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PROFESSIONAL FIRMS AND THE ALLOCATION OF PROFITS

– Suspension of the Commissioner's Guidelines

Author: Anna Wilson

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Professional Firms and the Allocation of Profits – Suspension of the Commissioner's Guidelines

by

Anna Wilson, Barrister

Foley's List

Introduction

The Commissioner's Guidelines are all about the types of structures that are permitted for 'professional practices', including law firms, from a tax law perspective. The issue of the Guidelines in 2014 and their suspension on 14 December 2017 are just the latest steps in a battle that has been raging for decades between the legal and accounting professions and the Commissioner of Taxation regarding the splitting of income.

At the heart of the fight is the question of whether it is a principle of our tax system that a professional practitioner must be paid a 'fair' or commercial wage for his or her work for the business. The Commissioner's Guidelines are based on the principle that they should whereas lawyers and accountants would argue that no such rule exists. Indeed, no such rule appears to apply to other small business owners or farmers, so why does it apply to professional practitioners?

Why were the Guidelines issued?

The Guidelines were issued in September 2014 as a reaction to what could be termed a perfect storm in favour of aggressive structuring by professional practices, which include legal, accounting, medical, engineering, architectural and other 'thought-based' professions.

The *Everett*[1] case in 1980 indicated that a partner in a law firm could assign the partner's interest in the partnership, or part of it, to a spouse, for example, and that would be effective to divest the partner of the income flowing from that interest in the partnership.

Although this opened up a huge opportunity for income splitting by lawyers and other professional partnerships, there were limitations. In particular, there were often requirements imposed by the regulatory bodies for professional practitioners to hold partnership interests personally, or at least a majority interest in the partnership personally.

Further, the introduction of capital gains tax in 1985 made Everett assignments less attractive because they became subject to capital gains tax.

However, in 1999 with the introduction of the small business capital gains tax concessions, the capital gains tax on Everett assignments was able to be minimised, or even eliminated. Further, the introduction of the *Legal Profession Act 2004* (Vic) removed a lot of the restrictions on the form that a legal practice could take, as it allows legal practices to be incorporated with no restrictions on who the shareholders of the incorporated practice must be and professional practitioners in a partnership are no longer required to hold the partnership interests personally.

This created a new era of structuring for legal practitioners. What has particularly irritated the Commissioner are instances where, for example, a law firm has been operating as a partnership of individuals with those individual partners drawing equity shares of, say, $800,000 per year. Then on 30 June they close the doors on this structure and on 1 July open the doors on a partnership of discretionary trusts where the professional practitioner who was formerly the partner is now just drawing trust distributions of, say, $150,000, and the remainder of the trust's drawings of $650,000+ are distributed to other family members/entities.

Personal services income

In the 2000/2001 income year the personal services income rules were introduced as specific anti-avoidance provisions. These rules mean that a person generating income from

[1] *FCT v Everett* [1980] HCA 6; 143 CLR 440

their own personal efforts cannot split that income by offering their services through a company, trust or partnership.

These rules have application to legal and accounting professionals who typically earn income through their own personal efforts. However, importantly in *Everett* the High Court indicated that Mr Everett's income was not personal services income but rather income from his interest in the partnership.

The Commissioner has generally accepted that this is the case, and that partners in legal and accounting firms are not earning personal services income provided the relevant professional practice is of a certain size. Ruling IT 2639 at paragraph 10 sets out an important rule of thumb for professional practices stating that if there are as many non-principal practitioners as there are principal practitioners, then this may indicate that the income is from the business structure rather than from the personal services of an individual. A practitioner is defined in the Ruling to include both professional and non-professional staff whose function is to derive material fees for the practice. It does not include clerical or support staff.

Even in the absence of the personal services income rules, case law such as the 'Doctors' cases'[2] in the 1980's indicates that the general anti-avoidance provisions in the Tax Act may apply where there is a scheme to split income from personal services. Up to now the Commissioner has not sought to apply the general anti-avoidance provisions to Everett assignments where the rule of thumb identified in the paragraph above is met. However, this has changed. In particular, the Guidelines state: "… we consider that Part IVA also has potential application where the IPP [individual professional practitioner] 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".

That is, having accepted that professional practices of a certain size are not generating personal services income, but are rather generating income from the business structure, the Commissioner still thinks it offends the general anti-avoidance provisions in the Tax Act for that income to be divided in a way that does not include 'fair' or 'commercial' remuneration for the professional practitioners themselves.

What do the Guidelines say?

The Guidelines indicate that taxpayers will be rated as low risk and not subject to compliance action if they meet one of the following guidelines regarding income from the firm (including salary, partnership or trust distributions, distributions from service entities or dividends from associated entities):

- the practitioner receives assessable income from the firm in their own hands as an appropriate return for the services they provide to the firm. The benchmark for an appropriate level of income will be the remuneration paid to the highest band of professional employees providing equivalent services to the firm, or to a comparable firm;
- 50% or more of the income to which the practitioner 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 practitioner; or
- the practitioner, and their associated entities, both have an effective tax rate of 30% or higher on the income received from the firm.[3]

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[2] *Federal Commissioner of Taxation v Gulland*, *Watson v Federal Commissioner of Taxation* and *Pincus v Federal Commissioner of Taxation* 85 ATC 4765; 17 ATR 1

[3] For an individual, an effective average tax rate of 30% kicks in at around the $140,000 mark

Where none of these guidelines are satisfied, the ATO says the practitioner's arrangement will be considered higher risk, with increased chance of compliance action. The lower the effective tax rate of an arrangement, the higher the ATO may rank the compliance risk.

There are a number of examples set out in the Guidelines. Two of these are set out below:

Example 1

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 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.

The Commissioner states that 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 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.

Example 2

A professional firm 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.

The Commissioner states that in this instance IPP 1 is at low risk because IPP 1 meets all three guidelines and 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.

Suspension of the Guidelines

On 14 December the Commissioner suspended the Guidelines and removed them from the ATO website on the basis that they were being abused. There is now a working group that is reviewing existing ATO guidance products with a view to issuing revised guidance. Thus if Everett assignments are occurring currently, there is no guidance as to when the ATO will or will not seek to apply Part IVA to those arrangements. The ATO website simply encourages people to engage with its specialist team upfront.

It is to be noted that the Guidelines always accepted the fact that there was limited case law guidance in this area and that an appropriate test case would be useful in clarifying the law. It appears that that is needed now more than ever.

2018 Budget announcement

In the meantime, it was announced in the 2018 Budget that the CGT small business concessions will not be available to Everett assignments from 8 May 2018. The announcement states:

> *"Some taxpayers, including large partnerships, are able to inappropriately access these concessions in relation to their assignment of a right to the future income of a partnership to an entity, without giving that entity any role in the partnership".*

It is anticipated that this means that where an Everett assignment takes place, it will be necessary for the partnership to satisfy the maximum net asset value and/or small business entity test, and not just the relevant partner. However, until the actual legislation is released, there remains some uncertainty about whether even small partnerships will be allowed to access the small business CGT concessions when undertaking Everett assignments.

Therefore, it may be that the days of Everett assignment are limited, as they will give rise to significant CGT consequences, at least for the bigger partnerships. Even for smaller partnerships who come within the small business concession thresholds, they may struggle to fall outside of the personal services income rules.

Summary

The war between the Commissioner and legal and accounting professionals is far from over in terms of acceptable income-splitting arrangements. The Commissioner has withdrawn the Guidelines – however these were of limited comfort to taxpayers in any event since they were simply guidelines sitting on the ATO website with no binding status. The next steps will be watched with interest, but hopefully another *Everett* -type case will make its way to the High Court before too long to bring the umpire back into the game.