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Tax Issues -Restructuring Legal Practices

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PARTNER

2

Issues

- ILPs – requirements and issues
- Income splitting – Part IVA
- Issues with goodwill
- Alternative to transferring practice to ILP
- Tax effect of partner entries & exits
- Everett assignments
- Service trusts

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3

Incorporated Legal Practices (ILPs)

- Legal Profession Act 2007
- Must have at least one legal practitioner as director (s 117)
- Shareholders can be non-lawyers (s128)
- Only restriction – cannot employ or share profits with “disqualified person” (s129)

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4

Can Practice Be Carried On By Trustee?

- Yes
- Trust has always been permitted – but Rule 67 no longer applicable
- Does not have to be ILP – can be individuals

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ATO Issues - Trust & ILP Practices

- Mark Konza, Deputy Commissioner – TIA Seminar 31 March 2009
 - Principals earn less than employed lawyers or industry norm
 - Checking that CGT has been paid on transfers of practices to IPL or trust
 - Query on whether a “trust” can be a partner

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6

Income Splitting

- Problem for sole practitioners
 - Personal services income
 - Gulland, Watson & Pincus - (1985) 160 CLR 55
 - ATO discussion paper (NTLG - 2 July 2009)
- No problem if income generated primarily from business structure/employees
- IT 2639 rule of thumb - at least as many employed fee earners as principals – on FTE basis

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Part IVA - Transfer of Practice to ILP/Trustee

7

- ATO will not generally apply Part IVA to sale of income producing asset - as opposed to diversion of income generated from the asset (CCH Federal Tax Reporter – 48-494)
- TD 95/4 – Part IVA would not apply to disposal of income producing asset from individual to company

Part IVA - Transfer of Practice to ILP/Trustee

8

- “A decision to conduct a business through one of the alternative structures available at law – sole trader, trust or company – will not itself attract Part IVA” - Michael Carmody (former Commissioner) 2002
- ATO did not argue Part IVA in Everett or IT 2540

Part IVA - Transfer of Practice to ILP/Trustee

9

- Importance of second purpose
 - Asset Protection
 - Business Efficiency
 - Payroll tax
- Prepare your case

Goodwill

10

- For “goodwill” partnerships – transfer to ILP or trust triggers
 - CGT event
 - stamp duty
- CGT may not be problem if CGT small business concessions available (Division 152 – 1997 Tax Act)

Goodwill Issues – CGT Concessions

11

- If small business concessions available – can disregard up to \$2m of capital gain
- Must satisfy “basic conditions” particularly:
 - Net assets < \$6m; or
 - Turnover < \$2m
- Do not necessarily have to pay part of gain into superannuation
- Implications of Henry review?

“No Goodwill Partnerships” - OSR

12

- OSR reluctant to accept profitable practice has no goodwill
 - Draft Revenue Ruling SD 41.1D
 - Revenue Ruling SD 223 (NSW)
- Will concede on partner entry/exit
- More likely OSR will assess on sale of practice

“No Goodwill Partnerships” - ATO

13

- ATO accept on partner entry/exit
- Current position is that there is disposal of goodwill if practice transferred to new entity

“No Goodwill Partnerships”

14

- ATO Guide – Tax Aspects of Incorporating your Business - www.ato.gov.au

The circumstances that permitted the recognition of no-goodwill arrangements in applying CGT law to the admission and retirement of partners are not applicable on the transfer of the business to a company.

This is influenced by the circumstance that the business is being transferred to the company and an ongoing interest in the company by way of shares is acquired.

“No Goodwill Partnerships”

15

- Fagenblat – [2001] VSC 479 - value of goodwill requires “careful attention to the specifics” of the business
- McFadden (79 ATC 4381) – court accepted no goodwill where
 - partnership did not recognise goodwill
 - partners not subject to any restraint of trade

“No Goodwill Partnerships”

16

- Parnell (79 ATC 4286)
A buyer would not be willing to pay for goodwill where there is no guarantee principals will remain with business

How to Avoid/Reduce Goodwill Issues

17

- Stipulate principals not entitled to payment for goodwill
- Ensure principals are not subject to restraint of trade
- Prohibit assignment of interest in practice

Business Licence

18

- Alternative to transferring practice
- Roussos – 92 ATC 4370
- Harrington – [2002] NSW SC 859

Business Licence – ATO Position

19

- IDs 2003/517 & 2004/7
- Private Rulings
- Part IVA may be more of an issue – importance of second purpose

Business Licence –Duty

20

- Grant of new right
- OSR
 - Require valuation
 - Will accept nominal value if licence can be terminated on short notice
 - May audit to ensure arrangement implemented as per documents

Business Licence

21

- Agreement essential
- Not just goodwill
- License should include other assets (e.g. operating structure/systems)
- KISS

Partner Entry/Exit

22

- Partnership is tax “entity”
- Entry or exit is a “technical” dissolution under Partnership Act
- Will this require new TFN/ABN?
- Important to ensure GST compliance

Partner Entry/Exit

23

- GSTR 2003/13 - ATO will accept that the same entity carries on business if
 - substantially all assets remain with partnership
 - nature of the enterprise is substantially unchanged
 - business name remains the same
 - **partnership agreement has “continuity” clause**

Everett Assignments

24

- Alternative to transferring practice to new entity – each partner can choose
- More effective now there is no restriction on who can share profits
- Assignee does not acquire direct interest in partnership

Everett Assignments

25

- Partner effectively holds all/part of partnership share on trust for assignee
- Potential “control” problem for other partners – e.g. if assigning partner is divorced

Everett Assignments

26

- Assignment triggers CGT event E1
- ATO & OSR will require valuation based on maintainable future earnings
 - Reynolds (86 ATC 4528)
 - IT 2540

Everett Assignments

27

- Assignee entitled to all income for year in which assignment occurs – even if 29 June (Galland – 86 ATC 4885)
- Assignments “on all fours” with Everett and Galland not caught by Part IVA (IT 2501)

Service Trusts - Problem Areas

28

- Lack of documentation
- Did firm seek prices from other suppliers
- No separation between operations of service entity and partnership
- No benchmarking of prices/margins
- Lease in wrong name

Service Trusts - Problem Areas

29

- Employee letters/contracts in wrong name
- Accounts/contracts with third party suppliers
- No tax invoices issued by service entity

Service Trusts

30

- Does it matter that service entity owns few assets
- On ATO problem list
- Ignores fact that business infrastructure has value

Service Trusts

31

- Have separate agreements/charges
 - IT
 - HR
 - Marketing
 - Premises/facilities
 - Staff
- More difficult for ATO to apply labour hire index

Service Trusts

32

- Does service trust serve any purpose?
- Many professionals choosing to transfer practice to ILP/Trust
- What happened to Phillips?
- Asset protection still important



Thank You

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