Law Council OF AUSTRALIA

Business Law Section

15 April 2021

Mr Simon Webster
Director, Professional Firms Compliance
Private Groups and High Wealth Individuals
Australian Taxation Office

By email: simon.webster2@ato.gov.au

Dear Mr Webster

Practical Compliance Guideline PCG 2021/D2: Allocation of professional firm profits – ATO compliance approach

The Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**) welcomes the opportunity to provide the following comments on draft PCG 2021/D2 Allocation of professional firm profits – ATO compliance approach (the **draft PCG**).

The Committee understands that the Commissioner has concerns in relation to particular arrangements or aspects of arrangements associated with the generation of business income. The Committee supports the ATO's efforts to identify and address those arrangements that the ATO considers are inconsistent with the existing law. However, the Committee does not consider that the draft PCG achieves this, for the reasons which follow, and considers that the draft PCG should not be finalised in its current form.

Flawed foundational premise

1. The Committee rejects the notion, which appears to be the foundational premise underpinning the draft PCG, that each business that derives income from services needs to compensate its individual owners for their services at an amount commensurate with the value of those services.

2. There is no general principle of taxation law that an individual owner of a business must receive a particular amount for his or her efforts, labour and skill. Absent specific statutory provisions like the PSI rules in Part 2-42 of the *Income Tax Assessment Act 1997* (Cth), a business owner can decide both on the quantum of remuneration and whether to receive any in the first place. Equally, the business owner can decide whether to receive a wage, to reflect the value of their services to the business, or a share of profits, which could reflect the value of services and/or the capital the owner has contributed to the business and the risks he or she has adopted.

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3. There is equally no general principle, outside of the PSI provisions, that income derived by a business structure (such as a partnership, trust or company) that has arisen from the effort, labour and skill of an individual is impermissibly “alienated” if it is not ultimately paid to the individual.

4. Although the draft PCG acknowledges (in the opening sentence to paragraph 7) that the ATO does not have a concern with the use of business structures such as companies and trusts *per se*, it then goes on to say that:

> *“when the business involves the provision of services, we will be concerned with arrangements where the compensation received by the individual is artificially low while related entities benefit (or the individual ultimately benefits), and commercial reasons do not justify the arrangement.”*

5. It then goes on to state (in paragraph 13) that the ATO considers an arrangement to be “high risk” where:

> *“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…”*[1]

6. Therefore, the draft PCG proceeds on the premise – contradicting the acknowledgement in the first sentence in paragraph 7 – that an individual whose skills or effort contribute to the profits of a business (carried on by a partnership, trust or company) which provides services must be remunerated for those skills and effort. For the reasons set out above, this is a proposition not supported by law and one that the Committee rejects.

7. Even if this proposition was supported by law, the draft PCG uses this single (flawed) concept as the basis for a much broader and arbitrary calculus that is not necessarily correlated to remuneration. Based on the thesis advanced in the draft PCG, if an individual receives remuneration equivalent to that received by others who provide similar services, then there would be no possible justification for a review of the overall tax rates of associated entities, or the percentage of income distributed amongst those entities. This is discussed in more detail below in paragraphs 14 to 19.

Inappropriate focus on “professional firms”

8. While the draft PCG acknowledges that its application is not limited to the accounting, financial services and legal industries, it is nevertheless limited to those industries that belong to a recognised profession.

9. The Committee considers that there is no valid justification for limiting the application of the Commissioner’s resources in this way. If the Commissioner’s concern is that businesses that provide services are not appropriately

[1] “IPP” being an individual professional practitioner.

remunerating their owners, then the Commissioner should be targeting all such businesses. There is no justifiable reason for limiting the draft PCG to those individuals who happen to belong to a recognised profession.

Absence of legal foundation for risk assessment factors

10. The draft PCG does not identify the statutory provisions the Commissioner will apply and at which the risk analysis is directed. While the draft PCG mentions Part IVA, it is not expressed as being limited to Part IVA.

11. If the draft PCG is intended to identify how the Commissioner will apply his resources in applying Part IVA, it should say so. Moreover, in that case, the document should be drafted by reference to the statutory tests in Part IVA and not by reference to abstract concepts like "genuine commercial basis", "commercial reasons" and "commercial rationale" which have no statutory basis in Part IVA or elsewhere in the tax law.[2]

12. Likewise, the three risk assessment factors which taxpayers are asked to apply after passing the Gateways are not referable to the statutory tests in Part IVA.

Abstraction of tests and duplication

13. The draft PCG uses a set of abstract, generalised tests (the Gateways) with specific risk assessment factors which, in the Committee's view, do not appropriately assess tax risk but create uncertainty and unnecessary administrative burden.

14. Gateway 1 seeks to generalise the application of Part IVA into abstract concepts like "genuine commercial basis", "commercial reasons" and "commercial rationale". These concepts have no basis in law and, together with the outcomes produced by the risk assessment framework, can only create uncertainty for taxpayers. If one were to accept that these concepts are an appropriate proxy to quickly assess Part IVA risk, the Committee considers that a taxpayer who satisfies Gateway 1 need not go any further. Any taxpayer with an arrangement that has a "genuine commercial basis", "commercial reasons" or "commercial rationale" should not need to apply a further set of complicated metrics to satisfy the ATO that they are paying an amount of tax that the ATO considers acceptable.

15. In order to satisfy Gateway 1, the draft PCG requires (in paragraph 41) there to be a *"genuine commercial basis for the way in which profits are distributed within the group, especially in the form of remuneration paid"*. The relevant considerations for whether this is met are said to include whether the remuneration is a true

[2] There are also parts of the draft PCG that refer to concepts (like the enjoyment of economic benefits, in paragraphs 41 and 47) which appear to be relevant to the operation of s 100A of the *Income Tax Assessment Act 1936* (Cth) yet there is nothing in the document that reflects or refers to the statutory tests in s 100A.

commercial comparable and whether it would be perceived as an arm's length payment. Commercial, arm's length remuneration is also what the third risk assessment factor looks at. This overlap is not justified and reinforces the Committee's view that, once a taxpayer satisfies Gateway 1, that should be the end of the matter.

16. The Committee considers that the arrangements identified in Gateway 2 are a useful tool for identifying the types of issues relevant to assessing high risk arrangements. However, these should not serve as a separate exclusionary mechanism to the application of the draft PCG but should be examples of the types of arrangements that may not pass Gateway 1.

17. The Committee does not understand or support the shift in the risk scoring from the suspended guidelines to those now used in the draft PCG. Under the suspended guidelines, a taxpayer was considered to be "low risk" if the taxpayer passed any one of three benchmark tests. Under the draft PCG, the taxpayer has to pass two Gateways and then pass the first and the second risk factors in aggregate (assuming the taxpayer cannot apply the third). This will result in taxpayers who were once in the "low risk" category now being considered "moderate" or "high risk", without any justification for the shift. The risk scoring model as a measure of risk is flawed and is not practical but, if it is to be adopted, the Committee considers that the risk assessment factors should be alternatives and that passing any one of them should be sufficient. For example, a taxpayer who receives arm's length, commercial remuneration should not be required to pass a test based on the total effective tax rate paid on that remuneration.

18. The Committee also does not understand why falling into the "red" zone means the Commissioner is "likely to use formal powers for information gathering" (paragraph 100). The use of those powers should be governed by whether the Commissioner considers that the information cannot be obtained using other means, not the risk rating the Commissioner attaches to a particular arrangement.

19. In summary, the Committee is concerned that the abstract, generalised tests (the Gateways) and the specific risk assessment factors create uncertainty for taxpayers and impose an unnecessary administrative burden and compliance cost without having a proper basis in law.

Unclear purpose and intended use

20. The suspended guidelines provided taxpayers with a safe harbour. By contrast, the draft PCG is expressly said not to be a safe harbour.

21. The suspended guidelines also did not seek to prescribe how the law applies to arrangements associated with the generation of business income. The draft PCG expressly acknowledges (in paragraph 22) that it is not a technical analysis of judicial decisions, does not replace, alter or affect the operation of the law in any way, yet it:

a. identifies the areas and basis upon which the Commissioner may seek to apply compliance resources;

b. imposes annual compliance burdens on taxpayers (see paragraph 20); and

c. mandates the arrangements which must exist in relation to the operation of a business and the derivation of income.

22. The shift away from a safe harbour tool is unexplained and, in the Committee's view, unwelcome. More importantly, the Committee considers it would be inappropriate for the draft PCG to be used as an audit selection tool when the thesis underpinning the document has no basis in law and when the proxies the document uses to assess Part IVA risk are likewise not reflective of the applicable statutory provisions or case law.

23. The Committee also considers it inappropriate for the Commissioner to seek to impose a compliance burden on taxpayers when the thesis underpinning the draft PCG has no basis in law and when following the PCG does not provide any protection.

Thank you again for the opportunity to provide comments. Should you wish to discuss any aspect of this submission further, please do not hesitate to contact Angela Lee, Chair of the Committee (angela.lee@vicbar.com.au or 03 8600 1777).

Yours faithfully

Greg Rodgers

Chair, Business Law Section