


SGM/ARA -

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These guidelines (published in 2015) were suspended in December 2017 and have been replaced by Practical Compliance Guideline [PCG 2021/4 Allocation of professional firm profits - ATO compliance approach](#).

PCG 2021/4 concerns arrangements involving taxpayers who redirect their income to an associated entity from a business or activity which includes their professional services, and it has the effect of significantly reducing their tax liability.

PCG 2021/4 applies from 1 July 2021 and clarifies how we assess the risk and our compliance approach relating to the allocation of profits within professional firms.

Providing certainty for years ending 30 June 2018 – 2022

If you have existing arrangements, you can continue to rely on these suspended guidelines for the years ending 30 June 2018 to 30 June 2022 as long as your arrangement:

- complies with the suspended guidelines
- is commercially driven
- does not exhibit any of the high-risk factors outlined in paragraph 47 of PCG 2021/4.

If your arrangement that was considered low risk under the suspended guidelines has a higher risk rating under the new guidelines, you can continue to apply the suspended guidelines to your arrangement until 30 June 2024.

Assessing the risk: allocation of profits within professional firms

Historically, most professional firms were partnerships of natural persons. Currently, professional firms are structured in a variety of ways, reflecting the economic and legal choices made by owners of those firms. In some cases, these structures may be used in ways that give rise to different tax consequences and resulting tax compliance risks.

These guidelines explain how the Australian Taxation Office (ATO) will assess the risk of Part IVA applying to the allocation of profits from a professional firm carried on through a partnership, trust or company, where the income of the firm is not personal services income.

The ATO has formulated these guidelines after extensive consultation with legal and accounting professional bodies, in order to understand the commercial, structural and operational issues affecting professional firms in these industries and, more broadly, for their clients in other professions. As a result, these guidelines apply to relevant arrangements within professional firms including, but not limited to, those providing services in the accounting, architectural, engineering, financial services, legal and medical professions.

The ATO recognises there are a wide variety of businesses of all sizes where equity holders contribute to the business through the provision of their skilled labour, including tradespeople. However, these guidelines only apply to tax compliance risks arising from the particular commercial and regulatory contexts for professional firm arrangements.

The revised guidelines:

- take into account feedback we received through consultation concerning the practical issues of applying these guidelines
- will apply from their date of issue – however we have committed to reviewing them during the 2016–17 year, subject to the possibility of judicial guidance pending an appropriate test-case being identified.

Intent of the guidelines

These guidelines explain how we assess tax compliance risks associated with the allocation of profits from the business structure of a professional firm carried on through a partnership, trust or company.

More specifically, these guidelines apply if the following three criteria are met:

- 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
- the income of the firm is not personal services income.

The ATO guidance booklet [Your service entity arrangements](#), which deals with the interaction between the service entity and the professional practice, continues to apply.

For the purposes of these guidelines, income received from the service entity will be considered when determining whether the IPP and/or associated entities meet the guidelines set out below.

This document is intended to highlight the situations which we will consider to be low or higher risk, rather than a technical analysis of the various judicial decisions in this area (which are examined in some detail in the rulings referred to on the following pages). The ATO is continuing work to identify taxpayers whose circumstances fall outside these guidelines or who wish to nominate themselves as a test case to obtain further judicial guidance on these issues in light of current business practices for professional firm structures.

IPP who provides professional services

These guidelines explain how we assess tax risks relating to the inclusion of profit or income of the firm in the assessable income of the IPP, being a person who provides services to clients of the firm, or to the firm itself, in circumstances where the IPP and/or associated entities have a legal or beneficial interest in the firm.

The themes emerging from the case law indicate that the profit or income of a professional firm may comprise different components, reflecting a mixture of income from the personal exertion of the firm's IPPs and income generated by the business structure – for example, from the activities of employees of the firm.

See also:

- [Federal Commissioner of Taxation v Gulland](#) ('Three Doctor Cases') (1985) 160 CLR 55
- [Henderson v. FCT](#) (1970) 119 CLR 612.

Legally effective partnership, trust or company

These guidelines only apply where the business is being carried on by a legally effective partnership, trust or company. In this context, a partnership includes a partnership of trustees or companies.

This will only be the case where:

- the practice entity is a legally valid and enforceable partnership, trust or company

- subject to Part IVA of the *Income Tax Assessment Act 1936*, the arrangement has the effect of causing the partner, trustee, or company to derive income or share in practice profits for income tax purposes.

Whether a trustee, company or partner derives practice income, or shares in practice profits, is inherently a question of fact and circumstance. This depends on a close examination of the contractual relationships, if any, existing between the IPP, the 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.

Whether a partnership exists is a question of fact.

See also:

- [Taxation Ruling TR 94/8](#)

Income of the firm is not personal services income

These guidelines only apply where the practice income is being generated by a business structure and does not, therefore, constitute income from personal services. Broadly, income from personal services is income earned mainly as a result of personal efforts or skills, rather than being generated by assets or employees of the firm.

For the purposes of determining whether income earned by an IPP from a professional practice is personal services income, the ATO will continue to follow the guidelines set out in its existing rulings.

See also:

These views are set out in Taxation Rulings

- [IT 25 Incorporation of medical practices](#)
- [IT 2121 Income Tax: Family companies and trusts in relation to income from personal exertion](#)
- [IT 2330 Income Tax: Income splitting](#)
- [IT 2503 Income Tax: Incorporation of medical and other professional practices](#)
- [IT 2639 Income Tax: Personal services income.](#)

IT 2639 provides, as a general rule of thumb, that if the trust, company or partnership 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. This rule of thumb will be applied for the purposes of these guidelines. For the purposes of applying the test in IT 2639 to these guidelines:

- 'Practitioner' includes IPPs and both full-time professional and non-professional staff whose function is to derive fees for the practice (see further, paragraph 11(a) in IT 2639).
- 'Principal practitioner' means the IPP.
- 'Non-principal practitioners' are those practitioners who are not 'principal practitioners'.

Our concerns

We are concerned about tax compliance risks associated with the allocation of practice profits have been discussed with the legal and accounting professions over recent years.

In some cases, practice income may be treated as being derived from a business structure, even though the source of that income remains, to a significant extent, the provision of professional services by one or more individuals. In this context, we are concerned that Part IVA may have application, despite the existence of a business structure. In particular, we are concerned that Part IVA may apply 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. Where an IPP attempts to alienate amounts of income flowing from their personal exertion (as opposed to income generated by the business structure), the ATO may consider cancelling relevant tax benefits under Part IVA.

The ATO acknowledges that the general anti-avoidance provisions have historically been applied to assess individuals on income generated by their personal exertion or application of their professional skills, rather than profits or income generated by a business structure. However, we consider that Part IVA also 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.

See also:

- [FC of T v. Mochkin](#) 2003 ATC 4272.

This is 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 their contribution to the business and is not otherwise explicable by the commercial circumstances of the business
- tax paid by the IPP and/or 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
- the structure does not provide the IPP with advantages, such as limited liability or asset protection.

ATO risk assessment factors for remuneration of IPPs

The ATO has prepared risk assessment guidelines for the application of compliance resources in 2014–15 and beyond for this issue. We will review the guidelines during the 2016–17 year, subject to the possibility of judicial guidance pending an appropriate test case being identified as outlined above.

In the meantime, the ATO is reviewing our potential application of Part IVA to arrangements of this type. We propose allocating compliance resources to applying these views to higher risk arrangements for the 2014–15 income tax year and later years.

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, income being salary, distribution of partnership or trust profit, distributions from associated service entities, dividends from associated entities or any combination of these. However, where compliance issues other than the alienation of income issues discussed within these guidelines are evident taxpayers will be rated as higher risk.

Benchmark 1: Appropriate remuneration

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, as a minimum, the level of remuneration paid to the upper quartile of the highest band of professional employees providing equivalent services to the firm. That is, to satisfy this benchmark the IPP needs to receive remuneration that is benchmarked with reference to the lowest paid member of the upper quartile. If there are no such employees in the firm, then like employees in comparable firms or relevant industry benchmarks should be used – for example, those provided by a recognised professional association, agency or consultant in the business of providing such industry benchmarks.

When considering whether the services provided by employees are equivalent for the purposes of applying the first benchmark some factors to consider are:

- the extent and nature of their client interactions
- the extent they are involved in business development
- their responsibilities for the attraction and retention of clients and staff
- their responsibility for the supervision of professional staff authorisation of work or advices
- the extent of their involvement in firm management decisions
- the extent of their involvement in the management of billings.

The total remuneration package of the upper quartile of professional employees who provide commensurate services should be recognised for this measure as it reflects the true value the business places on these services.

This will include the cost of any Fringe Benefits and FBT amount payable in relation to those Fringe Benefits to reflect the true cost to the business of employing these individuals.

Benchmark 2: 50% entitlement

50% or more of the income from the firm 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.

Benchmark 3: 30% effective tax rate

The effective tax rate must be 30% or higher on both:

1. income from the firm to which the IPP is entitled
2. income from the firm to which the IPP and their associated entities are collectively entitled.

For the purposes of the guidelines, the 30% effective tax rate will be calculated by treating income from the firm as if that income was derived by each entity after all other sources of income derived by the IPP and their associated entities. Where applicable, the taxable value of any fringe benefits to which the IPP is entitled will be taken into account.

For the avoidance of doubt, the gross income from the firm is to be used when calculating the effective tax rate. However, the IPP and their associated entities may utilise any deductions, losses and offsets available to them against income from other sources to which they are entitled.

Examples

Example 1

A professional firm subject to these guidelines has three equal trustee partners (with representative IPPs) and 10 employees. It generates a profit of \$1.5 million for the year. The three highest paid professional employees of the firm earned between \$240,000 and \$250,000 during the year. The IPPs at the firm bring in new clients, personally endorse the work of the employees, provide supervisory services, and represent clients in high-risk and high-value matters.

Trust Partner 1 distributes the \$500,000 as follows:

- \$300,000 to IPP 1
- \$200,000 to a company owned and controlled by the spouse of IPP 1.

Trust Partner 2 distributes the \$500,000 as follows:

- \$230,000 to IPP 2
- \$20,000 to the spouse of IPP 2
- \$250,000 to a company owned and controlled by IPP 2.

Trust Partner 3 distributes the \$500,000 as follows:

- \$60,000 to IPP 3
- \$80,000 to the spouse of IPP 3
- \$260,000 to a trust with losses
- \$100,000 to a company owned and controlled by IPP 3.

Based on the guidelines above, IPP 1 will be considered low risk because they meet all three of the guidelines. IPP 1 therefore should not be reviewed for their allocation of profits.

IPP 2 does not meet two of the guidelines, because the amount returned by IPP 2 is less than that paid to the band of the highest paid professional employees of the firm, and IPP 2 does not receive 50% or higher of the profits in their own hands. However, IPP 2 satisfies the effective tax rate measure, and on the basis that IPP 2 demonstrates no aggravating factors, they will be considered low risk.

IPP 3 is considered high risk – they do not meet any of the guidelines. IPP 3 is likely to face additional enquiry from the ATO.

Example 2

A small professional firm has two equal trustee partners (with representative IPPs) and generates profits of \$400,000 for the year. The three highest paid professional employees at the firm earned \$90,000 each for the year. The IPPs at the firm bring in new clients, personally endorse the work of the employees, provide supervisory services, and represent clients in high-risk and high-value matters.

The IPP 1 Trust distributes its \$200,000 as follows:

- \$130,000 to the IPP
- \$70,000 to IPP 1 Pty Ltd, a company owned and controlled by the spouse of IPP.

The IPP 2 Trust distributes its \$200,000 as follows:

- \$75,000 to the IPP

- \$75,000 to the IPP's spouse
- \$25,000 to IPP's adult child
- \$25,000 to IPP 2 Pty Ltd, a company owned and controlled by the IPP's spouse.

IPP 1 would be considered low risk – he satisfies both the comparable remuneration and 50% or greater distribution guidelines, even though he does not meet the 30% effective tax rate test.

IPP 2 would be considered high risk – they do not meet any of the guidelines provided, because they do not receive comparable remuneration, or 50% or greater of the distribution and does not have an effective tax rate of 30% or greater. Jo is likely to face additional enquiry from the ATO.

Example 3

We understand there may be circumstances where newly established firms may face a period of reduced profits due to initial start-up costs and business building expenditures so that Benchmark 1 and Benchmark 3 will not be satisfied. However, they may still be considered low risk under Benchmark 2. For example, consider the following scenario.

A newly established professional firm has two trustee partners and generated only \$80,000 profit for the year. The firm employs two senior professionals who earn \$125,000 for the year.

IPP 1 returns \$40,000 in their own name.

IPP 2 returns \$21,000 in their own name and distributes the remaining \$19,000 to their spouse.

As IPP 1 returns 100% of their income in their own name, IPP 1 is considered low risk as they comply with Benchmark 2.

IPP 2 will also be considered low risk under Benchmark 2, as they returned 50% of their income personally.

Example 4

A law practice is structured as a partnership of seven trustees of discretionary trusts each controlled by an IPP. The firm made a profit of \$3.5 million for the year and the partners share in the profits of the firm equally. The firm has 50 professional staff, 12 of which are at the special counsel level that provides 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 lowest paid employee within the upper quartile being \$330,000. Each of the partners returns their income in the following manner:

- The IPP associated with partner 1 returns an amount of \$400,000 in their personal return. Partner 1 distributes the remaining \$100,000 to a corporate beneficiary.
- The IPP of partner 2 returns an amount of \$330,000 in their personal return. Partner 2 distributes \$100,000 to the IPP's spouse and \$70,000 to a corporate beneficiary.
- The IPP of partner 3 returns an amount of \$200,000 in their personal return. Partner 3 distributes the remaining \$300,000 to a corporate beneficiary.

- The IPP of partner 4 returns an amount of \$255,000 in their personal return. Partner 4 distributes \$145,000 to the spouse of the IPP and \$50,000 to each of his two adult children.
- The IPP of partner 5 receives no income distribution and the entire \$500,000 distribution is paid to the IPP's spouse.
- The IPP of partner 6 receives \$100,000 personally, \$100,000 to the IPP's spouse and \$300,000 to an entity with significant carry-forward losses.
- The IPP of partner 7 receives a distribution of \$225,000 personally and makes a \$25,000 superannuation contribution, The IPP's spouse also receives \$225,000 and makes a \$25,000 superannuation contribution and the remaining \$50,000 is distributed to a corporate beneficiary.

Applying first benchmark to the example the IPP of partner 1 clearly exceeds the level of remuneration of its highest paid professional employees and would be categorised as low risk. Partner 2 receives remuneration comparable to the lowest paid employee within the upper quartile and will be considered as lower risk. The IPPs of the remaining partners receive distributions significantly below the firm's internal benchmark and will not satisfy this criterion.

Applying the second benchmark to this example the IPPs of partners' 1 and 2 would also pass the second measure and are considered low risk. The IPP of partner 4 would pass the second measure as more than 50% of the share in profit is returned by the partner personally and would be rated low risk. However, the IPPs of partners' 3, 5, 6 and 7 receive less than 50% of their distributions personally and are also unable to rely on this measure.

Applying the third benchmark to this example above the IPPs associated with partners' 1, 2 and 4 would also satisfy this benchmark. The IPPs associated with partners' 3 and 7 would satisfy the third benchmark as their income entitlement from the firm would have a collective effective tax rate exceeding 30%. However, the IPP of partner 5 and 6 are not able to satisfy this measure, nor will they satisfy the appropriate remuneration or 50% distribution measures. Therefore, the IPP associated with partners 5 and 6 will be rated high risk.

Additional information on the application of the benchmarks

As stated above, only one benchmark need be satisfied each year to be considered low risk. The IPP is not obliged to apply the same benchmark each year.

Where none of the benchmarks outlined above can be satisfied, the IPP's arrangement will be considered higher risk. 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. For example, an arrangement with an effective tax rate of 15% will be rated as higher risk than one with an effective tax rate of 25%.

The guidelines and service entities

The ATO guidance booklet [Your service entity arrangements](#), which deals with the interaction between the service entity and the professional practice, continues to apply.

The risk assessment guidelines in [Assessing the risk: allocation of profits within professional firms](#) apply at the individual practitioner level. Income received from a service entity will be considered as a part of the firm's income flow and must be taken into account when self-assessing against these guidelines.

We recognise that service entities may remain a sensible commercial arrangement for some businesses. However, we note that in a majority of professional firms with service entity

arrangements, the IPPs retain an interest, directly or otherwise, in the profits of the service entity. Therefore, as the profits of the service entity are sourced from fees from the practice, for the purposes of these guidelines, income received from the service entity will be considered when determining whether the IPP and associated entities meet the benchmarks set out above. This means that if a firm has a service entity then the income from the service entity is included as a part of the firm's income when applying the benchmarks.

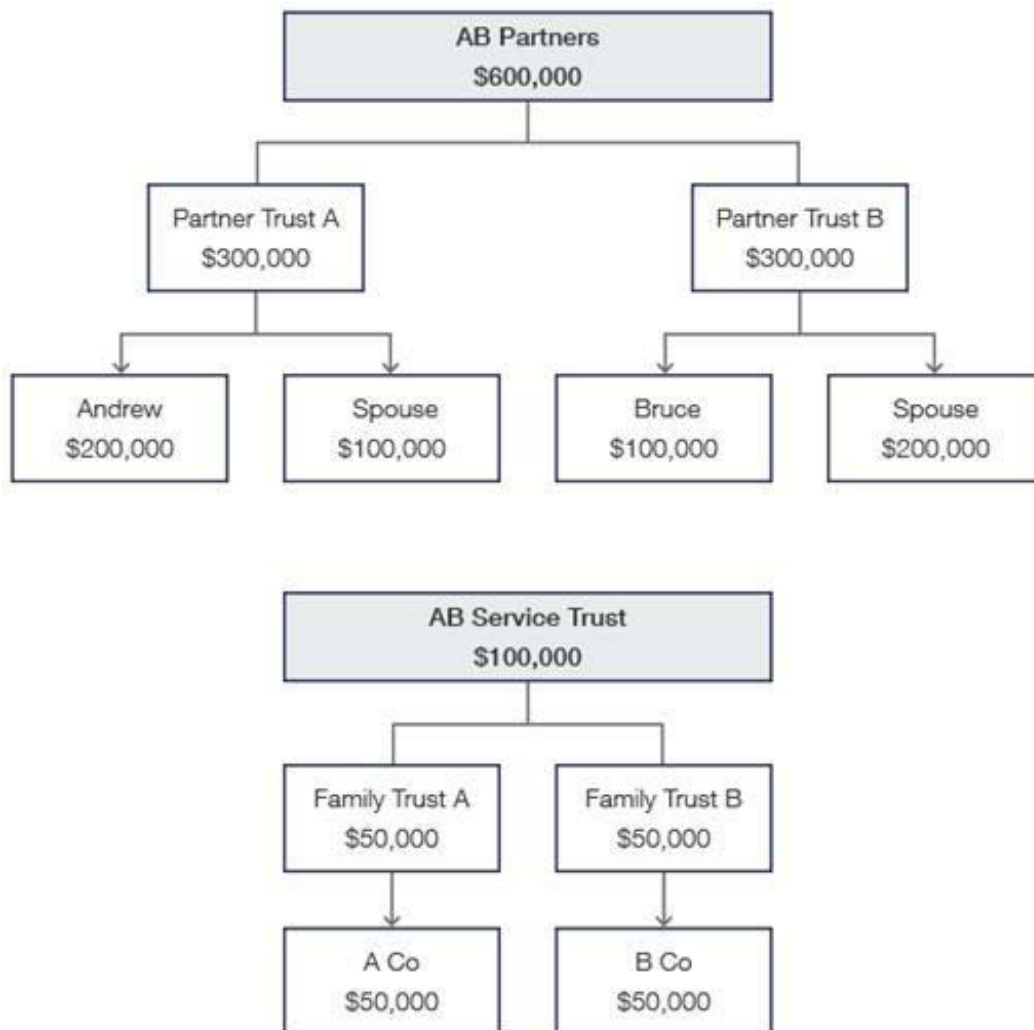
Example

AB Partners is a professional practice which trades as a partnership with two partners, Trust Partner A, an associate entity of Andrew, and Trust Partner B, an associated entity of Bruce. Both Trust Partners are discretionary trusts. AB Service Trust provides services to AB Partners.

For the year ended 30 June 2017, AB Partners has taxable income of \$600,000, and AB Service Trust has income of \$100,000. The highest paid qualified employee of AB Partners has total remuneration package of \$190,000.

AB Service Trust has two beneficiaries, Family Trust A, an associated entity of Andrew, and Family Trust B, an associated entity of Bruce.

AB Partners and AB Service Trust distribute as follows:



Relevant practice income for the purpose of self-assessing the level of risk for both Andrew and Bruce are their AB Partnership entitlement of \$300,000 plus the distribution from AB Service Trust to their respective Family Trusts of \$50,000.

Andrew satisfies Benchmark 1 as the \$200,000 of practice income returned by him personally exceeds the total remuneration of the highest paid professional employee of AB Partners who performs commensurate duties and has commensurate responsibilities. Andrew also satisfies Benchmark 2, as the amount returned by him personally is greater than 50% of the income from the firm.

Bruce will not satisfy Benchmark 1, as the \$100,000 of practice income returned by him personally is less than the total remuneration of the highest paid professional employee of AB Partners who performs commensurate duties and has commensurate responsibilities. Bruce will also not satisfy Benchmark 2, as the amount of \$100,000 personally returned by him is less than 50% of the income from the firm.

The guidelines and Everett assignments

We have previously taken the view that Part IVA does not apply to the assignment of an interest in a partnership (an 'Everett'¹ assignment), provided it constitutes a 'no strings attached' disposition on 'all-fours' with the facts in Everett.² However, we have revisited this position and now consider that Part IVA is capable of application to such assignments in appropriate cases.

The application of Part IVA to the entering into of an Everett assignment will be considered in relation to assignments that have been entered into in the 2015–16 income tax year and later years. This means that from 1 July 2015, if a partner has entered into an Everett assignment, one of the benchmarks needs to be met in order for the assignment to be rated as low risk. If this is the case, we will not seek to invoke Part IVA in relation to the arrangement.

We may consider the application of Part IVA to a pre-1 July 2015 assignment where, after 30 June 2015:

1. Either
 - a. a further assignment occurs, or
 - b. a power of appointment or other discretion is exercised, and
2. as a result, the partner does not satisfy any of the benchmarks in the guidelines.

Where this occurs, we will only consider the application of Part IVA in the 2015–16 and later income years and will provide an opportunity for the IPP to self-correct their arrangement in the following income tax year.

See also:

- [Everett assignments](#)

Example

A Professional Practice has 3 partners who share equally in the profits of the firm. It generated \$2m in annual profit. The firm does not operate a service entity and has no plans to commence a service entity arrangement.

On 15 July 2015 the partners decide that it would be acceptable for each of them to undertake Everett assignments. On that date the following transactions take place:

- Partner 1 assigns 50% of their interest to their family trust.

- Partner 2 makes 2 assignments, being 20% to their spouse and then 30% of the remainder of their interest to their family trust.
- Partner 3 assigns 70% of their interest to their family trust. The trustee of the family trust then exercises its discretion to distribute all of the income to a corporate beneficiary with a discretionary trust shareholder. A dividend is declared and the trustee distributes it equally to the partner's spouse and another corporate entity with \$300,000 carried forward losses.

In this example, Partners 1 and 2 would be considered low risk. Partner 1 will comply with the 50% distribution benchmark, as would Partner 2.

Partner 3 does not comply with the 50% entitlement benchmark and, assuming that he does not comply with either of the other two benchmarks he will be considered higher risk. The ATO will review the arrangement and consider the application of Part IVA to the Everett assignment transaction itself, as well as the appointment of the income flowing from the Everett assignment to beneficiaries other than Partner 3.

The guidelines and other high risk features

The above guidelines do not apply to other compliance issues. In cases where other compliance issues are evident, taxpayers will be rated as higher risk. This would include cases of non-recognition of net capital gains, transfer pricing, misuse of the superannuation system, promotion of schemes, repeated failure to lodge returns or a history of 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.

Further general guidance on the Benchmarks

This section answers frequently asked questions about the application of the guidelines more generally.

Why do the guidelines apply only to professionals and not 'non-professionals', such as plumbers, electricians and builders?

The guidelines do not apply to all professionals – or to non-professionals – as the structure of professional practices in certain 'thought related' professions (eg accounting, law, medicine) is unique and has been driven by a combination of factors, including:

- the historical regulatory environment which have imposed particular business structures (eg partnerships);
- reforms to those regulatory environments in recent times driven by national competition policy and deregulation of ownership restrictions to promote competition and efficiency (eg allowing incorporation and the sharing of profits with people that are not themselves professionals)
- the commercial business models adopted (including features such as practice size, the treatment of goodwill and the distribution of profits)
- concerns in relation to liability (eg professional negligence)
- the increasing level of mobility between professional practices.

This combination of factors has led some professions to adopt a variety of commercial structures. These factors differ from the commercial drivers in other sectors, such as those involving physical labour.

We appreciate that the regulators of these industries have allowed greater flexibility in how firms can structure their business for legitimate commercial reasons. However, some structures may provide the potential opportunity to alienate income. To address this, we engaged with representatives of the legal and accounting industries to co-design guidelines that focus on the alienation risk.

What does the term 'legally effective structure' cover?

For the purposes of the guidelines, the ATO recognises that there are alternative business structures to the traditional partnerships of natural persons.

Through its compliance activities, the ATO has observed that, in some circumstances, an IPP argues that he or she holds some or all of the partnership interest on trust for one or more beneficiaries, but there is no evidence to support the formation of the trust (eg a written trust deed), the partnership agreement prohibits any trust arrangements and the individual continues to hold him or herself out to staff, clients and the public as being a partner. In this scenario, the ATO would generally consider the arrangement not to be legally effective and would instead disregard it and attribute the income to the individual in his or her own capacity.

When retaining profits causes the remuneration to fall outside the benchmarks

We recognise that, in certain circumstances, professional firms may want to retain profits in the business structure and this may represent a sensible business practice. Where this occurs, it may impact on an IPP's ability to satisfy one of the three benchmarks. As a result, the IPP may not be able to self-assess as being low risk under the guidelines in that particular income year.

Where the ATO identifies an arrangement that is considered higher risk, further analysis of the available information will occur to determine any potential reason for the higher risk rating. This may result in the IPP being contacted by the ATO for the purposes of further understanding their arrangement. If, after a discussion and review of the IPP's individual circumstances, there appears to be a prudent, commercial basis for the firm to retain profits in the business structure, the IPP will be reclassified as low risk for that income year. However, it would be prudent for the IPP to first contact the Professional Firms Compliance team or send an email to professionalpfts@ato.gov.au regarding their intentions and the rationale for retaining profits, rather than distributing it in a particular income year. Where no or minimal profit distributions are made and the majority of profits are retained in the business, we may consider how the IPP is supporting their lifestyle.

IPPs who work part-time

If an IPP works part-time, the application of benchmarks' 2 and 3 are straight forward. Where 50% of the distribution is received by the IPP personally or an effective tax rate of 30% paid on income from the firm received by the IPP and the IPP and their associated entities, a low risk rating may be achieved.

If the IPP intends to rely on benchmark 1, the comparable wage measure should be determined on the basis of a pro-rata calculation.

Example

ABC Lawyers is a legal practice which trades as a partnership with 50 trustees of discretionary trusts, each controlled by an IPP. The partnership agreement of ABC Lawyers provides that each partner shares equally in the profits of the firm and that a profit

distribution to a partner who works on a part-time basis is calculated on a pro-rata basis. ABC Lawyers has 80 professional staff, 12 of which are at the special counsel level and provides relatively commensurate services and functions as the partners of the firm. The remuneration band of special counsel employees is from \$150,000 to \$400,000, the upper quartile of the Special Counsel band of employees, being \$370,000.

Gary is the IPP associated with the GC Practice Trust, a partner of ABC Lawyers. The GC Practice Trust's agreement with the firm is that Gary works part-time four days per week. In accordance with the partnership agreement, the GC Practice Trust is entitled to a profit distribution of \$600,000.

If Gary chooses to self-assess using the first benchmark under the guidelines, the remuneration received for four day's work would need to be at least equivalent to 80% of the upper quartile of the Special Counsel band of employees, calculated as:

$$\$370,000 \times 0.80 = \$304,000.$$

This means that Gary would need to declare in his income tax return at least \$304,000 in order to self-assess as low risk under the first benchmark.

Assessable income payments

As long as the IPP returns an amount that is equivalent to an appropriate return for their services personally, and declares that amount in their income tax return, the income does not have to be paid as a 'wage' and can, for example, be received as a profit distribution from the firm, as a distribution from a trust, as a dividend from an incorporated practice, as wages, fringe benefits, superannuation contributions or a mixture of all of the above.

Where a mixture of payment methods are made to remunerate the IPP, it may become more complex for the ATO to appropriately measure the total remuneration returned. Ensuring amounts are reported correctly (e.g. Reportable Fringe Benefits are appropriately disclosed for each individual IPP) will lower the likelihood of ATO contact if alternative profit distribution / remuneration strategies are used at the firm.

When an IPP does not meet any of the benchmarks

If an IPP does not meet any of the low risk benchmarks in the guidelines, there are a range of options the IPP may wish to consider. Where issues arise, contact should be made with the Professional Firms Compliance team or an email sent to professionalppts@ato.gov.au to discuss these issues and an IPP's options.

The ATO monitors compliance with benchmarks through an automated analytical model. We recognise that there may be cases where, due to reporting issues or other problems, an IPP who should meet the benchmarks appears to not meet any of the benchmarks based on the ATO's internal automated analytical modelling. In these circumstances, it is important to note that the ATO will conduct further profiling and will review the results of the analytical modelling prior to contacting the taxpayer.

The majority of interactions surrounding the guidelines are expected to be through either:

- an IPP or their appointed representative contacting the ATO when there are extenuating circumstances regarding their profit distribution for a particular year
- the ATO contacting an IPP or their appointed representative, where their distribution pattern changes and they do not appear to meet the guidelines, to discuss the drivers for the change, and potential risk mitigation strategies.

It should be noted that a failure to meet the guidelines will not automatically lead to the application of Part IVA, which requires a fuller examination of all facts and circumstances, including approval through the GAAR Panel.

Medicare Levy and Medicare Levy Surcharge

The Medicare Levy, the Medicare Levy Surcharge and any other levy introduced in the future, whether permanent or temporary, such as Temporary Budget Repair levy payable by the IPP is **not** to be included in calculating the tax payable of the IPP. The income of the IPP will be the tax payable of the IPP prior to the imposition of the Medicare Levy and Medicare Levy Surcharge.

Further information: Applying benchmark 1

This section answers frequently asked questions about the application of benchmark 1.

What does ‘equivalent services’ mean?

As a comparative analysis, when considering whether the services provided by employees are comparable to those of an IPP for the purposes of applying the first benchmark, some factors to consider are:

- the extent and nature of their client interactions
- the extent they are involved in business development
- their responsibilities for the attraction and retention of clients and staff
- their responsibility for the supervision of professional staff and authorisation of work or advices
- the extent of their involvement in firm management decisions
- the extent of their involvement in the management of billings.

If there is no employee who provides such equivalent services within the firm, then the IPP may look to what comparable firms of substantially the same size, areas of practice and geographical location pay their highest paid employee or the upper quartile of the band of highest paid employees as a comparable. If this information is not readily available, then the IPP may consider industry benchmarks for the same region, provided by a recognised professional association, agency or consultant in the business of providing such industry benchmarks. If this, too, is unavailable or difficult to obtain, the IPP should consider if one of the other low risk benchmarks may apply to the IPP’s particular circumstances.

Example

A large legal firm has 60 professional employees. The group of employees considered to provide equivalent services to the IPPs of that firm are Special Counsel (SCs). Within that group, there are 8 employees with the following total salary package:

| | | |
|-----------------|-----------------|-----------------|
| SC 1: \$150,000 | SC 2: \$210,000 | SC 3: \$270,000 |
| SC 4: \$300,000 | SC 5: \$350,000 | SC 6: \$350,000 |
| SC 7: \$400,000 | SC 8: \$450,000 | |

The upper quartile of the band of the highest paid professional employees will be SC 7 and SC 8. This means that the IPP must return income that is equivalent to or greater than

\$400,000, being the lowest wage within the upper quartile of the band of highest paid employees.

If, upon review of the services provided by the SC band, it appears that not all the SCs perform equivalent services as the IPPs, the ATO will recalculate the upper quartile. For example, if only the top 4 SC employees listed above genuinely provide equivalent services, the highest paid employee (SC8) would then represent the recalculated upper quartile. This would mean that, to meet the measure, the IPP must return equal to, or greater than, \$450,000 personally

What is considered remuneration when considering the ‘remuneration’ paid to the highest paid professional employee or the upper quartile of the band of highest paid employees of the firm?

In relation to the first benchmark, when self-assessing the remuneration the IPP should return as an appropriate reward for their personal efforts and services to the firm, the IPP should consider the total remuneration package given to the highest paid professional employee or the upper quartile of the band of highest paid employees, in the form of both monetary and non-monetary benefits.

Non-monetary benefits may include:

- employer superannuation contributions
- salary sacrifice arrangements
- other benefits subject to the FBT regime such as use of vehicles or car space; expense payments; entertainment and other non-cash benefits, in any form, given to the employee or their associates.

Including the total remuneration package, rather than just the monetary component, reflects the true value or cost of these benefits to the business or payer.

Example

IPPs within a professional firm provide the following services:

- Management of staff
- Setting of direction
- Client attraction and retention
- Representation of clients in high value matters, including hearings and settlements
- Final sign-off for client advice
- Promotion of the firm through professional development engagements
- Staff selection

There are 12 special counsel employees within the practice. This has been identified through work value analysis, where these individuals have been found to provide partner-like functions. As such, the upper quartile would be represented by the three highest paid of these staff members’ total remuneration packages. These 3 special counsels’ employee packages for the 2015 financial year are as follows:

| | SC10 | SC11 | SC12 |
|--------|-------------|-------------|-------------|
| Salary | 250,000 | 235,000 | 290,000 |

| | | | |
|--|---------|---------|---------|
| Superannuation Guarantee | 18,783 | 18,783 | 18,783* |
| Additional superannuation per contract | - | - | 20,537* |
| Fringe benefits provided: | | | |
| Car provided (including running costs) | 33,589 | 38,014 | - |
| Car fringe benefit (taxable value) | 23,200 | 24,800 | - |
| Car parking provided (cost) | 1,800 | 1,570 | - |
| Car parking benefit (taxable value) | 1,800 | 1,570 | - |
| 'Entertainment' fringe benefit received | 1,800 | 1,846 | - |
| Total taxable value of benefits provided | 25,200 | 28,216 | - |
| FBT amount paid | 24,638 | 27,587 | - |
| Professional Development Allowance | 1,000 | 1,200 | 680 |
| Total cost to firm: | 330,010 | 324,000 | 330,000 |

The appropriate level of remuneration should be between \$324,000 and \$330,000.

Further information: Applying benchmark 2

This section answers frequently asked questions about the application of benchmark 2.

How do benchmarks 1 (appropriate remuneration) and 2 (50% entitlement) interact?

Both of these benchmarks will operate in a similar manner but will have slightly different outcomes. Although both measures will effectively set a minimum threshold amount to be met by the IPP, where one threshold is lower, that threshold will take precedence. The following table clarifies this:

| | | | | | |
|-----------------------------|-----------|-----------|-----------|-----------|-----------|
| IPP Profits | \$500,000 | \$500,000 | \$500,000 | \$500,000 | \$500,000 |
| 50% of Profits Amount | \$250,000 | \$250,000 | \$250,000 | \$250,000 | \$250,000 |
| Appropriate Remuneration | \$190,000 | \$220,000 | \$250,000 | \$280,000 | \$300,000 |
| Applicable Threshold Amount | \$190,000 | \$220,000 | \$250,000 | \$250,000 | \$250,000 |

| | | | | | |
|--------------------|--------------------------|--------------------------|---------------------------|----------------------------|----------------------------|
| Applicable Measure | Appropriate Remuneration | Appropriate Remuneration | Either (equal thresholds) | 50% Entitlement to Profits | 50% Entitlement to Profits |
|--------------------|--------------------------|--------------------------|---------------------------|----------------------------|----------------------------|

An IPP may rely on any one of the benchmarks and may rely on a different benchmark each year.

Further information: Applying benchmark 3

This section answers frequently asked questions about the application of benchmark 3.

How is the effective tax rate of an IPP calculated?

To satisfy the third benchmark, the IPP alone must have an effective tax rate of 30% or higher and the IPP and their associated entities, collectively, must also have an effective tax rate of 30% or higher on income received from the professional firm. The collective tax rate is determined by adding the tax paid by the IPP and each associated entity (on firm income calculated as outlined below) and dividing this by the total firm income received collectively by them to determine the collective effective tax rate. The resulting figure should be a minimum of 30%.

The effective tax rate is calculated using the following formula:

$$\frac{\text{Income tax liability on taxable income} - \text{Notional income tax liability on taxable income excluding firm income included in assessable income}}{\text{Total Share of firm income}} = \text{Effective Tax Rate}$$

The 30% effective tax rate should be paid on the profits received from the professional firm, regardless of the availability of losses, deductions, franking credits or other means of offsetting taxable income, which may be available to the IPP or their associated entities elsewhere.

The effect of this is that where an IPP, and all associated entities who receive firm income individually have an effective tax rate of 30% or more, the IPP will satisfy the third benchmark. However, the fact that the effective tax rate of an associated entity falls short of 30% does not necessarily mean that the IPP will not satisfy the benchmark. That shortfall may be more than offset by effective tax rates in excess of 30% for the IPP and other associated entities.

Your notional income tax liability is calculated on taxable income in the same way, but adjusted to exclude any firm income included in your assessable income.

When calculating the 30% tax rate, we will treat the practice income as being the last income derived. That is, it will be considered to be 'on top' of all other income, giving the benefit of higher marginal rates to IPPs.

The way your effective tax rate is calculated will be different if you and/or your employer make deductible superannuation contributions on your behalf (see Q6) or part of your remuneration is received by way of reportable fringe benefits (see Q14).

Your effective tax rate is not the marginal rate applicable to the last dollar of income you derive. Rather it is referable to the average rate of tax paid across the entire income from the firm.

Example

In the 2014/15 income year, the trustee partners of the firm make the following distributions and the IPP and associated entities who receive firm income have no other income or deductions:

| TRUSTEE PARTNER | Income distributed to the following entities associated with the Trust Partner | | | | |
|-----------------|--|--------------|-----------------------|---------------------------|-----------|
| | IPP | IPP's Spouse | Corporate beneficiary | Related trust with losses | TOTAL |
| 1 | \$300,000 | \$20,000 | \$180,000 | - | \$500,000 |
| 2 | \$180,000 | \$20,000 | \$70,000 | \$230,000 | \$500,000 |
| 3 | \$35,000 | \$215,000 | \$250,000 | - | \$500,000 |

In this scenario, with regards to the third benchmark only:

- IPP 1 would satisfy the 30% effective tax rate benchmark as IPP 1, individually, would pay an effective tax rate of 36% on income distributed by the firm calculated as follows:

| | |
|---|---|
| | Income tax liability on firm income |
| | Share of firm income |
| = | \$54,547 + 45% of (\$300,000 - \$180,000) |
| | \$300,000 |
| = | \$108,547 |
| | \$30,000 |
| = | 36% |

IPP 1's spouse would have an income tax liability of \$342 on her \$20,000 distribution from the firm (19% of the excess over \$18,200) and the corporate beneficiary a tax liability of \$54,000 (30% of \$180,000).

The effective tax rate of the IPP, the IPP's spouse and the corporate beneficiary will therefore be:

Collective income tax liability of the IPP, the spouse and corporate beneficiary

| | |
|---|------------------------------|
| | Total share of firm income |
| = | \$108,547 + \$342 + \$54,000 |
| | \$500,000 |
| = | 32% |

Using the same analysis as for IPP 1:

IPP 2 individually has an effective tax rate of 30%. However, benchmark 3 requires that the IPP and those of their associates who receive income from the firm together satisfy the third benchmark also. Here, IPP 2, IPP 2's spouse, IPP 2's company and trust, collectively, have an effective tax rate of only 15%. Therefore, IPP 2 would not satisfy this benchmark and may be subject to further compliance action, if neither of the other two benchmarks is satisfied.

Despite the fact that IPP 3's spouse and IPP 3's company have an effective tax rate of 30%, IPP 3 would not satisfy the third benchmark. To satisfy the third benchmark, IPP 3 must individually satisfy the 30% effective tax rate benchmark, and the cumulative effective tax

rate across the entire interest must also be 30%. Whilst the collective effective tax rate of 30% is satisfied, IPP 3's individual effective tax rate is only 13%.

How is income received from sources other than distributions from the professional firm treated?

For the purposes of applying the guidelines, we will base calculations on the amount of distribution received by the spouse from the professional firm as a result of professional services rendered by the IPP. However, we will treat any distribution from the firm as being the last income derived when undertaking the calculation of the effective tax rate.

Please note that any Levy based on taxable income (i.e. Medicare Levy, Medicare Levy Surcharge, Temporary Budget Repair Levy etc.) is not included in the calculation of the effective tax rate.

Example

If IPP 1's spouse in the above example received \$20,000 of firm income and earned \$50,000 in 'other income', would the tax on their income from the firm for the purposes of the calculation be the tax on their taxable income \$0 to \$20,000 (i.e. \$342), or tax from \$50,001 to \$70,000?

The second of the two methods above will be used. Assuming the spouse of IPP 1 has no other deductions, the effective tax rate calculation will be as follows:

Based on the 2014/15 Income Tax Rates the spouse of IPP 1 would have an income tax amount of \$14,297 on their \$70,000 taxable income.

\$3,572 plus 32.5c for each \$1 over \$37,000

$\$3,572 + ((\$70,000 - \$37,000) \times 0.325) = \$14,297$

We then consider the notional tax liability of IPP 1's spouse, as if the practice income was disregarded. Based on the 2014/15 Income Tax Rates this equals \$7,797 on \$50,000 and is calculated as follows:

\$3,572 plus 32.5c for each \$1 over \$37,000

(being the 'other income' without the practice distribution being recognised)

$\$3,572 + ((\$50,000 - \$37,000) \times 0.325) = \$7,797$

The difference between the tax payable on the taxable income of IPP 1's spouse and the taxable income adjusted to exclude firm income (ie tax payable on practice income) is \$6,500 (\$14,297-\$7,797). To calculate the effective tax rate this amount will be divided by the practice distribution (\$20,000).

$(\$6,500 \text{ tax} / \$20,000 \text{ practice distribution}) \times 100 = 32.5\%$

The effective rate of 32.5% is recognised on income from the firm, meaning that the spouse of IPP 1 would comply with the second requirement of the third benchmark that the IPP and their associates combined have collective effective tax rate of 30% or greater.

How are superannuation contributions of the IPP treated where the fund receiving the contributions may or may not be an associated entity?

An IPP's superannuation contributions, whether or not made by the firm, will form part of the calculation for the 30% effective tax rate measure as this amount would otherwise have flowed directly through to the IPP in their own hands as the firm's profit distribution, in the absence of a partnership of discretionary trust or other business structuring arrangement.

Where these superannuation contributions are subject to a tax deduction in the hands of the IPP or the IPP's employer, they will be subject to tax in the hands of the superannuation fund at a rate of 15%. We will recognise the 15% tax paid as part of the calculations.

In determining whether the effective tax rate is at least 30%, is it sufficient to review the immediate tax rate or must the ultimate tax rate be traced?

In developing the risk assessment guidelines on the allocation of profits in professional firms, the ATO's intention is to ensure that the tax consequences appropriately reflect the economic reality. Where principal practitioners generate a significant part of the firm's income, it would be appropriate for them to be rewarded accordingly.

That said, in any risk assessment or review that the ATO undertakes, we will be taking a holistic approach and looking beyond the immediate tax rate paid to see whether there are other higher risk tax compliance issues within the arrangement, such as non-compliance with Division 7A and dividend streaming.

Example

An IPP takes a salary sufficient to meet the 30% effective tax rate and retains the balance of profits in a company at 30%. In that year the immediate tax rate will be at least 30%. However, in subsequent years the company may declare dividends to the shareholders. Where those shareholders are trusts they may distribute among family members of the IPPs. The ultimate tax rate may then drop below 30% where there is a refundable franking credit offset.

Where this occurs we will consider the overall effective tax rate for both the IPP, and the IPP and their associated entities. It is expected that the IPP would have an effective tax rate of 30% or higher, and the IPP and their associated entities will collectively, have an effective tax rate of 30% or higher. Generally, franking credits will be refundable where a taxpayer's effective tax rate falls below 30%. This is likely to cause the IPP or their associates to be unable to meet the 30% effective tax rate benchmark in future years. This will not automatically lead to compliance action, but may involve the ATO having informal discussions with the IPP to understand the reason the IPP is not meeting the benchmark. To lower the risk profile, the IPP may consider availing themselves of one of the other two low risk benchmarks.

How does the third benchmark interact with Fringe Benefits Tax?

Where correctly reported, the ATO will recognise the FBT payment as part of the IPP's share of profits. Where reporting is completed inaccurately and the ATO is unable to trace fringe benefits provided to specific IPP's, it may result in an IPP not satisfying the benchmarks on an initial assessment.

Example

An incorporated practice has 2 IPPs.

- IPP 1 receives their share of income as a salary totalling \$200,000, and pays \$63,547 in tax, resulting in an effective tax rate of 31.75%.
- IPP 2 receives \$75,000 in salary and \$75,000 in reportable fringe benefits.
- IPP 2 is liable to pay \$15,992 in tax (21.3%) and FBT will be paid on their reportable fringe benefits. The grossed up value of the reportable fringe benefits (assuming that they are type 1 GST-creditable benefits) is \$156,015.

The company pays FBT totalling \$73,327.05 on the amounts. This means that IPP 2 has tax paid or payable equal to \$89,319.05 on a grossed up value of benefits and remuneration of \$231,015 generating an effective tax rate of 38.66%.

Need help?

Where you have queries in relation to the guidelines, or wish to provide comments or feedback, please email us at Professionalppts@ato.gov.au