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Allocation of profits within Professional Services firms

Draft Practical Compliance Guideline PCG 2021/D2

The ATO has published the long awaited draft revised PCG2021/D2 setting out their proposed compliance approach to the allocation of profits by professional firms, which will take effect from 1 July 2021.

The PCG will supersede the previously "Suspended Guidelines" Assessing the risk: allocation of profits within professional firms guidelines. However, taxpayers may still rely on the Suspended Guidelines for pre-14 December 2017 arrangements for the 30 June 2018 to 2021 income years (or to 30 June 2023 for existing "low risk" taxpayers transitioning to comply with the PCG) if those arrangements comply with the Suspended Guidelines.

Due to the range of differing structures of professional firms, the ATO is concerned about arrangements involving the redirection of income to an associated entity, where it has the effect of altering the tax liability.

The ATO is adopting a risk-based approach to Individual Professional Practitioners (IPPs) and, to self-assess this risk, two 'gateways' must be satisfied.

1 There is sound commercial rationale for entering into and operating the arrangement or structure; and
2 There must not be certain 'high-risk features'.

As a general rule, schemes which are designed to ensure that the IPP is not directly rewarded for the services they provide, or receives a reward substantially less than the value of those services, are considered high-risk by the ATO. Where an IPP attempts to alienate amounts of income generated by their personal exertion, the Commissioner will consider applying the anti-avoidance provision under Part IVA of the ITAA 1936.

In assessing potential exposure to this draft PCG, professional services firms and their IPPs will need to assess where they sit in relation to the proposed risk assessment factors. In doing this, an Amber or even Red rating ought not be an immediate cause for panic and drastic change; rather it requires reconfirmation of the approach and supporting it with appropriate documentation.

Prerequisites for applying the PCG:

- An IPP provides professional services to clients of the firm, or is actively involved in the management of the firm and, in either case, the IPP and/or associated entities have a legal or beneficial interest in the firm;
- The income of the firm is not Personal Services Income under Part 2-42 of the ITAA 1997;
- The firm operates by way of a legally effective structure, such as partnership, trust or company;
- An IPP is an equity holder;
- The arrangement is commercially driven – satisfaction of Gateway 1; and
- The firm and IPP do not demonstrate any high-risk features – satisfaction of Gateway 2.

Gateway 1: Commercial Rationale

This gateway looks at whether there is a genuine commercial basis for the arrangement and for the way the profits are distributed, so that the commercial needs of the business are reflected. The arrangement must be appropriately documented with evidence that the commercial purpose was in fact achieved.

Indications of an arrangement lacking sound commercial rationale:

- Arrangement appears more complex than necessary
- Arrangement includes a step that appears to serve no real purpose other than to gain a tax advantage
- Tax result of arrangement appears at odds with its commercial result
- Arrangement results in little or no risk in circumstances where significant risks would be expected
- Parties to the arrangement are operating on non-commercial terms or in a non-arm's length manner
- There is a gap between the substance of what is being achieved under the arrangement and the legal form it takes

Relevant considerations to indicate a genuine commercial basis for the way profits are distributed include whether:

- The IPP actually receives an amount of the profits reflecting reward for their skill
- The income has been distributed in substance
- The IPP ultimately benefits from the distribution of income to associates
- The remuneration is less than a true commercial comparable and would not be perceived an arm's length payment
- There are loan accounts relevant to the arrangement

Gateway 2: High-risk Features

If Gateway 1 has been passed, it is then necessary to assess whether the arrangement contains any high-risk features, such as the following (non-exhaustive):

- Financing arrangements related to non-arm's length transactions
- Exploitation of the difference between accounting standards and tax law
- Arrangements where a partner assigns a portion of a partnership interest that are materially different in principle from Everett and Galland
- Multiple classes of shares and units held by non-equity holders.

The ATO has expressed it's expectation that an IPP would engage with them should any of the high-risk features be present in their arrangement.

Risk self-assessment of arrangement

Where Gateways 1 and 2 have been satisfied, a taxpayer is then able to self-assess their risk level against the three risk assessment factors outlined in the PCG. The resultant score then falls within a risk zone, being low risk (green), medium risk (amber), and high risk (red). Those arrangements falling within the amber and red zones are likely to receive ATO review activity.

Risk factor	**Score**					
	1	2	3	4	5	6
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%
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%
Remuneration returned in the hands of the IPP as a % of commercial benchmark for the services provided to the firm	>200%	>150% to 200%	>100% to 150%	>90% to 100%	>70% to 90%	≤70%

The first two risk assessment factors may be used instead of all three, where it is impractical to accurately determine an appropriate commercial remuneration against which to benchmark.

Risk zones

This table sets out the risk level applicable to the scores obtained from the Risk Assessment Factor table.

Risk zone	Risk level	Aggregate score against first 2 factors	Aggregate score of all 3 factors
Green	Low risk	<7	<10
Amber	Moderate risk	8	11 & 12
Red	High risk	≥9	≥13

The risk rating is to be based on the last lodged tax return. If, after self-assessment, the risk rating is not considered to be reflective of the underlying risk, then the taxpayer is encouraged to contact the ATO to discuss in further detail.

ATO activity in accordance with the risk zone

Risk zone	Expected ATO activity
Green	ATO unlikely to apply compliances resources to review allocation of profit, unless in exceptional circumstances, such as: • Inadequate documentary evidence of self-assessment • There are higher-risk features present in the arrangement • The ATO has become aware of a change in the arrangement • There exists a compliance risk with the broader arrangement • The arrangement relates to other circumstances being reviewed by the ATO • Changes to the arrangement have not been appropriately disclosed
Amber	ATO is likely to conduct further analysis on the arrangement.
Red	ATO will likely review the arrangement as a priority, which may proceed into an audit.

Transitional provisions

There will be transitional arrangements in place so that those arrangements entered into before 14 December 2017 are able to continue to rely on the superseded Assessing the risk: allocation of profits within professional firms' Suspended Guidelines for the years ending 30 June 2018, 2019, 2020 and 2021.

Further, IPPs may continue to apply the Suspended Guidelines for arrangements up to 30 June 2023 where those arrangements were considered low risk but are now higher risk under this PCG. Where steps are able to be taken to modify these arrangements to low risk it is advised those are taken during the grace period.

Way forward

Professional service firms should review by 1 July 2021 their existing arrangements and forecast income distributions for FY2022 to assess how they measure up under the relevant Gateways.

If you are affected by the PCG and require assistance in applying it, please contact your Grant Thornton representative to discuss the next steps on this matter.

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