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Successful Structuring for Professionals

A guide for choosing the right business structure for your professional needs

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Gone are the days when professional practices were restricted to the traditional partnership structure. Regulatory changes have allowed most professionals to choose from a wide range of practice structures.

Each of the structures has different legal and economic implications. It is important that you choose a structure which suits the goals and needs of the practice and the individual professionals.

Professional regulations will impact on structuring decisions, and may limit the types of practice structures which are available in your industry.

Choosing a professional practice structure is not just a decision you make when operations begin.

Professionals should review their practice structure to ensure that it is tax effective and maximises asset protection.

For professionals in existing practices, the challenge becomes how to move out of one structure into another with minimal transaction costs.

The purpose of this eBook is to outline the features, advantages and disadvantages of different structures, along with other factors that you need to consider.

This eBook provides a simple summary of these issues, but it is important to keep in mind that this is a complex area of accounting and law.

There is no substitute for professional legal and accounting advice.

We hope that you can use this eBook as a guide to understanding professional practice structuring so that you can communicate your unique needs to your advisors.

Income Tax Ruling System

The Taxation Ruling system was introduced in 1982. Public rulings are now binding on the Commissioner where an entity to which the ruling applies relies on the ruling. Rulings do not conclusively state the proper application of the tax law, and may be overturned by the courts in the event their subject matter is litigated.

For the standard series of public rulings, the type of ruling is indicated in the title, for example:

- TR – taxation ruling
- TD – taxation determination
- GSTR – GST ruling
- PR – product ruling
- CR – class ruling

An IT ruling is one that was published prior to 1982, before the new ruling system was introduced.

Part IVA of the *Income Tax Assessment Act 1936*

Part IVA of the *Income Tax Assessment Act 1936*, frequently referred to as the "general anti avoidance" provisions, contains the Commissioner's "catch all" powers for identifying and recovering under reported tax liabilities where such under reporting is not otherwise made expressly unlawful by operation of the tax law. Part IVA operates by identifying a "scheme" that has the effect of causing a taxpayer **to obtain a tax benefit otherwise** not reasonably available to the taxpayer. Where a scheme is **identified, the Commissioner** may amend the tax return of the offending taxpayer to reverse the **effect of the tax benefit. Penalties** and interest may also be applied in connection with the amendment. In considering professional practices, the Commissioner's chief concern is the attribution of income of the business for taxation purposes to individuals or other legal identities aside from **a practitioner chiefly responsible** for generating income. In such cases, income splitting amongst a practitioner's associates may be used to achieve a lower liability to tax than if the income had been taxed solely in the hands of the practitioner. These cases may constitute a scheme for Part IVA purposes.

Division 7A *Income Tax Assessment Act 1936*

Division 7A is part of the *Income Tax Assessment Act 1936* and **is intended to prevent profits** or assets being provided to shareholders or their associate tax **free. A payment or other benefit** provided by a private company to a shareholder or their associate can be treated as a dividend for income tax purposes under this division, even if the participants treat it as some other form of transaction such as a loan, advance, gift or writing off a debt. It may also apply when a private company provides a payment **or benefit to a shareholder or** associate through another entity, or if a trust has allocated income to a private company but has not actually paid it, and the trust has **provided benefit to the company's** shareholder or associate.
Division 7A doesn't apply to amounts that are assessable to the shareholder or their associate under other parts of the income tax law, such as normal dividends or director's fees.

Capital Gains Tax (CGT) Discount

The general CGT discount pursuant to section 115-A of the *Income Tax Assessment Act 1997* (Cth) may be available. This discount allows you to reduce your capital gain for assets held for 12 months or more before the relevant CGT event. The general CGT discount is 50% for individuals (including partners in partnerships) and trusts, and 33 1/3% for complying super funds. This is not available to companies.

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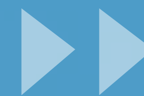
Professional Practice Structures



Choosing the right structure requires the consideration of a range of components, including:

Administrative efficiencies

A professional practice needs to be structured in a manner which is **flexible, efficient and simple to run.**

Funding

Debt and equity funding issues need to be considered. For example, companies can access both debt and equity funding.

Asset protection

Asset protection refers to the capacity of a particular structure to safeguard the assets of a practitioner from activities and claims against their business.

Assets may include real estate, **equipment, undrawn profits and** intellectual property.

Taxation

Income tax and stamp duty are high priority considerations when choosing an appropriate structure for a professional practice. Each structure has unique tax implications. The income of a business is made up of different components, including a combination of income from work undertaken by the personal exertion of professionals and income generated by the business structure (for example, by employees).

Income can be derived from a wage payment for services, a direct interest (for example as dividends from shares in a company), or indirectly through a trust distribution. For some professionals, the Personal Services Income regime will apply. We have provided a brief summary of this regime on page 26. Capital Gains Tax implications will also be important if your business owns CGT assets, such as real property.

Some other considerations include:

1 Limitation of liability

Professional standards legislation exists in each state and territory and is recognised by certain Commonwealth legislation. In NSW, the *Professional Standards Act 1994* and the *Professional Standards Regulation 2014* are the relevant provisions.

This legislation provides for the capping of liability pursuant to schemes **approved by the Office** of Professional Standards Councils. This limit would be set at a level that all consumer and most corporate claims would be able to recover.

The major benefits of professional standards legislation include:

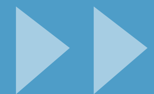
a. Giving consumers certainty that insurance is in place to meet successful claims;

b. Lowering the risk of consumers engaging uninsured service providers **without sufficient assets to** satisfy a claim for damages;

c. Reducing the decline in professionals not willing to practise because the risk is too high.

A list of industries that have a limited liability scheme can be found on the Professional Standards Councils website.

It is important that the requirements of access to these schemes are considered when choosing a practice structure.



2 Control

Each structure allows for different levels of control over the practice. For example, a sole trader has total control of the control of the practice.

Alternatively, in a partnership, control or management of the business is shared.

3 Exit and entry, and transfer of interests

Consideration should be given to how easy it is for professionals to enter and exit the practice, and how interests can be transferred.

4 Succession and estate planning

It must be contemplated how the business can be passed to another person or group on retirement and in the event of death.

5 Income splitting

It must be considered whether splitting income between multiple persons could allow for tax advantages.

Income splitting arrangements can either be challenged under the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act 1936* (Cth), or the personal services income (PSI) rules in Part 2-42 of the *Income Tax Assessment Act 1997* (Cth).

Further, tax rulings such as TR 2006/2 have restricted the capacity for service entities to facilitate income splitting. Service entity safe harbour provisions also apply to practice income being generated by a business structure.

The ATO states that taxpayers will be rated as low risk and will not be subject to compliance action where their circumstances satisfy one of three tests.

If the entity is unable to satisfy any one of **three tests, the entity will be classified as high** risk and potentially subject to ATO review.

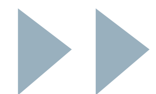
6 Relationship breakdown

The structure of the practice will impact on any future family law disputes involving a professional.

Some structures may provide more protection than others for relationship breakdown.

For example, a sole trader structure does not provide any protection from relationship breakdown issues.

On the following pages, we explain the different types of structures outline how they can impact on the factors listed above.



What is a 'sole trader' or 'sole proprietor'?

A 'sole trader' involves a person trading as an individual. This means that the proprietor is legally responsible for all aspects of the business, including all assets, liabilities, income, and losses.

Asset protection

One of the key disadvantages to running a business as a sole trader is that the proprietor has unlimited liability for debts and negligence committed in the course of doing business. This includes the liability of employees. If something goes wrong, all of the sole proprietor's business and personal assets are at risk. This means that the proprietor's personal assets can be seized to pay a debt.

Taxation

One of the problems with this structure is that the line between business and personal affairs becomes blurred; business equity and assets are often used for personal purposes. For this reason, quality record keeping is imperative to ensure that business deductions can be properly claimed. The proprietor is entitled to all of the profits of the business. Tax is usually paid as PAYG instalments on business income. Income is taxed in the hands of the individual. There are no opportunities for income splitting, or retaining profits within an entity. The general CGT discount is available.

This is the easiest structure to set up. Usually, only registration of an ABN and business name is required. The sole trader structure can be attractive due to its simplicity, low set up costs, and the fact that the proprietor has full control of the business. The proprietor makes all management decisions, and can hire employees.

Funding

Sole traders can only inject capital from their personal savings, or seek further debt funding.

Partnership

What is a partnership?

A partnership arises when at least two people, or incorporated entities, operate a business together. This is a common structure for professional practices.

Generally, partnerships can have up to 20 general partners with some exceptions. **Regulation 2A.1.01 of the Corporations Regulations 2001 specifies** the following exceptions:

Kind of partnership	Max no. of partners
Actuaries, medical practitioners, patent attorneys, sharebrokers, stockbrokers, or trademark attorneys	50
A partnership that has a primary **purpose of collaborative scientific** research and includes in its members: at least one university, and at least one private sector participant	50
Architects, pharmaceutical chemists or veterinary surgeons	100
Legal practitioners	400
Accountants	1000

Partnerships are made up of a group of individuals or entities. However, to trade with a single identity, partnerships can use a trading name or corporate agent. The appointment of a company agent is used to act on behalf of the partnership of trusts for administrative purposes, such as entering into contracts on behalf of the partnership.

Asset protection

This structure provides little protection for assets from claims against an individual partner, as each partner personally shares an interest in the assets of the business.

Joint and several liability can often be an issue as the actions of one partner potentially bind all partners to an obligation to perform a function or pay a debt.

Under partnership law, general partners will have unlimited liability for claims against the partnership.

However, some professional bodies provide access to limited liability schemes (see page 3).

According to section 33 of the *Partnership Act 1892* (NSW), a partnership will automatically dissolve on bankruptcy (or death) of a partner.

Therefore, considerations for partnerships in bankruptcy will be the same as sole traders.

You can shift the profits to another entity (e.g. trust, company), but this may not be effective to protect the assets against bankruptcy.

Pursuant to the 'clawback' provisions of the *Bankruptcy Act 1966* (Cth), a transfer will be void if the main purpose was to prevent property from being distributed to creditors.

Furthermore, clawback provisions can void uncommercial or undervalued transactions for transfers of property which occurred up to 5 years before bankruptcy.

Income Taxation

A partnership for tax law **purposes is a legal fiction and** does not have a separate legal existence apart from its members.

The partnership comes into existence from the time that the persons jointly commence an activity from which income is, or will be, jointly received.

The income tax treatment of partnerships will depend on the composition of partners in the partnership (for example individuals, trusts, companies or a combination of some or all of these).

A partnership does not own assets for CGT purposes, and consequently a partnership asset is owned by the partners in a proportion to which they have previously agreed.

If a CGT event happens to a partnership during the income year or the partnership received a share of a capital gain from a trust, each partner must include their share of the capital gain or capital loss on their personal tax return.

The general CGT discount pursuant to section 115-A of the *Income Tax Assessment Act 1997* (Cth) is available.

This discount allows the partners in a partnership to reduce a taxable capital gain by 50% on the disposal of a CGT asset where that asset has been held for greater than one year.

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Partnership structures may not be an effective instrument for income splitting.

Any distribution of partnership **income must be justifiable on** the basis of a partner's interest in the net income of the business.

Where the partner is a trust, the trustee of each trust can distribute the trust's share of partnership income among the **trust's beneficiaries in any** way it wishes.

A partnership does not have a separate legal existence apart from its members, as discussed above.

Despite this, the ATO's view in GSTR2003/13 is that a partnership for taxation purposes is not dissolved upon entry or exit of partners.

This decision may have capital gains tax consequences for continuing partners.

The actual effect of entry or exit of partners, or disposal of partnership assets, will depend on a number of factors unique to each partnership's circumstances.

Partners are taxed on their share of income at the rate of tax payable as if they had derived that income themselves.

Despite the fact the partnership itself does not pay income tax, a tax return must be prepared for the partnership showing income earned by and distributed to the partners.

Administrative efficiencies

Establishment
Partnerships are simple to establish, and are governed by a combination of state laws, common law, and partnership agreements.

The *Partnership Act 1892* (NSW), applies to partnerships established in New South Wales.

A partnership with taxable income is required to register an ABN and a TFN. Partnerships can apply for a TFN online on the Australian Business Register.

It is also recommended that a partnership agreement is executed. To give the appearance of a singular, united identity, a partnership can use a trading name or corporate entity agent.

Partnership agreements
A partnership agreement is an important document which sets out the terms and the conditions of the relationship between the partners.

Common clauses deal with:

- **Distribution of profits and losses**

A partnership agreement is important for tax reasons if **profits and losses are** not distributed equally amongst partners.

- **Restraint of trade**

This type of clause can protect the practice from the competition implications if a professional leaves the practice, such as client loss or establishment of a competing practice.

Bear in mind that these clauses could transform a practice into a 'goodwill' practice, which

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would have implications for tax liability when restructuring.

See page 29 to read more about 'goodwill' and 'no goodwill' practices, and the implications for restructuring.

- **Funding**
  Partnership agreements can include clauses dealing with capital raising and injections.

- **Remuneration**
  The remuneration of partners can also be formally agreed upon in the partnership agreement.

- **Entry and exit**
  The partnership agreement should outline procedures for retirement, admission of new partners and transfer of interests.

It is easy for a partnership agreement to be varied to account for new or exiting members. The interests, rights and duties of the partners can be varied at any time by agreement.

Entering into contracts or transactions

Unless otherwise provided by the partnership agreement, each partner may enter into agreements in the course of the business of the partnership, binding both themselves and other partners to perform the substance of the agreement.

Control

Partners share control of the business. The manner of decision making about the business of the firm may be dictated by the partnership agreement or, in the absence of any statement in the partnership agreement, by consent of all the partners.

Funding

Partnerships can receive a capital injection when a professional enters the practice.

If a partner is being replaced, capital funds from an incoming partner may need to be used to repay a retiring partner.

Outside of these capital injections and partners' resources, funding is limited to debt fundraising such as, for example, borrowing from a bank. Fundraising limitations can be outlined in the partnership agreement.

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Company

What is a company?

As outlined on the ASIC website, a company is defined as follows:

"A company is an entity that has a separate legal existence from its owners. The owners of the company are known as members or shareholders."

Its legal status gives a company the same rights as a natural person which means that a company can incur debt, sue and be sued.

Companies are managed by company officers who are called directors and company secretaries.

Small business owners often use a type of company structure called a proprietary limited company, which has the words 'Pty Ltd' after the name. This type of company does not sell its shares to the public and has limited liability.

Larger companies that do sell shares to the public can still limit their liability and will often have the abbreviation 'Ltd' after their name.

Companies are principally governed by the *Corporations Act 2001* (Cth). Shareholders have a proprietary interest in the shares they own, but have no interest in the company's assets.

Asset protection

Companies provide strong asset protection. As a company is a 'legal person', it has a separate legal identity to the individual professionals.

The personal liability of shareholders is limited to the value of shares they own. However, directors can be held liable for claims in some instances, such as if they provide a personal guarantee, are sued for breach of director's duties, engage in insolvent trading or are responsible for the commission of certain tax offences.

The separation of the corporate legal 'person' or entity shareholders is known as the 'corporate veil', as the company acts in its own right rather than just a vehicle for shareholders.

The courts have acknowledged that in some circumstances, the corporate veil may be pierced to prevent shareholders from gaining access to the asset protection provided by a limited liability company.

If the veil is pierced, the courts can hold shareholders responsible for the corporation's actions as if the actions were conducted by the shareholder.

It is difficult to predict when the courts will look behind the corporate veil, as each case is considered on its distinct facts.

Income Taxation

Often, company structures provide significant advantages for professional practices.

The tax rate for companies is capped, at 30%, with the exception of companies categorised as small business entities with an aggregated turnover of less than $2 million, for which tax is charged at 28.5% from 1 July 2016.

In the 2016-17 Budget, the Federal government announced plans to gradually reduce the rate of corporate tax for all companies to 25% by 2026-27.

A summary of the proposed rates is provided below:

Year	Aggregated Ann Turnover Threshold	Entities under Threshold	Other Corp Tax Entities
2015-16	$2m	28.5%	30.0%
2016-17	$10m	27.5%	30.0%
2017-18	$25m	27.5%	30.0%
2018-19	$50m	27.5%	30.0%
2019-20 to 2023-24	$50m	27.5%	30.0%
2024-25	$50m	27.0%	30.0%
2025-26	$50m	26.0%	30.0%
2026-27	$50m	25.0%	30.0%

From a CGT perspective, a **company is not an efficient** structure unless there are very small potential capital gains, or when the small business concessions discussed above are available, as the general CGT discount is not available.

A company retains its profits until paid as dividends. This can be advantageous from a funding perspective. The application of Division 7A of the *Income Tax Assessment Act 1936* (Cth) must be considered when accessing funds.

Under this division, payment or **provision of a benefit by a private** company to a shareholder or associated may be treated as a dividend for tax purposes, even if it is referred to by the relevant parties as some other form of transaction (for example a loan, gift or writing off of debt).

This division is design to ensure that shareholders or associates do not obtain payments or **benefits from a company which are from profits of that company** at a rate of tax lower than their personal rate.

In general, payments treated as dividends under Division 7A are unfranked, meaning the recipient **does not receive the benefit of tax** already paid by the company on **the profits received. This can have** detrimental tax implications.

Personal exertion income

The ATO have released a range of rulings regarding the use of incorporated entities to conduct professional practices: IT 25, IT 2121, IT 2330, IT 2503, and IT 2539.

These rulings focus on the application of the anti-avoidance provisions where professionals are using a company structure to alienate their income from personal exertion, or to claim superannuation contributions. This is most relevant to small professional practices where the income generated by the business is mainly attributable to the work of the principal professionals.

The rulings have less impact on large professional practices that employ a number of non-principal professional staff.

To limit the application of the anti-avoidance provisions can in both small and large practices by providing a market value salary to professional staff.

Restructuring a partnership into a company

If a partnership wishes to restructure to a company, they can access the rollover outlined under subdivision 122-B of the *Income Tax Assessment Act 1997* (Cth).

There are restrictions in the rollover in that:

- Each of the former partners must own shares in the company after the transfer of the partnership assets to the company; and
- Each former partner must own those shares in the company in the same capacity as the partner held his or her partnership trust.

If the partners restructured to a company without accessing this rollover, they may be able to minimise their tax by accessing the CGT general discount or small business CGT concessions. If only some partners were eligible for concessions, they could sell their interests to another entity (e.g. discretionary trust) before applying a s 122-B rollover.

Administrative efficiencies Establishment

It is relatively simple to incorporate a new company.

Shareholders agreement

A shareholders agreement governs the relationship between the shareholders of a company, and protects their interests if a dispute arises. This agreement can outline the structure, management, funding and

direction of the company. It is best to prepare a shareholders agreement when the company **is first established, before any** disputes arise.

Control

In small companies, shareholders and directors are often the same people. This provides full control over the decision-making process, as decisions are either required to be made by directors in board meetings or by shareholders by written resolution or by resolutions passed at general meetings.

Entry and exit

It is relatively easy to appoint new directors and admit new shareholders.

Use of trusts

A trustee can hold shares in a company using a discretionary trust. This separates the assets of the company one stage further from creditors of the principal **while allowing company profits** to be distributed to the principal **(or other beneficiaries of a** discretionary trust).

The discretionary nature of the trust can allow for distributions to a range of beneficiaries, which can be beneficial in terms of income tax implications.

Holding shares in a trust also separates assets one stage further from any creditors of the principle, while still allowing for company **profits to be distributed to the** principal or other discretionary **beneficiaries.**

Funding

Companies can access both debt and equity funding.

Debt can be an attractive fundraising option, as the liability of shareholders will be limited to the shareholder's equity. However, directors will usually be personally liable for loans as most will need to be personally guaranteed.

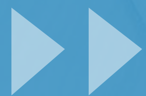
Equity funding can also be appealing, especially considering that that different shares can be issued with different voting rights allowing more control than a capital injection by a partnership entrant. New shareholders may be persuaded to invest by potential dividends.

A company structure is also appealing because non-professionals may be able to invest and have some control over the company.

Of course, this must be permitted by the relevant professional regulations.

A company is suitable if the remuneration structure for employees includes employee share schemes. A company is also seen to be simpler where there are investors who are not actually working in the business.

Trusts



There are several types of structures that involve trusts: discretionary (or family) trust, fixed unit trust and partnership of discretionary trusts.

Service entity structures also usually utilise trusts. **Trustees are subject to general law fiduciary** duties and statutory obligations.

Trusts have some common administrative efficiencies:

Establishment

Trusts are governed by a combination of state trustee laws, common law, equity, and trust deeds. The trust deed should be drafted by an experienced solicitor.

Control

The trustee will have control of the trust. However, they must exercise control for the **benefit of the beneficiaries.**

Exit and entry

The ease of adding new beneficiaries into the trust will depend on the vesting of the trust, **which is specified in the trust deed.**

Related parties

Discretionary trusts as usually only used by related parties as no **parties have a fixed interest.**

Discretionary trust

What is a discretionary trust?

A discretionary trust provides a trustee with discretion to apply trust income and capital **to or for the benefit of specified beneficiaries. The specified beneficiaries are usually members** of a family. This allows income to be split amongst a range **of beneficiaries with different income and tax profiles.**

A discretionary trust may be suitable for a sole practitioner if **flexibility and asset protection are** of high importance.

Asset protection

Asset protection will be dependent on trustee structure. If there is a corporate trustee, there will be similar asset protection **benefits to that of a corporation.**

If there is an individual trustee, assets may be exposed to claims if the trustee is the "at risk person" (e.g. principal of practice). If someone other than the 'at risk person' is the trustee, assets are shielded from claims against **at risk person. If a beneficiary** becomes bankrupt, the trustee can cease distributing income to **that particular beneficiary. Thus,** the assets in the trust may be protected from their creditors. If a corporate trustee is used, discretionary trusts are also advantageous for limiting liability. If the trust deed is drafted appropriately, only the trustee (and not the settlor or **beneficiaries) will be liable for the** debts and liabilities of the trust.

Taxation

One of the key benefits of a discretionary trust structure is that the availability of multiple **beneficiaries may allow income to** be split, and tax to be minimised. **The beneficiaries are taxed on** distributions personally, and the trustee is taxed on any undistributed income. Once the trustee exercises the discretion **to distribute to a beneficiary, that beneficiary becomes presently** entitled to the amount paid or **applied. Then, that beneficiary will** be assessable of the amount of the net income for tax purposes. **If the beneficiary is under a legal** disability (e.g. minors), the trustee will be assessable. In any event, the trustee will need to lodge a Trust Tax Return with the ATO.

The operation of Division 6AA of the Income *Tax Assessment Act 1936* (Cth) effectively removes most of the advantages of distributing large amounts of income to minors. The income distributed to minors above the tax free threshold is taxed at the top marginal rate if that income exceeds $416.

However, in the case of testamentary trusts, there are still strong tax advantages available for income splitting for minors using testamentary estate planning. Even with the operation of Div 6AA, the tax free thresholds of minors and family members over age 18 **years can still provide significant** tax advantages. Distributions will only be effective for obtaining tax **benefits if the beneficiary becomes** absolutely (not conditionally) entitled to the income.

The ATO will regard a purported distribution as sham with no **effect if the beneficiary is not ever intended to receive the benefit of** the trust income.

Discretionary trusts are CGT **efficient. The general CGT** discount is available. If the trust deed allows, trustees can **distinguish between beneficiaries** that receive capital, and **beneficiaries that receive income.**

This can be useful if a beneficiary has CGT losses that can offset capital gains. However, it is important to note that the general anti-avoidance rules in Part IVA of the Income *Tax Assessment Act 1936* (Cth) apply to cancel tax **benefits obtained by the individual.**

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Administrative efficiencies
It is important to bear in mind the legislative uncertainty that surrounds discretionary trusts, which are often discussed in proposals for tax reform. If this structure is used, the professionals must keep abreast of any proposed legislative changes.

Funding
Generally, trustees can accept further contributions to the trust at any time. Finance can also be sought through debt funding. The trustee is usually liable for debts and actions taken.

The trust itself does not have the capacity to retain earnings – all income must **be distributed. Profits may** be retained with the use of a **corporate beneficiary.**

However, when distributions are made to the corporate **beneficiary, there are various** Division 7A and Part IVA issues that may arise.

Losses can also be trapped in a discretionary trust.

The discretionary trust is a poor structure alternative for the addition of third parties.

If the trust has a corporate trustee, a transfer of an interest in the discretionary trust can be effected by a transfer of shares in the trustee.

However, this may not be satisfactory for an unrelated third party purchase of an interest in the business. Thus, a restructure would most likely be required to achieve the desired change in ownership.

Partnership of discretionary trusts

What is a partnership of discretionary trusts?
A partnership of discretionary trusts is a partnership in which each partner is the trustee of a discretionary trust.

In this situation, each individual's discretionary trust is the partner, rather than each individual being a partner in the partnership.

Like a company or unit trust, **each 'partner' has a fixed interest which can be specified** in the partnership agreement. It is a desirable structure in terms of asset protection **and flexibility.**

Asset protection
This structure provides effective asset protection where the income is ultimately distributed to an entity other than the 'at risk individual' (i.e. someone other than the principal working in the business).

If the only asset held by each 'partner' is an interest in the business, liability for debts of the partnership will be no different to a company or unit trust structure.

In this case, the assets available to meet debts incurred by the business are limited to the interest in the business.

Taxation
This structure allows for income to be split between the family members of each principal of the business.

The tax risks of the use of a partnership of discretionary trusts arise because of the Commissioner's view on a partnership of trusts.

The ATO issued Taxpayer Alert 2013/3, in which the Commissioner's concerns are set out as follows:

What are the ATO's concerns?

Broadly, the ATO's concerns with these types of arrangements include whether:

a. the transactions referred to above are legally effective, such as:

i. whether an interest in the net income of the partnership is an interest of the trustee or the individual for the purposes of section 92 of the Income *Tax Assessment Act 1936* (ITAA 1936),

ii. whether assessable income relating to work performed by the individual is derived by the individual or the partnership for the purposes of section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997),

b. any transactions intended to make the trustee a **partner in the firm give rise to or** increase a net capital gain for the individual in the year of income, such as:

ii. whether a CGT event has happened to an interest held by the individual in a partnership;

ii. what capital proceeds are associated with the event,

iii. whether the individual's net capital gain is reduced by the CGT discount or small business concessions in Division 152 of the ITAA 1997,

c. the general anti-avoidance rules in Part IVA of the ITAA **1936 apply to cancel tax benefits** obtained by the individual."

It is the Commissioner's view that a Partnership of discretionary trusts may not be a valid structure as the trusts do not hold professional **qualifications.**

Since the ATO Taxation Ruling TR 2010/3 on Division 7A unpaid present entitlements, partners of discretionary trusts have been **less efficient in terms of income** and CGT tax.

An unpaid present entitlement is a distribution from a trust which a trustee has decided to make, but has not yet paid out to a **beneficiary. This also includes** loans made from the trust to the **beneficiary.**

The ATO TR 2010/3 effectively made a 'U-turn' decision by announcing if a private company **that is the beneficiary of a** trust has an 'unpaid present entitlement' from that trust, then the company will be considered to have made a 'Div 7A Loan' to the trust if either the 'unpaid present entitlement' has been **satisfied and the company**

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agrees to loan that amount to the trust; or the company does not call for payment of the 'unpaid present entitlement' and therefore agrees that it can be used for trust purposes.

Before the issue of this Ruling, the ATO's position was that 'unpaid present entitlements' were not treated as loans for Div 7A purposes.

Many professional bodies argue that TR 2010/3 is inconsistent with legislative intent to require unpaid present entitlements to be solely regulated by former s109UB, and not s 109D. This has created uncertainty around this area of law.

Unlike company or trust structures, the losses of the partnership are not trapped within the entity.

This means that losses can be offset against the other income of the partners.

An example of this is where the client may have another discretionary trust that generates income that can make distributions to the Discretionary Trust partner which can be offset against the partnership losses. In this way, partnership losses do not remain trapped within the structure.

The general CGT discount is available.

Administrative efficiencies

As outlined in Tax Alert TA 2013/3, the Commissioner is concerned that a partnership of discretionary trusts with one trustee is not a partnership. It is worth considering having two trustees of the discretionary trusts.

Of course, it would be possible to have each discretionary trust with its own trustee but in a large professional practice this may mean the administrative requirements could become quite cumbersome.

However, this may be not much more cumbersome than a traditional structure of individuals.

Funding

Partnerships of discretionary **trusts can seek finance through** capital injections from a new partner entry, or debt funding.

Unit trust

What is a unit trust?

A unit or fixed trust is a trust whereby the beneficial ownership is divided into units **which are held by beneficiaries, instead of a class of beneficiaries what are entitled to specific or** discretionary interests.

A unit holder has an equitable interest in all of the trust property subject to the trust deed. Unlike a company, the trust itself does not have a separate legal identity and cannot sue or be sued in its own name.

Asset protection

A unit trust provides effective asset protection for the professional where assets are held by another legal entity (usually corporate trustee).

However, if units are held personally by the 'at risk individual,' creditors may

become entitled to the beneficiary's fixed entitlement to assets and income of the trust.

In professional practice structures, it may be more effective for a discretionary trust to **hold all units in the unit trust, leaving no fixed** entitlement against which creditors can claim.

This also provides freedom to plan distributions of income at year end rather than **being stuck with fixed entitlements.**

Taxation

Units can be held by the stakeholders' discretionary family trusts. This allows the unit holders to receive income and capital distributions from the trust, and allows **flexibility in how they deal with income and** capital.

From a CGT perspective, unit trusts are quite **efficient. However, note the operation of CGT** event E4, 'unit trust non-assessable payments.' The general CGT discount will be available.

Administrative efficiencies

A unit holders' agreement will define how the trust operates, the relevant units to be issued and under what conditions. It is important to consider how the trustee can be removed, and who will be the unit holders.

Funding

Unit trusts can raise equity by selling units with particular rights attached. Of course, debt funding is also an attractive option.

Like a partnership, a unit trust needs to distribute all of its income in the year that it is assessed. Whilst it cannot withhold income, corporate **beneficiaries can be utilised for similar results.**

However, as soon as a corporate beneficiary is engaged or utilised, Division 7A and Part IVA issues can come into play.

Service trust or entity

What is a service entity?

Usually a discretionary (or family) **trust or a fixed unit trust is used as** the service entity.

The service entity provides a vehicle to own assets, provide support services, limit the personal liability of professionals, and facilitate income splitting.

As defined by the ATO in TR 2006/2, service entity arrangements:

Involve, in essence, a taxpayer incurring a deduction for fees and charges in the conduct of its business for the acquisition of staff, clerical and administrative services, premises, plant and/or equipment from an associated entity.

The ATO will classify an arrangement as a 'service arrangement' if it exhibits most or all of the features outlined in TR 2006/2:

a "the taxpayer, being an individual or an entity, carries on a business, alone or in partnership, for the supply of professional or other services to clients;"

b "there is a trust that is controlled, or a company that is owned and/or controlled, by the taxpayer and/or associates of the taxpayer (the service entity);"

c "the taxpayer, alone or in partnership, enters into an agreement with the service entity whereby the taxpayer agrees to pay certain fees and charges to the service entity in return for the service entity supplying the taxpayer with a range of services which may include: staff hire and recruitment services, clerical and administrative services, premises, plant and/or equipment;"

d "typically, the service fees and charges are calculated by way of a mark-up on some or all of the costs of the service entity (although a fixed charge may be agreed by the parties up-front);"

e "the taxpayer claims a deduction for the service fees and charges as expenditure incurred by it in the conduct of its business;"

f "the service arrangement either **gives rise to profits in** the service entity, for both accounting and tax purposes, or would give rise **to profits in the service entity** but for remuneration or service fees paid to associates of the taxpayer or the taxpayer's partners; and"

g "the profits derived by the service entity are either retained by the service entity (usually where the service entity is a company) or distributed, directly or indirectly, to the taxpayer (and its partners in the case of a partnership) and/or to associates of the taxpayer (and associates of its partners in the case of a partnership)."

Taxation

The use of service trusts has declined since the release of ATO ruling TR 2006/2 and the 2006 ATO guide 'Your service entity arrangements.' By virtue of the ruling and the guidelines, services entities no longer **provide the benefits they formerly had. The ruling and guide confirm that a service** entity must be operated commercially, with a separate function to the practice entity.

The guide outlines how to determine whether service charges are commercially realistic, and 'safe harbour' mark-up calculation methods.

The guidelines also provide guidance on the 'ceiling' to its indicating rates for net and gross mark-ups. The ATO will classify a practice as 'low risk' if they use the indicative rates within the ceilings, and no more than **30% of the combined profits of the main** business and service entity are earned by the service entity from the service arrangement.

Staying within the ceilings means that it is unlikely that the practice will be audited by the ATO, however this means that the service **entity structure provides little benefit from a** tax perspective.

The indicative rates are as follows:

Type of service benefit	Fees/charges
Labour hire arrangements	**Gross mark-up on costs**– labour hire fees with a gross mark-up **on costs not exceeding 30% of the salary and benefits of staff** paid by the service entity. It is expected that operating costs **would represent approximately 18% of salary and benefits.** **Net mark-up on costs**– labour hire fees that result in the service entity deriving a net mark-up no more than 10% on the direct and indirect costs associated with hiring staff.
Recruitment services	**Net mark-up on costs**– expense of payment of fees that result in the service entity deriving a net mark-up no more than 10% on the direct and indirect operating costs associated with its recruitment activities.
Expense payments	**Net mark-up on costs**– expense payment fees that result in the service entity deriving a net mark-up no more than 10% on direct and indirect operating costs associated with its expense payment activities.
Equipment hire	**Gross mark-up on costs**– the hiring fee results in a gross mark-up not exceeding 10% on the cost to the service entity of the equipment with all relevant costs relating to the equipment being met by the service entity.
Rental	**Comparable market price**– the rent is at market rates (plus **finder fees if appropriate).**

In TR 2006/2, the ATO also expressed concern about arrangements where a professional engages a service entity to provide services to their practice, but the professional is also the sole director of the service entity's trustee company. The general CGT discount is available.

Asset protection

This is an effective form of asset protection as business assets may be maintained in a separate entity to the entity that provides professional advice.

Any professional negligence claims or debts are limited to the assets of the practice entity. As many tax advantages have been eliminated, asset protection is the main reason that service entities are used.

The service entity isolates the risks of operating a business away from the at-risk professionals. Business assets are effectively quarantined.

Administrative efficiencies

Running two entities concurrently **is not administratively efficient.**

This can make operation of a service entity structure time consuming and expensive.

You will also need to keep records proving how you are using the service entity.

This could include contracts, pricing information, trust deed, employee timesheets, and leases. The practice entity should also provide written instructions to the service entity.

Professional regulations

Professional regulations are a paramount consideration when deciding on a professional practice structure.

Failing to comply with the relevant professional regulations can lead to harsh penalties which would threaten the operation of your business. The constraints of professional regulations must be well understood before comparing potential practice structures.

Legal

Currently, the structuring of legal practices in NSW is governed by the *Legal Profession Uniform Law 2014* (NSW). Importantly, in NSW there are requirements in relation **to the person whom profits of** a legal practice can be shared with, thus, this can impact who may be a shareholder of such a corporate entity.

Section 37(c) *Legal Profession Uniform Law 2014* (NSW) states that both an Incorporated Legal Practice and Unincorporated Legal Practices can share receipts, revenue or other income from the provision of his or her legal **services with unqualified persons** of the law practice. Be aware that **the persons sharing the profits cannot be a disqualified person** under s 6 *Legal Profession Uniform Law 2014* (NSW).

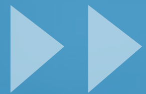
It is important to note that an incorporated legal practice must have at least one legal practitioner director, meaning an Australian legal practitioner with an **unrestricted practicing certificate.**

An incorporated firm will commit an offence if the practice does not have a legal practitioner director for a period of more than 7 days.

The conduct of non-practitioner directors can amount to unsatisfactory professional conduct or professional misconduct on the part of the Australian legal practitioner director.

Furthermore, subject to this law there is no prohibition to practising in the form of a company as trustee for a trust, a partnership of such companies.

Income Splitting



On their website, the ATO have released guidelines relating to income splitting within professional services firms.

What is clear from these guidelines is that the ATO focuses on individual professional practitioners ('IPPs') rather than the practice itself.

The guidelines will operate if the following criteria apply:

- an individual professional practitioner (IPP) provides professional services to clients of the firm, or is actively involved in the management of the firm and, in either case, the IPP and/or associated entities have a legal or beneficial interest in the firm

- the firm operates by way of a legally effective partnership, trust or company

- the income of the firm is not personal services income. Practices falling within these criteria are then classified as low risk or high risk.

If a practice meets the following three benchmarks, they are classified as low risk:

Benchmark 1:

"The IPP receives assessable income from the firm in their own hands as an appropriate return for the services they provide to the firm. In determining an appropriate level of income, the taxpayer may use, as a minimum, the level of remuneration paid to the upper quartile of the highest band of professional employees providing equivalent services to the firm.

That is, to satisfy this benchmark the IPP needs to receive remuneration that is benchmarked with reference to the lowest paid member of the upper quartile.

If there are no such employees in the firm, then like employees in comparable firms or relevant industry benchmarks should be used – for example, those provided by a recognised professional association, agency or consultant in the business of providing such industry benchmarks."

Benchmark 2:

"50% or more of the income from the firm to which the IPP and their associated entities are collectively entitled (whether directly or indirectly through interposed entities) in the relevant year is assessable in the hands of the IPP."

Benchmark 3:

"The effective tax rate must be 30% or higher on both: income from the firm to which the IPP is entitled [and] income from the firm to which the IPP and their associated entities are collectively entitled."

If the entity fails to satisfy any of these tests, it will be classified as high risk and therefore may be subject to ATO review

In these cases, the lower the effective tax rate, the higher the ATO will rate the compliance risk posed by the arrangements and the greater the likelihood of ATO compliance action being commenced.

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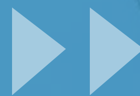
Exit and Entry of Professionals



You need the structure to be flexible enough to allow professionals to enter and exit the practice with minimal taxation implications and transaction costs.

The more complicated the structure, the more complicated it may be for professionals to enter and exit the practice.

In a sole trader structure, the proprietor is free to sell or discontinue the business at any point. Discontinuing the business as a sole proprietor will incur minimal legal costs.

This structure can only operate if there is only one proprietor. Once other professionals enter the business, a restructure will be required. It is important to note that the success and continuance of the business are directly linked to the skills, ability and health of the proprietor.

A partner can choose to dissolve the partnership when the term of the partnership is at an end; one partner has given notice to the other partner(s); there is a court order; or there is a death of a partner or the business has gone bankrupt.

Notably, if all the partners are not in agreement about the dissolution of the partnership, the exiting/retiring partner may continue to be liable for debts and defaults if the business continues to be run by the remaining partners.

Exit and entry of professionals in a company will involve issuing, purchasing, selling or cancelling shares, and removing or appointing directors. This may trigger CGT implications even if shares are bought and sold for more than a nominal value.

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Restructuring and Goodwill

Capital Gains Tax (CGT) can be a major obstacle to restructuring. These tax implications are triggered by the transfer of goodwill which is inevitable in a restructure. 'Goodwill' is not defined in tax law.

The Australian Accounting Standards Board 'Business Combinations' Compiled AASB Standards provides a useful **definition of 'goodwill':**

"Future economic benefits arising from assets that are not capable of being individually **identified and separately** recognised."

This means that goodwill is a single piece of property and an intangible asset which encompasses a range of elements related to the reputation of a business.

The goodwill is attributable to a combination of factors, such as the locality of the business, the way the business is conducted, and the personality of those who conduct it: *Whiteman Smith Motor Company v Chapin* [1934] 2 KB 35, 307.

Some sources of goodwill include:

Site goodwill
The aspect of goodwill that is linked to the location of a business, and the habit of customers or clients returning to that site.

Personal goodwill
The most important element of goodwill for professional practices, and relates to the personal characteristics of a person or persons associated with the business. For example, a partner may have a reputation for being **experienced in particular field.**

Name goodwill
Relates to a name or reputation which attaches to a business.

It is controversial as to whether personal goodwill can be transferred. Some cases say it can be, and some say it can't. In **TR 1999/16, the ATO clarified that** while personal goodwill cannot itself be transferred, it will usually contribute to other types of goodwill that can be transferred.

However, it is important to note that this ruling focused on individual partners leaving and joining a business, rather than the disposal of the partnership business itself. It is likely that the goodwill of even a 'no goodwill' partnership will have some value when transferred on incorporation of a practice.

Does your practice have 'goodwill'?
Some professional practices do not have goodwill, as the value of the business is solely attributed to the personal reputation of the professionals. However, personal goodwill can exist in a professional practice after a professional leaves if the relevant contracts contain 'restraint of trade' provisions.

Partnerships, trusts and companies need to bear in mind the taxation implications of restructuring when partners or principals enter and leave the practice.

The implications of restructuring will be different for 'goodwill' and 'no goodwill' practices.

In Taxation Ruling IT 2540, the Taxation Commissioner determined that in a 'no goodwill' partnership, exits and entries of partners do not trigger Capital Gains Tax (CGT) events:

Any consideration paid or received on the acquisition or disposal of an interest in the partnership will be used for Part 3 IIIA purposes in determining the cost base or disposal proceeds of the interests in the partnership assets that the partnership interest represents.

This will mean that if, for example, the partnership arrangement is such that no amount is payable for the acquisition or disposal of goodwill, it will be accepted for the purposes of Part IIIA that the value of the goodwill is nil.

This treatment will also apply to partners of small partnerships who deal with each other at arm's length, where those dealings take place in an ordinary commercial character.

The Commissioner subsequently released Taxation Decision 2011/26, which states that:

[I]f a share in a "no goodwill' incorporated professional practice is disposed of for no consideration, the Commissioner will accept in calculating the market value of the share upon a possible application of subsection 116-30(1) of the *Income Tax Assessment Act 1997* that the goodwill of the company can be taken to have a value of Nil"

The purpose of this tax determination is to extend the rationale of Taxation Ruling IT 2540, which considers the implications of a partnership practice being restructured as a company.

In IT 2540, the Commissioner set out his requirements to where he will accept that goodwill is nil:

Where a "no goodwill" professional partnership has incorporated or a new "no goodwill" incorporated professional practice has commenced, the following features must be displayed by the incorporated professional practice (the company) in order **that it qualifies as a "no goodwill"** company for the purposes of this Determination:

a) The original shareholders in the company are all natural person practitioners who previously held a fractional interest in the "no goodwill" partnership prior to the restructure (or would have been eligible to hold a fractional interest had the practice **first operated as a partnership);**

b) The provision of a share or shares to the practitioner-shareholder at the time of incorporation and in the post-incorporated **environment must be reflective of** that person's status as an active practitioner in the practice and must be held by that person both **legally and beneficially;**

c) The company is a proprietary limited company that adopts a constitution or shareholder agreement, or both, that regulates the basis:
- for admission to shareholding, and
- buy-back, cancellation or transfer of shares in the company, and
- the amount that is paid for it, and
- all the shareholders agree to be bound by it; and

d) The constitution or shareholder agreement, or both, provide that any share dealing effecting practitioner-shareholders joining or leaving the practice will be attended by an amount of consideration (including possibly nil consideration) calculated on the basis that the value of the goodwill of the company is nil.

The Commissioner further states at paragraph 21:

"Where the incorporated professional practice and its shareholders do not satisfy the conditions described in paragraphs 2 to 3 of this Determination the Commissioner's post incorporation approach cannot be applied.

All the shareholders of the incorporated practice will cease **to benefit from this approach as a** consequence when an entity other than a natural person practitioner acquires a share or shares in the company.

The approach will not apply in respect of any dealings in the shares of that company for any period during which even one share is held, whether legally or **beneficially, otherwise than in the** way described."

Complying with this taxation decision will result in an outcome which is in conflict with a main object of restructuring, that is, asset protection.

The shares will be held in the name of the individual principal when they continue to provide services and are at risk of being sued.

In this case, any dividends received by that principal would be vulnerable to creditors.

Any attempts to move such funds to a safer environment could later result in the operation of claw back provisions if the professional later goes bankrupt.

For a partnership to be characterised as 'no goodwill' it appears that this needs to **be reflected in the** partnership agreements.

If there are restraints of trade covenants in the agreement this may **be in conflict with the** argument that there is no goodwill.

However it is important to note that the ATO will look to substance over form.

The best way to ensure that the business will be assessed on a 'no goodwill' basis is to seek a valuation of the working capital requirements when a professional enters the partnership.

No excess funds should be provided by the professional above these working capital requirements.

Following IT 2540, these funds can be refunded when the professional exits the partnership without the application of CGT market substitution rules for goodwill.

The same principles will apply to assessing whether a company is a no-goodwill practice.

However, all the people that own shares in the company are natural persons that are also practitioners in the practice.

Also, the constitution or shareholders agreement must provide that entries and exists will be on the basis that goodwill has no value.

Licensing goodwill to a separate entity

To avoid issues in transfer of goodwill in restructure, an alternative is to license it to the new entity.

In *Commissioner of Taxation v Murry*[1998] HCA 42, the majority of the High Court confirmed that:

a Goodwill can be described as the 'legal right or privilege to conduct a business in substantially the same manner and by substantially the same means which in the past have attracted custom to the business.'

b Goodwill is an indivisible item of property.

c Goodwill is inseparable from the conduct of the business.

d Goodwill may derive from an **identifiable asset** of a business, but it is legally distinct from the sources.

e Goodwill can be separated from a particular asset of a business, and the transfer of that asset does not result in a disposal of the goodwill.

f The sale of an asset of a business does not involve any sale of goodwill unless the sale of the asset is accompanied by or carries with it the right to conduct the business.

It is important that the license of goodwill is done correctly and in fact there are two cases that **discuss this issue, the first being** *Roussos v Commissioner of Stamp Duties* [1992] TASSC 97 and *Sturt Football Club Inc. v Commissioner of State Taxation* [2010] SASC 279.

These cases demonstrate whether goodwill has in fact been transferred is a matter of fact and law. The effect of the licensing arrangement must be true in both form and substance.

The case of *Roussos v Commissioner of Stamp Duties* [1992] TASSC 97 involved an agreement between parties to operate and conduct a restaurant at the premises in the manner and style in which it was previously conducted.

The agreement provided for the transfer of assets including plant and equipment; stock; the registered business name and goodwill.

The Commissioner assessed stamp duty on the agreement on the basis that it was a conveyance upon the sale and disposition of personal property, name, the plant and equipment, goodwill and right to use the business name.

This taxpayer's appeal was allowed, with the court holding that the name was part of the goodwill of the business, which did not pass to the taxpayer under the agreement, merely the right **to avail temporarily the benefits** attaching to it.

In the later decision of *Sturt Football Club Inc. v Commissioner of State Taxation* [2010] SASC 279, the Supreme Court of South Australia found that goodwill was linked to tangible assets of a tavern business transferred to a taxpayer.

The taxpayer entered into an agreement which provided for the transfer of assets, including stock, liquor and gambling licenses, cash on hand, communication property, other than goodwill) to the taxpayer, and a licence for the taxpayer to use the tavern's goodwill.

The Commissioner initially assessed stamp duty of $192 000 on the basis that the agreement did not effect a transfer of goodwill, however later revised this decision and increased the assessment by $74 000 to include goodwill. Justice White stated at paragraph 54:

"The very nature and extent of the assets transferred to [the taxpayer] indicates that even without an express transfer (or licensing) of the goodwill... the taxpayer had acquired the business of the tavern."

This would have been so even if Sturt had been obliged to conduct the business under a different business name.

This demonstrates the importance of looking at the facts of the particular situation to determine whether goodwill has in fact been transferred.

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Other Restructuring Costs

In addition to CGT, other costs and taxation implications must be considered, including:

- **stamp duty;**
- **future payroll tax liabilities if partners or principals are paid salaries;**
- **tax implications of transferring assets; and**
- **implications of personal services income (PSI) rules**

Stamp duty considerations

Recently, many states have abolished stamp duty for business transfers of goodwill.

In New South Wales, South Australia, Tasmania, Victoria and Australian Capital Territory there is no stamp duty payable on transfers of goodwill. Stamp duty will be payable for stamp duty transfers in Western Australia, Queensland and Northern Territory.

Outside of transferring goodwill, restructuring could incur other stamp duty costs. For example, execution of some documents, such as trust deeds, will incur stamp duty costs. Transfer of real property will also incur stamp duty.

Personal Services Income regime

Income splitting arrangements can either be challenged under the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act 1936* (Cth), or the personal services income (PSI) rules in Part 2-42 of the *Income Tax Assessment Act 1997* (Cth).

This section discusses the operation of the PSI rules, which are an important consideration regardless of choice of business structure.

PSI is income that is the majority derived as a reward for the personal efforts or skills of an individual. Under the PSI regime, income which is derived by a business as a result of the personal exertion of an individual professional must be returned to the individual and taxed in their hands.

Does the PSI regime apply?
There are a range of tests used to determine whether an individual must follow the PSI rules.

If an individual can pass one the these tests, they avoid coverage of the PSI rules:

1. **Results test**
To pass the results test in an income year, you must meet three conditions: paid to product a specific result, required to provide the equipment or tools and required to fix mistakes at your own costs. To pass the test, you need to meet all three conditions for at lest 75% of the PSI for the income year.

2. **Unrelated clients test**
This test requires that your PSI must be produced from two or more clients who are not related.

Furthermore, following *Cameron v Commissioner of Taxation* [2011] FCA 1278, a business wishing to rely on this test would need to prove that their services have been offered to the public.

For a company, partnership or trust where there is more than one individual generating PSI, you will need to work out whether you pass the unrelated clients test for each individual.

3. **Employment test**
For the employment test to be passed, your business must employ one or more apprentices for at least six months of the income year, or other employees or contractors that you engage must perform at least 20% of the principal work.

4. **Business premises test**
For this test to be satisfied, your business premises must be used plainly for personal services work, used exclusively for your business, be physically separate from your home and physically separate from your clients.

This must occur at all times in the income year, which is every day during the income year in which PSI is generated.

Many professionals are able to disregard the PSI rules as they pass one of these tests.

It is important to keep in mind that even if the PSI regime does not apply to your practice, the general anti-avoidance provisions of Part IVA of the *Income Tax Assessment Act 1936* (Cth) may apply in some circumstances.

Small business rollover

Since 1 July 2016, small businesses have been allowed to transfer assets to other entities without incurring income tax liability.

This applies to active assets, which are used, or held ready for use, in the course of carrying on a business such as CGT assets, trading stock, depreciating assets and revenue assets.

The rollover is only available where the transfer of assets forms part of a genuine restructure, **rather than an artificial or** inappropriately tax-driven scheme.

To determine whether a restructure is genuine, all the facts surrounding the restructure must be examined.

For small businesses this can be **satisfied by the safe harbour rule.** This rule applies when there is no change in ultimate economic **ownership of any of the significant** active assets of the business, other than trading stock.

If more than one individual has ultimate ownership, there is an additional requirement that each individual's share of ultimate economic ownership be maintained.

Furthermore, a discretionary trust may meet the requirement for ultimate economic ownership in circumstances where there is no practical change involving **an individual gaining a financial** advantage from assets before and after the transfer.

It is also important to consider the tax implications that arise when applying the small business structure for income tax purposes.

Assets transferred will not result in income tax liability for either party at the time of the transfer.

Following this, the transferor is taken to have received an amount for the transferred asset that is equal to the transferor's cost of the asset.

Finally, the transferee will be taken to have acquired the asset at the time of the transfer for an amount that equals the transferor's cost before transfer.

Relationship
Breakdown Issues

Relationship breakdown issues

In family law proceedings, a court can order the transfer of any partnership interest to a separating partner.

The High Court considered this power in *Stanford v Stanford* (2012) 247 CLR 108, stating that for this to occur, the court must identify the proprietary interests of the spouses and then only make an adjustment to those interests if it is considered 'just and equitable' to do so under s79(2) of the *Family Law Act 1975* (Cth).

For companies and trusts, the situation is different, depending on the actual or defacto control of the company.

Actual or defacto control

For companies and trusts, the court will consider actual (no necessarily legal) control in separation or divorce proceedings.

If a partner has 'effective' or 'de facto' control of the company (even if not actual legal control), assets of the company may be made available in the pool of relationship assets, allowing a court to issue orders to transfer to the other partner: *Romano v June* [2013] FamCA 344. The court can then make orders to transfer property from a trust with a partnership entitlement to an ex-partner if it is just and equitable to do so.

This situation is unlikely in a professional structure with many principals, but is worth bearing in mind.

Relationship breakdown involving a family trust is again similar to the "effective" or "de facto" control test for companies. This may extend to circumstances where a particular partner is not the sole trustee or sole director of the corporate trustee, but other trustees will agree with **their resolution when profit** distributions are determined: *Romano v June* [2013] FamCA 344.

These tests will also apply if a professional holds company shares in a discretionary trust. Under Family Law, courts have the power to 'look through' trust arrangements to make orders that trust property should be treated as property of a marriage and open to transfer to an ex-partner.

In *Kennon v Spry* [2008] HCA 56, the High Court found that even when divorcing partners **were no longer beneficiaries of** a discretionary trust, the control exerted by one party to the marriage as settlor and trustee meant that a series of changes to the structure of the trust could be reversed.

This meant that trust property was open for distribution amongst the couple in divorce proceedings.

In *Richstar Enterprises Pty Ltd v Carey* (No. 6) [2006] FCA 814, French J of the Federal Court (as he then was) stated: "where a discretionary trust is controlled by a trustee who is in truth the alter **ego of a beneficiary, then at the** very least a contingent interest **may be identified because…** it is as good as certain" that **the beneficiary will receive the benefits of distributions either of** income or capital or both.

He found that "the beneficiary who effectively controls the trustee's power of selection because he is the trustee or one of them and/or has the power to appoint a new trustee has something approaching a general power and the ownership of the trust property."

Here, a discretionary interest was found to be, in effect if not in law, a proprietary interest capable of management by a receiver under the *Corporations Act 2001* (Cth) Where control of a trust is not effectively in the hands of one partner the trust is excluded from the pool of assets available for distribution to their ex-partner and **is instead taken to be a 'financial** resource' of the partner unavailable for distribution but taken into consideration by the Courts when formulating property settlement orders on the basis of what is 'just and equitable' in the circumstances of the property dispute.

This means that the family court could take into account a party's financial resource without making orders specifically in respect of that property.

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Everett and Gulland Assignments

Assignments of partnership interests to divert income of a professional have had significant tax law consequences.

This includes *Federal Commissioner of Taxation v Everett* [1980] HCA 6, in which a partner made an assignment of their partnership interest to their spouse for market consideration of $2,832.50.

The assignment meant that 6/13ths of the income derived by Mr Everett from the partnership would be held on trust for his wife. The court held the assignment to be valid.

Later, in *Federal Commissioner of Taxation v Gulland* [1986] HCA 83, the court treated as valid an assignment of an interest **in partnership profits to a** discretionary trust.

In IT2330, the ATO stated that absolute 'no strings' assignments will not be caught by both section 260 and Part IVA of the *Income Tax Assessment Act 1936* (Cth). This view was reiterated in Taxation Ruling IT 2501.

The ATO has since revised the conclusion reached in IT 2501, stating that these sort of assignments will be caught by both 260 and Part IVA of the *Income Tax Assessment Act 1936* (Cth).

As a chose in action is property, CGT implications are also a barrier to these sorts of assignments.

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Is the Structure Legally Effective?

In September 2014, the ATO released guidelines explaining how the department will assess the risk of Part IVA of the Part IVA of the *Income Tax Assessment Act 1936* (Cth) applying to a practice.

To escape coverage of this provision, the practice must be validly established, and be carried out in accordance with the documentation.

However, the guidelines will not apply if the income of **the firm is personal services** income, or to arrangements involving equity holders who **contribute to the profits of the firm through skilled labour** (e.g. tradespeople).

The ATO have focused their **attention on firms operating in** the accounting, architectural, **engineering, financial services,** legal and medical professions that are structured as a partnership, company or trust.

Particularly, the ATO have **turned the spotlight onto firms** where income is derived from the business structure, and professionals (or associated entities) hold equity and provide skilled labour to clients. The guidelines are a useful risk assessment tool.

Validly established and carried out in accordance with documentation

To ensure that the practice is validly established, make sure that all documentation is appropriately executed and dated, and that all required formalities are properly carried out.

The practice must then be carried out in accordance with this documentation.

Marketing materials and **correspondence must reflect the** nature of the structure.

For example, it would be problematic if an email signature referred to a solicitor as a 'partner' when the practice is supposedly operated by a company. In this instance, the solicitor should be described as a 'principal' so long as they are a director of the company.

Contractual agreements must also be executed by the contracting entity.

Sham arrangements

There have been a number of cases regarding sham arrangements, or the use of business structures only for tax avoidance.

A few of these cases are discussed below.

Tupicoff v FCT 84 ATC 4851
In *Tupicoff*, the taxpayer was a life assurance agent.

He restructured his business so as to become an employee of a family trust. The trust started receiving the commissions formerly paid to the taxpayer who was paid a salary by the trustee.

The balance of the income in the trust was distributed to family members. The case was heard in the Supreme Court of Queensland where Shepherdson J in a decision **at first instance held that the** then tax avoidance legislation - section 260 of the Income

Tax Assessment Act 1936 (Cth) - operated to nullify the arrangements for income tax purposes. This legislation has now been replaced with Part IVA. **He stated that:**

Before the transactions the taxpayer was an agent of NML selling life assurance on its behalf.

The sales were made purely as a result of his selling ability. After the transactions the taxpayer sold life assurance on behalf of NML - as he had done before - save that he was then an accredited agent and an employee of the company. In the 1980 year all the gross earnings of the company were derived from the taxpayer's selling ability.

The taxpayer, so far as dealings with clients and potential clients were concerned, operated in exactly the same way both before and after the transactions. There were admittedly minor differences - e.g. the business cards, the letterheads and NML paying commission to the company and the company acquiring certain assets.

These differences do not, in my view, cause me to believe that from the clients' viewpoint there was any substantial change in the taxpayer's operations after the transactions were completed. This was upheld on appeal to the Federal Court.

The court took into account the fact that as an accredited representative approved by National Mutual Life Association of Australia Limited ("National Mutual"), he preserved for **himself his existing benefits** in superannuation, medical, accident and sickness funds conducted by National Mutual.

This type of arrangement has come to be described as a 'Friday to Monday' arrangement – as the business is one

structure on Friday, then another on Monday but nothing else has changed apart from tax implications.

Since this case, the ATO have introduced IT 2121 which addresses arrangements where a salaried tax payer starts deriving a personal services income through another entity, with a lower salary being paid and income being split or diverted to other family members.

As outlined in IT2121, the Commissioner considers that these arrangements:

"... may be characterised as arrangements entered into primarily or principally or predominantly to avoid liability for income tax by means of the splitting of income."

They are not explicable as ordinary or family dealings. To the extent that the arrangements were entered into prior to 28 May 1981 section 260 will operate to nullify them for income tax purposes.

The tax benefit arising out of arrangements entered into on or after 28 May 1981 will be removed through the application of Part IVA. In both cases, the practical result will be that the taxpayer doing the work will be liable to tax on the amount paid by the former employer to the interposed entity.

***Federal Commissioner of Taxation v Mochkin [2003]* FCAFC 15**

A different outcome was reached in *Mochkin* in respect to the operation of Part IVA.

In this case, the taxpayer carried on a successful stockbroking business under a series of arrangements with **different stockbroking firms.**

The arrangements involved the sharing of commissions, the provision **of office space and other facilities for** the taxpayer's business.

However, after being sued by one of **the firms for the default of his clients** in completing share transactions, the taxpayer arranged for the business to be carried on through family trusts.

During the years in question, the taxpayer was not paid a salary but received trust distributions.

In 1999, the Commissioner issued amended assessments for the 1992 to 1997 income years, including in the taxpayer's taxable income brokerage commissions (totalling almost $12.5 million) paid to the corporate trustee of one of the trusts.

The Commissioner argued that the commission income was derived by the taxpayer as Part IVA applied to the arrangements.

The Full Federal Court in this case concluded that a restructure from sole trader to company was motivated by a genuine desire to protect the taxpayer from personal liability to clients, and that the revised structure did in fact achieve this end.

The corresponding tax benefit of the restructure was therefore incidental to the purpose of the restructure and not an improper minimisation of tax open to the Court to undo.

***C of T v Gulland*(1985) 160 CLR 55, *Pincus v FCT*85 ATC 4765 and *Watson v FCT*(1953) 87 CLR 353**

C of T v Gulland, *Pincus v FCT* and *Watson v FCT* all considered similar facts. In each case, a doctor practiced in their personal name, and the practice was acquired by the trustee of a unit trust.

The units were held by the trust of the doctor's family trust. The doctor was employed by the unit trust at an amount less than his total income.

The rest of his income was split amongst family members, effectively splitting the income upon which the medical practitioners might otherwise have been liable to tax with a consequent reduction in the amount of tax payable

The High Court rendered these arrangements void under the then tax avoidance section.

The majority found that the arrangements were not capable of explanation without being labelled as a means to avoid tax.

This was due to the fact that the medical practitioner had power to remove the trustee of the family trust and therefore could control the family trust, the trustee of the unit trust did not actively engage in the medical practice and that the medical practices carried on the same as before the arrangements had been entered into.

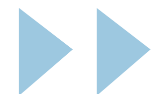
The High Court also stated that the then tax avoidance section, section 260 of the *Income Tax Assessment Act 1936* (Cth), was not a "catch all" tax avoidance measure as previously thought, but is subject to certain limitations.

As outlined in IT2330, the Commissioner stated that:

It is not possible to formulate a general rule for the operation of section 260 which will operate across the board.

Whether the section applies in the particular case must be determined in the light of all the facts of the case... The reconciliation of section 260 with other provisions of the *Income Tax Assessment Act 1936* means that a decision can only be made in individual cases by examining all the features of the particular arrangement.

While this Ruling is directed at the operation of the old taxation avoidance legislation in relation to income splitting arrangements, there appears to be much in the Court's reasoning in the doctors' cases to support the operation of the section in a number of other tax avoidance schemes.



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Top Tips!

Regardless of the business structure you choose, you must make prudent legal and accounting decisions.

Here are our top tips:

1. Avoid accumulating assets in the name of the professional, including in the capacity of an individual trustee of a trading or passive trust. If possible, also avoid accumulating tangible assets in the same entity that carries on business operations.

2. Be aware that in the event of bankruptcy, 'clawback' provisions can operate to void uncommercial or undervalued transactions up to 5 years beforehand. It is important that the best practice structure is chosen from the beginning to limit future transfers of property which could become subject to clawbacks.

3. Do not dismiss using a separate legal entity from professional practice planning simply because the PSI regime will return the income to the hands of the professional. Asset **protection benefits may still flow** from these structures even if tax **benefits do not.**

4. Ensure that you understand how legal documents deal with control of the entity. For example, a trust deed will outline who is trustee, how they can be removed, and who will be **beneficiaries.**

5. If possible, income should be directed to persons not at risk. This is possible using a discretionary trust, company, or a unit trust with a discretionary trust holding shares.

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Conclusion

Choosing a practice structure for your business is a complicated process.

As discussed above, there are multiple advantages and disadvantages to each different business structure.

It is crucial to consider the particular needs of your business when making this decision.

Critically, it is also important to ensure that the reality of the business' operations align with the chosen practice structure.

The law surrounding this area places emphasis on the substance of each arrangement over the legal form, as seen in past case law discussed above.

Therefore, it is essential that the substance and form align when relying on the benefits of a particular business structure.

Due to the complexities involved in choosing a practice structure, it is important to seek advice from a professional business advisor.

This will ensure that you gain the maximum advantages from the opportunities to lawfully minimise tax, safeguard the personal interests of practitioners and facilitate future growth and reorganisation of the business.

The solicitors at *Butlers Business and Law* are experts in professional practice structuring and can help you decide what is right for your business.

Want to know what *Butlers Business Lawyers* can do to assist you in your legal matter?

Talk to our experienced solicitors in Newcastle, the Hunter or Sydney! Call us on (02) 4929 7002, email us or complete an enquiry form to book.