

By email: simon.webster@ato.gov.au

6 April 2021

Mr Simon Webster
The Australian Taxation Office

Dear Sir,

DRAFT PCG 2021/D2 - ALLOCATION OF PROFESSIONAL FIRM PROFITS - BDO SUBMISSION

BDO refers to the invitation by the Australian Taxation Office (ATO) to provide comments on the ATO's Draft PCG 2021/D2 - Allocation of professional firm profits - ATO compliance approach.

BDO is pleased to provide comments on the Draft Practical Compliance Guideline (draft PCG). In summary, our main concerns are that the draft contains a number of inconsistencies and does not fully explain some of the concepts used to determine the ATO's compliance approach. Nor does the draft PCG adequately identify and discuss certain arrangements that would be considered common arrangements. BDO's detailed comments in this regard are in the attached appendix.

Should you have any questions, or wish to discuss any of the comments made in our submission, please do not hesitate to contact me on 02 9240 9736 or lance.cunningham@bdo.com.au.

Yours sincerely

Lance Cunningham

BDO National Tax Director

BDO Submission to the Australian Taxation Office
Draft PCG 2021/D2 - Allocation of professional firm profits - ATO compliance approach

BDO has considered the Draft PCG 2021/D2 - Allocation of professional firm profits - ATO compliance approach (draft PCG) which explains how the ATO intends to apply compliance resources when considering the allocation of professional firm profits or income in the assessable income of individual professional practitioners (IPP) and we provide the following comments on the issues of concern in the draft guideline.

1. Inconsistencies in the draft PCG

One of the inconsistencies contained in the draft PCG relates to the calculation of the risk assessment factors used to assess the risk of attracting compliance attention from the ATO. We note that our review of the risk assessment scoring table and risk zones indicate that provided IPPs receive a proportion of profit entitlement of greater than 50% (say 50.1%) and a total effective tax rate of greater than 30% (say 30.1%), they would be in the green zone.

However, if the facts were changed only slightly so that the IPP has a proportion of profit entitlement *equal to 50%* and an *effective tax rate equal to 30%*, they would have a risk rating of 9 for the first two risk factors and therefore fall in the red zone. This shows that a minuscule change in the profit distribution and tax rate amounts can result in a dramatic change in the compliance risk result. We suggest that such a small change in the amounts/tax rates for a particular case should result in a more gradual change to the risk rating.

We acknowledge that the ATO has redefined the risk parameters based on their concerns (about arrangements involving taxpayers redirecting their income to associated entities where it has the effect of altering their tax liability), however, we are concerned that the difference in risk rating of an IPP can vary from low to high based on a minuscule difference in the commercial and taxation outcomes.

2. Examples of professional firms run through a corporate structure

We note that the draft PCG contains five examples illustrating how to apply different aspects of the proposed compliance approach and seven case studies. However, the guideline does not contain any examples of the common scenario of professional firms run through a corporate structure and does not deal with profit distributions made via dividends. We would request that prior to finalisation of the draft PCG examples of this common practice structure are included. This should also include consideration of the following matters which are relevant to professional practices operated by entities other than partnerships.

3. Are franking credits taken into account in determining remuneration received by IPPs

Following on from our point No 2 above, in relation to *Risk assessment factor 1 - Proportion of profit entitlement from the whole of firm group returned in the hands of the IPP* and *Risk assessment factor 2 - Effective tax rate*, the draft PCG does not mention whether franking

credits/offsets are to be taken into account in determining the remuneration received by the IPP for the first risk factor or the effective tax rate for the second risk factor. If an IPP receives their profit allocation as a franked dividend The tax paid by the IPP in their assessment would be reduced by the franking offset. We suggest the franking offset should be seen as recognising the tax prepaid by the company on behalf of the IPP or other recipient of the dividend. This tax paid by the company should be taken into account in determining the effective tax rate of the IPP.

We would request that before the draft PCG is finalised, the ATO clarify whether franking credits/offsets are to be taken into account in calculating the remuneration received and tax paid by IPPs for the purposes of risk factor 1 and 2. This may require further detail as to what should be included in or excluded from the risk assessment factors.

4. Timing mismatches for profit / dividend payment

The draft PCG does not deal with profit /dividend payment timing mismatches. For example, if the firm's profits for year one are paid to the IPP as a dividend in year two, the question arises as to which year the profit entitlement should be taken into account for the risk assessment factors? In other words, the draft PCG needs to clarify whether the profit entitlement should be taken into account in year one or year two?

We would request that before the draft PCG is finalised, the ATO clarify this issue which is common for many professional practice firms run through corporate structures.

5. Superannuation contributions by or for the IPP

It would not be uncommon for IPPs who are employed by entities other than partnerships to compulsorily or voluntarily direct a portion of their before-tax income to a superannuation fund to boost their retirement savings. While the draft PCG refers to the inclusion of superannuation in the 'risk factor 3 - appropriate remuneration' it is silent on whether superannuation contributions and superannuation fund tax paid should be taken into consideration as part of 'risk factor 1- proportion of profit entitlement' and 'risk factor 2 - effective tax rate'.

Also are salary sacrifice contributions to be treated differently to SGC contributions?

This is in contradistinction to the manner in which the draft PCG treats superannuation contributions made by partners on behalf of themselves, which would (on our reading) not reduce the remuneration percentage of the partner.

Similarly, the draft PCG is silent on whether Division 293 tax paid by an IPP would increase the effective tax rate. We would request that before the draft PCG is finalised, the ATO clarify these issues.

6. Fringe benefits not considered in Draft PCG

Further, while the draft PCG refers to the inclusion of fringe benefits in 'risk factor 3 - appropriate remuneration' it is silent on whether fringe Benefits and FBT paid by the employer should be taken into consideration as part of 'risk factor 1- proportion of profit entitlement' and 'risk factor 2 - effective tax rate' for fringe benefits provided to IPPs by entities other than partnerships. For example, IPPs who receive fringe benefits in place of salary would, using the methodology in the

Draft PCG, have a lower effective tax rate than if the IPP receives cash remuneration instead of the fringe benefits. However, if the FBT paid by the employer were taken into account, the effective tax rate would generally be higher.

This is also in contradistinction to IPPs who are partners in partnerships where the provision of the non-deductible benefits (e.g. car parking) would reduce neither their remuneration percentage nor their effective tax rate.

Clarification is needed in circumstances where fringe benefits are provided to IPPs in professional practices operated by entities other than partnerships.

7. Clarification of transitional rules

In relation to the transitional rule, does it apply on a firm wide basis or on an IPP basis? For instance, where a firm that put in place a structure before 14 December 2017 that complied with the suspended guidelines and the firm subsequently admitted new IPPs into the firm after that date. Will the transitional rule only apply to the IPPs in the firm as at 14 December, 2017 or does it apply to all the IPPs in the firm?

Conclusion

BDO submits that the ATO should resolve and clarify many of the issues and inconsistencies contained in the draft PCG that are highlighted in our submission and provide a clear explanation of the concepts used to determine the ATO's fundamentally different compliance approach in common arrangements.