taxation Office's (ATO's) draft Practical Compliance Guideline PCG 2021/D2 ("PCG"). We thank you for the opportunity to provide our submissions on the draft PCG and we set out our summary of submissions below and detailed submissions in the attached Appendices.

Summary of submissions

1. The ATO should reinstate the 2014 Suspended Guidelines.

2. The ATO should clarify some important issues if the PCG is to be implemented:
    a. How the PCG applies in an incorporated practice scenario (examples 1 and 2 in detailed Submission 2 attached),
    b. How the PCG will not disadvantage low income practices (example 3),
    c. How the PCG will not disadvantage part-time IPPs and non-equity partners (examples 4, 5 and 6),
    d. CGT issues arising from an Everett Assignment (example 7), and
    e. Professions to be covered by the PCG (example 8).

3. The ATO should modify the PCG if the PCG is to be implemented:
    a. Expand the PCG to cover non-equity partners to avoid discrimination against future leaders and part time IPPs,
    b. Exclude Services Trusts from the calculation,
    c. Modify the risk matrix (as suggested in Submission 3),
    d. Provide that a risk score of 2 under any factor will result in IPP being low risk (as suggested in Submission 3), and
    e. Provide simple arms-length remuneration tests (as suggested in Submission 3).

We thank you in advance for your consideration of our submissions.

Please contact Yan Wong (yan.wong@au.gt.com or 08 8372 6609) if you wish to discuss this matter further.

Yours sincerely

Greg Keith
CEO, Grant Thornton Australia

Appendices

Submission 1: The ATO should reinstate the Suspended Guidelines

The Suspended 2014 Guidelines – "Assessing the risk: allocation of profits within professional firms" has provided clear and simple guidance to professional firms in respect to how profits can be distributed within an acceptable level of risk tolerance. It has been largely adopted by professional firms as a tool by which they have structured or restructured within both tax and other legislative requirements.

Operating within the guideline has provided a simple and cost effective way to manage possible diverse tax outcomes without the cost and disruption to professional firms in dealing with protracted tax litigation despite the breath of tax law supporting the tax positions that could be taken.

The ATO in withdrawing the guidance cited a number of high risk matters that had arisen. We note the matters raised but also note that the ATO has sufficient scope under the existing tax laws to deal with these risks without requiring the imposition of the arbitrary guidelines in the PCG. If the ATO identifies weaknesses in the tax laws, the appropriate approach to deal with this is by legislative amendment. For example, we note that a legislative amendment (*Treasury Laws Amendment (2019 Tax Integrity and Other Measures No 1) Bill 2019*) was passed in respect to Everett assignments and Capital Gains Tax. Further, it is clear that the suspended guideline was only ever a guide for assessing the risk of a tax audit and not an interpretation of the law.

Reinstatement of the suspended guidelines is considered appropriate irrespective of concerns with restructures. Significant change has occurred in professional legislative or membership rules, stamp duty and professional liability over the period prior to 2014 and up to today that has resulted in firm restructures. These changes have largely been driven by commercial decisions to grow or compete in a developing and litigious market place that demands a wider range of expert skills, global reach and time critical response. Undertaking a restructure should not limit the ability of a firm or IPP from benefiting from a compliance guideline. As such, it follows that reinstating the suspended guidelines would allow a restructured professional firm to continue to utilise on the suspended guidelines.

It is respectfully submitted that the suspended guidelines provided to professional firms the following benefits:

- A low cost compliance tool in respect to the allocation of professional firm profits.
- A structurally agnostic approach (i.e. did not discriminate between the use of partnership, trust or company structures, or combinations thereof).
- Was widely used and complied with.
- Whilst not based on technical interpretation of tax law, the suspended guidelines provided a commercial outcome that achieved a similar result.
- Provided a reasonable safe harbour for firms to operate in.
- Reduced tax litigation.

In return, the suspended guideline provided to the ATO the following benefits:

- Achieved a high degree of compliance with little audit resource required and with minimal loss of tax revenue.
- Dealt with the issue of reward for personal services without needing to address the legal issue of what is business income or the components thereof.
- Allowed the ATO to provide Guidance without being locked into a binding ruling or interpretation of the tax law.

In our view, the PCG would not materially improve the outcomes to the ATO or professional firms but would instead introduce additional hurdles such as:

1. Adding compliance cost to consider, interpret and apply the PCG on both the Individual Professional Practitioner (for Risk Assessment Factors (RAF's) 1-2, and certain gateway criteria) and the Firm (consideration of gateways and RAF3),

2. Potentially applying retrospectively because the Gateway tests have both historic (retrospective) and current tests, which is a typically undesirable approach to tax law administration.

3. Penalising, through the tax rates implicit in RAF2, lower income practices, IPP's who are part time, IPP's who take reduced practice income as a result of parenting leave or other leave, new IPP's joining the market place or IPP's leaving the industry.(see examples 3 & 4 below)

4. Failing to address the application of the RAFs 1 and 2 to franking credits and circumstances when profits are distributed for a particular year by a corporate to an IPP. (See example 2 below)

5. Excluding IPP's who do not hold full rights to participate in the voting, management and income of the firm. (See example 1 & 6 below)

6. Introducing incorrect statements of law whilst the PCG is not meant to be an interpretation of tax law. For example, paragraph 8 of the PCG expresses the view that "the profit or income of a professional firm may comprise different components- reflecting a mixture of income from the efforts, labour and application of skills of the IPPs (that is, personal exertion) and income generated by the business structure". This statement is inconsistent with the decision in FCT v Everett case at ATC 4083 in which the majority of the High Court held that "The respondent's entitlement under the partnership agreement was to a proportionate share of the partnership profits as disclosed by the partnership accounts. The relevant proportion of the partnership profits was payable to the respondent because he was a partner and the owner of a share in the partnership. The respondent was entitled before the assignment to his proportionate share of the partnership profits, **however much or however little energy he devoted to the practice**, so long as the partnership remained on foot. **Accordingly, it is a misnomer to speak of the respondent's share of the income as having been gained by his personal exertion".**

7. Introducing inappropriate concepts of "arm's length remuneration" into the domestic tax law environment. Paragraphs 88 to 93 set out the acceptable basis for calculating arm's length remuneration. In particular paragraph 90 lists eleven dot points that need to be considered. In the current format it is unclear whether the application of the points increase or decrease the remuneration that should be paid. These paragraphs are also to be applied to each IPP. On the basis put forward in Paragraph 90 it would be practically impossible to find an "acceptable arm's length value" without external input for each IPP. To meet the criteria the Professional Practice will likely need an externally prepared remuneration report for each IPP or groups of IPP (if one can link the eleven dot points to a group of IPPs) to give any credibility to the process. This is adding compliance cost as it needs to be documented. This requirement is clearly at odds with current High Court decisions and is not applied to any other industry group. Everett's case was determined in 1980 and to date the Commissioner has not sought to bring another test case, noting that Everett's case was an appeal to the High Court citing this very issue. Likewise the Government has not sought to amend tax law to require taxpayers to be remunerated based on commercial rates.

8. Seeking to provide an overly complicated and costly solution to a problem that already has existing solutions. To the extent that IPP's have rearranged their affairs to bring them within the suspended guidelines by restructuring solely to gain a tax benefit, the ATO has sufficient powers under Part IVA of the ITAA 1936 to address these issues.

9. Inappropriately duplicating the work of existing rulings. Service Entity income should be excluded from Practice Income for the purposes of this PGC as Service Entity income is the subject of a separate ruling TR 2006/2 and published guidelines (Your service entity arrangements) that address both audit risk and commercial framework compliance.

10. Introducing benchmarks for which the ATO may not have appropriate information to assess based on tax return information, is inconsistent with the stated purpose of the PCG being an ATO compliance tool to help identify high risk IPPs without the ATO having to undertake wide ranging audit activity of professional firms. For example, the RAF3 arm's length remuneration for IPP's is currently not required to be disclosed in the tax return. It is therefore unclear how

the ATO will be able to assess compliance against the risk matrix and therefore select IPP's for audit.

11. Failing to allow IPPs to save compliance costs by applying self-assessment. If the ATO will not have sufficient data from the lodgement of tax returns to assess these risks without further enquiry of the IPPs and their firms, then that will lead to additional resources being required both of the ATO and the IPPs/firms to deal with these enquiries.

The PCG complicates risk assessment as each test is dependent on at least one other test. The risk matrix in our view does not strengthen the risk assessment framework. It merely will create more exceptions largely driven by factors that will not be visible to the ATO from data supplied in the returns lodged for a particular year. This will lead to greater uncertainty for both IPP and the ATO requiring more resources for both ATO & IPP. It will not focus audit resources as more exceptions will apply.

It should also be noted that the Government recently announced that it is further trying to reduce the "Red Tape" hampering business. The Commissioner of Taxation, being included in the group to assist the reduction of "red tape", should be reducing compliance obligations rather than increasing it.

It is clearly acknowledged that the ATO is charged with administering the collection of taxation based on the laws established by government. The ATO and Professions have had a long history of working together to achieve this. The success of this cooperation was most recently demonstrated in respect to COVID-19 concessions provided by the government.

It is our view that if this guidance is released in this form it will detract and distract from this objective.

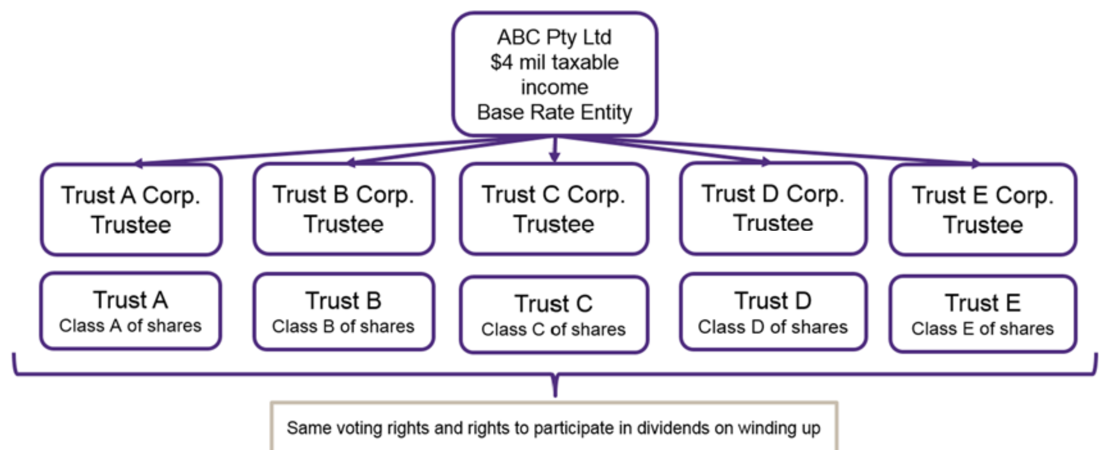
Therefore, as our primary Submission, we remain firmly of the view that the existing guidelines must be reinstated.

Submission 2: Clarifications required should the PCG be implemented

We detail below examples of the complexity that the PCG now adds which will require clarification as per the various submissions accompanying each example:

Example 1: Incorporated Practice issues & who is an IPP?

An incorporated practice company carries on business as Accountants (ABC P/L).ABC P/L has a turnover of $20m and has taxable income $4m in FY2021/22. ABC P/L is a base rate entity and pays tax at 25%. No distribution is made in 2021/22 by ABC P/L. The net profit before tax is $3.5m because of non-deductible entertainment and application of accounting standards related to arm's length employee entitlements and leases. ABC P/L is owned by 5 Discretionary Trusts each with a Corporate Trustee. Each Trust holds a different class of shares. All shares have the same voting rights and rights to participate in dividends and on the winding up of ABC P/L. Dividends can be paid to any class of shares at the exclusion of the others. Each Trust can appoint a Director to the Board of ABC P/L who is a Chartered Accountant. Each Director is paid $52000 pa and is expected to attend to the business as required.



Questions requiring clarification:

We submit that the PCG should clarify the following matters:

- Who is the IPP if no individual is an equity holder (equity held by trusts) or, under the definition in Paragraph 25, holds "full" equity rights? In this scenario, each Shareholder trustee has rights, and each Director has rights but do each of these separate parties hold "full" rights to participate in voting, management and income)?
- Is ABC P/L excluded from the guideline because the IPP does not hold "full rights?"
- Is ABC P/L excluded from the guideline because of the different classes of shares?

Assuming there is an IPP and ABC P/L is not excluded from the guidelines:

- What is the effective tax rate in this instance?

    a. Is it simply 25% paid by ABC P/L as the company is the entity carrying on the Professional Practice? This will give it a RAF2 score of 5 as this is the primary tax paid by the Practice.
    b. Is it 25.13% being tax on ABC P/L of $1m as ABC is related to the IPP plus the tax paid by the Director of $6287? This will give it a RAF2 score of 4 as this is the primary tax paid by the Practice plus the IPP.
    c. Is it 12.1% being the $6287 paid on $52000 paid to the Director related to the trust giving a RAF2 score of 6.

- What is the Proportion of Profit entitlement of the IPP if no income is distributed by ABC Pty Ltd and the only payment received by each Director is the Director's Fee?
    a. Is it 0% (if no profit is distributed by ABC Pty Ltd)? And is this appropriate if the reason the Practice did not distribute was because it chose to retain profits to expand?

b. Is it 100% because ABC is excluded as an associate of the IPP (and thus the only distributed income of the Practice is the Director's Fee)?
c. Is it 4.9% because ABC is an associate of the IPP (being the Director fee as a percentage of the profit of ABC P/L plus the Director's Fee)?

- Assuming the Director is the sole Shareholder of the Trustee Shareholder, will the Director be an IPP who meets the Gateway test?

The Directors of ABC P/L meet and consider the PCG. They do not understand risk factor 3 guidance and decide not to test remuneration. The payroll records show that they have managers who are Chartered Accountants and being paid $180,000.

- Is their decision sufficient to exclude risk factor 3?

In 2022/23 ABC P/L pays a franked dividend to each class of shares on issue amounting to $300,000 per class of share out of 2021/22 profits. ABC P/L makes the same taxable income $4m. Each Director receives $52,000. Trust 1 has no expenses and distributes $150,000 of the trust's net income to Director and the balance to the Director's spouse. Neither have any income other than the Director's income.

Director Taxable Income $252,000, Tax $84,067 (based on grossed up dividend and before franking credit)

Spouse Taxable Income $200,000, Tax $60,667 (based on grossed up dividend and before franking credit)

ABC P/L Taxable income $4,000,000, Tax $1,000,000

- On these facts, the PCG must clarify whether ABC P/L should be included in the RAF determinations as an associate of the IPP because this will impact the ratings as follows:

a. The RAF2 tax rate is 32% based solely on Director and Spouse or 25.7% if you include ABC P/L?
b. The RAF1 percentage of profit for the IPP is 5.7% if you include the income of ABC P/L or 55.8% (if you take into account only the IPP & Spouse only)?

If ABC P/L is included, the Risk Factor Score is 10 (RAF1 of 6 (<25% to IPP) + RAF 2 of 4 (25.7% tax rate).

If ABC P/L is excluded, the 2 factor RAF score = 7 (RAF 1 of 4 (55.8%) + RAF2 of 3 (32%))

If RAF3 is required, would it be tested against the manager remuneration of $180,000? What counts as the remuneration for testing under RAF 3 for the Director? The total taxable income declared $252,000 (RAF3 score of 3) or the Director fee $52,000 (RAF3 score of 6)?

It should be noted that we are now comparing multiple years' incomes and distributions and assumes the inclusion of the Director's Fee of $52,000. The process is also impacted by the company's profit retention policies.

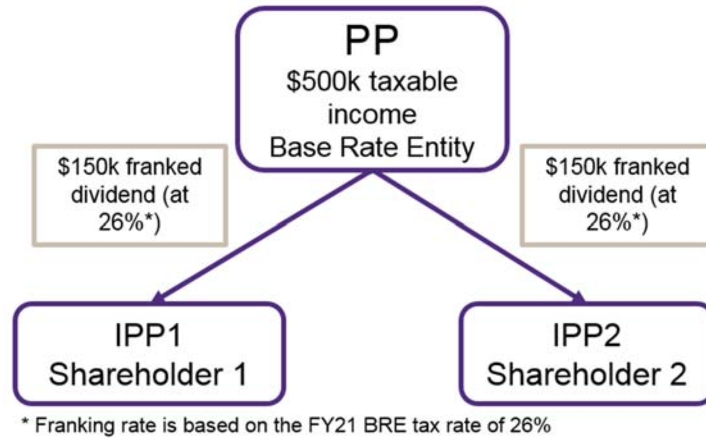
One of the reasons for using a corporate structure apart from limited liability is the company's ability to retain after tax funds to fund growth, thus leveraging where the tax rate is 25% or 30% compared to a Partnership or Trust structure that may be subject to a higher tax rate of up to 47%.

Whilst the example above may seem extreme, it must be remembered that under the COVID-19 economic environment, many Professional Practices were holding on to cash and limiting distributions to ensure that the practice would be able to continue to operate.

As evident from the above analysis, there are a number of complexities that arise from implementing the PCG. If this was analysed under the suspended guidelines, the result would be much simpler.

Example 2: Franking Credits

An incorporated practice, PP has two shareholders, IPP 1 and IPP 2. The practice is a base rate company with a tax rate of 25%. PP has a taxable income of $500,000 for FY21/22. No remuneration is paid to the IPP as Salary or Directors fees. PP has distributed, as fully franked dividends during the year $150,000 to each shareholder (franking credit 26%, as based off FY21 tax rate).



- We submit that the PCG must clarify how the RAF1 proportion of profit is to be determined where franked dividends are received:

  a. Is it $150,000/ $150,000 giving 100% (being the net dividend received)?
  b. Is it $202,703/ $202,703 giving 100% (being the net dividend received grossed up for the franking credit)?
  c. Is it $150,000/ $650,000 giving 23.1% (being the net dividend received divided by PP income plus net dividend)?
  d. Is it $150,000/ $250,000 giving 60% (being the net dividend received divided by 50% PP income)?
  e. Is it $202,703/ $250,000 giving 81.1% (being the dividend grossed up for franking credit received divided by 50% PP income)?

The above clarification is critical because, following the same point made in Example 1, the RAF scores may give rise to different risk outcomes due to factors entirely unrelated to tax risk, and potentially outside the control of the IPP, which thus undermines the stated purpose of the scores. In this example, the RAF outcome is affected by the franking rate (where there is a change in the company tax rate from one year to the next), whether the franking credit is included for RAF1 purposes and whether the corporate entity is an associate of the IPP.

Under the suspended guidelines, the issue of franking credits would be superfluous as the key issues was whether the income was allocated in an appropriate manner.

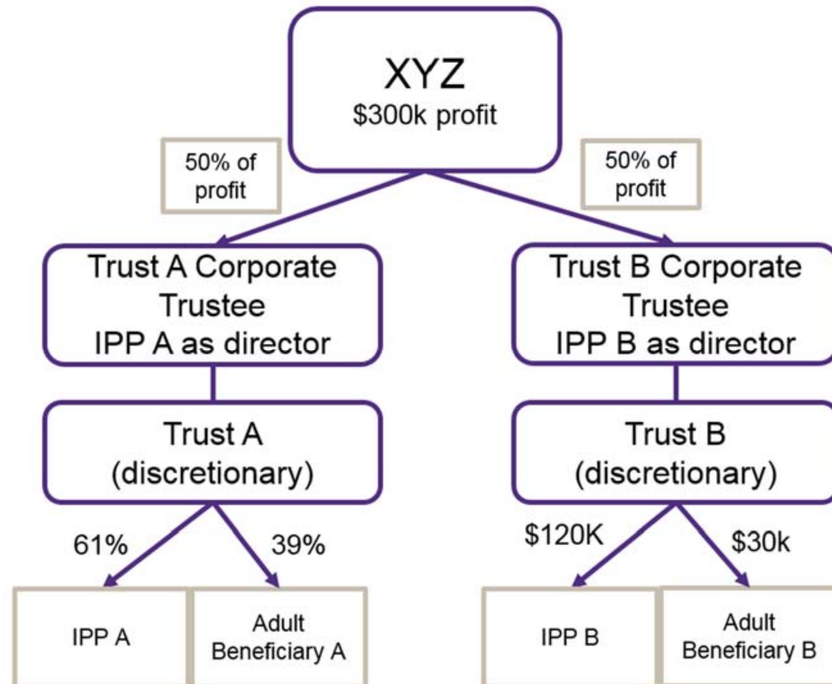
Example 3: Low income Practice

XYZ is a professional practice operating as a partnership of two discretionary trusts, A & B. The trusts have corporate trustees with the shares in the trustees held by IPP's A & B separately. A & B are Directors of their respective Trustee Company. XYZ operates in a lower economic area. XYZ derives $300,000 profit for the year. The Partnership profit is split 50/50. Trust A distributes 61% to IPP A and 39% to an adult beneficiary A. There is no outside income.

Based on the Risk Assessment Table, IPP A would score 3 under RAF 1 and under RAF 2 the score would be 6 (IPP A tax $19,170, Adult Beneficiary A tax $8,400, total tax $27,569 on $150,000 = 18.4%) giving a combined score of 9 making the IPP high risk.

If Trust A income was $250,000, and using the same percentage distribution split, IPP A would have a combined score of 7 and be regarded as low risk. Let us say the $100,000 difference is attributed to

increased profitability due to improved margins, lower bad debts and the ability of IPP's or staff to attend their office or work remotely.



- We submit that the PCG should provide an example covering this matter and explain why the same IPP applying the same RAF1 income split should have a different overall Risk score simply because of commercial factors due to business improvement and increased income?

Trust B distributes $120,000 to IPP B and the balance to an Adult Beneficiary B. There is no outside income. Based on the Risk Assessment Table, IPP B would score 2 under RAF 1 and 5 under RAF 2 (IPP B tax $29,287, Adult Beneficiary B tax $1,987, total tax $31,274 on $150,000 = 20.8%) giving a combined score of 7 making IPP B low risk.

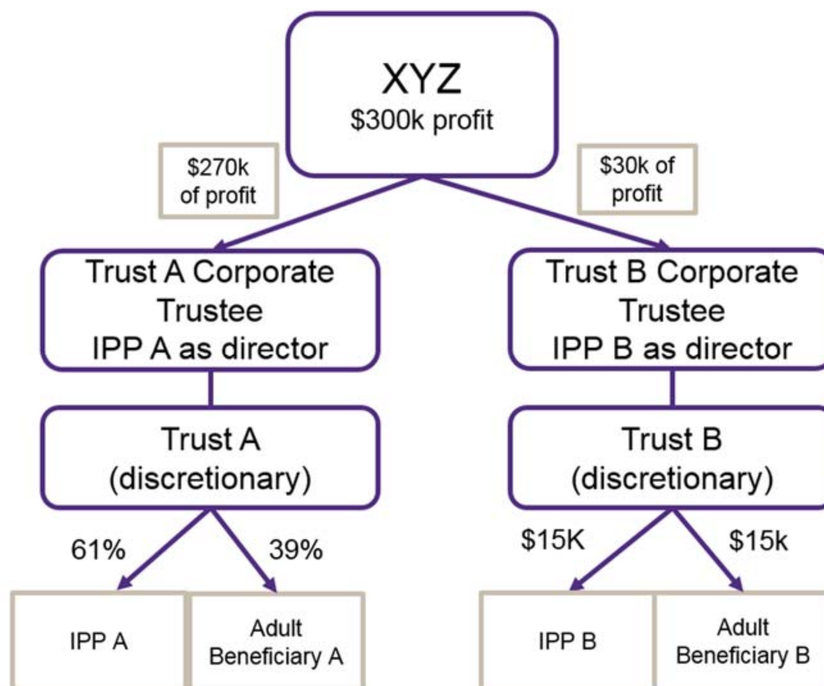
If Trust B incurred $12,000 in deductible interest and motor vehicle expenses and this amount reduced the distribution to the Adult Beneficiary B, then the combined RAF1+2 score would be either 8 if you use $150,000 income or 7 if you use $138,000 net income. So the same IPP with the same facts could have different risk outcomes depending on how a trust deduction is treated.

- We submit the PCG should clarify this issue of how the RAFs apply where there are deductions in an interposed trust.

Under the Suspended Guidelines, IPP A and IPP B would have been classified low risk by virtue of meeting the 50% test.

Example 4 Part time IPP role

Assuming the same structure as in Example 3 however IPP B takes parental leave for 12 months.



The partners in the XYZ Partnership agree to the leave after Trust B agrees to reduce its profit share to 10%. As a result of the efforts of the remaining team and additional casual staff, the same profit $300,000 is derived for FY21/22 but the profit is now shared as follows: Trust A $270,000 and Trust B $30,000.

Trust B distributes $15,000 to IPP B and the balance, $15,000 to Adult Beneficiary B. Previously, IPP B was viewed as low risk. Now IPP B will have a score of 5 under RAF 1 and a score under RAF 2 of 6 giving a combined score of 11 making IPP B high risk. This outcome seems nonsensical if the reason for the difference was due to the drop in IPP B's overall share of firm income because of IPP B taking parental leave and not due to any factor pointing to an increase in tax risk.

Given IPP B's absence, it is clear that Trust B's share of professional firm income is attributable to the business and not the personal exertion of IPP B and thus challenges the assumption that a "low risk" IPP profile is one that assumes a high degree of firm income relates to personal exertion and should be returned to the IPP.

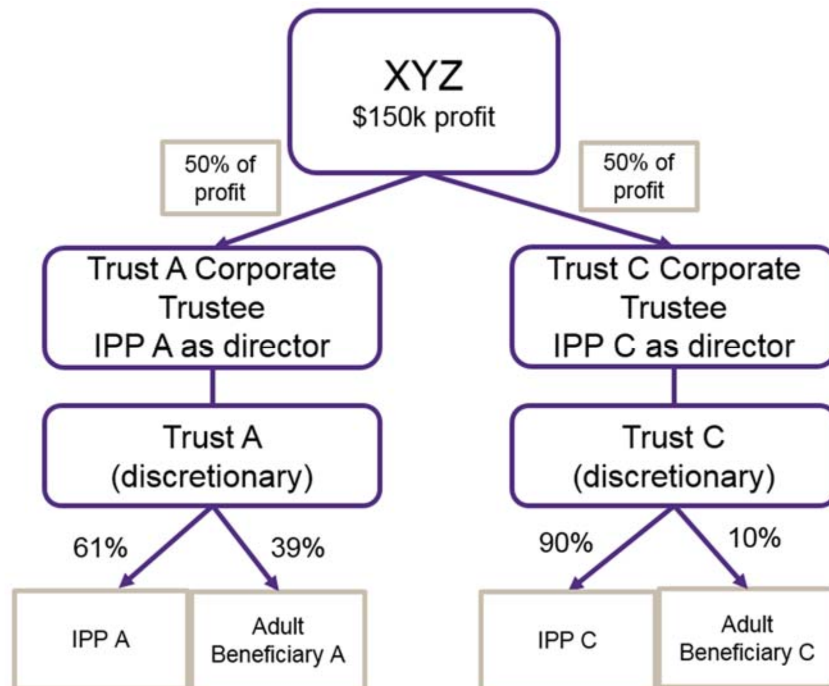
Assuming Trust A adopts the same 61%/39% distribution split, IPP A will score 3 under Factor 1 and 4 under Factor 2 giving a combined score of 7 now low risk. Again the change in risk factors being driven by profitability not the ATO's identified concerns.

Again under the Suspended guidelines, IPP A and IPP B would have been classified as low risk.

- We submit that the ATO should provide an example in the PCG that highlights this impact on part time IPPs to make clear to IPPs that this is indeed an intended outcome of the PCG.

Example 5 New entrant

Assuming the same structure as in Example 3 and 4, however Trust B decides to sell its interest in the XYZ Partnership on 31 December 2021 to Trust C. Trust C has a Corporate Trustee in which the shares are owned by IPP C and IPP C is the sole Director. The new Partnership operates for 6 months and derives $150,000 in taxable profit for the year ended 30 June 2022. Trust C distributes 90% to IPP C and the balance to Adult Beneficiary C. IPP C and Adult Beneficiary C have no other income as they were travelling for the 6 months prior to that time.



IPP C will attract a score of 2 under RAF 1 and a score of 6 under RAF 2 giving a combined score of 8 making IPP C a moderate risk. If IPP C had worked for the prior 6 months and earned $60,000, IPP C would have a score of 5 and be low risk. In other words, the PCG would classify an IPP as a moderate risk based on the fact that the IPP has a low tax rate due to deriving lower income.

If the distribution was IPP C 60%/ Adult Beneficiary C 40% (RAF1 = 4) and RAF2 = 6, giving a combined score of 10, i.e. high risk.

The above example shows the potentially negative tax risk ratings outcomes for lower income IPPs under the same structures.

Under the Suspended guidelines, IPP C would have been classified as low risk.

- We submit that the ATO should provide an example in the PCG that highlights this impact on part time IPPs to make clear to IPPs that this is indeed an intended outcome of the PCG.

Example 6 Non-Equity Partner

ABC Partnership is a Professional Practice and has 3 Partners A, B & C. A & B have full voting rights in respect the operations of the Partnership. Partner C can attend meetings and contribute but has no voting rights unless the C contributes a loan to the Partnership of $100,000. Each of A & B have contributed that loan. ABC has bank borrowing of $700,000. The bank has a fixed and floating charge over all the assets of the Partnership and has priority over the Partners Loans. The Partners agree to share profits as follows:

- The first $720,000 to be divided equally and the balance shared equally between A & B
- C profit share for FY21/22 is expected to be $240,000 based on prior performance.

Partners A, B & C draw $20,000 monthly against the expected profit. ABC engages a Service Trust (ST), which provides services to ABC and is paid monthly. ST provides staff and office premises and has taxable profit of $150,000. The trust is compliant with service trust guidance. The Trust distributes profits equally to 3 adult individuals related to IPP A, B & C.

Before the year end the Partnership receives a formal Professional Indemnity (PI) Claim from a client. The Partnership has a deductible under its insurance policy of $250,000 and the client refuses to pay their outstanding accounts. This reduces the profit for FY21/22 to $450,000. Each of the Partners has drawn in excess of this amount.

The legal claim progresses and the insurance company refuses the claim as it should have been notified earlier. The claim is currently for $1.5m plus costs against each of the Partners. Both A & B do not have any assets in their own name except for a leased motor vehicle, a 1% interest in their primary residence and superannuation. Partner C owns a house that was inherited from parents, a 1% interest in C's primary residence and superannuation.

As C is a Partner, C is jointly and severally liable for the debts of the Partnership. After investigation C discovers that if the case is successful it is unlikely, even if A & B are bankrupted, that they will be able to contribute their proportion to the claim thus leaving C exposed to the debt.

In this example, the ATO view is that Partner C would not have "full rights to participate in the voting, management and income of the firm" and not be eligible to access the guidance. Under the previous guidance C would have been low risk as more than 50% of profit from ABC is distributed to C and the service trust is excluded.

The ATO assertion that a Fixed Income Partner is not at risk is incorrect. A Partner is jointly and severally liable for the debts of the Partnership. If a claim is made against the Partner in their role as a Partner the Partner is liable to pay. The Partner then has a legal right of contribution from the other partners. If the other Partners are unable to pay the Partner is exposed to the extent that they cannot recover. In the example provided, the non-voting Partner is probably at greater commercial risk than each of the full right partners.

It is common practice that equity in Professional Practices is awarded over time and may be driven by a number factors including skills, access to new clients, IP development or exploitation of a brand. Again, we refer to the decision in FCT v Everett case at ATC 4083 in which the majority of the High Court held that "The respondent's entitlement under the partnership agreement was to a proportionate share of the partnership profits as disclosed by the partnership accounts. The relevant proportion of the partnership profits was payable to the respondent because he was a partner and the owner of a share in the partnership. The respondent was entitled before the assignment to his proportionate share of the partnership profits, **however much or however little energy he devoted to the practice**, so long as the partnership remained on foot. **Accordingly, it is a misnomer to speak of the respondent's share of the income as having been gained by his personal exertion."**

This remains clear guidance to the law on this issue. An IPP should not be discriminated based on how far along they are in their career. If they participate in the profits of a Professional Practice they should be able to access the guidance.

- Therefore, the PCG, if finalised, should apply to IPPs who are non-equity holders where they or their related entities are entitled to share in profits of a Professional Practice.

Example 7 Partner who has 49% Everett Assignment and CGT issues

Partner A in Partnership ABC assigned 49% of their interest in the Partnership to a trust, "Trust A" on its formation. Partner A is an excluded beneficiary of Trust A. Under the suspended guidelines IPP A would be regarded as low risk as more than 50% of the profit is distributed to IPP A and no service trust arrangement is in place. In order to now be considered low risk IPP A must score 3 or less under risk factor 2. To have an average rate of above 30% an individual requires an income of approximately $196,000. Depending on the distribution mix from Trust A, any IPP who has an Everett type assignment where the share of profit is below $392,000 will no longer be low risk. The contemplated solution is to reduce the proportion assigned. As an Everett assignment is a CGT asset the disposal or cancellation will trigger a CGT event with the proceeds equal to the market value of the disposed or cancelled asset.

As the guidance is to be reviewed (Paragraph 15 of the draft) there is no certainty that even triggering the CGT event and paying the subsequent CGT will not be reviewed in the future. Structures that have been put in place under the old guidance and were compliant are now viewed as higher risk.

The guidance should not be retrospective and compliant arrangements under the former guidance should be grandfathered. It should also be noted that the issue identified by the ATO related to access to the CGT small business concessions has been removed by legislation.

Example 8: Professions covered by the PCG

Currently the PCG is broadly worded to apply to tax compliance risks arising from particular commercial and regulatory contexts for professional firm arrangements. Paragraph 28 sets out a non-exhaustive list of professions intended to be covered by the PCG. However, given the term 'profession' is not defined by tax legislation, as paragraph 29 points out, further clarity around the breadth of the scope is needed.

For example, are IPPs who are partners in management consulting firms or financial advisory firms subject to the PCG?

Further, a number of trades, such as electrical or plumbing, whilst not adhering to the traditional interpretation of a 'professional', would each exhibit the indicators of a 'professional' as outlined in paragraph 29, for example, adherence to a code of conduct or industry norms and requirements to maintain licences. Would the PCG apply to these too?

- If finalised, the scope of the PCG should be made clearer and the legislative basis for selecting particular industries and sectors confirmed.

Example 9: Restructured professional firm

If the suspended guidelines are not reinstated, we submit that the PCG should be modified to clarify the ability of a professional firm that has undertaken a restructure to rely on the PCG, assuming the restructure does not fall within Part IVA.

As an example, Firm XYZ undertook a restructure for purely commercial reasons, and under the current PCG, Firm XYZ would not be entitled to apply the PCG. For reasons given in Submission 1, the PCG should make it clear that a professional firm in this situation should be allowed to rely on the PCG, as restructures are often a natural commercial requirement in the life of many professional firms.

Submission 3: Modifications required should the PCG be implemented

Should the ATO implement the PCG, we submit that the following modifications be considered:

1. The PCG must be expanded to cover a broader range of IPPs that are non-equity holders as set out in our submissions in example 6 of Submission 2 above.
2. The PCG must exclude Service Trusts from the calculation, as these are already covered by ATO guidance and should not be considered as professional services income.
3. The PCG must modify the risk matrix as set out below (see table below at submission 3.1). These amendments are practical and will help take away some of the discriminatory impacts on low income/part time IPPs as highlighted previously (examples 3-5).
4. Provide that a score of 1 under any of the three RAFs will result in an IPP being low risk (see Submission 3.1 below for an example), and
5. Provide simple arms-length remuneration tests as suggested below (see Submission 3.2 below for an example).

Submission 3.1: Proposed amended Risk Assessment Factor table:

We submit the PCG should reflect a more appropriate table as follows:

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	≥35%	≥30% to 35%	≥25% to 30%	≥20% to 25%	≥15%to 20%	<15%
3. Remuneration returned in the hands of the IPP as a % of commercial benchmark for the services provided to the firm	≥100% to <110%	≥90% to <100%	≥80% to <90%	≥70% to <80%	≥60%to <70%	<60%

The above table reflects the following changes:

- RAF1 should be amended to reflect primarily that a score of at least 50% (not >50% as is currently in the PCG) should be rated as 4 not 5 to be more consistent with the position in the Suspended Guidelines.
- RAF2 should be amended to reflect that a tax rate of at least 25% should be rated 3 (low risk) in alignment with the tax rate to be applicable for BREs. In this regard, the use of a BRE in a professional practice structure simply reflects the reality of the increasing corporatisation of professional services practices and should not be deemed as anything other than low risk. Where at least 25% is achieved at RAF2 and at least 50% of the income is assessed to the IPP, this should entitle the IPP to be classified as low risk in line with the principles of the Suspended Guidelines.
- RAF3 should be amended to reflect more realistic benchmarking against comparable employees.

Submission 3.2: If a score of 2 is achieved under any factor, then no further testing is required.

It is submitted that if an IPP can demonstrate a score of 2 on any of the three RAFs, then that should entitle the IPP to be treated as low risk. This would simply reflect a common sense application of the principles behind each RAF and would allow an IPP not to have to exhaustively review each of the 3 factors so long as one of the RAFs is clearly low risk. The rationale of this can be explained as follows:

Risk Factor 1:

If the score is greater than or equal to 75% (under our proposed modified table) and Gateway 1 & 2 have been passed, there is minimal risk to tax revenue as 75% has been declared in the individual's hand. Having 25% of profits being treated as being generated from the business structure is arguably not contentious given the requirements of the Gateways.

Risk Factor 2:

To achieve a score of 2 an individual requires a taxable income of approximately $295,000. As the score is across all entities and associates, all individuals receiving distributions would require this level of income, $295,000. If the profit was split 50/50 between individuals, then at least $410,000 out of $590,000 (69.5%) is taxed at 45% or taxed in the hands of the IPP. This is because the IPP would receive 50% (or $295,000 of the distribution of $590,000). The other individual associate of the IPP would receive $295,000 as well, of which $115,000 will be taxed at the maximum marginal tax rate, i.e. the amount above $180,000.

If a Base Rate corporate entity (BRE) is an eligible recipient of profits than the entitlement at these levels can only be small given the impact on average tax rate of all entities. The amount a BRE can receive does increase as tax on IPP's or adult profit recipient's increase. But the more this income increase the more likely the income is derived from the business structure and not personal exertion (noting our view and that of the High Court on this issue). It should also be noted that this is not the final tax on the income derived by the BRE as potentially top up tax is payable by the shareholders in due course and further the BRE is required to comply with Division 7A of the Income Tax Assessment Act 1936 (ITAA36).

Risk Factor 3:

It should be made clear that risk factor 3 is optional to apply. If an IPP receives an amount (whether by salary, distribution or dividend) which is at least 90% of "Market Value", this should be sufficient as it addresses the ATO's concern about the split between the business structure and personal exertion (Again noting our view and that of the High Court on this issue) and receive a score of 2.

Further the Market Value test should be simplified. The concept of comparable arm's length should incorporate acceptable simple tests. For example:

- Option 1: If an IPP receives an amount (whether by salary, distribution or dividend) which is greater than $180,000 (at 2021/22 individual rates) the score should be 1. (This option ensures that the IPP is in the top marginal rate)
- Option 2: Where there are more than 20 employees and an IPP receives an amount (whether by salary, distribution or dividend) which is greater than the 75th percentile of the total remuneration package of professional employees paid in the previous year the score should be 1.
- Option 3: Where there are less than 20 employees and an IPP receives an amount (whether by salary, distribution or dividend) which is greater than the average of the top quarter of employees total remuneration package of professional employees paid in the previous year should give a score of 1.

These simple changes make it possible for Professional Practices to:

- Determine amounts relative to the current year before year end to enable compliance for example with Trust resolutions or the payment of dividends.
- Provide Options depending on the size of the firm and its geography.
- Provides an administrative view without reliance on law related to remuneration.