ISSUE PAPER

WATERHOUSE
CHARTERED ACCOUNTANTS

Legal firms: how compliant is your income?

Professional services firms are a crucial part of the community, with law firms, frequently providing a suite of legal services under one roof. For decades, lawyers have worked collaboratively to provide complementary services to clients and then distributing the firms profits or income amongst the practitioners. A recent change by the Australian Taxation Office, published as the Practical Compliance Guideline (PCG 2021/4) provides a framework for addressing and reviewing the appropriate allocation of profits within professional firms, which is likely to have implications for many legal practitioners in determining their assessable income and whether it complies with current tax legislation.

What is PCG 2021/4?
PCG 2021/4 is a risk assessment framework to help individual professional practitioners (IPPs), such as those in law firms, determine whether their professional income is being appropriately allocated for taxation purposes.

Law firms can be structured in a variety of ways, whether through companies, trusts or other arrangements, with some giving rise to different tax consequences that can result in a risk to compliance. The taxation department is concerned about IPPs whose income is inappropriately allocated in a way that can significantly reduce their tax liability.

The PCG 2021/4 is about identifying arrangements where:

- income from a business or activity is redirected to an associated entity
- income from professional services is not included in IPP's income
- the outcome of their arrangements is a significant reduction in personal tax liability.

This means that the lawyers, whether solicitors, barristers, judges or corporate counsel, will have their income assessed via a structured process to determine the level of their risk or compliance.

How does this work?
Before the new framework can be applied, the taxpayer's income needs to pass two 'Gateways' to determine whether it is:

a. commercial income, and
b. does not have high-risk features

Commercial Rationale
Income may not be classed as commercial and not compliant if it:

- is unnecessarily complex to achieve the relevant commercial objective
- only provides a tax advantage
- has a tax outcome at odds with its commercial result

- results in little or no risk in circumstance, where risk would be expected
- operates on non-commercial terms, or in a non-arm's length manner
- presents a gap between the substance of what is being achieved and the legal form it takes.

Non-High-Risk Gateway
Income needs to be assessed to ensure it does not have high-risk features, such as:

- arrangements relating to non-arm's length transactions
- exploiting differences between accounting standards and tax law
- obviously different in principle from *Everett* and *Galland* (Everett assignments)
- involving multiple classes of shares, units, and entitlements
- involving multiple assignments or disposals of equity interest
- misusing the superannuation system
- the distribution of income, with losses, to non IPP entities

Are you at risk?
Once the IPPs income has passed these two Gateways, then it can be assessed against the PCG 2012/4 risk assessment framework to see how compliant it is. If it is deemed high-risk, then a restructuring of income arrangements will be necessary.

The PCG 2012/4 combines three factors to provide a risk measurement: low, moderate, or high.

Risk Assessment Scores[1]

RISK ASSESSMENT	SCORES					
	1	2	3	4	5	6
Factor 1: Proportion of profit from the whole of firm group to the IPP	>90%	>75% - 90% inc.	>60% to 75% inc.	50% or more to 60%, inc.	>25% to less than 50%	25% or less
Factor 2: Tax rate for income received from the firm by the IPP and associated entities	>40%	>35% - 40% inc.	30% or more to 35%, inc.	>25% to less than 30%	>20% to 25%, inc.	20% or less
Factor 3: Remuneration returned to IPP as percentage of commercial benchmark for services provided to the firm	>200%	>150% to 200%, inc.	>100% to 150%, inc.	>90% to 100%, inc.	>70% to 90%, inc.	70% or less

[1]Australian Taxation Office, 2022, Assessing the risk: allocation of profits within professional firms, https://www.ato.gov.au/business/income-and-deductions-for-business/in-detail/professional-firms/assessing-the-risk--allocation-of-profits-within-professional-firms/, Accessed 11 February 2023.

Use your total score to work out your risk zone.

RISK ZONE	RISK LEVEL	AGGREGATE SCORE	
		FIRST TWO FACTORS	ALL THREE FACTORS
Green	Low	7 or less	10 or less
Amber	Moderate	8	11-12
Red	High	9 or more	13 or more

If the profit allocation is shown to be moderate or high risk, it's necessary to readdress the structure to ensure compliance.

Legal Practice (Northern Beaches)

"We have been operating a small legal firm on Sydney's Northern Beaches for over a decade. We have four lawyers, providing a broad, yet crucial, range of legal services to the local community. Working together as legal professionals makes total sense for us, as it means we have the necessary infrastructure and provide integrated and complementary services to our clients.

It was our accountant that alerted us to the Practical Compliance Guidelines and the necessity to address our business structure and the arrangements we have in place for allocating the firm's profits. We were very surprised to discover the possible tax implications and risks that we unknowingly exposed to; it was a very stressful time knowing that we could be non-compliant.

Thankfully our accountant was able to advise us and help us each make the necessary changes to our business arrangements and profit distribution to ensure that we were fully compliant.

Legal Principal, Mona Vale.

Who's affected?

All law firms and their practising professionals need to review their allocation of profits or income to ensure they are fully compliant with current tax legislation.

There are a variety of business structures that may not give rise to tax avoidance concerns. And certain individuals may be allocated significantly less of the firm's profits than would be expected but the use of structures does provide avenues for minimising taxable income.

What can we do?
In a nutshell, it’s imperative that legal firms’ structures and their practitioners’ taxation arrangements are compliant to ensure no adverse financial repercussions. PCG21021/4 provides the framework to ensure the appropriate allocation of IPPs income and profits, through a step-by-step approach.

This framework has recently been updated and demonstrates the Australian Taxation Office’s commitment to adherence to appropriate business structures and profit allocation. It is therefore critical that both the firms and IPPs address their income to ensure that they comply with the requirements and aren’t taking an unnecessary risk.

To discuss the issues raised in this paper and how they might affect your firm, please give us a call on 02 8973 2222.