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ATO GUIDELINES – PROFESSIONAL SERVICE FIRMS’ ALLOCATION OF PROFITS – IMPORTANT FOR FINANCIAL PLANNING AND CREDIT BUSINESSES

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Introduction

In 2014, the Australian Taxation Office (**ATO**) released risk assessment Guidelines *Assessing the Risk: Allocation of Profits Within Professional Services Firms*. The guidelines explain how the ATO will assess tax compliance risks associated with the allocation of profits within professional firms. The ATO refers to the guidelines as a working draft, however, the ATO will apply the guidelines from the 2014/2015 income year. Although the guidelines do not have the status of a taxation ruling or determination, all practitioners who have a financial interest, direct or indirect, in a professional services firm should be aware of the guidelines, and consider the application of the guidelines to their firms. The guidelines also apply to clients in their own right, if those clients are or have a financial interest in a professional services firm. Accordingly, practitioners should be aware of the guidelines, and consider the application of the guidelines to their own and their clients’ affairs.

At the time of writing, we located a short and informative **video** on the ATO website. It was also possible to download the transcript from that video. We found that video and transcript provided further information which was very helpful in interpreting the guidelines and the ATO’s intentions. We found the guidelines limited in some circumstances.

The guidelines appear to be based upon a pragmatic approach. The ATO states that the guidelines are based around a “structurally neutral approach”, and are outcomes based. The approach could be described as “follow the money”, because the ATO appears to be interested in actual financial outcomes, rather than the use of particular business structures.

Do the Guidelines apply to you?

The guidelines will apply if:

- you are an individual professional practitioner (“IPP”) providing professional services to clients of the firm or you are actively involved in the management of the firm;
- your firm operates as a **partnership, trust or company**; and
- the income of the firm does not constitute income from personal services.

The guidelines apply to all kinds of professional services firms – financial planners, insurance brokers, lawyers, accountants, architects, doctors and so on.

It is uncertain from the guidelines whether the failure of one member of the firm to satisfy at least one of the guidelines will potentially lead to all members of the firm enjoying the higher level of compliance attention from the ATO. In most of the examples in the guidelines, there is reference to the individual practitioner facing additional enquiry from the ATO, rather than a reference to the members of the firm facing additional enquiry.

ATO's Position

The ATO has expressed concerns that practice income is being treated as income generated by a business structure, even though the source of that income is predominately the result of personal services from one or more individuals.

Taxpayers who meet **one** of the three guidelines below will be rated as low risk and will not be subject to compliance action by the ATO on this issue.

The guidelines are as follows:

1. The assessable income the IPP receives in their own hands is an appropriate return for the services they provide to the firm. To determine the appropriate level of income, the taxpayer can 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, the taxpayer can use the level of remuneration from comparable firms or relevant industry benchmarks; or
2. 50% or more of the income that the IPP and their associated entities are collectively entitled to in the relevant year is assessable in the hands of the IPP; or
3. The IPP, and their associated entities, both have an effective tax rate of 30% or higher on the income received from the firm.

Practical Comments as to each of the Guidelines

Consideration of the level of remuneration which is acceptable will be an interesting task, and one where the views of practitioners may differ from the views of the ATO. In the video, the ATO suggests that the payments made to the top quartile of the relevant band of employees providing equivalent services be used as the benchmark for determining the IPP's appropriate level of income. The ATO states that to determine whether equivalent services are provided, consideration must be given to client-facing responsibilities, responsibility for management decisions, finalisation of work, attracting and retaining clients and approval of client billing. However, if there is no comparable band of employees within the firm, and an external industry benchmark is unavailable because the firm:

- is in a remote area;
- is unique in the services it provides; or
- has a niche operation,

then the firm should not utilise this measure.

We have some concerns about this. Our experience is that partnership (or other equivalent positions in alternative structures, such as directors in incorporated legal practices) typically brings with it a level of responsibility which exceeds that of employees. That is why many skilled and senior practitioners either choose not to become partners, preferring to remain as Special Counsel/Senior Consultants, or once they reach a certain age and decide to slow down a little, revert to the position of Special Counsel/Senior Consultants. We do not believe that the difference between Special Counsel/ Senior Consultant and equity partner is always just a matter of who has contributed equity to the firm.

We also believe that there should be an allowance for the contribution of equity to the firm and the risk adopted by the partners of the firm.

High Risk

Taxpayers who fail to meet one of the three guidelines referred to in the section above headed "ATO's Position" will be rated as higher risk and may be subject to compliance action by the ATO. In cases where the taxpayer is considered higher risk, the lower the effective tax rate paid by the IPP and their associated entities, the higher the compliance risk and the greater the likelihood of the ATO commencing compliance action. For example, the ATO would consider an arrangement where the IPP has an effective tax rate of 15% to be higher risk than an arrangement where the IPP has an effective tax rate of 35%.

Example

The ATO provides a detailed and helpful example in the video. The example is replicated below in full.

Example: Background Facts

- A law practice is structured as a partnership of trustees of discretionary trusts each controlled by an IPP.
- There are seven partners who share in profits of the firm equally.
- The firm made a profit of \$3.5 million for the year.
- The firm has 50 professional staff, 12 of which are at the Special Counsel level who provide relatively commensurate services and functions as the partners of the firm.
- The remuneration band of Special Counsel employees is from \$150,000 to \$350,000, the upper quartile average is \$330,000.

Example: Partner Income Distribution

| | IPP Personally | IPP Spouse | Other | Total |
|-----------|--------------------------------------|--------------------------------------|---|-----------|
| Partner 1 | \$400,000 | \$0 | \$100,000 (Corporate beneficiary) | \$500,000 |
| Partner 2 | \$330,000 | \$100,000 | \$70,000(Corporate beneficiary) | \$500,000 |
| Partner 3 | \$200,000 | \$0 | \$300,000 | \$500,000 |
| Partner 4 | \$255,000 | \$145,000 | \$100,000(Split between 2 adult children) | \$500,000 |
| Partner 5 | \$0 | \$500,000 | \$0 | \$500,000 |
| Partner 6 | \$100,000 | \$100,000 | \$300,000 (loss entity) | \$500,000 |
| Partner 7 | \$225,000 (\$25k super contribution) | \$225,000 (\$25k super contribution) | \$50,000 (Corporate beneficiary) | \$500,000 |

Application of Guideline 1

- IPP receives assessable income from the firm in their own hands as an appropriate return for the services they provide to the firm.
- Based on total remuneration package of top quartile of qualified employees who provide commensurate services, including:
 - client interaction;
 - development;
 - attraction and retention of clients;
 - authorisation of work;
 - firm management decisions; and
 - approving fee arrangements with clients.
- Alternatively, industry benchmarks may be suitable.
- This measure should not be relied on where there:
 - are no equivalent employees; or
 - no appropriate market basis for the comparison.

Guideline 1: Example Application

- The equivalent measure of earnings for the individual for the firm is \$330,000 based on the example.
- Partner 1 and 2 would satisfy this measure by returning at least an equivalent amount to represent their services.
- Partners 3 through 7 are significantly below the measure. They are unable to satisfy this measure.

Application of Guideline 2

- 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 IPPs.

Guideline 2: Example Application

- The equivalent amount of earnings for the individual for the firm is \$250,000 based on the example.
- Partner 1 and 2 would also satisfy this measure by returning at least 50% personally.
- Partner 4 would satisfy this measure.
- Partners 3, 5, 6 and 7 are significantly below the measure.

Application of Guideline 3

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

Guideline 3: Example Application

- The equivalent threshold for the firm is tax payable of \$150,000 per partner based on the example;
- Partner 1, 2 and 4 would also satisfy this measure;
- Partner 3, 5, 7 are able to rely on this measure to be considered low risk; and
- Partner 6 is unable to meet this measure. As partner 6 has not satisfied any of the measures, he or she will be considered higher risk.

Example Summary

| | Guideline 1 | Guideline 2 | Guideline 3 | Overall Risk Rating |
|-----------|---------------|---------------|---------------|---------------------|
| Partner 1 | Satisfied | Satisfied | Satisfied | Low Risk |
| Partner 2 | Satisfied | Satisfied | Satisfied | Low Risk |
| Partner 3 | Not Satisfied | Not Satisfied | Satisfied | Low Risk |
| Partner 4 | Not Satisfied | Satisfied | Satisfied | Low Risk |
| Partner 5 | Not Satisfied | Not Satisfied | Satisfied | Low Risk |
| Partner 6 | Not Satisfied | Not Satisfied | Not Satisfied | Higher Risk |
| Partner 7 | Not Satisfied | Not Satisfied | Satisfied | Low Risk |

Additional Enquiry from the ATO

In recent years, the ATO has significantly increased its data matching capacities. It would seem, however, that in order to obtain information to determine if taxpayers are within the guidelines, the ATO might send questionnaires to firms and practitioners. This practice has been used by the ATO in other areas. It has also become an accepted technique used by ASIC. Accordingly, practitioners may not be able to avoid the issues associated with this by simply keeping a low profile.

Timeline

The guidelines will have application from 2014-15 and beyond. The ATO plans to review the guidelines during at least 2016-17 (although possibly earlier from our correspondence with the ATO) and is looking for a suitable test case to obtain judicial guidance.

Note

The ATO may deem the taxpayer to still be a higher risk if other circumstances exist which the ATO see as a compliance risk. There are a number of categories of these circumstances, which include cases of non-recognition of net capital gains, transfer pricing, misuse of the superannuation system, late lodgement of returns, income injection to entities with carry forward losses and avoidance of Division 7A. Where these situations come to the attention of the ATO, it seems likely that the taxpayer will still 'enjoy' the compliance attention of the ATO even if the guidelines apply.

The guidelines do not provide protection:

- a) in relation to personal services income; or
- b) where the structure which has been established (for example, the trust, partnership or company which is purportedly providing the services) has not been properly established. It appears from the comments by senior ATO staff that this occurs quite frequently.

Other practical comments

The guidelines are only available online, and there is no hard copy available from the ATO.

The ATO intends to update the guidelines, and the ATO recommends accessing the guidelines online, to ensure that the most recent version is being accessed. **What should you do?**

If the guidelines apply to you, we recommend that you consider the application of the guidelines to your particular circumstances. You should also consult your professional taxation adviser to determine if your current structure is effective, or is likely to cause you to "enjoy" escalating compliance attention from the ATO.

We will be holding a workshop on this topic in the next month. If you would like to attend, please let us know by return email with "WORKSHOP" in the subject line and we will let you know the details.

FURTHER INFORMATION

For further information on any of these articles, please contact:

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