



Alienation of professional firm income

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1 The evolution of a business

1.1 From employee to multinational – and the desire to alienate the income to a lower taxed person

When you started as an accountant, you took a job at your local firm, and you were paid a salary. You would have loved to have diverted some of that income to a low tax relative but under subsection 6-5(4) states...

*(4) In working out whether you have derived an amount of * ordinary income, and (if so) when you derived it, you are taken to have received the amount as soon as it is applied or dealt with in any way on your behalf or as you direct.*

So you will still derive the income if you direct it to be paid to someone else.

You also cannot just get that relative employed and have them paid half your salary as section 109 of the ITAA1936 states:

If a private company pays or credits to an associated person an amount that is, or purports to be:

(a) remuneration for services rendered by the associated person; or...

so much (if any) of the excessive amount as exceeds an amount that, in the opinion of the Commissioner, is reasonable:

(c) is not an allowable deduction; and

(d) shall, ... be deemed to be a dividend paid by the company:

(i) to the associated person as a shareholder in the company;

(ii) out of profits derived by the company; and

(iii) on the last day of the year of income of the company in which the excessive payment or credit is made.

You then went out on your own as an accountant, first as a sole trader then incorporated, originally with just one big client (that you may or may not have stolen while you were an employee). With just one client, and getting paid by the hour, and working on the client's site most of the time, you are probably caught by the Personal Services Income Rules in Division 84 to 87 of the ITAA97 and so could not alienate income to your low taxed spouse.

But you get multiple clients and things are booming – and importantly you are now a personal services BUSINESS for the PSI rules do not apply. You are still getting paid for your work and it is probably still personal services income. You would love to alienate income to low taxed entities, like the classic of leave income in the company so it is taxed at 25%, but in

the famous Taxation Ruling IT 2503 (titled "Income tax: Incorporation of medical and other professional practices"), the Commissioner states you cannot do this:

Practice company should have no taxable income. The total income for the year should be fully paid out to the practitioner by way of salary. The company is not permitted to retain profit to manipulate timing of distributions to shareholders.

But you now bring on staff, being three employed accountants. In Taxation Ruling IT 2639 the Commissioner says things have just changed for you as it now looks like this is not personal services income any more but income from a business structure and so IT 2503 no longer applies:

10. For the purpose of determining whether a practice company or trust falls within the scope of IT 2503 (and only for that purpose), this Office will apply the following guidelines as a general rule of thumb:

a. If the practice company or trust has at least as many non-principal practitioners (see paragraph 11) as principal practitioners, then income is considered to be derived from the business structure (and therefore does not fall within the scope of IT 2503).

b. If the practice company or trust has fewer non-principal practitioners than principal practitioners, then whether it derives income from personal services will still need to be determined by considering the factors contained in paragraph 8 of this Ruling and the guidelines in previous Rulings on this issue. If these factors indicate that the practice company or trust derives income from personal services, it will fall within the scope of IT 2503. If they indicate that the practice company or trust derives its income from the business structure, it will not fall within the scope of IT 2503.

11. In paragraph 10:

"Practitioners" include both full-time professional and non-professional staff whose function is to derive material fees for the practice. Part-time staff count proportionately. The term does not include administrative, clerical or support staff. For example, a nurse under the direction of a doctor or a legal secretary under the direction of a solicitor are not "practitioners" unless they earn material fees in their own right.

"Principal practitioners" are those practitioners who own or share in the ownership of the practice, whether directly or indirectly.

"Non-principal practitioners" are those practitioners who are not "principal practitioners".

More recently the Commissioner has confirmed this understanding that many anti-avoidance rules do not apply to income derived from a business structure as the income is not personal services income (From TR 2022/3):

42. Income which is generated from the business structure of an entity is not PSI.

43. Where income is derived by an entity which has substantial income-producing assets or a number of employees, or both, the income is more likely to be generated by the profit-yielding structure of the business rather than from the rendering of personal services.

44. Entities may have regard to the following factors to determine whether their income is mainly a reward for the personal efforts or skills of individuals or is derived from a business structure:

- the number of arm's length employees or others engaged by the entity to perform work and their relative contribution to the income earning activities*
- the existence of goodwill*
- the extent to which income-producing assets of the business are used to derive the income*
- the nature of the activities carried out*
- the size of the operation, and*
- the extent to which the income is dependent upon a particular individual's own personal skills, efforts or expertise.*

So just when you begin to think that we can alienate income to whoever we want once we are talking about either income from a personal services business, or actual business income, the Commissioner reminds us that we have overlooked one last anti-avoidance provision (From TR 2022/3):

160. The general anti-avoidance provisions of Part IVA of the ITAA 1936 may still apply to cases where the PSE is considered to be conducting a PSB and the PSI rules do not apply. The ATO may seek to apply Part IVA where there are factors indicating that the dominant purpose of the arrangement is to obtain a tax benefit by diverting, alienating or splitting an individual's PSI or retaining profits in the lower taxed PSB.

161. In deciding whether the PSB and test individual has engaged in income splitting in order to gain a tax benefit, the following considerations may be relevant:

- whether the salary or wages paid to the test individual is commensurate with the skills exercised or services provided, and with the income received by the PSB for those services*
- whether the PSB distributes income to associates and does not distribute income to the test individual who provided the actual services, and*

- *whether the salary or wages paid to associates by the sole trader or PSB is not commensurate with the skills exercised and services provided, and the income received by the sole trader or PSB is for services performed by the test individual.*

An example of a situation where there may be income splitting to which Part IVA could apply would be where an independent contractor (conducting a PSB through an interposed entity) is paid less than the contracted price for their work and the profit made as a result of paying less than the contracted price is distributed to the contractor's relatives who are on a lower marginal tax rate or accumulated in the interposed entity and taxed at a lower marginal rate of tax.

Now even though it is definitely business income, not subject to the PSI rules or the principle in IT 2503, the Commissioner says he still might look to apply Part IVA.

The changes ensure that the CGT concessions are only available for capital gains arising from CGT events that relate to rights or interests that entitle an entity to income or capital of a partnership by making that entity a partner of the partnership.

2. Allocation of professional firm profits- ATO compliance approach

In December 2017 the Commissioner stated he was going to suspend guidelines on alienating profits from firms. He indicated that early in 2018 he would release new guidelines... and in December 2021 he has now reissued these guidelines.

These guidelines cover arrangements where:

- taxpayers redirect their income from a business or activity to an associated entity;
- that income includes income from their professional services; and
- the outcome is that they significantly reduce their tax liability.

2.1 When does this apply from?

The new guideline (PCG 2021/4) applies from 1 July 2022... But...

If you have existing arrangements, you can continue to rely on the suspended guidelines for 1 July 2017 to 30 June 2022 if your arrangement is commercially driven and does not exhibit any of the high-risk factors listed below.

More importantly, if you find that an arrangement was low risk under the suspended guidelines but has a higher risk rating under PCG 2021/4, you can continue to apply the suspended guidelines until 30 June 2024!!!!

2.2 A summary of the suspended guidelines we can use to 30 June 2024

The suspended guidelines were much simpler than what you will see below. They were that if any of three benchmarks were satisfied, then the practitioner would be considered low risk and unlikely to be subject to ATO review provided no other compliance issues were evident.

The three benchmarks were:

- The income derived by the professional practitioner had to be at least the level of remuneration paid to the highest band of professional employees providing equivalent services to the firm. If the firm did not have any employees providing equivalent services, you could use data from comparable firms or industry benchmarks
- The income derived by the professional practitioner had to be at least 50% of the firm's income to which the practitioner and their associated entities were collectively entitled
- The practitioner and their associated entities both had to have an effective tax rate of 30% or higher on the income received from the firm

Give the professional 50% of the income from the firm and send the other 50% to the spouse, adult kids, other entities... and there was no risk. Pay them a commercial rate and there was no risk...

This is probably what we will use until 2024, but then we will be stuck with the new guideline.

2.3 The new guidelines in PCG 2021/4

First issue – pass two “gateways”

The Guideline states that first we must assess if our arrangement is commercial and does not have high-risk features.

The first is we need to pass through the commercial rationale gateway, by showing the arrangement is commercial. The Commissioner states the following arrangements show a lack of commercial rationale:

- seem more complex than necessary to achieve the relevant commercial objective
- appear to serve no real purpose other than to gain a tax advantage
- have a tax result that appears to be at odds with its commercial or economic result

- result in little or no risk in circumstances where significant risks would normally be expected
- operate on non-commercial terms or in a non-arm's length manner
- present a gap between the substance of what is being achieved and the legal form it takes.

The second gateway is the “no high-risk features” gateway. The Commissioner states that arrangements with high-risk features can:

- have financing arrangements relating to non-arm's length transactions
- exploit the difference between accounting standards and tax law
- be materially different in principle from Everett and Galland
- involve multiple classes of shares and units, including creating discretionary entitlements such as dividend access shares
- involve multiple assignments or disposals of an equity interest
- misuse the superannuation system, including assignments or disposals of an interest to associated SMSFs
- distribute income to entities with losses.

Risk Assessment Framework

If you do pass both gateways, you can then self-assess against the Risk assessment framework to see the type of compliance attention that we will give to your arrangement. This involves testing the arrangement in three ways (or just two ways if the third test does not make sense) and adding up the “risk points” from the table below.

Risk assessment factor	Score 1	Score 2	Score 3	Score 4	Score 5	Score 6
Factor 1: Proportion of profit entitlement from the whole of firm group returned in the hands of the IPP	More than 90%	More than 75% to 90%, inclusive	More than 60% to 75%, inclusive	50% or more to 60%, inclusive	More than 25% to less than 50%	25% or less
Factor 2: Total effective tax rate for income received from the firm by the IPP and associated entities	More than 40%	More than 35% to 40%, inclusive	30% or more to 35%, inclusive	More than 25% to less than 30%	More than 20% to 25%, inclusive	20% or less
Factor 3: Remuneration returned in the hands of the IPP as a percentage of the commercial benchmark for the services provided to the firm	More than 200%	More than 150% to 200%, inclusive	More than 100% to 150%, inclusive	More than 90% to 100%, inclusive	More than 70% to 90%, inclusive	70% or less

For example, if the partner in the engineering firm took 62% of the amounts coming from the firm (Factor 1 is score 3), the effective tax rate across all of the income coming out of the firms was 28% (Factor 2 is score 4) and there is no commercial benchmark (Factor 3 does not apply, the risk score is 7 (3 + 4) and this in the table below say we are at low risk.

Risk zone	Risk level	Aggregate score against first 2 factors	Aggregate of all 3 factors
Green	Low risk	7 or less	10 or less
Amber	Moderate risk	8	11 and 12
Red	High risk	9 or more	13 or more

2.4 Commissioner's examples

Example: low-risk arrangement

Brooke, a management consultant, assigns 30% of her partnership interest in the Better Business partnership to her discretionary trust. Brooke's total income entitlement from the partnership is \$425,000. The beneficiaries of the trust include Brooke, her spouse Brody, and a corporate beneficiary BB Pty Ltd whose shares are jointly held by Brooke and Brody.

Brooke and Brody also jointly own a rental property that has a net rental loss of \$10,000 and they each claim \$5,000 net rental loss on their tax return.

Brooke includes \$297,500 (70% of the income entitlement) in her tax return and the trustee distributes the balance of \$127,500 (30% of the income entitlement) as follows:

- \$50,000 to Brody
- \$77,500 to BB Pty Ltd.

The total income of \$425,000 from the partnership is taxed in the hands of Brooke and her associates as follows:

- Tax on Brooke's share of \$297,500 is \$104,542 (applying 2020–21 individual tax rates).
- Tax on Brody's share of \$50,000 is \$6,717 (applying 2020–21 individual tax rates).
- Tax on BB Pty Ltd's share of \$77,500 is \$20,150 (applying 2020–21 company tax rate of 26%).
- The total effective tax rate on the income from the partnership is $\$104,542 + \$6,717 + \$20,150 = \$131,409 \div \$425,000 \times 100 = 30.92\%$

When determining the effective tax rate on the income from the partnership, the rental losses are disregarded as they are unrelated to the professional firm income.

The risk assessment for this arrangement is as follows:

- Brooke returns 70% of her profit entitlement from the partnership in her personal tax return, which gives her a score of 3 against the first risk assessment factor.
- Brooke and her associates pay an effective tax of 30.92% on the income received from the partnership, which gives her a score of 3 against the second risk assessment factor.
- Brooke has worked out that in the circumstances it is impractical to accurately determine an appropriate commercial remuneration to benchmark against, so she self-assesses against the first 2 risk assessment factors only.

As the total score under the first 2 risk assessment factors is 6, this arrangement is considered low risk.

Example: moderate-risk arrangement

Julie and 3 other individuals run a legal practice through Legal Services Pty Ltd. Julie's family trust, JJ Trust, is a shareholder in the company. The beneficiaries of JJ Trust include Julie, her spouse Kurt and a corporate beneficiary, Company X Pty Ltd, whose shares are held by Julie.

Julie's total income entitlement from the company, which includes her salary and wages and franked dividends to her family trust, is \$800,000. She includes \$380,000 received as salary and wages from the company in her tax return. She reflects this is an appropriate return for her services she provides. The tax paid on this amount is \$141,667.

The trustee of the JJ Trust receives \$420,000 as a fully franked dividend (\$294,000 as cash and \$126,000 as franking credits). The trustee distributes:

- \$370,000 to the corporate beneficiary Company X Pty Ltd; and the tax paid on this amount is \$96,200 (applying 2020–21 company tax rate of 26%)
- \$50,000 to Julie's spouse, Kurt; and tax on this amount is \$6,717 (applying 2020–21 individual tax rates).

The total tax paid by Julie and her associates is \$244,584 (\$141,667 + \$96,200 + \$6,717). This gives a total effective tax rate of 30.57% ($\$244,584 \div \$800,000 \times 100$). This arrangement is considered moderate risk as Julie:

- returns 47.5% of her profit entitlement from the partnership in her personal tax return, which gives her a risk score of 5 against the first risk assessment factor

- and her associates pay an effective tax of more than 30% on the income received from the partnership, which gives her a score of 3 against the second risk assessment factor
- has determined the appropriate commercial remuneration to benchmark her remuneration against for the services she provides to the firm

The industry benchmark for the provision of equivalent or similar services is \$325,000. As she personally returns \$380,000 (which is 116.9% of the benchmark remuneration ($\$380,000 \div \$325,000 \times 100$)), this gives her a score of 3 for the third risk assessment factor.

Julie's total score against the 3 risk assessment factors is 11, which places her arrangement in the moderate risk category.

Example: high-risk arrangement

Ashley, Peta and Raj operate an accounting practice as an equal partnership of 3 discretionary trusts with each of Ashley, Peta and Raj as trustees of their respective discretionary trusts. The practice generates a profit of \$2,100,000 for the income year. The partnership distributes Ashley's \$700,000 profit share to Ashley Trust. Ashley, in her capacity as the trustee, distributes the profits as follows:

- Ashley receives \$147,000, which is 21% of the profits; with tax of \$39,457 (applying 2020–21 individual tax rates).
- Ashley's spouse James receives \$130,000; with tax of \$33,167 (applying 2020–21 individual tax rates).
- Ashley Investments Pty Ltd (of which Ashley and James are equal shareholders), receives \$423,000; with tax of \$109,980 (applying 2020–21 company tax rate of 26%).

The total tax paid by Ashley and her associates on the total profit entitlement of \$700,000 from the practice is \$182,604, ($\$39,457 + \$33,167 + \$109,980$), which gives an effective tax rate of 26.09% ($\$182,604 \div \$700,000 \times 100$).

This arrangement is risk assessed as follows:

- Ashley returns 21% of the total income entitlement from the practice in her tax return, which gives her a risk score of 6 for the first risk assessment factor from the risk assessment scoring table.
- The effective tax rate of 26.09% paid by Ashley and her associates on the total income entitlement of \$700,000 from the practice is less than 30%, which gives her a risk score of 4 for the second risk assessment factor.

- After reflecting on her duties, responsibilities, risks and roles she undertakes in the firm, Ashley determines that a commercial remuneration for similar roles is \$250,000. This results in Ashley's remuneration as a percentage of the commercial benchmark for her services being less than 70% ($\$147,000 \div \$250,000 \times 100$). This gives her a score of 6 for the risk assessment factor 3.

As the aggregate score against all the risk factors is 16, this is a high-risk arrangement

3 What will this mean for practitioners?

3.1 Questions I am sure I will get asked

Ken, what if we also get related service trust income?

Add it in to the total calculation for Factor 1 and Factor 2.

Ken, what if I have rental losses or other deductions?

For the purposes of calculating the total effective tax rate in Factor 2, deductions not related to the professional income are disregarded.

Ken, what if I am Amber or Red?

If you find your client is Amber, the Commissioner states "We are likely to conduct further analysis on the facts and circumstances of your arrangement. We may contact you to understand the arrangement and resolve any areas of difference." If you find your client is Red, the Commissioner states "We will conduct further analysis on the facts and circumstances of your arrangement as a matter of priority. If further analysis confirms the facts and circumstances of your arrangement remain high risk, we may proceed to audit where appropriate." So you will want to stay GREEN.

3.2 What does this mean for us?

1. Stick with the old rules until 2024
2. From 1 July 2024 we will have to play with how much we give to other associated entities to get a low risk, possibly only giving them much less than 50% as we could under the suspended guidelines
3. I imagine we will be looking for high "commercial benchmark rates" (Factor 3) as a way to bring down our risk rating. If you can show your client is being paid 200%+ of the commercial benchmark for the services they provide to the firm that gives you 9 risk points to play with for Factors 1 & 2