Print whole section

Professional firms

Detailed information about income and deductions for professional firms.

QC 47758

Assessing the risk: allocation of profits within professional firms

How we assess the risk on allocation of profits in professionals firms if income is derived from professional services.

Last updated 26 September 2024

We've published **PCG 2021/4** *Allocation of professional firm profits – ATO compliance approach* for individual professional practitioners (IPPs) when considering the allocation of profits by professional firms. You should:

- assess whether you can use the risk assessment framework in PCG 2021/4
- find out how we will assess your risk and apply our compliance approach.

Practical compliance guideline

PCG 2021/4 replaces the web material published in 2015, **Assessing the Risk: Allocation of profits within professional firms guidelines**. We suspended these guidelines in December 2017 as we became aware that it was being misinterpreted in relation to arrangements that go beyond the scope of the guidelines.

PCG 2021/4 is about arrangements where:

- taxpayers redirect their income from a business or activity to an associated entity
- that income includes income from their professional services
- the outcome is that they significantly reduce their tax liability.

PCG 2021/4 applies from 1 July 2022 and clarifies how we assess the risk and our compliance approach to the allocation of profits in professional firms.

Before you apply PCG 2021/4

Before you apply **PCG 2021/4**, you must assess if your arrangement is commercial and does not have high-risk features. We call these 'gateways' which you must pass before you can apply PCG 2021/4.

Commercial rationale gateway

You must assess if your arrangement has a sound commercial rationale. An arrangement that shows a **lack** of commercial rationale can:

- seem more complex than necessary to achieve the relevant commercial objective
- appear to serve no real purpose other than to gain a tax advantage
- have a tax result that appears to be at odds with its commercial or economic result
- result in little or no risk in circumstances where significant risks would normally be expected
- operate on non-commercial terms or in a non-arm's length manner
- present a gap between the substance of what is being achieved and the legal form it takes.

No high-risk features gateway

You must also assess that your arrangement does not have high-risk features.

Arrangements with high-risk features can:

- have financing arrangements relating to non-arm's length transactions
- exploit the difference between accounting standards and tax law
- be materially different in principle from *Everett* and *Galland* (refer to **Everett assignments** for information on high-risk features of Everett assignments)
- involve multiple classes of shares and units, including creating discretionary entitlements such as dividend access shares
- involve multiple assignments or disposals of an equity interest

- misuse the superannuation system, including assignments or disposals of an interest to associated self-managed super funds (SMSFs)
- distribute income to entities, other than the IPP, with losses.

If you don't pass both gateways

If we identify arrangements that lack apparent commercial rationale or have high-risk features, we may consider applying anti-avoidance provisions under Part IVA or other integrity rules.

If you do pass both gateways

If you pass the gateways, you can then self-assess against the [Risk assessment framework].

Risk assessment framework

If you pass both gateways, you can then self-assess against the risk assessment framework to see the type of compliance attention that we will give to your arrangement.

Complete the risk assessment scoring table

You self-assess your risk level against each of the risk assessment factors in the risk assessment scoring table. This gives a risk rating of low, moderate or high.

Table: Risk assessment scores

Risk assessment factor	Score 1	Score 2	Score 3	Score 4
Factor 1: Proportion of profit entitlement from the whole of firm group returned in	More than 90%	More than 75% to 90%, inclusive	More than 60% to 75%, inclusive	50% or more to 60%, inclusive

the hands of the IPP				
Factor 2: Total effective tax rate for income received from the firm by the IPP and associated entities	More than 40%	More than 35% to 40%, inclusive	30% or more to 35%, inclusive	More than 25% to less than 30%
Factor 3: Remuneration returned in the hands of the IPP as a percentage of the commercial benchmark for the services provided to the firm	More than 200%	More than 150% to 200%, inclusive	More than 100% to 150%, inclusive	More than 90% to 100%, inclusive

As an IPP, if you return 100% of the profit entitlement from the firm in your personal tax return, you:

- are automatically in the green risk zone
- don't need to assess against the other risk assessment factors.

Total effective tax rate

The total effective tax rate is the average rate of tax for the entire income received from the firm by the IPP expressed as a percentage. It is calculated using the following formula and excludes any levies such as Medicare levy, Medicare levy surcharge or the Temporary budget repair levy.

The calculation is

((Total tax paid by the IPP, and associated entities of the IPP, on professional firm income) ÷ Total firm income collectively received) × 100

Work out your risk zone

After you complete your self-assessment, use your total score to work out your risk zone. Then check it against the risk assessment framework to see the type of compliance attention that we will give to your arrangement.

Assessing against the 3 risk assessment factors

If you are self-assessing using all 3 risk assessment factors, your arrangement is considered low risk (green zone) if your aggregate score of all 3 risk assessment factors is 10 or less.

Assessing against factors 1 and 2 only

You can self-assess against the risk assessment factors 1 and 2 only. You may do this if it is impractical to accurately determine an appropriate commercial remuneration against a benchmark for risk assessment factor 3.

Your arrangement is considered low risk (green zone) if your aggregate score for risk assessment factors 1 and 2 is 7 or less.

Table: Risk zone and risk rating

Risk zone	Risk level	Aggregate score against first 2 factors	Aggregate of all 3 factors
Green	Low risk	7 or less	10 or less
Amber	Moderate risk	8	11 and 12
Red	High risk	9 or more	13 or more

We are likely to further analyse the facts and circumstances of the arrangement or initiate compliance activity if either the:

- IPP's profit allocation arrangement exhibits high-risk features

- arrangement has a moderate or high-risk rating.

Profits retained by a Practice Entity

There may be circumstances where for commercial reasons some or all of the profits of a firm may be retained by the firm in one or more income years, rather than being distributed to the IPPs of the firm.

When undertaking a self-assessment in accordance with PCG 2021/4, an IPP's portion of retained profits is taken to be a part of their profit entitlement when calculating the basis for risk assessment factor 1 and 2. When calculating their risk assessment factor 1, it should be assumed that the IPPs entitlement includes the proportion of the amount retained by the firm that they would have otherwise received if all amounts were distributed.

This approach ensures consistency and comparability in an IPP's risk assessment from year to year and prevents skewed risk assessment outcomes that could otherwise arise in instances where profits are retained by the firm; noting it is expected that an IPP will receive their proportionate entitlement to the retained amounts in a later year.

Example: low-risk arrangement

Brooke, a management consultant, assigns 30% of her partnership interest in the Better Business partnership to her discretionary trust. Brooke's total income entitlement from the partnership is $425,000. The beneficiaries of the trust include Brooke, her spouse Brody, and a corporate beneficiary, BB Pty Ltd, whose shares are jointly held by Brooke and Brody.

Brooke and Brody also jointly own a rental property that has a net rental loss of $10,000 and they each claim $5,000 net rental loss on their tax return.

Brooke includes $297,500 (70% of the income entitlement) in her tax return and the trustee distributes the balance of $127,500 (30% of the income entitlement) as follows:

- $50,000 to Brody
- $77,500 to BB Pty Ltd.

The total income of $425,000 from the partnership is taxed in the hands of Brooke and her associates as follows:

- Tax on Brooke's share of $297,500 is $104,542 (applying 2020–21 individual tax rates).
- Tax on Brody's share of $50,000 is $6,717 (applying 2020–21 individual tax rates).
- Tax on BB Pty Ltd's share of $77,500 is $20,150 (applying 2020–21 company tax rate of 26%).

The total effective tax rate on the income from the partnership is $104,542 + $6,717 + $20,150 = ($131,409 ÷ $425,000) × 100 = 30.92%

When determining the effective tax rate on the income from the partnership, the rental losses are disregarded as they are unrelated to the professional firm income.

The risk assessment for this arrangement is as follows:

- Brooke returns 70% of her profit entitlement from the partnership in her personal tax return, which gives her a score of 3 against the first risk assessment factor.
- Brooke and her associates pay an effective tax of 30.92% on the income received from the partnership, which gives her a score of 3 against the second risk assessment factor.
- Brooke has worked out that in the circumstances it is impractical to accurately determine an appropriate commercial remuneration to benchmark against, so she self-assesses against the first 2 risk assessment factors only.

As the total score under the first 2 risk assessment factors is 6, this arrangement is considered low risk.

Example: Retained profits

ABC Pty. Ltd. (the firm) has 5 equal principals, and generates $5m profit for the year. $2.5m is distributed equally as directors' fees with the 5 principals receiving $500k each based on the agreement of the principals. The remaining $2.5m is retained by the firm. In effect, only half of the profit of the firm has been taxed in the hands of each IPP, based on the collective decision to retain those profits. If Chris, a principle of the firm, is retiring at the end of the next income year, he will receive his proportion of the retained profits ($500k) at that time.

In the current income year, for Risk Assessment Factor 1, Chris would have a score of 4, as he received 50% of the profit entitlement (50% of his share of $1 million), with the remaining 50% retained within the firm.

For Risk Assessment Factor 2, where the firm has retained profits and is taxed on the amounts, the tax paid is recognised for the calculation of the effective tax rate for Chris in relation to their proportion of the retained profits, whether that be 25 or 30 per cent.

As the $2.5m in retained profits is the equivalent of $500k for each IPP, if tax is paid at 30%, it would equate to $150k. The $150k in tax paid by the firm would be added to the Chris' personal tax amount paid, ensuring that the full tax contribution is considered when calculating the effective tax rate for Risk Assessment Factor 2 in relation to an IPP's share of the income on the $1m generated.

Example: moderate-risk arrangement

Julie and 3 other individuals run a legal practice through Legal Services Pty Ltd. Julie's family trust, JJ Trust, is a shareholder in the company. The beneficiaries of JJ Trust include Julie, her spouse Kurt and a corporate beneficiary, Company X Pty Ltd, whose shares are held by Julie.

Julie’s total income entitlement from the company, which includes her salary and wages and franked dividends to her family trust, is $800,000. She includes $380,000 received as salary and wages from the company in her tax return. She reflects this is an appropriate return for her services she provides. The tax paid on this amount is $141,667.

The trustee of the JJ Trust receives $420,000 as a fully franked dividend ($294,000 as cash and $126,000 as franking credits). The trustee distributes:

- $370,000 to the corporate beneficiary Company X Pty Ltd; and the tax paid on this amount is $96,200 (applying 2020–21 company tax rate of 26%)
- $50,000 to Julie's spouse, Kurt; and tax on this amount is $6,717 (applying 2020–21 individual tax rates).

The total tax paid by Julie and her associates is $244,584 ($141,667 + $96,200 + $6,717). This gives a total effective tax rate of 30.57% ($244,584 ÷ $800,000 × 100). This arrangement is considered moderate risk because:

- Julie returns 47.5% of her profit entitlement from the partnership in her personal tax return, which gives her a risk score of 5 against the first risk assessment factor
- her associates pay an effective tax of more than 30% on the income received from the partnership, which gives her a score of 3 against the second risk assessment factor
- Julie has determined the appropriate commercial remuneration to benchmark her remuneration against for the services she provides to the firm
  - The industry benchmark for the provision of equivalent or similar services is $325,000.
  - As she personally returns $380,000 – which is 116.9% of the benchmark remuneration ($380,000 ÷ $325,000 × 100) – this gives her a score of 3 for the third risk assessment factor.

Julie's total score against the 3 risk assessment factors is 11, which places her arrangement in the moderate risk category.

Example: high-risk arrangement

Ashley, Peta and Raj operate an accounting practice as an equal partnership of 3 discretionary trusts with each of Ashley, Peta and Raj as trustees of their respective discretionary trusts. The practice generates a profit of $2,100,000 for the income year. The partnership distributes Ashley's $700,000 profit share to Ashley Trust. Ashley, in her capacity as the trustee, distributes the profits as follows:

- Ashley receives $147,000 (21% of the profits) with tax of $39,457 (applying 2020–21 individual tax rates).
- Ashley's spouse James receives $130,000, with tax of $33,167 (applying 2020–21 individual tax rates).
- Ashley Investments Pty Ltd (of which Ashley and James are equal shareholders), receives $423,000, with tax of $109,980 (applying 2020–21 company tax rate of 26%).

The total tax paid by Ashley and her associates on the practice's total profit entitlement of $700,000 is $182,604, ($39,457 + $33,167 + $109,980). This gives an effective tax rate of 26.09% ($182,604 ÷ $700,000 × 100).

This arrangement is risk assessed as follows:

- Ashley returns 21% of the total income entitlement from the practice in her tax return. This gives her a risk score of 6 for the first risk assessment factor from the risk assessment scoring table.
- The effective tax rate of 26.09% paid by Ashley and her associates on the total income entitlement of $700,000 from the practice is less than 30%. This gives her a risk score of 4 for the second risk assessment factor.
- After reflecting on her duties, responsibilities, risks and roles she undertakes in the firm, Ashley determines that a commercial remuneration for similar roles is $250,000. This results in Ashley's remuneration as a percentage of the commercial benchmark for her services being less than 70% ($147,000 ÷ $250,000 × 100). This gives her a score of 6 for the risk assessment factor 3.

As the aggregate score against all the risk factors is 16, this is a high-risk arrangement.

Certainty for 1 July 2017 to 30 June 2024

If you have existing arrangements, you can continue to rely on the **suspended guidelines** for 1 July 2017 to 30 June 2022 if your arrangement:

- complies with the suspended guidelines
- is commercially driven
- does not exhibit any of the high-risk factors outlined in the No high-risk features gateway.

If you satisfy these conditions, your arrangement will be considered low risk for 1 July 2017 to 30 June 2022.

You may find that your arrangement was low risk under the suspended guidelines but has a higher risk rating under **PCG 2021/4**. If so, you can continue to apply the suspended guidelines until 30 June 2024.

If you have concerns

If you have any concerns on the tax consequences of any proposed restructure of your arrangements, further information is available on our website, see **Private rulings**.

QC 42218

Everett assignments

How to assess the risk rating of your Everett assignment arrangements and our compliance approach.

Last updated 26 September 2024

On this page

What are Everett assignments

When a partner assigns their partnership interest to an individual or other entity (the assignee), it is usually an entity related to the partner (the assignor). These assignments are commonly known as Everett assignments, after the case *Federal Commissioner of Taxation v Everett* [1980] HCA 6 (Everett).

In the Everett case, Mr Everett practised in partnership with 3 other solicitors and held a 13% interest in the capital and income of the partnership. He executed a *Deed of Assignment* to assign 6/13ths of his share of the firm to his wife. The Commissioner assessed both Mr Everett and his wife on the assigned portion. The High Court found that the assignment was effective for tax purposes. Income payable to Mr Everett’s spouse was trust income, which was assessable in her hands only.

A similar type of assignment was undertaken in *Commissioner of Taxation v Galland* [1986] HCA 83 (Galland) where Mr Galland, a solicitor in a partnership assigned 49% of his share in the partnership to a related family trust.

Legal principles from Everett and Galland

The principles established by the High Court in Everett and Galland may be summarised as follows:

- A partner’s interest in a partnership is a 'chose in action', which is assignable in whole or in part by way of equitable assignment.
- The effect of this type of assignment is that the assignor holds that assigned partnership interest on trust for the assignee.
- The assignment does not make the assignee a partner in the partnership or give the assignee any entitlement to the assets, management or administration of the partnership or the right to inspection of books and accounts.
- As a partner's partnership interest is an entire chose in action, a partner's entitlement to participate in profits is not separate and severable from the interest of the partner.

- A partner's income is not income from personal exertion but income from property, with the property being the partner's fractional interest in the partnership.

Our risk assessment approach

Practical Compliance Guideline **PCG 2021/4** *Allocation of professional firm profits – ATO compliance approach* clarifies how we assess the risk and our compliance approach relating to the allocation of profits within professional firms.

The PCG applies from 1 July 2022 and outlines that the risk assessment framework is only available to taxpayers if their arrangements are commercially sound and do not exhibit high-risk features.

Your arrangement would be materially different in principle to Everett and Galland and may be high risk where:

- it purports to admit an individual who is not an owner or equity holder in the partnership as a partner of the partnership
- a partner's relationship with the partnership has characteristics indicating that relationship is akin to a contractor or employee of the partnership.

We also consider a partner undertaking an Everett assignment as high risk if they:

- do not have rights to full participation in management and the benefits of partnership
- receive a fixed draw or salary when they have limited or no exposure to the risks and benefits associated with the performance of the partnership to that draw or salary
- are indemnified by partners for any professional liability in respect of actions against the partnership.

Example: high risk assignment by non-equity partner

Jamie is made a non-equity partner in Design Partnership, an engineering firm. Jamie:

- is not required to make a capital contribution
- has a fixed salary of $130,000
- has no right to vote or participate in the management of the firm.

She undertakes an Everett assignment of a portion of her interest in the partnership to her family discretionary trust. This assignment is considered high risk because it is materially different in principle to *Everett* and *Galland* because Jamie does not have the full rights, entitlements and obligations of a partner.

If your Everett assignment has high risk features, the Commissioner is likely to give closer attention to the individual facts and circumstances of the arrangement. This includes a deeper consideration of whether anti-avoidance provisions, such as Part IVA, apply.

Our approach to assessing the risk associated with Everett assignments that do not exhibit high risk factors will be determined in accordance with the risk assessment framework set out in the **PCG 2021/4**. For information on how we risk assess the profit allocation in professional firms, refer to **Assessing the risk: allocation of profits within professional firms**.

If you need advice about how the law will apply to you, including the tax consequences of any proposed restructure of your arrangements, you can submit an **Early engagement advice request**.

Everett assignments and small business CGT concessions

Since 8 May 2018, law changes limit access to the small business capital gains tax (CGT) concessions relating to Everett assignments.

Under these changes, the assignment of a partnership interest must meet an **additional basic condition** to access the concessions.

The changes ensure that the CGT concessions are only available for capital gains arising from CGT events that relate to rights or interests that entitle an entity to income or capital of a partnership by making that entity a partner of the partnership.

QC 46120

Administrative treatment: acquisitions and disposals of interests in ‘no goodwill’ professional partnerships, trusts and incorporated practices

Determine tax treatment of buying and selling interests in 'no goodwill' professional partnerships and other entities.

Last updated 26 September 2024

On this page

This information will explain our administrative treatment of the acquisition and disposal of interests (practice interests) in ‘no goodwill’ professional partnerships, trusts and incorporated practices (practices).

Professional practices are traditionally structured in one of two ways, either recognising goodwill or not recognising goodwill in determining whether practitioner entities have to pay to join the practice.

In a 'no goodwill' professional practice the practitioner entities agree that when a new practitioner entity is admitted into the practice they are not required to pay an amount which reflects a value for any goodwill of the practice. Further, when the practitioner exits the practice, they are not entitled to receive a payment which reflects a value for any goodwill of the practice.

These guidelines are concerned with the application of provisions in the tax law which potentially apply where entities carrying on ’no goodwill’ professional practices acquire and dispose of a practice interest for an amount which may differ to the interest’s market value. For example, the guidelines may apply to the acquisition or disposal of a practice interest during either:

- the admission or exit of practitioner entities into and out of the professional practice during the natural course of its business
- a takeover or merger involving more than one practice.

Broadly, the guidelines are concerned with arm’s length dealings between practitioner entities that are unrelated, aside from their involvement in the practice. Accordingly, the guidelines do not apply to the following dealings:

- practitioner entities and entities who are not and will not become a participant in the practice (for example, an ‘Everett assignment’)
- commonly owned or controlled entities (for example, internal restructures or reorganisations).

The provisions in the tax law that potentially apply relate to capital gains tax (CGT), employee share schemes (ESS) and off-market buy-backs (OMB).

This document is intended to highlight the circumstances when the administrative treatment will be available, rather than provide a technical analysis of the issue.

See also paragraphs 22 to 30 of **IT 2540** *Income tax: capital gains: application to disposals of partnership assets and partnership interests* which outlines the ATO view for the tax consequences of a partner in a partnership entering into an Everett assignment

Administrative treatment

The administrative treatment will apply in relation to a tax issue set out in the following table where they adopt the treatment corresponding to that issue and satisfy the guidelines set out below.

Administrative treatment table

Tax issue	Provisions	Applicable treatment
CGT: Calculation of cost bases and reduced cost bases of the practice interest	Section 112-20, *Income Tax Assessment Act 1997* (ITAA 1997)	The market value of the practice interest at the time of acquisition is treated as being equal to the amount the taxpayer pays (including nil) in respect of the acquisition.
ESS: Calculation of a discount (if any) on the issue of shares in an incorporated practice	Section 83A-20, ITAA 1997	The market value of the practice interest at the time of acquisition is treated as being equal to the amount the taxpayer pays (including nil) in respect of the acquisition.
CGT: Calculation of the capital proceeds in respect of a CGT event happening to a practice interest	Section 116-30, ITAA 1997	The market value of the practice interest at the time of disposal is treated as being equal to the amount the taxpayer receives (including nil)

		in respect of the disposal.
OMB: Calculation of consideration in respect of an off-market share buy-back of shares in an incorporated practice	Subsection 159GZZZQ(2), *Income Tax Assessment Act 1936* (ITAA 1936)	The market value of the practice interest at the time of disposal is treated as being equal to the amount the taxpayer receives (including nil) in respect of the disposal.

Where the administrative treatment is applied, the following conditions must be met:

- The administrative treatment must be applied to all applicable tax issues set out above.
- The CGT treatment of assets which are exchanged for practice interests subject to the guidelines should be determined on a consistent basis.

Where a taxpayer adopts the administrative treatment in relation to an applicable tax issue, we will not undertake compliance action in relation to that issue if they satisfy the requirements in the guidelines set out below.

These guidelines only apply in relation to the tax issue identified above. They do not apply in relation to other tax issues, for example, in determining whether an amount represents a share of the net income of a partnership or trust or a dividend from a company.

Guidelines

For the administrative treatment to apply in relation to the applicable tax issues set out above the taxpayer must satisfy all of the following requirements.

Practitioner entity

The first requirement is that the taxpayer (practitioner entity) must both:

- carry on or participate in the carrying on of a professional practice
- be one of the following
  - partner in a partnership carrying on that practice
  - shareholder in a company carrying on that practice
  - beneficiary of a trust (including a unit holder) carrying on that practice.

For the purposes of these guidelines an entity is also a practitioner entity where they will start to satisfy the above conditions upon acquiring a practice interest or cease to satisfy them upon disposing of such an interest (see further below). The practitioner entity can be an individual, trustee or company.

For the purposes of these guidelines, a practice is a professional practice if both of the following are met:

- Practice income is derived mainly from the provision of services involving the exercise of specialised knowledge and skill of members, excluding services that are commonly considered to be provided by tradespersons (such as plumbers, mechanics, electricians, etc).
- The conduct of its members would normally be regulated by legislation, regulations or other professional standards of conduct and ethical behaviour administered by a professional body or association or regulatory authority.

Applicable circumstances

The second requirement is that the dealings and relationships between the parties satisfy **all** the following conditions:

1. The governing documents of the practice provide that
   a. in the case of a partnership – consideration payable and receivable by a practitioner entity for the acquisition and disposal of a practice interest in goodwill will be nil or a nominal amount
   b. in any other case – consideration payable and receivable by a practitioner entity for the acquisition and disposal of a practice

interest will be determined on the assumption that the value of goodwill is nil or a nominal amount.

2. The governing documents have no further provision relating to consideration for practice interests, or such documents provide that:
   a. in the case of a partnership – consideration payable and receivable by a practitioner entity for the acquisition and disposal of a practice interest in assets other than goodwill will be nil or a particular amount
   b. in any other case – consideration payable and receivable by a practitioner entity for the acquisition and disposal of a practice interest will be determined on the assumption that the value of certain assets other than goodwill will be nil or a particular amount.
3. An acquisition or disposal occurs in the circumstances covered above.
4. The following parties have an arm's length relationship with one another immediately before the acquisition or disposal
   a. the acquiring entity (if any)
   b. each practitioner entity (if any) who disposes of a practice interest which the acquired interest represents or is reasonably attributable to.
5. The evidence reasonably supports the conclusion that both of the following represent arm's length dealings
   a. the governing documents
   b. the acquisition and/or disposal transaction.
6. The practitioner entity applies the treatment in these guidelines to all acquisitions or disposals covered above.

Governing documents

For the purposes of the guidelines, the term 'governing documents' refers to the partnership deed, trust deed, constitution, shareholders' agreement or other document governing the ongoing relationship between practitioner entities or the operation of the practice.

Practice interest

For the purposes of these guidelines, a practice interest is an interest of a practitioner entity comprising one of the following:

- an interest in a CGT asset of a professional practice structured as a partnership
- a share in a company carrying on a professional practice
- a unit or other interest in a trust carrying on a professional practice.

Arm’s length relationship

For the purposes of condition 4, the term ‘arm’s length relationship’ is intended to have its ordinary meaning. However, a practitioner entity will not be regarded as being in a non-arm’s length relationship with another entity merely because the other entity is either:

- a practitioner entity in the same professional practice
- an individual who is a relative of the practitioner entity (or another practitioner entity) for income tax purposes.

We accept that it is possible for parties dealing at arm’s length to come to an agreement about the future value of an asset; see Granby v. FC of T 95 ATC 4240. However, such an agreement must be reasonably capable of explanation in terms of the commercial or business objectives of a professional practice, and not in terms of an arrangement where the parties have colluded to achieve some ulterior objective.

See also the definition of ‘relative’ in **subsection 995-1(1)** of the *Income Tax Assessment Act 1997*.

Arm’s length dealing

For the purposes of the guidelines, the term ‘arm’s length dealing’ has its ordinary meaning.

An arm’s length relationship is to be distinguished from an arm’s length dealing. The former is concerned with the nature of any connection between the parties, whereas the latter is concerned with the nature of a particular transaction between them.

If the parties agree that nil or nominal consideration is payable in respect of interests in practice assets which have been purchased for substantial consideration, it may be inferred that those parties are not dealing at arm’s length.

Particular amount

For the purposes of the guidelines, the term ‘particular amount’ is intended to convey the need for consistency between the treatment of acquisitions and related disposals.

Application

These guidelines replace guidance formerly contained in:

- Taxation Ruling IT 2540 (paragraphs 13 and 14).
- Tax Determination TD 2011/26 (withdrawn).
- Draft Tax Determination TD 2011/D9 (withdrawn).
- Draft Tax Determination TD 2011/D10 (withdrawn).

These guidelines will be applied to all income years, including income years prior to their date of issue.

The guidelines and other compliances issues

The administrative treatment does not apply to other tax compliance issues. In cases where other compliance issues are evident, taxpayers may be subject to compliance action. This would include cases of:

- non-recognition of net capital gains (other than those affected by these guidelines)
- transfer pricing
- misuse of the superannuation system
- promotion of schemes
- repeated failure to lodge returns or a history of late lodgment of returns
- income injection into entities with carry forward losses
- trust reimbursement arrangements
- avoidance of Division 7A
- inappropriate access to low income tax offsets or other benefits

- non-tax advantages that are dependent on taxable income.

Need help?

If you need advice about how the law will apply to you, including the tax consequences of any proposed restructure of your arrangements, you can submit an **Early engagement advice request**.

Examples

Example 1: Applicable acquisitions and disposals

Chan Partners (CP) is a professional practice conducted by Mr Chan, Ms Brown and Mr Bruni. Under the CP partnership agreement, no amount is payable when a partner joins CP, nor is any amount receivable when a partner exits CP.

New partner

Ms Diamond joins CP as a new partner. At that time, CP's assets comprise goodwill, work in progress and a trade debtor (trade debtor 1). Ms Diamond does not pay anything to acquire her interest in these assets. The guidelines apply to the acquisition of her interest in CP.

As a result of Ms Diamond joining CP, CGT events happen to the interest of Mr Chan, Ms Brown and Mr Bruni in the assets of the partnership. The guidelines also apply to the disposal of their fractional interests to Ms Diamond when she joins CP.

Internally generated assets

Mr Chan, Ms Brown, Mr Bruni and Ms Diamond perform services. As a result, they create, and acquire an interest in new work in progress and a second trade debtor (trade debtor 2). The partners do not need to apply the guidelines to these acquisitions.

Disposal of internally generated assets

Mr Chan, Ms Brown, Mr Bruni and Ms Diamond then dispose of their interests in trade debtor 1 as a result of CP receiving payment for work performed. The guidelines do not apply to these CGT events.

This is the case, even though the guidelines applied to Ms Diamond when she acquired her interest in trade debtor 1.

Partner retirement

Mr Chan retires from the firm. He should apply the guidelines to the CGT event that happens to his interests in goodwill, work in progress and trade debtors.

As a result of Mr Chan's retirement, Ms Brown, Mr Bruni and Ms Diamond acquire additional interests in the goodwill, work in progress and trade debtors. The guidelines apply to the partner's acquisition of these interests as a result of Mr Chan retiring from CP.

Sale of practice assets

Chan Partners receive an offer from Boris Partners, a professional practice unrelated to Chan Partners, to purchase the practice of Chan Partners and all of the partnership assets for $1 million, being the market value. Ms Brown, Mr Bruni and Ms Diamond accept the offer. The guidelines do not apply to the CGT events which occur in relation to their interests in these assets.

Example 2: Admission of an unrelated partner

The ABC partnership (ABC) has 100 partners and carries on a professional practice. The assets of ABC comprise internally generated receivables, work in progress, contractual rights and goodwill.

The partnership agreement for ABC provides that no amount is payable on admission of a partner, nor is any amount receivable when a partner exits the partnership. Mr Chrysler becomes a partner in ABC. He does not pay anything for his interest in the partnership. There is no pre-existing relationship between Mr Chrysler and any of the other partners of ABC.

Mr Chrysler's entry into the partnership causes CGT events to happen to a part of the interests of the other partners in the assets of ABC. Capital proceeds in respect of those events are taken to equal the market value of those interests when Mr. Chrysler becomes a partner of ABC. The administrative treatment will be available to the other partners of ABC in relation to the CGT treatment of their part-interests in the assets of ABC if they treat the market value of those interests as nil for the purposes of determining:

- the capital proceeds in respect of their disposal
- their cost bases and reduced cost bases – to the extent that they were interests in partnership assets held by ABC at the time of their admission (for example, goodwill).

Example 3: Admission of a related partner

The facts in this example are the same as those in Example 2, except that Mr Chrysler is the son of Mr. Morris, another partner in ABC.

In accordance with the guidelines and in the absence of further facts, the administrative treatment will apply to Mr Morris in relation to the CGT treatment of his part-interest in the assets of ABC. For the purposes of condition 4 of the guidelines, the parties will not be treated as being in a non-arm's length relationship because of the family relationship between Mr Morris and Mr Chrysler.

Mr Chrysler's admission to ABC was on the same arm's length terms and conditions which would apply to the admission of other partners. Further, for the purposes of the administrative treatment, the parties will not be treated as being in a non-arm's length relationship merely because Mr Chrysler is Mr Morris' son.

In the absence of any further evidence suggesting the existence of a non-arm's length relationship between the parties, the administrative treatment can apply.

Example 4: Retirement of an IPP: arm’s length

Mr Dank, Ms Evans and Mr Frawley are unitholders in the DEF Unit Trust (DEF), which carries on a professional practice. The assets of DEF comprise internally generated receivables, work in progress, contractual rights and goodwill.

The trust deed for DEF provides that a nominal amount is payable or receivable when an individual professional practitioner (IPP) or an entity associated with the IPP, becomes or ceases to be a unitholder. Mr Frawley became a unitholder in DEF on 1 July 2010.

On 30 June 2018, Mr Frawley retires from DEF. His units are acquired by the remaining unit holders, Mr Dank and Ms Evans (in equal proportion), for the nominal amount.

Mr Frawley’s retirement causes a CGT event to happen to him upon disposal of his units in DEF. Capital proceeds in respect of that event are taken to equal the market value of his units at the time of his retirement.

In accordance with the guidelines, the administrative treatment will apply to Mr Frawley in relation to the CGT treatment of his units in DEF if he treats the market value of those units as the nominal amount for the purposes of determining:

- the capital proceeds in respect of his disposal of his units in DEF
- his cost base and reduced cost base – to the extent that they were interests in assets (for example goodwill) held by DEF at the time he acquired his units.

Example 5: Retirement of an IPP: inconsistent treatment on acquisition and subsequent disposal of a practice interest

The facts are the same as in Example 4, except that Mr Frawley determines that the market value of his interest in the goodwill of DEF was $100,000 at the time he acquired his units. Mr Frawley uses that amount as the cost base and reduced cost base of his interest in the goodwill in DEF.

The administrative treatment will not apply to Mr Frawley to determine the capital proceeds in respect of his interest in the goodwill of DEF as he did not apply the guidelines in determining the cost base and reduced cost base of that interest.

It should be noted that the non-availability of the administrative treatment to Mr Frawley will not impact the availability of the administrative treatment to the other unitholders in DEF.

Example 6: Transfer of an IPP's interest: not at arm's length

The facts in this example are the same as those in Example 4, except that instead of Mr Dank and Ms Evans acquiring Mr Frawley's units in DEF he transfers his units to the trustee of the Frawley family trust (FFT). FFT is a trust which Mr Frawley effectively controls. FFT pays the nominal amount to become a unitholder in DEF.

Mr Frawley asserts that he did not transfer anything of value to FFT and that even if he did, the transfer occurred at arm's length on the same terms as would apply to a transfer to an unrelated entity.

The administrative treatment will not be available to Mr Frawley as:

- the interest acquired by FFT can reasonably be regarded as corresponding to the interest disposed of by Mr Frawley

- there is a non-arm's length relationship between Mr Frawley and FFT.

Example 7: Retirement not at arm's length

On 1 July 2010, Mr Covic, Ms Brand and Mr Pham are partners in the GHI partnership (GHI), which carries on a professional practice. At that time, the assets of GHI comprised internally generated receivables, work in progress, contractual rights and goodwill.

The partnership agreement for GHI provides that no amount is payable or receivable when an individual professional practitioner (IPP) or an entity associated with the IPP, becomes or ceases to be a partner.

On 1 July 2012, the partners each contribute $100,000 in additional equity to GHI to enable GHI to purchase shares in an investment company.

On 30 June 2018, Mr Pham retires from GHI. He does not receive anything for his interest in the partnership.

Without further facts, the administrative treatment may not be available to Mr Pham. It would be necessary to investigate this arrangement further to determine whether the parties are dealing at arm's length. In particular, it would be necessary to determine why Mr Pham did not receive anything in respect of his shares in the investment company, despite having contributed significant funds to the partnership to enable it to acquire those shares.

Example 8: Merger of two professional firms: parties at arm's length

The JKL partnership (JKL) carries on a law firm, which has 40 partners who specialise in corporate, employment and family law matters. The assets of JKL comprise internally generated receivables, work in progress, contractual rights and goodwill. The partnership agreement for JKL provides that no amount is payable or receivable when an individual professional practitioner (IPP) or an entity associated with the IPP becomes or ceases to be a partner.

The MNO partnership (MNO) also carries on a law firm which has 4 partners and specialises in intellectual property matters. The assets of MNO comprise internally generated receivables, work in progress, contractual rights and goodwill. The partnership agreement for MNO also provides that no amount is payable or receivable when an IPP or an entity associated with the IPP becomes or ceases to be a partner.

JKL often refers intellectual property matters to MNO and as a result, the two firms have developed a close working relationship with each other. However, JKL believes it would be more efficient for both firms if their practices merged. MNO agrees and enters into discussions with JKL to discuss the terms of the proposed merger. The parties enter into a merger agreement that provides that no amount is payable or receivable when an IPP or an entity associated with the IPP becomes or ceases to be a partner in the merged firm.

For the purposes of applying the guidelines, the parties to the merger will not be treated as being in a non-arm's length relationship merely because of their pre-existing work relationship.

The administrative treatment will be available to the partners of MNO in relation to the CGT treatment of their part-interests in the assets of MNO when the MNO partnership merges if they treat the market value of those interests as nil for the purposes of determining:

- the capital proceeds in respect of their disposal
- their cost bases and reduced cost bases – to the extent that they were interests in partnership assets held by MNO when they acquired their initial interest in the partnership (for example, goodwill).

Furthermore, the administrative treatment will be available to the other partners of JKL in relation to the CGT treatment of their part-interests in the assets of MNO if they treat the market value of those interests as nil for the purposes of determining:

- the capital proceeds in respect of their disposal
- their cost bases and reduced cost bases – to the extent that they were interests in partnership assets held by JKL when they acquired their initial interest in the partnership (for example goodwill).

Example 9: Everett assignment: parties not at arm's length

A professional practice has 60 partners who share equally in the profits of the firm. The firm does not operate a service entity.

On 15 July 2017, the partners decide that it would be acceptable for the partners of the practice to enter into an Everett assignment if they choose to. On that date Mr A, a Partner of the practice, assigns 50% of his interest to the A Family Trust. The A Family Trust is a trust which Mr A effectively controls. The A Family Trust does not pay anything to acquire an interest in the professional practice from Mr A.

The administrative treatment will not apply to Mr A as:

- there is a non-arm's length relationship between Mr A and the A Family Trust and they are not dealing at arm's length as there was no consideration paid by the A Family Trust when Mr A assigned his interest
- the making of the assignment is not to a current or future practitioner or the professional practice.

Example 10: Incorporated practice: parties at arm’s length

On 1 July 2010, Ms Cannon became a practitioner-shareholder in X Pty Ltd (X), which carries on a professional practice. Under the X constitution, X shares are traded at a fixed price of $1 per share. Ms Canon purchases 10 shares. Assets of X comprise internally generated receivables, work in progress, contractual rights and goodwill.

Ms Canon decides to retire from the practice. X cancels the shares issued to Ms Canon and pays her $10 for her 10 shares.

The cancellation causes CGT events to happen to the shares held by Ms Canon. Capital proceeds in respect of the event are taken to be the market value of the shares at the time of Ms Canon’s retirement, worked out on the assumption that the cancellation did not and was not proposed to occur.

The administrative treatment will apply to Ms Canon in relation to her CGT treatment of the shares if she treats the market value of the shares as being $1 per share for the purposes of determining:

- the capital proceeds in respect of their disposal
- their cost bases and reduced cost bases.

Example 11: Employee share scheme

Young Pty Ltd (Young) is an incorporated professional practice. Under Young’s constitution, shares in Young are traded at a fixed price of $10 per share.

On 30 June 2018, Mr Young retires and Ms Old, a current employee practitioner within Young, is promoted and acquires an ownership interest in the firm.

The administrative treatment will apply to Ms Old in relation to her application of the ESS provisions to this acquisition. The market value of the shares is treated as being the same as the amount she pays such that no discount is taken to arise.

Example 12: Off market buy-back

Z Pty Ltd (Z) is an incorporated professional practice. Under Z's constitution, shares in Z are traded at a fixed price of $10 per share. Mr X acquires shares in Z at a fixed price of $10 per share and becomes a practitioner-shareholder in Z.

Several years later on 30 June 2018, Z has receivables, work-in-progress and goodwill. At this time, Mr X retires from Z and his shares are bought-back for $10 each and cancelled, as part of an off-market share buy-back.

The administrative treatment will apply to Mr X in relation to his tax treatment of the buy-back proceeds if he assumes that the buy-back price of the shares is not less than their market value for the purposes of subsection 159GZZZQ(2) of the ITAA 1936.

QC 48882

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