MORSE | GROUP
ACCOUNTANTS & ADVISORS

PROFESSIONAL FIRMS AND TAX RISK MANAGEMENT

(A Paper authored by

Paul Dowd FCA CTA M Tax

Tax Counsel, Morse Group)

Taxpayers who derive their income from professional services e.g. accounting, legal, architectural, engineering, financial services, medical, pharmaceutical, etc. have long been a focus of ATO compliance activities.

On 2 September 2014, the ATO issued Guidelines entitled "Assessing the risk: allocation of profits within professional firms". They attempt to explain how the ATO will assess the risk of Part IVA (the general anti avoidance provisions) applying to the allocation of profits from a professional firm carried on through a partnership, trust or company where the income dies not constitute personal services income.

These risk assessment guidelines will apply for the 2014/15 year of income and will be reviewed during the 2016/17 year subject to the possibility of judicial guidance pending an appropriate test case being identified.

1. Purpose of the guidelines

The guidelines only apply to tax compliance risks arising from the particular commercial and regulatory contexts for professional firm arrangements and specifically apply if:

- an individual professional practitioner (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 firm operates by way of a legally effective partnership, trust or company; and
- the income of the firm is not personal services income.

The focus of the guidelines is on the IPP who provides professional services to clients of the firm or the firm itself in circumstances where the IPP and/or associated entities derive, directly or indirectly, the profits or income that arise to the firm.

The guidelines only apply where the firm business is carried on by a legally effective partnership, trust or company and includes a partnership of trusts. Whether a partnership exists will be a question of all the facts and circumstances and regard will be had to existing ATO Rulings, Determinations, etc. In this regard, it will be crucial to conform with any industry standards, regulations, etc concerning the structure adopted as the operating entity. Whether the relevant entity derives practice income or shares in practice profits will be a question of facts and circumstances. The ATO says this, in turn, depends on a close examination of the contractual relationships, if any, existing between the IPP, clients of the firm and the practice entity and whether, in substance, the practice is conducted in accordance with the terms of those contractual relationships.

In this regard, the ATO makes the following statement:

> "Generally, where one or more IPPs appear to be contracting with clients – e.g. the IPP holds themselves out to be a partner of the firm – the IPP will be taken to share in practice profits or derive practice income in their own right, unless the IPP can produce evidence that establishes they are contracting in a different capacity, such as a trustee, agent or employee".

The guidelines will only apply where the practice income is being generated by a business structure and do not apply where the income constitutes income from personal services i.e. as a result of personal efforts or skills rather than being generated by assets or employees of the firm. Existing Rulings and Determinations will continue to apply and, in this regard, IT 2639 provides, as "rule of thumb" that if the partnership, trust or company carrying on the professional practice has at least as many non-principal practitioners as principal practitioners, then the income will be considered to be derived from the business structure.

For the purposes of applying the test in It 2639 in the guidelines:

- "practitioner" includes IPPs and both full time professional and non-professional staff whose function is to derive fees for the practice;
- "principal practitioner" means the IPP; and
- "non-principal practitioners" are those practitioners who are not "principal practitioners".

2. What are the ATO's concerns?

The ATO says that their concerns about compliance risks associated with the allocation of practice profits have been discussed with the legal and accounting professions over recent years but without any details of the discussions and/or the outcome(s).

One particular concern is the potential application of Part IVA to schemes which are designed to ensure that the IPP is not directly rewarded for the services they provide to the business or receives a reward which is substantially less than the value of those services. The ATO considers that Part IVA has potential application where the IPP arranges for the distribution of business profits or income to associates without regard to the value of the services the IPP has provided to the business and is said to be particularly the case where:

- the level of income received by the IPP, whether by way of salary, distribution of partnership or trust profit, dividend or any combination of them, does not reflect the contribution to the business and is not otherwise explicable by the commercial circumstances of the business;
- tax paid by the IPP and/or the associated entities on profits of the practice entity is less than that which would have been paid if the amounts were assessed in the hands of the IPP directly;
- the IPP is, in substance, being remunerated through arrangements with their associates; and

- the structure does not provide the IPP with advantages such as limited liability or asset protection.

The first of the points immediately above would seem to come out of the decision of the Supreme Court of New Zealand in a case, *Penny and Hooper v CIR* [2011] NZSC 95, decided in August 2011. The case involved two (2) orthopaedic surgeons who each sold their practices to a company owned by their family trusts and thereafter became employees of their respective company. The remuneration of each was substantially less than the income previously derived on their own account. The Commissioner of Inland revenue issued assessments increasing the taxable income of each taxpayer by an amount equal to the difference between the salaries actually paid and what the Commissioner assessed as commercially realistic salaries for their services.

The case was based on the NZ general anti avoidance provisions (containing similar wording that was once found in the former s260 of the Australian Tax Act) and provided that relevant arrangements were void as against the Commissioner. The Reasons for Decision of the Supreme Court contain the following;

> "The Commissioner's case is that the avoidance (of tax) resulted from a single step taken by each taxpayer which took advantage of an otherwise unobjectionable business structure. That step was the taxpayers' actions on each side of the employment contract relationship (as controlling director of the employer and as employee) in setting an artificially low level of salary which had the effect of altering the incidence of taxation.
>
> … plainly, the tax advantage was, objectively, at the least one of the principal purposes and effects of each arrangement. Indeed, the taxation advantage produced by the fixing of the salaries at low levels can fairly be seen as the predominant purpose.
>
> If the salary is not commercially realistic or, objectively, is not motivated by a legitimate (that is, non-tax driven) reason, it will be open to the Commissioner to assert that it was, or was part of, a tax avoidance arrangement".

Whilst the case is not a precedent for Australian purposes and is based on totally different provisions (although with the same perceived purpose), it could well be that an Australian Court will, in appropriate circumstances, find the decision persuasive in considering a similar fact pattern.

3. Risk assessment factors

As noted above, the guidelines provide risk assessment criteria for the application of compliance resources in 2014/15 and beyond will a proposed review in 2016/17 subject judicial guidance pending an appropriate test case being identified. In the meantime, the ATO is reviewing the potential application of Part IVA to arrangements of the type set out herein. The guidelines will mean that relevant taxpayers will fall into two (2) categories – LOW RISK and HIGHER RISK.

Taxpayers will be rated as LOW RISK (and will not be subject to compliance action on this issue) where their circumstances indicate they meet one of the following guidelines regarding income from the firm (salary, distribution of partnership or trust profits, distributions from associated entities, dividends from associated entities or any combination of them i.e. what might be described a "consolidated" income:

- the IPP receives assessable income from the firm in their own hands as an appropriate return for the services they provide to the firm. In determining an appropriate level of income, the taxpayer may use the level of remuneration paid to the highest band of professional employees providing equivalent services to the firm, or if there are no such employees in the firm, comparable firms or relevant industry benchmarks e.g. industry benchmarks for a region provided by a professional association, agency or consultant;

- 50% or more of the income to which the IPP and their associated entities are collectively entitled (whether directly or indirectly through interposed entities) in the relevant year is assessable in the hands of the IPP; or

- the IPP, and their associated entities, both have an effective tax rate of 30% (the current corporate rate) or higher on the income received from the firm.

Where none of the above can be satisfied, the arrangements of the IPP will be considered to be HIGHER RISK.

The ATO says that, in these cases, the lower the effective tax rate, the higher the ATO will rate the compliance risk posed by the arrangements and the greater the likelihood of ATO compliance action being commenced e.g. an arrangement with an effective tax rate of 15% will be rated as higher risk than one with an effective tax rate of 25%.

STOP PRESS - third compliance benchmark (30% effective tax rate)

In response to numerous requests, Mr Bruce Collins (ATO Assistant Deputy Commissioner of Taxation, Technical Excellence Services, Private Groups & High Wealth Individuals) has written to the Chartered Accountants Tax Team to clarify the practical application of the third compliance benchmark set out above. That response states:

> "Meaning of "both"
>
> We have been asked about the meaning of 'both' when calculating the 30% effective tax rate - i.e. whether it means collectively the IPP and the IPP's associated entities have an average effective tax rate of 30% or higher OR whether the IPP and all entities associated with the IPP must each have an effective tax rate of 30% on practice income received.
>
> Our intent for this criterion is that the 30% effective tax rate benchmark requires that the IPP has an effective tax rate of 30% or more in respect of practice income and also that each entity associated with the IPP that receives practice income collectively have an effective tax rate equal to or greater than 30%.

"Tax rate on assessable income or taxable income"

We have also been asked whether the effective tax rate of 30% must be achieved on assessable income (before taking into account deductible amounts, such as superannuation contributions or prior year losses) or on taxable income (after taking into account such potential deductions).

As is common to effective tax rate calculations, our intent for this criterion is that the 30% effective tax rate is applied to taxable income, i.e. the IPP (and their associated entities) must each have a 30% effective tax rate on their actual taxable income.

Importantly, the excessive use of deductions and over-utilisation of losses are examples of 'other compliance issues' which may result in an IPP's arrangement being rated as 'higher risk', in any event."

Note: The above guidelines do not apply in relation to other compliance issues e.g. non-recognition of capital gains, misuse of the superannuation system, promotion of schemes, late lodgment of returns, income injection to entities with carry forward losses, trust reimbursement arrangements, avoidance of Division 7A, inappropriate access to low income tax offsets or other benefits or non-tax advantages which are dependent on taxable income.