NEWS &
INSIGHTS

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ATO RELEASES DRAFT *PRACTICAL COMPLIANCE GUIDELINE* PCG 2021/D2 (ALLOCATION OF PROFESSIONAL FIRM PROFITS)

"Since the dawn of time, man has yearned to split their income and to pay less tax".

In June 2015, the ATO issued guidelines regarding the allocation of profits within professional firms, which were withdrawn suddenly in December 2017—as a result of their being misinterpreted in relation to arrangements that went beyond their scope.

However, on 1 March 2021 the ATO issued replacement guidance by way of draft *Practical Compliance Guideline* PCG 2021/D2 (Allocation of professional firm profits—ATO compliance approach) (PCG).

The PCG is likely to affect professional firms, including (but not limited to) in the accounting, architectural, engineering, financial services, legal and medical professions.

When Does the PCG Apply?

The PCG is aimed at arrangements where an "individual professional practitioner" (IPP) redirects their share of the income from a professional practice (or a portion thereof) to an associated entity or entities—such as a trust, company or family member—where that has the effect of reducing the IPP's tax liability (typically because the associated entity or entities pay tax at lower marginal rates than if the income were taxed in the IPP's hands).

A taxpayer must pass through two "gateways" before being able to rely on the PCG.

Gateway 1 considers whether the arrangement, and the way it operates, are commercially driven.

Gateway 2 requires that the arrangement must not contain potentially high-risk features, such as:

- financing arrangements relating 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 from those in the *Everett* and *Galland* cases, and
- multiple classes of shares and units held by non-equity holders.

If a taxpayer satisfies Gateways 1 and 2, the PCG provides a "risk assessment scoring table" that assigns a score depending on:

- the proportion of profit entitlement from the "whole of the firm group" returned in the hands of the IPP
- the total effective tax rate for income received from the firm by the IPP and associated entities
- remuneration returned in the IPP's hands as a percentage of the commercial benchmark for the services provided to the firm.

Those risk scores are added up to place a taxpayer within a low, medium or high risk level zone (green, amber or red).

The PCG is designed to give taxpayers confidence that if their circumstances have a low-risk rating, the ATO *"will generally not allocate compliance resources to test the relevant tax outcomes".*

What the PCG Does Not Do

The PCG does *not* apply to businesses subject to the personal services income (PSI) regime.

The PCG does *not* constitute a "safe harbour" or relieve taxpayers of their legal obligation to self-assess their compliance with relevant tax laws.

The general anti-avoidance provisions in Pt IVA of the ITAA 1936 will continue to apply to schemes designed to ensure the IPP is not appropriately rewarded for the services they provide to the business, or receives a reward substantially less than the value of those services.

Finlaysons' comments

We will be reviewing and analysing the PCG in greater detail and will issue a more detailed Client Alert in due course.

In the meantime, our initial reactions include the following:

- The PCG is clearly the result of a substantial amount of work and consultation by the ATO, and the ATO's positions and views should not come as a surprise.
- The PCG has been drafted to make clear that any "*misinterpretation*" or "*inappropriate outcomes*" will likely result in a taxpayer falling into the amber or red zones and being subject to further analysis or, in some cases, proceeding "*direct to audit*".
- In terms of applying the PCG:
  - determining the "risk level" that will relate to a firm's arrangements will involve detailed accounting and financial modelling; but
  - structuring a firm's arrangements—or restructuring them to achieve appropriate risk zone outcomes—will very much be a legal task.
- The PCG provides a number of examples for determining "effective tax rate", and includes seven detailed Case Studies. Six of the Case Studies result in taxpayers being in the green zone; and there are no examples of taxpayers clearly triggering the risk review process. This suggests that, with proper tax planning and business structuring in place, one may be able to split their income and pay less tax.

If you would like to discuss any of the issues raised above in greater detail, please do not hesitate to contact our Tax & Revenue Team:

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