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Firm profits allocation guide ‘a very blunt instrument’

TAX

PCG 2021/4 resolves the risk issue for just a small sliver of cases, says BDO tax partner.

By Philip King•28 November 2022•6 minute read

The ATO’s risk assessment approach to professional firm profits in PCG 2021/4 is a “very blunt instrument” that will fail to resolve the risk issue in the vast majority of cases, says BDO tax partner Mark Molesworth.

He said the numbers would not add up for firms with a relatively large number of staff but few partners, even when their salaries were at the top end for the profession.

This “highly leveraged” situation had become more common over the past 20 years and that meant the tax office approach was already out of date.

“I'm worried that it's a little bit like the generals fighting the last war in that the professions have moved on, particularly the accounting and legal fraternity, and the focus is still on how it used to be,” Mr Molesworth said.

“The guideline is a very, very blunt instrument.

“At least the old guideline had three alternative tests ... it was a bit flexible. It worked well for the vast majority of people who were just running their business structure and fitted one of the three tests.”

However, PCG 2021/4 was complicated and worked only within a narrow range.

“The problematic part of the new PCG is that it applies two or three tests – it's complex,” he said. “When you actually sit down and do the numbers, it resolves the risk issue in a very small sliver of cases for the tax office.

“It works more sensibly in small firms with a relatively low staff-to-partner ratio. If you have a high staff-to-partner ratio, and your profits reflect that leveraged model … then it doesn’t work so well.”

“In a situation where you've got a small number of owners with lots of employees and therefore making lots of profit, the numbers don't add up.”

Under the PCG, individuals were trying to get to an average tax rate of 30 per cent but getting into the low-risk “green zone” required at least half the profits from the firm being assessed to an individual practitioner.

The case of BDO, for example, with 246 partners and more than 1,700 employees, the PCG worked poorly.

“It doesn't work so well in our circumstances, because it assesses people on what percentage of the overall profit of the organisation is taxed to the individual? And then what's the average tax rate across that individual’s group?”

“When you've got a large number of employees with a large profit coming through, by the time by the time you get to 50 per cent of the profits from the firm being taxed to the individual practitioner, they're probably up to about a 35-40 per cent average tax rate.

“Even if we pay the owners appropriately high salaries – salaries that are probably at least as high as the assistant commissioners in the tax office – then the numbers still don't work.”

Mr Molesworth said the PCG was meant to be focused on the individual but kept referring back to the firm.

“So it's a bit difficult because the firm ultimately doesn't have a lot of control over what individuals do in their in their personal tax affairs.”

But he said the PCG might change that.

“Firms, being very conservative, are not going to want to be seen by the tax office as pushing the boundaries because of something that their individual partners do.

“So the firms may need to get more interested in what the individual partners are doing.”

But despite this, he said many individuals behind highly leveraged firms would end up in the red zone, and then it became a question of whether to wait or contact the ATO first.

“People in those circumstances are going to have to go and talk to the tax office separately. And so the tax office is creating a fair bit of work for itself.”

That held its own jeopardy because audit teams would soon start treating the PCG as gospel.

“You have to make sure that discussion is with a sufficiently high level individual in the tax office because otherwise the PCG becomes the L-A-W as far as the audit teams are concerned,” he said.

“So it was supposed to be a risk analysis to work out whether you're going to apply compliance resources, but once you're in the sights of the tax office these PCGs have a habit of becoming – if you're not exactly in compliance with that percentage – then we're going to smash it.”