PROFESSIONAL PRACTICE STRUCTURES

&

50 Shades of Exertion

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1 OVERVIEW

Structures used by professional service providers have evolved over recent years. The main drivers away from the traditional partnership of individuals include the following:

   a) Changes by the various professional bodies allowing alternative types of structures;
   b) The ATO crackdown on service trust arrangements;
   c) The desire to limit ones liability away from the notion of “joint and several” liability associated with traditional partnerships;
   d) The need to offer alternate ways of equity participation for employees.

2 TAX OFFICE ACTIVITY

The recently published minutes of the National Tax Liaison Group (NTLG) from 28 March 2012 contained an update on the ATO investigation of professional practice structures. This investigation has been going on for some time and was originally raised in the September 2008 NTLG meeting.

From the minutes, the following areas were raised as concerns:

   a) Whether CGT has been accounted for when there has been a transfer of an interest in the partnership to an associate or associates (e.g. a discretionary trust)?
   b) IT 2540 issues concerning dealings between practitioners for entry/exit from the partnership and not dealings between practitioners and their family trusts
   c) Can an Everett assignor as trustee for the Everett assignee be a separate partner?
   d) Contention that the new partners is the current partner-practitioner as Trustee for his family trust so that the practitioner is in partnership with himself (albeit as Trustee)
   e) What does the practitioner as Trustee bring to the practice that didn't exist prior to the restructure?
   f) Extension of Everett assignments to assert assignees are partners at law (an Everett assignment does not include management rights or the right to participate in the partnership).
   g) Some transactions are being entered into without supporting documentation.
   h) Some trusts that have no employees claim a superannuation deduction.
   i) How the arrangement is implemented and whether the form of the arrangement is implemented in fact, including:
      a. The admission of discretionary trusts as partners without documenting or updating the partnership agreement (if one exists);
      b. Concerns about how the purported interest in the partnership is created (whether the trustee of the trust is actually a partner or merely an Everett assignment has taken place)?
   j) Whether Part IVA will apply where a practitioner is returning income which is now low compared to the partnership profitability following a restructure.
      a. For example, a partner that receives in excess of $600,000 into a discretionary trust; this is distilled into a taxable income of only $60,000 in the hands of the natural person practitioner
   k) Understanding the commercial drivers when practitioners restructure to a partnership of discretionary trusts.
Despite the long history of this issue, the ATO stated that it is still in the early stages of its audit work and had not formed any conclusions about some of the structures such as partnerships of trusts. The Commissioner has recently elevated the use of partnerships of discretionary trusts by professional practices to a Priority Technical Issue\(^1\).

I intend to consider some but not all of the areas of concern mentioned in a) to k) above. My concern is that we don’t end up with another “service trust” debacle where the ATO provided little guidance for years on what was or was not acceptable which lead to some professionals pushing the boundaries.

3 MARKET BASED SALARIES FOR ALL SME OWNERS?

Much of the current focus appears to be directed at accountants, lawyers and other professionals. The emphasis on what is a “reasonable salary” has yet to extend to the greater business community. In my experience, most SME operators pay themselves a salary far lower than what might be considered market value. The reasons often have more to do with keeping sufficient working capital in the business rather than some form of tax avoidance.

Recommendation 10 in the Henry review states the following:

“Consideration should be given to a revised regime to prevent the alienation of personal services income that would extend to all entities earning a significant proportion of their business income from the personal services of their owner-managers, whether in employee-like or non-employee like cases. This regime may also apply an arm’s length rule to deductions arising from payments to associates to ensure deductions reflect the value of services provided.”

Should we be concerned about this? Whilst I have not seen any further developments on this recommendation, it fits in nicely with the current focus of the NTLG.

My question (which was also raised by the professional associations) is why the ATO is only concerned about what lawyers and accountants pay themselves? Why not the SME owners who run a business via a family trust and pay no salary at all?

4 INCOME FROM PERSONAL EXERTION – WHAT IS IT?

4.1 Personal services income

This paper is not about the Personal Services Income measures contained in Part 2-42 of the Income Tax Assessment Act 1997. These measures are designed primarily around contractors providing employee like services through entities with a limited number of clients, no employees, no business premises or own significant assets.

The main focus of this paper is for taxpayers who are clearly outside the scope of the PSI rules, but none the less need to deal with the general concept that you cannot alienate income from personal exertion.

The concept “income from personal exertion” overlaps but is not the same as that referred to in the Income Tax Assessment Act 1997 set out in section 84-5. In that section, the term “personal services income” is defined as:

(1) Your *ordinary income or *statutory income, or the ordinary income or statutory income of any other entity, is your **personal services income** if the income is mainly a reward for your personal efforts or skills (or would mainly be such a reward if it was your income).

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\(^1\) PTI 1210 – Clarifying the appropriate treatment of partnerships of discretionary trusts. As at 15 May 2012 the ATO view – planned date is 31 August 2012.
The definition is clarified further by the Explanatory Memorandum to the Bill.

*By reason of this definition, income which is:*

- Ancillary to an entity supplying goods or granting a right to use property; or
- Principally generated by assets an entity holds;

*is not personal services income as it is not paid mainly as consideration for the provision of the goods or due to the use of an asset.*

Clear examples of income that will be from personal services provided in the EM includes:

- Salary & wages
- Income of a professional person practising on his or her own account without professional assistance;
- Income derived by a professional sports person or entertainer from the exercise of his or her professional skills. This does not include income from endorsement by the person of a sponsor’s products.

Less clear is the meaning of “income gained *mainly* as a reward for an individual’s personal effort”. As the EM states, this requires a conclusion as to the substance of contractual arrangements between the relevant parties to those contracts.

### 4.2 Income from personal exertion

In Taxation Ruling IT 2639 at paragraph 3, the Commissioner defines income from personal services as follows:

“*Income from personal services* is income that an individual taxpayer earns predominately as a direct reward for his or her personal efforts by, for example, the provision of services, exercise of skills or the application of labour. The inclusion of *predominately* in this definition allows for the situation where personal services involve the use of some equipment, for example the drawing board of an architect*.”

The ruling outlines the following factors for identifying income from personal services:

i) The nature of the taxpayer’s activities. The activities of salary & wage earners and professionals practising on their own account clearly generate personal services income. Radiologists who operate on their own account, however, often employ many technical staff and operate an array of technical equipment. Their income is generated from a business structure rather than from rendering of personal services;

ii) The extent to which income depends on their own skill and judgement. The more the exercise of the taxpayer’s own personal skill and judgement, the more probable it will be income derived from personal exertion:

iii) The extent of income producing assets used to derive the income. The ruling does note that the expression “income producing assets” includes tangible business assets such as premises, fixtures and fittings, plant and equipment and industrial or intellectual property (whether owned or leased). The inclusion of intellectual property in this expression would in my view include legal precedents used by a firm or lawyers and business names and trademarks.

iv) The number of employees and others engaged. The more substantial the number of employees used in a practice the more probable it is that the income is derived from the business structure rather than from rendering personal services.

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2 Extract from the EM at para 1.23
IT 2639 – Rules of Thumb-number of practitioners v non-practitioners

The ruling states for the purpose of determining if a practice company or trust falls within the scope of IT 2503 (Incorporation of medical and other professional practices), the ATO will apply the following rules of thumb:

a) If the practice company or trust has at least as many non-principal practitioners as principal practitioners, then the income is considered to be derived from the business structure;

b) If the practice company or trust has fewer non-principal practitioners than principal practitioners, consideration needs to be given to the factors i) to iv) outlined above and then consider if the company or trust derives its income from personal services.

Accepted practice for incorporated practices where income is derived from personal services

In Taxation Ruling IT 2503, the Commissioner accepts the incorporation of professional practices where income is derived from personal services provided:

i) There is nothing in the relevant State or Territory law to prevent incorporation;

ii) There are sound business or commercial reasons for incorporation;

iii) There is no diversion of income from the personal services of the professional practitioner to family members or other persons; and

iv) The only advantage for income tax purposes is access to greater superannuation benefits.

The advantage of access to greater superannuation benefits has been reduced significantly since the abolition of the rule for personal contributions which limited the deduction to the first $3000 + 75% of the excess.

4.3 Can income from personal exertion be alienated?

It is generally accepted the income from personal exertion cannot be assigned. Income from personal exertion first has to be received as income by the assignor.

The High Court in FCT v Everett\(^3\) refers to the remarks in Spratt\(^4\):

“No taxpayer can, by way of assignment, escape the assessment of tax on income arising from his personal activities – such income always remains truly his income and is derived by him irrespective of the method he may adopt to dispose of it”

The Court also refers to the observation of Menzies J in Peate\(^5\):

“…that it is established that a family man… cannot achieve taxation immunity by the simple expedient of assigning his earnings to his wife and family”

In Everett’s case it was not necessary for the Court to decide the true limits of the principle that a taxpayer cannot assign income from personal exertion. In that case, the income was not concerned income from personal exertion. The Court did note however the following:

“Whatsoever be its true and its precise limits, we do not consider that the principle applies here. The income of the respondent from the partnership was not income from personal exertion in the sense in which that expression has been used in the cases. There, with the exception of Kelly’s Case, it has been usually employed to signify income by way of wages or salary under a contract of employment where the contractual right to receive the income has been incapable of present assignment. It would also apply to

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\(^3\) 10 ATR 608 at 615

\(^4\) Spratt v IR Comr (NZ) [1964] NZLR 272 at 277

\(^5\) Peate v FC of T (1962) 111 CLR 443 at 446
the income earned by a sole trader who operates a business and a professional man who practises on his own account. In this context it is correct to say that the taxpayer’s remuneration is the product of his personal exertion and that all that he has to assign are his future receipts as distinct from any right to receive those receipts.\footnote{10 ATR 608 at 615}

In Taxation Ruling IT 2330, the Commissioner restates the principle that income from rendering of personal services cannot be so dealt with as to make it liable to income tax to any person other than the person who rendered the personal services.\footnote{IT 2330 at para 9}

More clear cut examples of where income splitting has attracted the provisions of the former anti-avoidance provision section 260 or the current Part IVA are the cases of Tupicoff v FCT\footnote{15 ATR 1262} (the National Mutual insurance agent) and C of T v Guillard, Watson v FCT and Pincus v FCT\footnote{17 ATR 1} (the doctors’ cases).

In these cases, the taxpayers restructured from a situation where all profits were derived personally into a trust structure where income was effectively split with family members. In both of these cases the anti-avoidance provisions applied. In all cases however, it was considered that the income derived was income from personal exertion.

5 PROFITS ARISING FROM A BUSINESS STRUCTURE -V- PERSONAL EXERTION

It follows the income derived from a business structure is one that does not derive its income predominately from personal exertion.

At what point this occurs will always be a question of fact. If, for example, a professional firm has a typical partner to staff ratio of say 1:5, it seems clear enough that profits result from a business structure and not predominately from the personal efforts of the partner. Where time billing is still the norm, the billable hours required of a partner are often below 40%, whereas the professional team may be at 85%.

Assuming the test of a business structure can be met, at what level should the wage of a partner be set? The Commissioner would have this set at an arm’s length rate based on an employee of similar skills and experience.

This concept does not sit well with me. Once the threshold of a business structure can be met, what difference does it make whether the owner pays themselves a salary or not? If we apply the same test to any family held business, most would fail.

In Taxation Ruling IT 2330 at paragraph 29, the Commissioner does however consider that Part IVA may apply in the following situation:

“In the circumstances outlined in paragraphs 27 and 28, i.e. where a trustee employs a former proprietor of a business to continue to conduct the business, the level of salary paid to the former proprietor could well be indicative of a purpose of tax avoidance in the arrangements. Accordingly, the payment of a salary to the former proprietor considerably lower than the profits which he or she formerly derived from the business, accompanied by a corresponding diversion of income to family members, would require examination. There may be good and valid reasons for the particular level of salary, e.g. reduction in duties and responsibilities, contraction in business activities, payment that adequately enough compensates for the work that is done, participation by beneficiaries in the business activities, etc. As a general proposition the level of salary paid to the former proprietor should be no less than commensurate with his or her continuing duties and responsibilities”\footnote{10 ATR 608 at 615}
This point is made again in Taxation Ruling TR 2001/8:

“The ATO will not seek to apply Part IVA to make adjustments in cases where the nature of the equipment and other factors, relative to the skills and efforts of the individual, do not clearly indicate that the income is generated predominantly from the personal activities of the independent contractor, rather than from the use or the sale of property or from a business structure. However, the ATO will seek to do so where other factors clearly indicate that the dominant purpose of the arrangement is income splitting.”

“An example of a situation where there may be income splitting to which Part IVA could apply would be where an independent contractor, who conducts his or her business through an interposed entity, is paid substantially less than the market value for his or her work, and the profit made by the entity as a result of paying less than a market value salary is distributed to those of the contractor’s relatives who are on a lower marginal tax rate, or accumulated in the interposed entity at a lower marginal rate of tax.”

The NTLG minutes noted, in section 2 above an example where a partner receives in excess of $600,000 into a discretionary trust; this is distilled into a taxable income of only $60,000 in the hands of the natural person practitioner. Is it necessarily true however that the partner earned $600,000 (profit not fees) from his or her own personal exertion? Surely there was always an element of profit arising from the business structure.

In the Compendium to TD 2011/26 where a share in a “no goodwill” incorporated professional practice, the issue of the requirement to pay a market based salary was raised.

**Question** - What is the ATO position on part of a partner’s share of profit being replaced by a salary post incorporation? Will employers be required to pay arm’s length salaries or will what was previously a partner’s profit share now to be paid as a dividend?

**Answer** – The ATO has no view on whether dividends or salaries should be paid.

In contrast, Part IVA did not apply in Ryan’s case. In that case the taxpayer was an information analyst, who, with his wife, worked for their family company. The taxpayer paid himself a salary and also a small income to his wife for administrative work. The company also paid superannuation for the husband and wife. In the 1996 year for example, the following amounts were paid.

<table>
<thead>
<tr>
<th>Marjsp Pty Ltd</th>
<th>Dr Ryan</th>
<th>Mrs Ryan</th>
<th>Dr Ryan</th>
<th>Mrs Ryan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total income</td>
<td>Wages</td>
<td>Wages</td>
<td>Super</td>
<td>Super</td>
</tr>
<tr>
<td>$117,695</td>
<td>$37,541</td>
<td>$6,000</td>
<td>$20,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

The case pre-dates the PSI legislation, so it was essentially about the application of Part IVA. It was accepted by the AAT that the wages paid to Mrs Ryan were not excessive. The main issue was the $50,000 super contribution.

The AAT held that Part IVA did not apply. In order to conclude that there was “tax benefit”, the question was whether the superannuation contributions might reasonably be expected to have been included in the assessable income of Dr Ryan. In that case the AAT held that it could not make this finding.

The Commissioner has accepted this proposition in TD 2005/9. Absent any unusual features, the Commissioner will not seek to apply Part IVA where a company, trust, partnership or individual conducting a personal services business pays super contributions up to the maximum aged based limits in respect of the associate of the main service provider. The associate must however provide some legitimate services.

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10 TR 2001/8 para 264 & 265  
11 TD 2011/26EC – Issue 5.12  
12 Re Ryan and FCT 56 ATR 1122
6  RESTRUCTURING FROM A PARTNERSHIP TO A TRUST OR COMPANY

It is generally accepted that a genuine disposition of income producing assets to a trust will not attract the operation of Part IVA. The High Court Decision in Purcell\textsuperscript{13} held that the former section 260 did not apply to a taxpayer who executed a declaration of trust in respect of various assets on behalf of himself, his wife and his daughter. The transaction was characterised as an “ordinary family dealing”. This was despite the taxpayer retaining wide powers of management. The Commissioner has stated in IT 2330 that the outcome of that case is one that could be expected to occur in the context of Part IVA.\textsuperscript{14}

In Everett’s case the High Court held that the assignment of a 6/13\textsuperscript{th} share of an interest in a partnership to his wife was effective. The taxpayer’s share of the income was not income from personal exertion in the general law sense; his entitlement to his share of partnership profits derived from his ownership of a share in the partnership and hence the assignment of share in his interest in the partnership was effective to vest the right to future income in his wife.

In Galland’s case\textsuperscript{15} the partnership interest was assigned to a trust. The High Court re-affirmed the decision in Everett. The Court also re-affirmed the view expressed in Everett that a partner’s interest in the net income of the partnership derives from the partner’s interest in the partnership and not from the partner’s personal exertion.

In Taxation Ruling IT 2501, the Commissioner states at paragraph 9:

“Valid assignments on all fours with the Everett or Galland decisions will be accepted for tax purposes and will not be regarded as caught by section 260 or Part IVA”

It is reasonably clear that there is nothing inherently wrong with the concept of restructuring a professional firm where it meets the test of a business structure. On the other hand if the income is considered income from personal exertion, the principles set out in the decisions of Tupicoff and Galland, Watson and Pincus will attract the operation of Part IVA. To avoid this, the taxpayer must generally ensure all income is paid to him or herself in the form of wages and super (with the possible exception of super paid to an associate as noted at section 5 above).

Restructure v New Structure

In the context of income from personal exertion cases, it does not matter if the arrangement was the classic employee on Friday / business entity on Monday type of restructure or one with a taxpayer starting out on day 1 trading via a company or trust.

The Commissioner states in IT 2330 at paragraph 10:

“It would be a curious result if a medical practitioner who commenced practice for the first time and structured the practice along the same lines as the arrangements which were nullified in the doctors’ cases were free of section 260.”

\textsuperscript{13} D.F.C. of T v. Purcell (1920-21) 29 CLR 464
\textsuperscript{14} IT 2330 at para 17
\textsuperscript{15} FC of T v Galland 18 ATR 33
7 THE PRACTICE OF RESTRUCTURING

7.1 Issues that can arise

Assuming we have gotten past the personal exertion and Part IVA hurdles, the decision to restructure will need to consider many issues:

- Transfer of the business assets to a new structure or transferring or assigning an interest in a partnership will trigger a CGT event. Where no consideration is received or the consideration is less than market, the market value substitution rules set out in section 116-30 will operate to deem the consideration to be market value.
- Stamp duty in most cases is the biggest issue and is often the deal breaker. For example, profession firm valued at $1 million in unencumbered assets will incur $38,175 in transfer duty.
- Transferring into a new structure where the partners now receive salaries may also incur additional payroll tax.
- Usually work in progress (WIP) and debtors are not transferred. Consideration needs to be given to the taxation consequences of the partnership realising its WIP in the first year where all expenses are now paid by the new structure. A bad result could see the partners with large taxable incomes in the year after the restructure and the new entity with losses it cannot offset.
- Consideration needs to be given where deductions are claimed for the partners. For example, interest on loans to fund the interest in the partnership, superannuation deductions and motor vehicle expenses.

7.2 Typical restructure approaches

7.2.1 Partnership rolls into a company using subdivision 122-B CGT rollover relief

The partners can transfer the assets to a newly formed company. The downside will be:

- The partners must own all the *shares in the company just after the time of the trigger event.
- Each partner must own the shares the partner received in the same capacity that the partner owned the partner’s interests in the assets that the company now owns (if the partner was a trustee of a trust, the partner must receive shares as trustee).16

7.2.2 Sell to a company without using 122-B

In professional firms cases the significant partnership asset is usually goodwill. Some partners may have pre-CGT interests. Others may be eligible to use the small business CGT relief provisions of Div 152 to reduce or eliminate the capital gain on transfer.

Provided the CGT relief is possible, this approach gives greater flexibility in the new structure. For example the shares in the company could be held by discretionary trusts. Alternatively, the new partnership could be a partnership of trusts.

16 Section 122-135 ITAA 1997
7.2.3 No goodwill professional practices

In Taxation ruling IT 2540 (which issued on 22 June 1989) the Commissioner agrees that, provided the partners are dealing at arm’s length it will generally be accepted that a partnership that operates as a “no goodwill” partnership the value of the goodwill is nil. In other words the fact that no consideration is paid will not enliven section 116-30(1) and substitute the market value.

In TD 2011/26, the Commissioner will also accept that the market value of goodwill in an incorporated professional practice is nil. Somewhat controversially, this will only be the case where all the following conditions are met:

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;

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 and must be held by that person legally and beneficially;

c) The company is a proprietary company that adopts a constitution or shareholder agreement or both, that regulates the basis for admission, buy-back, cancellation or transfers of shares in the company; and

d) The constitution or shareholder agreement provides that in dealing with practitioner-shareholders leaving the practice will be calculated on the basis that goodwill is nil.

The rationale for restricting the shareholding to natural individual practitioners seems to revolve around the concept of the “natural ebb and flow” of natural person practitioner-shareholders. The Commissioner noted that when IT 2540 was issued; the ability for many professionals to trade via an incorporated entity was restricted by State legislation or other regulatory bodies.

This reasoning is somewhat curious and at odds with commercial reality. If it can be accepted that we’re not dealing with income from personal exertion and the partners are dealing at arm’s length, why is it necessary for the practitioner-shareholder to be individual?

In the compendium to TD 2011/26, the following issues and responses are worth noting:

Issue raised

3.7 If the Commissioner is concerned about income splitting in a post incorporation environment, the Commissioner should explain why he has the opinion that structures that involve the interests in a professional practice being held by entities other than natural persons is inappropriate, especially given that other types of businesses may be structured in exactly the same manner without attracting the concern of the Commissioner. If the Commissioner believes entities other than natural persons holding shares in an incorporated environment facilitates income splitting, the Commissioner should apply appropriate provisions to the persons that choose to structure their shareholdings in that way, rather than adopt a different application of the market value substitution rule to all dealings in the company’s shares.

ATO response

3.7 Disagree- the ATO makes no comment on the use of various business structures by professional practices that incorporate. However, the ATO view in TD 2011/26 is limited to those arrangement that satisfy the conditions in paragraph 3 and only applies to those few professions where goodwill in the firm is disregarded.
Issue raised

3.8 IT 2540 recognised that an individual partner could achieve income splitting through an Everett assignment and confirmed that the (so called) "concession" in IT 2540 would not apply to that partner (IT 2540 paragraph 29). Importantly however there is no impact on the "ebb and flow" treatment for remaining partners.

ATO response

3.8 Disagree - Everett assignments still have their own CGT implications quite separate from the consideration of the market value of the goodwill/shares for the practitioner joining or leaving a no goodwill practice.

8 USE OF EVERETT ASSIGNMENTS & DIV 152

The Commissioner considers that the effect of an Everett assignment is that the partner disposes of part of his or her partnership interest, notwithstanding that the assignee only has an equitable interest in the assignor’s partnership interest and that legal title to the partnership continues to vest in the partners to the exclusion of the assignee.\(^\text{17}\)

It would be unusual for an Everett assignment to be made on an arm’s length basis; therefore the market value substitution rule will apply. In Reynolds case\(^\text{18}\) the assets used by the partnership were held by a service trust. The practice did not recognise goodwill. Despite this, the Court held that the assigned partnership interest was of value. The value is the right to future income from the assigned interest in partnership profits. This is the approach adopted by the Commissioner.\(^\text{19}\)

It follows that the use of Everett assignments will give rise to both CGT (for post CGT interests) and duty. Notwithstanding this, the small business relief contained in Div 152 may be used to reduce or eliminate the CGT component.

Provided the partner’s interest is less than 40%, the partner need only count his or her share of the net partnership assets when considering the maximum net asset test.

9 LICENCING ARRANGEMENTS

Rather than transfer the business to a company or partnership of trusts, can (for example) a professional partnership licence its business assets to a company?

This practice is becoming increasingly common.

The entering into a licence agreement will give rise to CGT event D1. CGT event D1 occurs if you create a contractual right in another entity (s 104-35). A capital gain will arise if the capital proceeds from creating the right are more than the incidental costs you incurred in relation to the event. The capital proceeds from a CGT event are the total of the money or property you receive, or are entitled to receive, in respect of the event happening.

If there are no proceeds paid in respect of the entering into the licence agreement, no capital gain will arise.

\(^{17}\) IT 2540 para 24    \(^{18}\) Reynolds v. Commissioner of State Taxation (WA) 17 ATR 987    \(^{19}\) IT 2540 para 28
In ATO ID 2003/517 a Licence Agreement was entered into between Company A and Company B for a non-exclusive right to use port facilities by Company B in consideration for a Licence fee. The Licence fee was to be paid over the term of the Licence from the income generated by the use of the port facilities. No amount was paid to Company A upon entering into the Licence Agreement. In this case the Commissioner considered that Company A’s undertaking to pay relates to the use of the port facilities, rather than the grant of the licence.

In ATO ID 2004/7 (Withdrawn), the taxpayer acquired an existing business by purchasing all the business assets including the goodwill. The taxpayer then leased the assets, including the goodwill, to a company connected with the taxpayer and the connected company then operated the business. The ATO ID relates mainly to whether or not the goodwill remained an active asset for the purposes of the small business CGT concessions. The conclusion in the ATO ID was that it did in fact remain an active asset.

If a professional partnership was to licence the business (including the goodwill) to a newly incorporated entity, it would seem that no CGT will arise on entering the agreement and the ability to access the small business CGT relief if the partner was to sell/retire remains with the original partnership interest.

The payment of the licence fee will of course be income in the hands of the licensor. I do not know what rate at which the licence fee should be set in the case of a professional firm. In the case of a franchised business, annual franchise fees are often in the 5-7% of turnover range.

9.1 Can goodwill be licenced?

The High Court in FCT v Murry held that goodwill is inseparable from the conduct of a business. It may derive from identifiable assets of a business, but it is an indivisible item of property. That which can be assigned and transferred from the business may, while it is connected to the business, be a source of the goodwill of the business but cannot logically constitute any part of the goodwill of the business.

It follows that 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. Unless a business is transferred to the person to whom an asset of the business is transferred, the transfer of the asset does not transfer any part of the goodwill of the business.

Whilst the decision in Murry assists in helping understand the nature of goodwill, it does not answer directly the question of whether we can licence it along with the right to conduct a business.

In Roussos v Commissioner of Stamp Duties (TAS), Kamari Pty Ltd agreed to licence the business to Mr & Mrs Roussos. The terms of the agreement were such that

a) Kamari retained ownership of the plant and equipment;

b) The Roussos acknowledged that the licence is personal to them and may not be assigned;

c) Roussos also acknowledged that Kamari holds the premises on lease and agree to take a non-assignable sub-lease;

d) At the commencement of the term Kamari would sell to Roussos all the stock in trade;

e) The business name for the restaurant would be transferred to the Roussos. An undated transfer form was also prepared in favour of Kamari which transferred the name back in the event the agreement was lawfully terminated.

f) The Roussos had an option to purchase the business for an agreed sum with the purchase price apportioned so that the plant and equipment could be sold at its written down value.

The Commissioner attempted to assess duty on the basis that the agreement amounted to a sale or disposition of personal property consisting of plant, goodwill and the right to use the business name.

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20 39 ATR 129
21 23 ATR 336
The Court had no difficulty in finding that no property in the plant, equipment or goodwill passed. The option to purchase was a clear indication of the parties' intention that ownership would remain the property of the licensor.

The authority to use the business name during the currency of the licence was not a proprietary right passing to the Roussos which could be characterised as a disposition of personal property. The goodwill did not pass to the Roussos under the agreement, but merely the right to avail themselves temporarily of the benefits attaching to it.

The decision in Roussos can be contrasted with another stamp duty case Sturt Football Club Inc v Commissioner of State Taxation [2010] SASC 279.22

In that case, the taxpayer was the purchaser of a tavern in South Australia. Under the agreement the vendor and licensor of the business and the assets of the business (other than goodwill and the intellectual property) were to be transferred to the taxpayer. The agreement also provided that the taxpayer would be licensed to use the goodwill and intellectual property in the conduct of the business of the tavern.

The Court held that the transfer of the defined assets to the taxpayer did involve inherently a substantial transfer of goodwill. Parts of the goodwill that passed included:

a) Location goodwill on the grant of the sub-lease of the premises;
b) Designs, signage, advertising and upgrade to the gaming areas which were features giving rise to goodwill of the Tavern.

The very nature and extent of assets transferred to the taxpayer indicated even without an express transfer (or licensing) of the goodwill, or the use of the business name, the taxpayer had acquired the business of the tavern.

There are some features in Sturt’s case which created some obvious difficulties for the taxpayer. Firstly the agreement itself was described as an “Agreement for Sale of Licenced Business”. The “intellectual property was defined in generic terms only without any specific property to which it referred.

The main problem in Sturt was that the agreement sort to sell all the other assets except the goodwill and unspecified IP.

The Commissioner submitted that it was not, in any event, possible to lease or licence the use of goodwill of a business. White J rejected this argument:

“*I do not understand….to be suggesting that parties may not adopt a means of transferring goodwill which is different from that used to transfer other assets, or that goodwill may not be transferred to an entity which is different from that used to transfer other assets…The proposition is only that goodwill cannot be dealt with separately from the business with which it is associated.*”23

9.2 Duty on licence

Duty is most definitely not my area of expertise; however, my understanding is that the implications are as follows:

a) The grant of a licence will constitute the grant of a new right and transfer duty will be payable;
b) The OSR will require a valuation of the licence but, provided the licence can be terminated at short notice, minimal duty will be payable.24

22 80 ATR 532
23 80 ATR 532 at 542
24 See Linda Tapiolas SME Critical Update TIA Qld Division 24 October 2011
9.3 Conclusion on licencing

Considerable care needs to be taken with licencing arrangements. The documentation and implementation of the arrangement remains critical. Aside from the taxation consequences, the commercial imperatives are also worth noting.

Using a licencing arrangement will allow a professional firm to introduce employees into the business without providing access to the underlying goodwill and other assets. Issuing shares to employees at a discount presents its own problems when it comes to the employee share acquisition rules. The value of the shares in the licenced entity is likely to be considerably lower.

10 PARTNERSHIPS OF TRUSTS

The issues surrounding partnerships of trusts was the subject of my last Tributum paper. I don’t propose to revisit this other than to consider some of the concerns raised by the ATO it section earlier:

a) contention that the new partner is the current partner-practitioner as Trustee for his family trust so that the practitioner is in partnership with himself (albeit as Trustee)

Why is this a problem? The definition of “Entity” in section 960-100(3) of the ITAA 1997 states the following:

A legal person can have a number of different capacities in which the person does things. In each of those capacities, the person is taken to be a different entity.

Example: In addition to his or her personal capacity, an individual may be:

• sole trustee of one or more trusts; and
• one of a number of trustees of a further trust.

In his or her personal capacity, he or she is one entity. As trustee of each trust, he or she is a different entity. The trustees of the further trust are a different entity again, of which the individual is a member.

b) Some trusts that have no employees claim a superannuation deduction

I am assuming that in these cases the partner is a discretionary trust which receives its shares of partnership profits. The ability of the trust to claim a deduction for superannuation is questionable where the trust itself is only deriving passive income. In may be better for the individual practitioner to either pay this contribution personally or become an employee of the partnership and deduct the superannuation contribution at the partnership level.

25 This can be found on the bed stand next to your copy of 50 Shades of Grey!