Professional Services Firm Profits Guidance Finalised

The Australian Taxation Office's finalised position on the allocation of profits from professional firms starts on 1 July 2022.

The ATO's guidance uses a series of factors to determine the level of risk associated with profits generated by a professional services firm and how they flow through to individual practitioners and their related parties. The ATO may look to apply the general anti-avoidance rules in Part IVA to practitioners who don't fall within the low-risk category.

With the new guidelines taking effect on 1 July 2022, professional firms will need to assess their structures now to understand their risk rating, and if necessary, either make changes to reduce their risks level or ensure appropriate documentation is in place to justify their position.

The Problem

The finalised guidance has had a long gestation period. The ATO has been concerned for some time about how many professional services firms are structured – specifically, professional practices such as lawyers, accountants, architects, medical practices, engineers, architects etc., operating through trusts, companies and partnerships of discretionary trusts and how the profits from these practices are being taxed.

The ATO guidance takes a strong stance on structures designed to divert income in a way that results in principal practitioners receiving relatively small amounts of income personally for their work and reducing their taxable income. Where these structures appear to be in place to divert income to create a tax benefit for the professional, Part IVA may apply. Part IVA is an integrity rule which allows the Commissioner to remove any tax benefit received by a taxpayer where they entered into an arrangement in a contrived manner in order to obtain a tax benefit. Significant penalties can also apply when Part IVA is triggered.

Determining the risk rating

The guidance sets out a series of tests which are used to calculate a risk score. This risk score is then used to classify the practitioner as falling within a Green, Amber or Red risk zone, which determines if the ATO should take a closer look at you and your firm. Those in the green zone are at low risk of the ATO directing its compliance efforts to you. Those in the red zone, however, can expect the ATO to conduct further analysis as a matter of priority which could lead to an ATO audit.

Before calculating the risk score it is necessary to consider two gateway tests:

- **Gateway 1** - considers whether there is commercial rationale for the business structure and the way in which profits are distributed, especially in the form of remuneration paid. Red flags would include arrangements that are more complex than necessary to achieve the relevant commercial objective, and where the tax result is at odds with the commercial venture, for example, where a tax loss is claimed for a profitable commercial venture.
- **Gateway 2** - requires an assessment of whether there are any high-risk features. The ATO sets out some examples of arrangements that would be considered high-risk, including the use of financing arrangements relating to transactions between related parties.

If the gateway tests are passed, then you can self-assess your risk level against the ATO's risk assessment factors. There are three factors to be considered:

- The professional's share of profit from the firm (and service entities etc) compared with the share of firm profit derived by the professional and their related parties;
- The total effective tax rate for income received from the firm by the professional and their related parties; and
- The professional's remuneration as a percentage of the commercial benchmark for the services provided to the firm.

The resulting 'score' from these factors determines your risk zone. Some arrangements that were considered low risk in prior years under the ATO's previous guidance may now fall into a higher risk zone. In these cases, the ATO is allowing a transitional period for those practitioners to continue to apply the previous guidelines until 30 June 2024.

For professional services firms, it will be important to assess the risk level and this needs to be done for each principal practitioner separately. Those in the amber or red zone who want to be classified as low risk need to start thinking about what needs to change to move into the lower risk zone.

Where other compliance issues are present - such as failure to recognise capital gains, misuse of the superannuation systems, failure to lodge returns or late lodgement, etc., - a green zone risk assessment will not apply.

PCR and RAT tests to be tax deductible, FBT free

The Treasurer has announced that PCR and rapid antigen tests (RAT) will be tax deductible for individuals and exempt from fringe benefits tax (FBT) for employers if purchased for work purposes.

There has been confusion over the tax treatment of RAT tests with the Prime Minister stating for some time that they are tax deductible, but in reality, the tests were probably only deductible in limited circumstances.

If you have had to purchase RAT tests to be able to work, you will be able to receive a tax deduction for the cost you have incurred from 1 July 2021 (you will need evidence of the expense). If the RAT test cost $20, someone on a marginal tax rate of 32.5% would receive a tax benefit of $6.50.

For business, it is expected that RAT, PCR and other coronavirus tests will be exempt from FBT from the 2021-22 FBT year.

Legislation enabling the change is expected before Parliament this week.

Covid-19 and car parking fringe benefits

For a car parking benefit to arise for FBT purposes, amongst other conditions, a ‘commercial parking station’ must be located within a one-kilometre radius of where the employee’s car is parked.

Therefore, a car parking benefit will not arise during any period in which all commercial parking stations within a one-kilometre radius of where the employee’s car is parked have closed, or the parking station has provided free parking, during the COVID-19 lockdowns. This is because no commercial parking station will be regarded as being located within the one-kilometre radius during this period.

Furthermore, a car parking benefit will not arise if, on the first business day of an FBT year, the lowest fee charged by all commercial parking stations within a one-kilometre radius was at or below the applicable car parking threshold ($9.25 for the 2022 FBT year). Accordingly, if, on 1 April 2021, the lowest fee charged for all-day parking by all commercial parking stations located within a one-kilometre radius of the premises on which a car is parked, was no more than $9.25, then no car parking benefits arise with respect to those premises for the entire 2022 FBT year. This assumes the lowest fee is a "representative" fee, as anti-avoidance rules can apply if car parking rates are artificially low.

The ATO has acknowledged that this situation arises where all of the commercial parking stations discounted their all-day parking rate (to at or below $9.25) due to COVID-19 on and around 1 April 2021.

Editor: This and various other FBT tips, along with other crucial FBT issues, will be discussed in the NTAA's 2022 FBT seminars presented during March and also available online.

FBT, GST and Income Tax Rulings

LCR 2021/3 — Temporary full expensing

This Ruling is about the temporary full expensing (referred to as 'TFE' in the Ruling) of depreciating assets that was introduced as part of the Government's response to the economic impact of the COVID-19 pandemic and provides the ATO's view on how these laws apply.

The TFE rules have a formal commencement date of 1 January 2021. However, the critical application date for taxpayers is '2020 Budget Time' (i.e., 7.30pm in the Australian Capital Territory on 6 October 2020). The TFE rules apply to assets first held at or after this date, and the formal commencement date does not limit this application or otherwise modify the timing aspects of the TFE rules.

Editor: The TFE provisions are currently legislated to apply to eligible depreciating assets that were first held between 2020 Budget Time and 30 June 2022 (and first used (or installed ready for use) for a taxable purpose by 30 June 2022). However, the Treasury Laws Amendment (Enhancing superannuation outcomes for Australians and helping Australian businesses invest) Bill 2021 (before Parliament at the time of writing) seeks to extend the TFE regime for another 12 months to 30 June 2023 (i.e., through to the 2023 income year).

Below is a summary of some of the main concepts covered by the ATO in the Ruling.

Eligible entities

Although TFE applies to depreciating assets, not all depreciating assets are eligible. Assets may be excluded based on:

- when they were first held or used for a taxable purpose;
- specific exclusions (which may differ depending on whether the taxpayer is an SBE using simplified depreciation);
- specific exclusions for entities with an aggregated turnover of $50 million or more, including the exclusion for second-hand assets;
- specific exclusions applicable to entities using the alternative income test, including the exclusion for intangible assets; and
- the occurrence of a balancing adjustment event in respect of an asset.

Rules for full expensing of eligible assets by eligible entities

The Ruling explains the rules for full expensing of eligible assets by eligible entities, including the choice to not apply TFE. Note that this choice is only available for those entities that do not use the simplified SBE depreciation rules (i.e., SBEs using the simplified depreciation rules cannot 'opt out' of TFE for individual assets).

Interaction with other provisions

In Part C of the Ruling, the ATO explains the interaction of the TFE with the instant asset write-off, backing business investment ('BBI') and the R&D tax offset.

Small business entities

In Part F of the Ruling, the ATO outlines the operation of TFE for SBEs, focussing on SBEs choosing simplified depreciation, but the Ruling also describes how the rules work for entities who do not make that choice.

Integrity issues

Finally, the ATO explains that it expects taxpayers to engage in behaviour that enables them to access these incentives, and an increased scale of investment in response to these measures is not, of itself, likely to attract the attention of the ATO.

However, integrity rules (e.g., Part IVA of the ITAA 1936) may apply to tax-driven arrangements. The ATO will focus on arrangements involving transactions between related parties that facilitate the claiming of TFE (and potentially also loss carry-back tax offsets) without any increase in the business asset base of the economic group.

How Super works: Super news for February 2022

$450 income threshold lifted

The Treasury Laws Amendment (Enhancing Superannuation Outcomes For Australians and Helping Australian Businesses Invest) Bill 2021, which allows for a number of changes to super and removes the $450 monthly threshold for wages on which super must be paid, has passed through parliament. Previously, if employees earned less than that a month their employer did not need to pay the superannuation guarantee for them.

“We’re pleased the government has listened to super funds and abolished this threshold. This decision will benefit an estimated 300,000 lower-paid Australian workers, 63% of which are women and many of whom are our valued Hostplus members,” Hostplus chief executive officer David Elia said in a post on LinkedIn.

“This long overdue reform is a marked step forward to ensure greater numbers of workers in entry-level, part-time and casual jobs get a much-needed and well-deserved contribution to their super savings.”

The passage of the Bill will also allow older Australians aged between 67 and 75 to use the bring-forward rule for non-concessional super contributions and repeals the work test for non-concessional and salary-sacrificed contributions for 67–75 year olds.

And SMSF trustees will be able to use their preferred method of calculating exempt current pension income where the fund is fully in the retirement phase for part of the income year.

Retirement income covenant introduced

The Corporate Collective Investment Vehicle Framework and Other Measures Bill 2021 has also been passed. This Bill allows for the Retirement Income Covenant, which will require superannuation trustees to have a retirement income strategy formulated in writing (and a summary publicly available), from 1 July 2022.

"The Retirement Income Covenant will help a growing proportion of Australians plan with certainty as they move into their retirement," Financial Services Council acting chief executive officer Blake Briggs said.

SMSFs will not be included in the covenant but all other trustees will be required to develop appropriate retirement income strategies for members. Even so, it's still advisable for SMSF trustees to consider their retirement income strategy.

The Corporate Collective Investment Vehicle (CCIV) regime also allows fund managers to offer an investment vehicle with a corporate structure and appropriate flow-through tax treatment. This structure is expected to be more familiar to international investors and should open up export opportunities for the Australian funds management industry.

"Only five percent of the funds managed in Australia comes from offshore ($145 billion out of $2.6 trillion), showing the significant scope for Australia to build on our existing strengths to export this to the globe," Briggs said.

Aware Financial Services Australia fined $20 million by ASIC

Aware Financial Services Australia Limited (Aware FS), formerly State Super Financial Services Australia Limited (StatePlus), has been ordered by the Federal Court to pay a $20 million penalty for charging over 25,000 customers fees for financial services it did not provide, in contravention of the ASIC Act.

ASIC Deputy Chair Sarah Court said, 'Aware FS charged fees to tens of thousands of customers for financial services it had grounds to believe it would not be able to provide. As a result, over $50 million in fees was charged to customers who have nothing to show for it.'

Aware Financial Services Australia provides financial planning services to Aware Super, Australia's 2nd largest super fund in terms of assets, and 4th largest super fund in terms of members.

Between 21 August 2014 and 30 June 2018, Aware FS charged approximately 25,300 customers a total of $50 million in fees for advice services included as part of the superannuation product offered by Aware FS, which at that time was also a superannuation trustee. The firm provided at least 17,500 customers with written disclosure documents advising them that they would receive an annual financial planning review called an Annual Review Service. Another 7,800 customers entered into ongoing advice service arrangements that included provision of an Annual Review Service. However, Aware FS did not provide the promised services.

Aware FS's conduct was the subject of a case study by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Inflation hits retirees

Increases in the cost of fuel and healthcare hit retirees' bottom lines in 2021 as they experienced the largest annual price rises since 2010.

The Association of Superannuation Funds of Australia (ASFA) Retirement Standard for December 2021 revealed that couples aged around 65 living a comfortable retirement need to spend $64,771 annually, while singles need to spend $45,962. That's an increase of 1.5% and 1.6% respectively over the quarter, and higher than the general increase in the December CPI of 1.3%.

Over 2021, comfortable budgets rose by 3.5% for couples and 3.9% for singles.

"It's so important that future retirees are able to build sufficient savings over their working lives to ensure they can face retirement with financial confidence," ASFA deputy chief executive officer Glen McCrea said.

"It is crucial that the government addresses the repair of people's retirement budgets as we start to see the other side of the COVID-19 crisis."

APRA to focus on sub-standard practices in super

In its policy and supervision priorities for the next 12 to 18 months, the Australian Prudential and Regulation Authority (APRA) has put super – specifically sub-standard industry practices and eradicating unacceptable product performance – at the top of its list of supervision priorities for 2022.

Other supervision priorities include cyber risk preparedness and responsiveness, and a continuing focus on risk culture.

"While the financial system has demonstrated its resilience throughout the pandemic, COVID-19 has underlined the potential for unexpected shocks to emerge at any time. With that in mind, a substantial emphasis of our policy and supervision agenda this year is bolstering entities' ability to withstand shocks, whether it be financial or operational," APRA chair Wayne Byres said.

"We will also continue to force persistent underperformers in the superannuation industry to quickly lift their standards or exit the industry," he added.

Australian super funds lead decarbonisation

Institutional and super funds are a "powerful constituency in Australia" when it comes to environmental, social and governance (ESG) issues, according to global research house Cerulli Associates.

"Superannuation funds in particular, a powerful constituency in Australia with $3.3 trillion (US$2.4 trillion) under management, have pushed for stronger ESG behaviour among investees, which has had a galvanizing effect across the entire Australian corporate landscape. This has been the defining theme of 2021," Cerulli said in its first The Cerulli Edge – Asia Pacific Edition report for the year.

Australian super funds say change is being driven by members who are more engaged with their super on these issues.

"Whatever you read about the government position on climate in Australia, the presence of the fund management industry on a decarbonisation course makes it self-fulfilling. That is the power of institutional money, and everyone who serves these funds will need to be on board," the Cerulli report said.

SMSF Association calls for simplification of transfer balance cap

The SMSF Association has proposed the removal of transfer balance cap (TBC) proportional indexation in its 2022–23 Budget Submission to Treasury.

The transfer balance cap was raised to $1.7 million from $1.6 million on 1 July 2021, however a member's individual transfer balance cap may differ from the general TBC depending on when they retired.

"This is an overly complex situation which, over time, will result in most individuals with a retirement phase income stream having a personal TBC that is different to the general TBC maximum. This distortion will continue to grow in complexity as future indexation of the TBC is applied," the SMSF Association said in its submission.

The Association said the costs of allowing a broad application of TBC indexation, along with the loss of tax revenue, would not be significant, especially so in light of the administration costs of proportional indexation which are incurred each time the general cap is indexed.

Proxy advice regulations overturned in Senate

The proxy advice regulation introduced late last year, and criticised by many in the industry, lasted just three days before being overturned in the Senate on 9 February.

Independent senator Rex Patrick succeeded with a move to disallow the regulations by 29 votes to 25. The regulations, which required proxy advisers to have an Australian Financial Services Licence among other requirements, had come into effect on 7 February 2022.