Professional practice structures: the Commissioner on the warpath?

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1. INTRODUCTION

1.1 It is no secret that the ATO has a particular interest in the way legal and accounting practices are structured.

Many of you will recall (some more painfully than others), the ATO ‘crack down’ on service trust arrangements several years ago, which resulted in the introduction of Taxation Ruling, TR 2006/2, together with a booklet outlining ATO guidelines on service entities should operate.

1.2 As a result of the ATO crack down on service trusts and also changes in legislation that allow accountants and lawyers to practice in company and trust structures, there have been a lot of practice restructures in recent years.

Not surprisingly, this increase in restructuring activity has attracted the attention of the ATO.

1.3 The front page headline in the Australian Financial Review on 24 September 2008 said that ‘the Tax Office widens crack down on lawyers, accountants’.

In a later address to the Canberra conference of the Tax Institute in March 2009, Deputy Commissioner Mark Konza delivered a paper titled Is the Tax Office Widening it’s Crack Down on Lawyers and Accountants?

In that paper, Mr Konza acknowledged that the ATO was examining practice structures of legal and accounting practices and said that ‘now that the use of service trust is generally within the law we have broadened our examinations, again, to look more widely at what is happening in these two professions’.

1.4 The taskforce the ATO set up to undertake the review of service trusts appears to have now turned its attention to practice restructures and, from recent discussions with the head of that group, my understanding is that the ATO intends to undertake a substantial number of reviews and audits of professional practices over the next few years.

It is reasonable to expect that practices that have recently restructured are the most likely targets for those reviews and audits and therefore it is important that you and your clients are aware of the issues that may be raised and how you might deal with them if and when an audit eventuates.

1.5 My purpose in this paper is to try to identify some of the main issues on which the ATO appear to be focusing when reviewing practice restructures.

2. ALTERNATIVE PRACTICE STRUCTURES

2.1 The primary alternative structuring models available for accounting and legal practices are:

(a) partnership of individuals;
(b) partnership of entities (such as trusts);
(c) use of Everett assignments;
(d) unit trusts; and
(e) incorporated practices.

I do not intend to set out any detailed discussion on the pros and cons of the alternative structures in this paper but will make some comments on limited specific issues.
2.2 The traditional model where practices were conducted by a partnership of individuals was largely a result of legislative and professional regulations that prohibited practices from being carried out other than by individual practitioners.

With the relaxation of these rules, and particularly the introduction of legislation allowing incorporated legal practices (ILPs), there has been a significant movement away from the individual partnership model.

2.3 A significant disadvantage of partnerships of individuals relates to the risk involved in being jointly and severally liable for claims against the partnership.

This risk is compounded because, if the individual derives their share of partnership income personally, there is a limited capacity to move the after-tax profit share into more sheltered structures (such as in the name of a spouse or a family trust) because of the claw back provisions in the bankruptcy legislation.¹

2.4 However the partnership structure still has significant appeal for small practices that may be eligible to apply the small business CGT concessions on sale of the practice or interest in the practice.

A common model that is emerging is for these practices to be set-up (or restructured) as partnerships of discretionary trusts, which provide a measure of asset protection (if there are corporate trustees) while still allowing significant access to the small business concessions on the disposal of practice assets or interests in the partnership.

2.5 A significant asset protection advantage of a trust structure is that if the income from the practice can be derived initially in a trust structure and then distributed to eligible beneficiaries in the normal way, then the after-tax practice income is almost immediately sheltered from any claims against the practice.

2.6 Moving to an incorporated practice structure provides some measure of asset protection, but the ability to achieve income splitting benefits (without the risk of a tax dispute) may be limited for many practices because of the very restrictive views of the ATO as to how these restructures should be implemented.

3. SOME RISK ISSUES

3.1 In this paper I do not intend to provide an exhaustive summary of all the available restructuring options or issues that arise from the implementation of these options.

I will focus on the following specific issues the ATO have flagged as being of concern to them either in public pronouncements or in the course of audit activity of which I am aware.

(a) Issues arising from conversion of a partnership structure to a company carrying on practice in its own right.

(b) ATO issues with partnerships of trusts (or where some of the partners are trustees).

(c) Specific problems for ‘no goodwill’ practices.

(d) Status of Everett assignments;

(e) What happens to the service trust if the practice is transferred to a company or trust structure?

¹ For example, sections 120 and 121 of Bankruptcy Act.
(f) Possible application of Part IVA if the restructure results in significant income splitting benefits.

3.2 It is also important to appreciate that legal practices that incorporate have an increased risk of being subject to ATO review or audit because it is necessary to register the ILP with the relevant state law societies and, as a result, the ATO can easily identify all of these restructures.

4. CONVERTING FROM PARTNERSHIP TO COMPANY

4.1 At one level it is fair to say that the ATO does not have particular concerns about partnerships that incorporate, but only where the ATO consider that the purpose of incorporation is essentially one of asset protection and to achieve improved administrative efficiency.

Where there is any hint of an income splitting the ATO will generally take a keener interest in the restructure.

4.2 Several years ago the ATO promulgated a template questionnaire that I understand is used as the basis for initial letters to newly incorporated practices selected for review. That letter identifies some key issues of interest for the ATO and requires information on a range of issues such as:

(a) details of the capacity in which each partner held their interest in the partnership;
(b) the reasons for the restructure;
(c) the capacity in which parties hold their interests in the practice entity after the restructure;
(d) any ‘post-restructure’ changes in the capacity in which parties hold their interests in the practice entity;
(e) whether all parties having an interest in the practice have the necessary legal/accounting qualifications;
(f) whether the business entity operates the business as nominee or manager for other entities;
(g) particulars of any capital gains arising on the restructure and how these were dealt with;
(h) if the partnership was a no goodwill practice, information to support application of IT 2540.

This issues list provides a useful pointer to the key issues that should be considered in implementing a restructure so that the practice is prepared to deal with an ATO audit.

4.3 Where a partnership practice has been transferred to a company and the partners have applied the rollover concession in subdivision 122-B of the 1997 Tax Act, the ATO will not be particularly concerned about the implications of the restructure but will put the taxpayers ‘to the proof’ to ensure that they have strictly complied with the rollover conditions.

This means that care will be required if incorporating an existing practice and claiming subdivision 122-B rollover.

4.4 In order for the subdivision 122-B rollover to apply:

(a) all the partners must transfer their interest in the relevant assets; and
(b) the shares that each partner receives in the new company must:

(i) not be redeemable shares; and
(ii) have substantially the same value as the interest each partner had in the partnership.

4.5 While these requirements seem reasonably straightforward, there will be cases where it may be difficult to satisfy the conditions because of the way in which some partnerships are structured.

4.6 For example, it is quite common to have equity and ‘salaried’ partners. Salaried partners will generally be included in the ‘partners’ who must transfer their interest in the partnership assets to the practice company. Care will be required to ensure the rights attaching to shares issued to ‘salaried partners’ are substantially the same as their interest in the partnership.

4.7 Also, many partnership agreements provide that a partner can be expelled by a vote of a special majority of partners. In the context of a corporate structure this would generally mean that the partner’s shares were subject to redemption. However, as the shares issued in the practice company cannot be redeemable, the constitution of the company will have to be drafted to ensure that this power of expulsion is implemented in other ways.

4.8 One requirement of the rollover under subdivision 122-B is that the partners must own the shares in the new company in the same capacity as they held their partnership interests. This necessarily means that incorporation in that context does not provide any opportunity for income splitting (at least initially).

Therefore, the primary goal of many practices that chose to incorporate and apply subdivision 122-B rollover may be just to achieve a measure of asset protection by removing the partners from a joint and several liability environment but the ongoing tax consequences will not be significantly different to continuing to practice as a partnership of individuals.

4.9 However, where the partnership as a whole elects to incorporate and apply subdivision 122-B rollover, this does not preclude individual partners from transferring their interest in the practice to another entity such as a family trust to achieve some income splitting. This could be done before the rollover (e.g. via an Everett assignment) or after by transferring shares. However, any transfer of partnership interests or shares following the restructure will have duty and CGT issues and is an issue that is on the ATO checklist. Also, as discussed later, if the practice does not recognise goodwill, any attempt by some partners to achieve income splitting benefits may impact on the other partners.

4.10 An alternative approach will be for the partnership to transfer the relevant assets of the partnership to a company and for each partner to apply the available CGT discounts (particularly the small business discounts available under Division 152).

For practices that can avail themselves of these concessions this may be an effective way to get an uplift in the cost base of their interest in the practice without triggering any material tax consequences.

However, the ATO will closely examine the transactions to ensure that the partners satisfied the basic conditions required to apply the small business concessions.

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2 *Stekel v Ellice* [1973] 1 All ER 465 and *Walker v McLelland* - NSW Supreme Court, Equity Division, 24/2/1988 - unreported
5. **ATO VIEW ON INCOME SPLITTING AND POSSIBLE APPLICATION OF PART IVA**

5.1 If all or some of the partners elect to take their shares in the practice company in a trust or another related entity and thus achieve an income splitting benefit, the ATO is likely to raise questions about the objectives of the restructure and Part IVA may be an issue.

5.2 In his March 2009 paper, Mark Konza indicated that one area of interest for the ATO when reviewing practice restructures was where ‘accountants or lawyers contribute, and work, at a partner level but derive less gross income than the employees of the same firm, or where a partner’s taxable income is well below the industry norm for a similar practice’.

He also said that:

‘Conceptually, the Tax Office’s interest in any taxpayer may be summarised as being the need to understand the economic performance of the taxpayer, their comparative taxation performance and the reason for any material discrepancy. Put another way, we are seeing partners in professional practices who are returning incomes which are very low compared to partnership profits.’

5.3 Therefore, if after a restructure, principals who had previously been deriving the bulk of the partnership income suddenly have a much lower assessable income, there is a material risk that this will attract the attention of the ATO.

5.4 This risk will be mitigated if the parties ensure that principals receive an economic return from the practice after the restructure which, to use Mark Konza’s words is commensurate with ‘the industry norm for a similar practice’.

5.5 If the ATO considers that the restructure has achieved significant income splitting benefits and that, after the restructure, the income derived by the principals is not commensurate with ‘the industry norm’ then the ATO may raise Part IVA.

5.6 The ATO has not historically applied Part IVA to arrangements involving the disposal of income producing assets from one entity to another or to restructures involving the selection of alternative tax entities.

The *CCH Australian Federal Tax Reporter* suggests that ‘In general, the Commissioner considers that Part IVA will not apply in a true business situation (as opposed to a personal services business) where the assets of the business are transferred to a family company or trust which then carries on the business for the benefit of family members’.

Also, in *Everett* and subsequent rulings on Everett assignments, the ATO did not seek to invoke section 260 or Part IVA.

In *Taxation Determination TD 95/4* the ATO posed the question whether a ‘simple disposition of an income producing asset by a natural person to a wholly owned private company’ would trigger Part IVA and concluded that it would not.

In that determination the ATO specifically acknowledged that the intention of the arrangements would be to allow earnings on shares to be retained in a company tax environment rather than assessed to the individual.

5.7 However, recent history suggests that the ATO may not adopt such a benevolent approach when considering restructures of legal and accounting practices and caution is required.

5.8 The approach adopted by the ATO in TR 2006/2 (on service trusts) perhaps provides some guide posts in this context. In that ruling the ATO did accept that, when considering Part IVA ‘asset protection does make objective business sense where an arrangement has the effect of

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3 p 48-494
4 Taxation Ruling IT 2501
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Protecting assets but that it is more likely Part IVA will apply where ‘service fees are excessive and not negotiated in a commercial manner’.

This suggests the risk of a Part IVA attack may be diminished if the level of income that the principals derive after the restructure is commercially realistic.

In particular, Mark Konza highlighted that arrangements where principals are paid less than employees in the practice will be targeted.

5.9 Therefore, at a minimum you should ensure that the share of practice income that each principal receives is at least equal to the remuneration of the senior fee earners in the practice.

5.10 It is not necessary that the practice company or trustee pays salaries to principals as this may trigger a payroll tax liability.

The ATO focus is on the level of income derived by principals after a restructure and, in my opinion, it should not be necessary that the practice entity pays salaries to principals in order to reduce the risk of an ATO attack.

For example, the ATO accept that where a trust is used to carry on a professional practice generating personal services income, this will be acceptable provided that the practice profits are distributed to the practitioner as a beneficiary.5

6. PARTNERSHIPS OF TRUSTS

6.1 As a result of the relaxation of restrictions on who can practice as accountants and lawyers, many firms have elected to carry on practice in a trust structure.

The model many firms have adopted is to operate through a partnership of trusts rather than a unit trust as the partnership model will generally give better access to the small business CGT concessions.

In order to maximise the asset protection benefits of the trust structure, many firms will have a corporate trustee(s).

For ease of administration where there are multiple principals, there is often a preference to have a single company as the ‘face of the firm’ rather than having a large number of corporate trustees that have to be disclosed on firm documents.

This is usually achieved by appointing a single company to hold the goodwill and operate the practice as the ‘nominee’ of the partners or to have a single company that acts as trustee of all the trusts that make up the ‘partnership’.

6.2 The ATO has flagged that it has concerns about arrangements involving partnerships of trusts. The main areas of concern appear to be as follows:

(a) The ATO maintains that where a nominee holds an asset as nominee of a partnership, the nominee arrangement constitutes a trust and the partners are beneficiaries of that trust. This may significantly impact on the ability of the parties to apply the small business concessions.

(b) In his March 2009 speech, Mark Konza indicated that ‘it might be questionable whether the trust is capable or actually involved in the ‘carrying on a business in common with a view to profit’ as required under the various state partnership acts.’

5 IT 2503 - paragraph 34
(c) I am aware of several audits where the ATO has questioned whether an arrangement where a party is a partner in a partnership in different capacities (e.g. in their own right and as trustee for a trust) is effective.

6.3 There are issues where a company acts as nominee for the partnership.6

(a) There are a number of cases where the courts (and the ATO) appear to have accepted that there can be a partnership for tax law purposes even though the trust property is held in the name of a nominee.7

(b) Also there is authority that a person will still be held to carry on a business even though a manager is appointed to operate the business.8

(c) However, the ATO has indicated in Taxation Determination TD 2005/28 that syndicates that are ‘registered managed investment schemes’ should be treated as trust estates and therefore taxed under division 6 of the 1936 Tax Act and not as partnerships under division 5.

It is arguable the determination should be confined to registered managed investment schemes as it appears to be based on the fact that section 601FC(2) of the Corporations Act stipulates that the responsible entity of a registered scheme, holds the scheme property ‘on trust’ for scheme members.

(d) Colonial First State Investments Limited v FCT9 involved a situation where interests in a head trust were held by a custodian for a sub-trust. The court determined that the trustee of the sub-trust was the beneficiary of the head trust – not the custodian.

This is inconsistent with the ATO argument that partners whose assets are held by a nominee have an interest as beneficiaries in a trust rather than a direct interest in the assets as partners.

In the decision impact statement on the Colonial First State decision, the ATO, acknowledged there is some uncertainty as to the correct tax treatment where assets are held by a nominee and noted that reform options to address this issue are discussed in the options paper released in November 2011 in relation to modernising the taxation of trust income.

However, the ATO indicated that until any reforms are actually introduced, they will continue to apply their view that a custodian arrangement creates a separate trust estate that is subject to Division 6 of the 1936 Tax Act – except for cases on all fours with the facts in Colonial First State.

(e) Even, if the appointment of a nominee creates a trust estate, there are good arguments that, for CGT purposes, any dealing with the practice assets should be treated as a dealing by the partners as they will be ‘absolutely entitled as against the’ nominee – which would preserve their ability to claim the small business concessions.10

(i) In TR 2004/D25, the ATO argue that where there is more than one beneficiary, those beneficiaries are not absolutely entitled to the trust assets unless the assets are ‘fungible’ (paragraph 90) and clearly, practice goodwill is not a fungible asset. However there are strong arguments that the ATO view is incorrect.

(ii) The key element which must be satisfied for section 106-50 to apply is that the capital must be ‘absolutely entitled to the CGT asset as against the trustee’. Unlike

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6 See also Wynnum Holdings v FCT
7 A.R.M. Constructions Pty Ltd v FCT 87 ATC 4790 and Ryvitch v FCT 2001 ATC 4403.
8 Howland Rose & Ors v FCT 2002 ATC 4200 and Hance v. FCT [2008] FCAFC 196
9 [2011] FCT 16
10 Section 106-50 – 1997 Tax Act
section 104-55, there is no additional requirement that that beneficiary is the ‘sole beneficiary’.

(iii) The expression ‘absolute entitlement as against the trustee’ is taken from similar provisions in the UK legislation and there have been some case authorities as to what it means in that context.

(iv) The commentaries and cases appear to suggest that there will be an absolute entitlement if the beneficiaries are entitled to demand immediate transfer of the trust asset from the trustee and can give a good and valid discharge and that this requirement can be satisfied if there is more than one beneficiary.11

For example, in Booth the Court considered that it was possible for several beneficiaries to be ‘jointly and absolutely entitled as against the trustees to the assets vested in the trustees’.

(v) In GSTR 2008/3 the ATO acknowledge that where an entity holds an asset as nominee for several parties and ‘has no discretion regarding the use and disposal of the trust property’ then the entity that holds as nominee is a bare trustee12 and that this principle applies ‘regardless of whether there is a single beneficiary or multiple beneficiaries of the bare trust’.13

6.4 The Mark Konza issue – ‘whether the trust is capable or actually involved in, the ‘carrying on a business in common with a view to profit’:

(a) It is difficult to understand the ATO concerns on this issue but I am aware of one audit of a legal firm where the ATO argued that a transfer of partnership interests to partners acting as trustee was invalid because the same individuals were purporting to act as partners in their own right and also as trustee of a trust.

I also understand that the Federal Court has heard a matter involving similar issues but that the decision has not yet been handed down.

(b) In the ATO position paper for the audit referred to above, they conclude that a natural person acting in the capacity of trustee can become a partner in that capacity, but argue that there are ‘legal difficulties’ where the same person holds a partnership interest in their own right and also as trustee.

The ATO conclusion in the position paper in that case was that, in Queensland at least, ‘it is not valid or enforceable for a partnership to be comprised of a legal personality acting as partner in their capacity as an individual while at the same time acting as a partner in their capacity as trustee’.

(c) The reasoning of the ATO in that position paper is confusing to say the least and is inconsistent with the decision in Everett14 where the High Court had no difficulty in accepting a situation where a partner retained some of their interest in the partnership in their own right and held the assigned portion on trust for the assignee under the Everett assignment.

(d) The ATO arguments also misinterpret the provisions in the Property Law Act 1974 (Qld) which are intended to allow parties to deal with themselves in different capacities.

Legislation in the other states contains similar ‘self-dealing’ provisions.

12 paragraph 13
13 paragraph 84
14 [1980] HCA 6
The ATO argument that a person cannot act in their own right and as trustee in the context of a partnership arrangement appear to rely solely on their interpretation of section 14 of the *Property Law Act* - which refers to leases and conveyances.

In particular, the ATO rely on section 14(4A) which says that, if a person in whose favour a conveyance is made is precluded from validly carrying out the transaction because of a fiduciary relationship, then the conveyance or lease ‘shall be liable to be set aside’.

The section does not say the transaction is void but merely that it would be liable to be set aside – presumably only in the event of a complaint by the person to whom the fiduciary relationship was owed.

(e) The ATO position also ignores the provisions of both section 50 of the *Property Law Act* and section 59 of the *Trusts Act 1973* (Qld).

Section 50 clearly states that an agreement between a party and themselves with one or more other parties can be capable of being enforced and section 59 of the *Trusts Act* provides that a trustee may sue themselves in a different capacity.

(f) In *Browne v Commissioner of State Revenue*15, the court clearly held that section 50 of the *Property Law Act* provided that contracts between a person and themselves and another person were enforceable and, importantly (in view of the ATO position in the audit position paper referred to above), also commented that section 14 of the Act similarly authorised transfers of property from an owner to the owner and another.16

(g) Therefore, it is difficult to understand why the ATO adopted this position I understand that they may be reconsidering whether to pursue the argument.

6.5 A practice structured as partnership of trusts with a single corporate trustee has the following implications:

(a) The position is somewhat more difficult where a practice is structured as a partnership of trusts, but with a single corporate trustee.

(b) It does seem clear that such a structure does not actually qualify as a ‘partnership’ as the definition of partnership in the tax legislation requires that there must be ‘an association of persons’.17

If there is only one legal entity (a company) then there is not an association of ‘persons’.

While the *Acts Interpretation Act* 1901 provides that, in any commonwealth act, ‘words in the singular include the plural’18 this is qualified by section the requirement in section 2 that the application of the Act is subject to a contrary intention.

Given that the expression used in the definition of partnership in section 995-1(1)) is to an ‘association of persons’ it seems clear that the context requires more than one person and that the general rule that the plural includes the singular and vice versa will not apply.

While each trust estate is a separate entity for the purposes of the tax legislation19, the requirement in the act is that there is an association of persons, not an association of entities.

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15 [2002] QCA 388
16 paragraph 11
17 995-1(1)
18 Section 23
19 Section 960-100
(c) In *Fagenblat v Feingold Partners Pty Ltd*\(^{20}\) the court was prepared to allow litigation to proceed on the basis that a legal practice was carried on by a partnership or trusts where each trust had the same trustee.

(d) There are also instances where the ATO has accepted an arrangement involving a ‘partnership’ of trusts with the same trustee in the past\(^{21}\) but it seems clear that they will challenge such arrangements where the structure involves legal or accounting practices.

For example, in discussions with ATO officers undertaking an audit I am currently advising on, they have indicated that the ATO does not accept that it is possible to have a partnership of trusts with a single trustee.

However, I am not aware of any litigation pending on this issue or exactly what the ATO considers will be the practical consequences if such a structure does not qualify as a partnership.

(e) Irrespective of whether a grouping of trust estates with a single trustee qualifies as a partnership, it is difficult to see that this will result in any materially different outcome from an income tax or capital gains perspective.

Even if there is not a partnership, the operation of the tax acts will still result in each trust estate deriving a share of practice income and any capital gain as each trust estate is a tax ‘entity’.

(f) The problem that practices structured in this way may have if they are audited is that the ATO may argue that they are incorrectly registered for GST purposes. For example, if the parties have registered as a ‘partnership’ the ATO may argue that the incorrect entity has been registered and GST has not been properly accounted for.

While this may not impact on the actual amount of GST payable, this approach could result in significant penalties and interest.

(g) In view of the current uncertainty, practices and clients who have adopted this type of structure should consider alternatives that will reduce the risk of an ATO attack. For example, if each trust had the same two trustees, there would be an association of ‘persons’ carrying on the business and it would therefore be arguable that the structure satisfied the requirements for a partnership.

7. **SO WHAT DO YOU DO WITH YOUR SERVICE TRUST?**

7.1 The risks associated with operating a service trust with profit margins in excess of the ATO guidelines means that, for many practices, continuing to operate a service trust is not an effective option and this is one of the drivers to move to a trust or company structure.

7.2 However, it is important to consider what will happen with the service trust structure if an existing partnership is converted to a trust or corporate entity as, in one audit that I have been involved in, the ATO expressed a number of concerns about the way in which the service trust assets were dealt with.

7.3 The first question is whether there may be sound commercial reasons for retaining the service trust structure.

The arguments that were relied on by the taxpayer in *Phillips case*\(^{22}\) still hold true. For most professional practices, while there may not be significant tangible assets, there would be a substantial cost if the practice had to re-establish itself.

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\(^{20}\) [2001] VSC 479.

\(^{21}\) ATO ID 2005/43 (since withdrawn).
That is, what I refer to as the ‘practice infrastructure’ can have significant value, not so much in terms of resale value, but in terms of replacement costs.

Therefore, the objective of protecting that infrastructure and ensuring that some or all of the practitioners have the ability to continue in another practice structure if there is a large claim against the firm, may still be important.

It is always sobering to recall that the firm of which Phillips was a taxpayer was subsequently placed in receivership as a result of being sued following the collapse of a major finance company.

7.4 The benefits of protecting the practice infrastructure have to be weighed up against the additional cost involved in continuing to operate two entities. If there are good commercial reasons to retain the practice entity structure, then it may be simpler to run the service entity as a not for profit business after the practice restructure.

7.5 In a recent audit of a professional practice that had been corporatised, the ATO floated the argument that the service trust had transferred its business assets to the ILP and that, because the service trust had been profitable, there must be some goodwill associated with that business and that the capital gain arising from the transfer of that goodwill had not been accounted for.

In circumstances where the practice entity simply stops outsourcing the services provided by the previous entity, it is difficult to see how there could be a disposal of goodwill.

However, it is important to be aware this may be an issue the ATO will raise.

This possibility may itself be a good reason to retain the service entity structure – at least for a period.

7.6 Another issue that the ATO has floated in an audit I have been involved in is that, if the service entity is terminated and all practice assets are transferred to a single entity, this is in direct conflict with the argument that the commercial justification for the service trust arrangements was ‘asset protection’ may not be sustainable.

This could be an issue if, at the time of the ‘restructure audit’, the ATO is still in time to review assessments for years in which the service entity was operating.

8. NO GOODWILL PRACTICES

8.1 The issue which appears to be causing most concern in the context of practice restructures relates to the CGT implications where a ‘no goodwill’ practice is restructured.

8.2 The ATO has accepted for many years that where partnership interests are transferred as a result of normal partner exit and entry arrangements, these transactions will generally be on an arm’s length basis and, if the partners agree there is no goodwill value in the practice, the ATO will not attempt to impute a market value for goodwill.23

The ATO has recently issued a final and several draft determinations indicating that they will adopt a similar approach in relation to no goodwill practices which have incorporated but only in situations where there is a dealing in relation to shares in the company.24

However, the ‘concession’ granted by the ATO in that ruling is subject to reasonably stringent conditions. The explanatory part of the ruling indicates That for a partnership to take advantage of the ‘no goodwill concession’ in IT 2540 it must satisfy the following conditions:

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23 IT 2540
24 TD 2011/26 and TD 2011/D9 and D10
(a) the partners in the partnership are all natural person practitioners who hold a fractional interest in the 'no goodwill' partnership;

(b) the acquisition or disposal of an interest in the partnership must be reflective of that person's status as an active practitioner in the practice and held by that person both legally and beneficially; in this context 'active partner' will include managing partners who do not undertake client work and non-practitioner consultants (for example legal counsel in an accounting firm);

(c) the partnership has capital which reflects merely a nil or immaterial value for goodwill, except in circumstances where the partnership has taken over another practice with goodwill, and such acquired goodwill remains on the partnership's books; in that circumstance, provided the partners cease to recognise that goodwill in dealings between themselves for the admission and exit of partners this condition will be satisfied;

(d) the partnership adopts an agreement that regulates the basis for admission and exit of partners and the amount that is paid for it; and

(e) the partnership agreement provides that no or an immaterial payment is to be made for acquiring a partnership interest, disposing of a partnership interest or any change to the profit distribution entitlements attached to an interest in the partnership, in respect of goodwill.

8.3 The ruling also indicates that similar requirements will apply for incorporated practices (with necessary modifications to accommodate a corporate structure).25

8.4 The effect of these conditions is that the ATO is arguing the value of an asset can vary depending on the capacity in which a person holds the asset or the capacity in which other parties own interests of the same character.

While it is difficult to see how the ATO's position can be correct, the reality is that principals in 'no goodwill' practices will need to make a conscious decision whether they comply with the ATO conditions in order to avoid a dispute.

8.5 The ATO has also indicated in a number of forums that, where the entire practice is assigned from an existing entity (usually a partnership) to a new entity (trust or company) then, even though the partners themselves may not recognise goodwill, there is goodwill that can be valued and that the market value substitution rule will apply.

This is a substantial obstacle for larger practices that may be considering incorporation because the ability of the partners to apply the small business concessions in those situations will either not exist or be very limited.

While the ATO position is questionable, the reality is that practices that elect to incorporate or convert to a trust structure will have to accept the likelihood that, irrespective of whether they recognise goodwill, the ATO is likely to argue that the market value substitution rule applies and to assess on a capital gain based on the market value of the goodwill.

In many cases, the terms of the practice partnership or stakeholder agreement may be an obstacle to disputing the Commissioner's position because many agreements stipulate that, although goodwill is not recognised, the principals are still subject to restraint of trade covenants.

If the principals continue to be subject to those restraints once the practice is transferred to a company or trust structure, there may well be an argument that there is a market value for the goodwill of the practice, bearing in mind that the definition of 'market value', which is generally

25 Paragraph 3
accepted is the price that a willing but not anxious purchaser would have had to pay to a vendor who was not unwilling but not anxious to sell.26

A similar test was adopted by the High Court in *Abraham v FCT.* 27 If a practice is a genuine no goodwill practice and the principals agree that none of them is subject to any restraint of trade covenant in the event of their retirement from the practice, then it will be more difficult for the Commissioner to successfully contend that any significant market value should be attributed to goodwill.

It must be at least arguable that a willing but not overanxious buyer is unlikely to be prepared to pay a material amount for goodwill where all of the principals of the business are free to compete with the business immediately after the sale.

8.6 Therefore, partnerships that are considering restructuring need to weigh up the potential tax arguments that they may have in terms of goodwill issues if they accept that they are not subject to any restraint of trade after the restructure as opposed to the commercial benefits that they may see which will arise if restraints remain in place.

8.7 There is an ancillary issue for non-goodwill practices which purport to impose restraints of trade on partners or principals.

If the partnership or company documents stipulate that there is no goodwill or that the goodwill has a minimal value, there may be a threshold question of whether the restraint of trade covenant is enforceable in any event because restraints are generally only enforceable if they protect goodwill and go no further than is necessary to protect that goodwill.28

The better protection that a practice has in those contexts where there is a ‘rogue partner/director’ is more to rely on the duties of good faith and fiduciary obligations that partners and directors are subject to.

9. EVERETT ASSIGNMENTS

9.1 I do not wish to spend a lot of time in discussing Everett assignments. However, it is relevant to note that implementing an Everett assignment can achieve income splitting benefits using an approach that has been accepted by the courts.29

9.2 In *Everett*, the High Court held that the effect of an Everett assignment was that the assigning partner becomes a trustee of the assignee.

9.3 In IT 2501 the ATO stated that ‘Valid assignments on all fours with the Everett or Galland decisions will be accepted for tax purposes and will not be regarded as caught by section 260 or Part IVA’

The ATO subsequently issued *Taxation Ruling IT 2540* outlining its views on the CGT implications of an Everett assignment (albeit when these provisions were contained in the 1936 Act). The ATO view is that, the value of a partnership interest that is assigned under an Everett assignment is to be determined by applying a net present value approach based on the maintainable future earnings based on the decision in the stamp duty case of *Reynolds v Commissioner of State Taxation (WA).*30

9.4 Therefore, the possibility of implementing an Everett assignment should be at least one of the options considered in any restructure, particularly given the comments in IT 2501 that Part IVA will not apply.

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26 *Spencer v The Commonwealth* (1907) 5 CLR 418
27 (1944) 70 CLR 23
28 *Amoco Australia Pty Ltd v Rocca Bros Motor Engineering Co Pty Ltd* (1973) 133 CLR 288
29 *FCT v Everett* ([1980] HCA 6
30 86 ATC 4528
However, it is critical to appreciate that the ATO comments on Part IVA are subject to the caveat that the restructure must be ‘on all fours’ with the transactions in Everett or Galland.31

10. DUTY ISSUES

10.1 Any restructure involving a transfer of practice assets or an Everett assignment may have duty implications in those states that still impose duties on dealings with business assets – which include Queensland and New South Wales.

10.2 In Queensland the Office of State Revenue (OSR) adopt a similar position to the ATO and argue that, irrespective of whether the principals recognise goodwill, if there is a transfer of the practice (or an interest in the practice under an Everett assignment) then duty will be assessed on what they contend is the ‘market value’ of goodwill.

10.3 The approach of the OSR in relation to ‘partner to partner’ dealings in no goodwill practices seems to be somewhat inconsistent. I am aware of some cases where they have argued that the dutiable value of the partnership interest includes some value for goodwill and others where they have adopted a similar position to the ATO in IT 2540.

10.4 In assessing Everett assignments the OSR relies on the decision in Reynolds and calculates the value of the partnership interest as an amount equal to the net present value of maintainable future earnings.

10.5 In Queensland, the OSR have adopted a ‘template’ valuation formula that they will accept to determine a value of goodwill.

This involves applying a capitalisation rate of between 20-25% of average ‘consolidated’ partnership profit for the previous three years after allowing an adjustment of notional partner salaries and deducting the value of tangible assets.

10.6 The OSR considers this approach is applicable even if the practice does not recognise goodwill and irrespective of whether the principals are subject to restraint covenants.

10.7 I am aware of a number of current disputes between legal firms and the OSR in Queensland but it will be some time before it is clear whether any of the firms are prepared to litigate the issues.

11. CONCLUSION

The issues canvassed in this paper demonstrate that there are many pitfalls for practitioners who implement a restructure.

Possibly the most frustrating aspect of the restructuring minefield is that both the ATO and state revenue offices appear to have decided that legal and accounting practitioners should be treated differently to the wider business community.

In particular, the requirements imposed by the ATO in IT 2540 and TD 2011/6 as a condition of accepting transfers of interests in no goodwill practices are tantamount to administrative blackmail.

Unfortunately, this means that practitioners who want to restructure and deal with tax issues arising from the restructure by applying the rules that apply to their clients face an increased risk of audit and the likelihood of a dispute with the ATO or OSR or both.

31 86 ATC 4885
This paper is only intended as a general overview of issues relevant to the topic and is not legal advice. If there are any matters you would like us to advise you on in relation to this paper, please let us know.