THE TAX INSTITUTE

THE MARK OF EXPERTISE

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Mr Michael Cranston
Deputy Commissioner
Private Groups and High Wealth Individuals
Australian Taxation Office

By email: Michael.Cranston@ato.gov.au

Dear Michael,

Assessing the risk: allocation of profits within professional firms

The Tax Institute writes to comment on the ATO's draft guidelines, *Assessing the risk: allocation of profits within professional firms* (**Guidelines**). The Guidelines directly affect our members and also impact on the professional advice given by our members to their clients regarding the use of business structures in a wide range of industries.

Overview

Our main concern is that the Guidelines conflate two substantially different and not necessarily related items:

1. restructuring of professional businesses into partnerships of trusts; and

2. the ATO view on how a legitimate business which happens to derive its business income from professional services, should distribute its profits.

It is our view that these two discrete issues should be dealt with separately in ATO guidance.

Technical clarification vs Guidelines

We welcome the ATO's release of the Guidelines for public comment. Guidelines assist practitioners by providing clarity on the ATO's compliance approach in a particular area. However, from a technical point of view, the value of guidelines is low compared with a court decision, public ruling or legislative amendment.

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The use of working groups such as the Professional Practice Structures Working Group, which The Tax Institute was involved in, can assist with the initial drafting of such guidance. It is important, however, for the ATO to remain open to changing those draft guidelines during public consultation to accommodate a broader range of views.

Technical issues

Relevant cases

We have set out the development of the relevant case law in an Appendix to this letter.

There is no principle of law that income derived by a trustee from operating a professional services business belongs to the professional service providers rather than to the trustee: see *Liedig v FCT* 94 ATC 4269 per Hill J at 4277-4278. Although there is old (pre-1990) case law supporting the application of general anti-avoidance provisions to the incorporation of professional practices, those cases are distinguishable on a number grounds. Unlike modern professional practices:

- Professional practices before the 1990's were generally not permitted to incorporate by their professional associations or carry out their practice through trust structures;
- There was far less risk of being sued for professional negligence;
- Most of the cases were determined under former section 260 of the I*ncome Tax Assessment Act 1936* (**ITAA 1936**) which did not require a dominant purpose of obtaining a tax benefit; and
- Professional services firms were far more reliant on the personal exertion of individual practitioners than is currently the case.

Restructures

We understand that the Guidelines were prompted by some legal practitioners restructuring their partnerships of individuals into partnerships of discretionary trusts in "Friday/Monday" arrangements, resulting in a sudden decline in income derived by the individual practitioners. We support the ATO's view that Part IVA may apply to such arrangements if there is no genuine commercial reason for the restructure (cf *Commissioner of Taxation v Mochkin [2003] FCAFC 15 ('Mochkin')*).

It is unclear how significant the above problem is and whether it warrants the Guidelines. The Guidelines apply a broad brush to what is essentially a factual inquiry on Part IVA. There are some compelling non-tax reasons to favour alternative business structures over a partnership of individuals, however the relevance of Part IVA to any business restructure will obviously turn on the facts in each case. We agree that a taxpayer is wise to at least consider the potential implications of Part IVA in respect of any significant restructure. This applies equally to professional firms, irrespective of whether a professional firm chooses to restructure to a partnership of trusts, company structure or another alternative as a logical preference to a partnership of individuals.

Naturally where a professional firm or individual adopts a particular structure or changes their structure for sound commercial reasons, and there is no dominant purpose of achieving a tax benefit, Part IVA would not apply.

Part IVA should generally not be relevant where a new professional firm is initially established as a company, trust or partnership of trusts. Generally, a choice of structure is open to all new businesses and will be influenced by a variety of commercial, relationship, legal and taxation considerations. The ATO should not dictate the type of structure a business should adopt through the Guidelines. For example, the facts of *Mochkin* illustrate a common scenario, where a well-founded fear of litigation drives a natural desire to structure a business in a way that leaves personal assets unavailable to creditors of a business. Any experienced litigation lawyer would advise their client to do exactly what Mr Mochkin did. Part IVA does not reverse such rational business structuring choices.

Business income

If the ATO were to actively pursue professional practices consistent with the statements in the Guidelines then this would have fundamental consequences for all businesses and all business structures including companies and trusts, as there can be no valid distinction between a professional services business and a business of primary production, a manufacturing business or a retail business.

We do not agree with the view in the Guidelines that remuneration received by the individual partner is relevant to determining whether amounts derived by the professional services firm are business income. If remuneration was treated as relevant to this issue, then this would have implications for any person who does not receive a benchmark remuneration for the services rendered, for example, a farmer in a primary production enterprise. It is our view that the Guidelines unfairly require professionals to be paid for their labour before turning a profit on the business. This would be tantamount to a domestic transfer pricing rule, requiring an 'arm's length' wage to be derived by every worker. We question whether this is an appropriate use of Part IVA, particularly given the narrow line of case law outlined above.

We request that the ATO reconsider the interpretation of business income implicit in these Guidelines. If the ATO is minded to pursue this course of action, further technical guidance should be provided on this issue, as the approach in the Guidelines appears to be inconsistent with existing rulings such as IT 2639 (in particular para 10) and TR 2001/7.

It is clear that Divisions 85 and 86 of the *Income Tax Assessment Act 1997*, which deals with the alienation of personal services income could never apply to a sizeable professional practice, irrespective of structure. This point is uncontentious and consistent with the Commissioner's correct reasoning in Taxation Ruling TR 2001/7. Example 7 from TR 2001/7 provides as follows:

> "John is a partner in a large accounting partnership which has 20 partners and 200 employees.
>
> As a partner, John's income from the partnership flows from property, namely, his proprietary interest in the partnership. That interest is an interest in, among other things,

> the profit derived by the partnership as a whole, i.e., in the profits generated by the other partners and employees from custom attracted by the goodwill of the partnership, and use of the partnership assets. When a partner participates in profits generated not merely in law, but as a commercial reality, from the efforts of the entire firm, it is properly attributed to the taxpayer's interest in the business structure or organisation of the partnership (which is his capital).
>
> Accordingly, as a partner in the partnership, John's income is income of a business structure rather than his own personal services income. The partnership has numerous employees and business assets and the income of the partnership is generated by these employees and the partnership assets and goodwill. "

Even in cases where Divisions 85 and 86 have potential application (e.g. smaller professional firms), the income of a company, trust or partnership would often be excluded on the basis that there is a personal services business under Division 87.

Regardless of business size or structure, any business operating in Australia relies on the efforts of people. There is no general principle in Australian law that the income of the business should simply be attributed to those individuals on the basis of their perceived contribution (unless the income is personal services income under Division 84 to 87 of the Income Tax Assessment Act 1997 or subject to anti-avoidance provisions in accordance with the case law outlined above and in the Appendix). This is irrespective of whether that person is a CEO, a member of a board of directors, a shareholder, marketing manager or director of a trustee company. An attribution approach would represent a fundamental change to Australian law that would significantly undermine Australian business at all levels. This is essentially the proposition of the Guidelines albeit that, at this stage, the ATO chooses to limit this approach to accountants, lawyers and other professionals. For example, paragraph 4b(ii) refers to income that is not "*attributed solely to the efforts of employees or income producing assets*". This is a clear departure from established tax law outlined above.

We recommend that the Guidelines and IT 2639 should also be reviewed to ensure that they accommodate emerging changes in professional services. A key example of such a change is increased automation. For example, drafting a trust deed can now be done without much human interaction and no physical drafting. Another example is increased outsourcing and a shift to towards international salary benchmarks. The examples in the Guidelines suggest the ATO is not aware of such rapid changes. The ATO needs to be mindful of the impact of such rulings on our competitiveness in an international marketplace. This changing environment also casts doubt on the applicability of the older cases outlined in the Appendix.

Compliance issues

If the ATO is minded to pursue the interpretation of business income apparent in the draft Guidelines, our view is that the tests in the Guidelines set out fair thresholds for ATO compliance activity. We do however, request clarification in the Guidelines of the following points:

- *The interaction between the Service Entity Booklet and the Guidelines.* Is income derived by service trusts still relevant to the analysis? If so, please provide a relevant example in the Guidelines.

- *The 30% effective tax rate compliance benchmark.* We understand that this benchmark has been included primarily to address the risk of a principal reducing their personal income to a level where they may be eligible for government benefits or tax concessions, or may be able to understate child support calculations. We note that changes to the Guidelines are proposed to set this out more clearly. However, we question whether this benchmark should be applied to the principal's income before deductions rather than taxable income so that it is not impacted by unrelated deductions such as charitable donations, unrelated tax losses and superannuation contributions.

- *Income calculation when determining if 50% of the income is assessed in the hands of the individual professional practitioner.* It is unclear whether this calculation includes items such as franking credits, superannuation and fringe benefits. On a purely economic basis, such amounts should be included as income of the professional.

- *Part-time partners*. We suggest that the Guidelines clarify how the ATO will identify and accommodate partners who are part-time in their risk assessment.

* * * *

If you would like to discuss any of the above, please contact either me or Tax Counsel, Thilini Wickramasuriya, on 02 8223 0044.

Yours sincerely,

Michael Flynn
President

APPENDIX – OUTLINE OF RELEVANT CASE LAW

Peate v Federal Commissioner of Taxation (1964) 111 CLR 443 ('*Peate*')

Dr Peate practiced in a partnership of individual doctors for some years. In the relevant year of income, the partnership was dissolved by mutual agreement. By forming companies and executing agreements, the doctors then began attending to patients on behalf of a company. Patients contracted with the company that payment for the services would be made to the company, even though the doctors might have rendered services in his own name. In practice, the contracts were sometimes not complied with and patients sometimes paid the doctor directly. In these instances, the doctors forwarded the payments to the company. Justice Menzies noted that the Medical Practitioners Act of NSW at the time prevented the interposed companies from suing for fees for medical services (at 457).

The payments received by the company were applied in accordance with the decisions made by the participating doctors in their capacity as directors of the company. This included the payment of service fees to the family companies in respect of each of the participating doctors. The service fees were in effect the distribution of the net income of the company to the family companies of each of the doctors in proportions agreed upon by the doctors.

The High Court found that the restructure in this case was carried out for a number of reasons, including protection of the individual doctors against liability for negligence. Nevertheless, it was found that the restructure was a tax avoidance scheme within former section 260 of the ITAA 1936.

Justice Menzies stated at 461 (para 14 of his judgment):

> There is a strong prima facie case that the purpose and effect of what was done was to obtain increased tax deductions from assessable income and to divide what would otherwise have been Dr. Peate's taxable income between himself, his wife and his children… It is true that I do regard the incorporation of Raleigh and the seven other doctors' family companies as colouring everything that was done here but, even without this, I would have concluded that it was not an ordinary business transaction for a body of professional men who are entitled to sue for fees for medical services to transfer their practices, their libraries and their instruments to a company which could not sue for fees and to become that company's servants in the conduct of their profession, particularly in the circumstance that, to the extent to which patients paid fees to the company, their expenditure was not deductible under s. 82F. What, outside a profession, might be regarded as an ordinary business transaction may, within a profession, have an altogether different appearance.

Justices Kitto and Taylor agreed that section 260 of the ITAA 1936 applied. Although the restructure also had the purpose of providing for the doctors' families, it was outside an ordinary family or business dealing and had a purpose of avoiding tax (Kitto J at 469, Taylor J at 476).

Federal Commissioner of Taxation v Gulland ("Three Doctors Case") (1985) 160 CLR 55

Dr Gulland was conducting a one-man medical practice at the beginning of the relevant income year. He had a family trust which provided management, office, staffing services for the practice. Later in the year a unit trust was set up and the taxpayer and another doctor became its trustees. The taxpayer sold his practice to the unit trust and began serving as an employee of the unit trust. All the units of the unit trust were held by the trustee of the taxpayer's family trust.

Dr Watson was in a partnership with four other doctors. In the relevant income year, a family trust was established with the taxpayer and his wife as trustees. Similar trusts were also established by the other doctors. A unit trust was formed and the family trusts of each of the doctors held the units in the unit trust. The individual partners sold the practice to the unit trust and because employed by the trust. A superannuation fund was created for the employed doctors. A service trust controlled by the doctors was formed and provided services to the unit trust.

Dr Pincus carried on a partnership with three other doctors at two surgeries. In the relevant year of income, the partnership was dissolved. The decision to dissolve the partnership was first made by the taxpayer because he was dissatisfied with the manner in which the partnership was conducted. The assets of the partnership were sold to two unit trusts, the beneficiaries of which were family trusts of the doctors. Each doctor became employed by one of the unit trusts. The doctors each became trustees of the particular unit trusts they were not employed by.

The High Court (Deane J dissenting) found that former section 260 of the ITAA 1936 applied in each of the three cases. The Court rejected the taxpayers' arguments that *Peate's Case* was no longer good law, and that they were merely making use of a tax advantage for which the Tax Act provides.

Peate's Case and the *Three Doctors Case* were decided under former section 260 rather than Part IVA. Justice Dawson noted at para 16 of his judgment that "*it is unnecessary for the purpose or effect of an arrangement to fall within s 260 that it be the sole or, it would seem, even the dominant purpose.*" Similarly, Gibbs CJ stated at para 8 of his judgment that "*if tax avoidance is one of the main purposes of the arrangement in the sense that it is not inessential or merely incidental, that is enough*". This can be contrasted with Part IVA which does require a dominant purpose.

Referring to passages in *Peate's Case*, Dawson J noted at para 24 of his judgment that it was the artificial character of the arrangement in that case which brought it within section 260 of the ITAA 1936. He stated "*its very complexity pointed to its contrived nature and took it beyond the range of transactions ordinarily encountered in the organisation of affairs for business or personal reasons*." At para 27 of his judgment Dawson J said it is significant that the arrangements in question do not facilitate the practice of the profession and it is also significant if the structure adopted fails the requirements of the law or professional standards. It should be noted that structuring partnerships with trusts is much more common now, and authorised by professional standards such as in the legal profession, and the result might be different today. Indeed Dawson J supported this proposition in para 68 of his judgment:

> It is, of course, conceivable that the nature of professional practice may change in such a way that an arrangement of the type struck down in Peate's Case will no longer be seen as an artificial contrivance for the purpose of tax avoidance but as the exercise of a choice in the ordinary course of things which brings with it a tax advantage. That would not, however, be to deny the principles laid down in Peate's Case. It would merely be to require their application to changed circumstances.

Applying this reasoning to *Gulland*, Dawson J held at para 32 of his judgment that the purpose and effect of the whole arrangement was to alter the income tax liability of Dr Gulland. There was no business or family purpose other than to provide Dr Gulland with superannuation benefits. No limitation of liability was achieved and the provision of medical services was not facilitated in any way (para 33). Similar conclusions were reached in relation to *Watson* (para 51 and 52).

Chief Justice Gibbs stated at para 14 of his judgment that the fact that Dr Gulland's family trust was already in place (whereas Dr Watson's was not) did not change the conclusion that section 260 applied in both cases.

He stated at para 20 of his judgment that *Pincus* was not distinguishable from *Peate's Case*. The taxpayer argued that the cases were distinguishable because, at the time that the partnership was dissolved, the subsequent structure was not finalised. The Chief Justice found *"it would be wrong to regard the income after the dissolution as coming from a new source; the source remained the practice by the taxpayer of his profession at [the surgery where he practiced]".* A similar conclusion was reached by Dawson J at para 72 of his judgment.

Justice Deane, in dissent, gave precedence to a later line of cases in *Mullens*, *Stutzkin* and *Cridland*[1] over *Peate's Case*. He stated in para 21 of his judgment that

> The judgments in those three cases in this Court have 'made it quite plain…that a taxpayer is entitled to create a situation to which the Act attaches taxation advantages for the taxpayer. Equally, the taxpayer may cast a transaction into which he intends to enter in a form which is financially advantageous to him under the Act'

In relation to *Pincus* he noted that the re-arrangement of the relationships between the individual partners "*could not be seen as a mere casting into another form of the 'actual transaction' or 'situation' between them...The new relationships which the transactions created were quite different in substance from those which had existed before*."

Re Commissioner of Taxation v Robert J Bunting [1989] FCA 98 ('Bunting')

Mr Bunting was a computer programmer who migrated to Australia in 1980 and sought employment. He spoke to a company known as Computations Pty Limited (Computations) which was looking for a consultant for a particular programming project. Computations suggested that, if Bunting were to be involved, he may need to do so through a company with limited indemnity. This was a common arrangement in the computer industry. A company called Manting Pty Limited (Manting) was incorporated and its share capital became held by Bunting's wife and Bunting on trust

[1] *Mullens v Federal Commissioner of Taxation* [1976] HCA 47; *Slutzin v Federal Commissioner of Taxation* (1977) 140 CLR 330; *Cridland v Federal Commissioner of Taxation* [1977] HCA 61.

for his wife. Manting became the trustee of a family trust whose beneficiaries were Bunting's family excluding Bunting himself. Bunting became employed by Manting. Manting contracted to provide Bunting's services to Computations at a rate calculated on the number of hours Bunting worked. The same arrangement was subsequently used with another computer project for another entity after the project with Computations was completed.

Justice Lockhart in the Federal Court reversed an AAT decision and found that former section 260 of the ITAA 1936 applied to the arrangement. He held at para 24 of his judgment:

> There could be no business or family purpose served by the arrangement in question other than to provide Mr. Bunting with superannuation benefits and to adopt a corporate vehicle for provision of his services, as appears to have been a common practice in the computer industry at the relevant time. However, the structure which was created was more than was necessary to provide those benefits. No business or family purpose can be found for the creation of the family trust. The trust is a discretionary trust from which Mr. Bunting is expressly excluded as a beneficiary. This provides a strong indication that the primary purpose of the transaction was to split Mr. Bunting's income between himself and members of his family.

In *Gulland*, Justice Dawson at para 28 noted a distinction between an arrangement which modifies an antecedent transaction or situation (where former section 260 could apply) and "one which merely orders a taxpayer's affairs in relation to income from a new source…" (where former section 260 could not apply). Bunting argued that section 260 could not apply because there no relevant antecedent situation in this case. Justice Lockhart rejected this argument stating that there was a relevant antecedent situation consisting of Bunting's work as a computer industry in the UK. He held at para 32 that the change to the corporate structure did not give rise to a new source of income and referred to the fact that the money paid to Manting by Computations was directly related to and calculated by reference to Bunting's services on the basis of an hourly rate.

Commissioner of Taxation v Mochkin [2003] FCAFC 15 ('Mochkin')

Mochkin is the latest case in the line of relevant case law. It is the only case in the line of authority which deals with Part IVA instead of former section 260, and the Commissioner was unsuccessful in this case.

In 1987 Mr Mochkin entered a commission-sharing arrangement with a firm of stockbrokers (Bridges). Later that year, Mochkin and Bridges had a dispute about Mochkin's liability for the default of his clients in completing share transactions. The arrangement with Bridges was terminated and Mochkin entered a similar arrangement with another firm of stockbrokers ("Pembroke").

In 1988, as litigation between Mochkin and Bridges was reaching finalisation, Mochkin caused a company called Daccar to enter the commission-sharing arrangement with Pembroke in his place. Daccar was the trustee of a discretionary trust whose beneficiaries included the Mochkin family and a charity. In 1989, Pembroke entered an agreement with a company called Ledger, which was also the trustee of a discretionary trust whose beneficiaries were the Mochkin family and a charity. Ledger entered further

agreements with other stockbroking firms in subsequent years. The net income by Ledger were distributed in a tax effective manner.

The Commissioner argued that Part IVA applied and that the commissions earned by Ledger were assessable to Mochkin. The Full Federal Court rejected the Commissioner's argument and held that the arrangement was the product of commercial imperatives. Justices Merkel and Kenny agreed with the judgment of Sackville J. At para 81, Sackville J stated:

> In the present case, the objective facts indicate clearly that, following the settlement of Bridges' claim against him, the Taxpayer was not prepared to conduct the stockbroking business on his own account. He had not merely been exposed to possible personal liability in respect of client defaults, but had actually been required to make good defaults by his clients.

Further, the Court held that the income received by the trustee companies were not merely a substitute for income generated by the services of the taxpayer alone. At para 83, Sackville stated:

> …in this case the income received by Daccar and Ledger was not generated simply by the personal exertion of the Taxpayer. Doubtless, he played an important role in the business. But the primary Judge's findings establish that Daccar and Ledger each employed or acquired substantial facilities for which they paid. The companies also utilised the services of persons other than the Taxpayer. On the primary Judge's findings, it cannot be that this was merely a one person business.

There were other structures available to Mochkin to achieve limitation of liability benefits. The Court acknowledged that the discretionary trust structure he adopted had substantial tax advantages compared to other structures and that one of the purposes of Mochkin entering into the arrangement was to obtain a tax benefit in distributing the net income of the business in a tax effective way. However, this was insufficient to show a dominant purpose for Part IVA purposes (paras 84, 98).

Further, the Court found that there was no tax benefit for the purpose of Part IVA. Given the taxpayer's unwillingness to accept personal liability for client defaults, the taxpayer would have carried on the business through another limited liability entity rather than carrying on the business in his personal capacity. Accordingly, even if the current arrangement was not in place, the alternative hypothesis would not have resulted in Mochkin deriving the commission income personally (para 102, 105).

It should also be noted that the Commissioner submitted that the fees or commissions paid to the trustee company should be regarded as income derived by the taxpayer under former section 25(1) of the ITAA 1936. The Court rejected this argument because the business of the trustee company was not a "one person" business, and further because the Full Court in *Tupicoff*[2] held that such a result could not operate if the anti-avoidance provision did not apply.

[2] *Tupicoff v Federal Commissioner of Taxation* (1984) 4 FCR 505