PRACTICE COMPANIES & SERVICE ENTITIES

At the Australian Bar Association Conference held in Townsville in July, David Bloom Q.C. discussed aspects of tax planning and incorporation for Barristers.

The nature of a Barrister's practice does not permit of much tax planning - short of negatively geared investments, home investment (Capital Gains Tax Free) and Service companies or trusts, there is very little a barrister can do.

One of the greatest problems is the barrister himself. A barrister is typically a person who can afford the price of a good suit but not the time it takes to have it measured.

In Sydney, barristers wanting chambers in Wentworth or Selborne must purchase shares in Counsels Chambers Ltd. Apparently, in 1957 when Garfield Barwick led his fledgling group into Wentworth, shares relating to a single room cost 1,000 Pounds; a good young barrister could earn for a year 1,000 Pounds out of which he paid 100 Pounds in tax. Today, the same shares cost $200,000. A young barrister will be lucky to net, before tax, $50,000 and tax on that will be approximately $20,000. The shares purchased for $200,000 could not be valued at half that on an asset-backing basis.

Clearly, there is a very large element equivalent to goodwill. But it is not goodwill - which means that for Capital Gains Tax purposes, the Sydney barrister can't even take advantage of the reduction in Capital Gains Tax for which S.160ZZR provides on disposals of businesses under $1m.!

The young barrister in Sydney will thus try to make ends meet until he takes silk. Then - for a limited period in most cases - he will have a high income and pay high tax. Superannuation is his own responsibility and he will for that now get the "massive" deduction of $3,000. p.a. There is no averaging of incomes for barristers.

Incorporation, then, may be of some superficial interest. It will - at least for a limited time - provide tax benefits in the sense of a lower tax rate of 39% compared with the present highest personal rate of 49%. "Super" contributions can be made by the company at better than $3,000 p.a. tax deductible - although the contributions will now themselves be taxable at 15%; and there are the other new limitations to which Ian Gzell has made detailed reference in his paper.

Spouses and other relatives may be employed by the company without the possibility of the Commissioner using S.65 of the Income Tax Assessment Act, 1936 to reduce the deduction allowable to such amount as the Commissioner thinks reasonable; and in those places which permit incorporation - the Northern Territory and South Australia - spouses and other relatives can be shareholders.

Further, quarterly instalments of company tax are, in effect, paid in the year of income, not in advance. And in IT Ruling 25, the Commissioner has said that he will permit a practice company which satisfies his criteria to return on a cash basis, thus preserving the barrister's greatest single advaantage.

That's the good news. However, for income tax purposes the benefits of incorporation are largely illusory. In the first place, unless the practice company represents the first vehicle whereby the barrister practices, the Commission may well be entitled to treat all its income as income of the practitioner. Certainly, he has said he will do so unless the following four criteria are satisfied:

1. there is nothing in State or Territory law <u>or professional rules</u> to prevent incorporation;

2. there are sound business or commercial reasons for incorporation;

3. there is no diversion of income to family members;

4. the only advantage for income tax purposes is access to greater superannuation benefits.

I have quoted these four criteria from a paper delivered by Mr. Mills, First Assistant Commissioner, on 16 June, 1988. It is worth examining these four propositions individually. But in doing so, it is necessary to warn practitioners that, in modern Australia, as Mr. Mills candidly admits, the taxpayer must satisfy three standards -

<u>First</u> - those imposed by the Statute;
<u>Secondly</u> - those imposed by the Courts;
<u>Thirdly</u> - those imposed by the Commissioner in indicating what he finds to be "acceptable".

He will indicate, in general terms, what he finds to be "acceptable" in "Rulings". These are so voluminous that C.C.H. now publishes them. You can have the service for a large fee.

Rulings Nos. 2 and following must be read subject to Ruling 1. That provides, in effect, that the Commissioner is not bound by anything in a Ruling.

But taxpayers who behave in a way which the Commissioner finds unacceptable, do so at their own peril!

To return to Mr. Mills' four categories - the <u>first</u> you will recall is only capable of being satisfied in South Australia and the Northern Territory - and soon, perhaps, Victoria. The <u>second</u>, according to the Commissioner, can never be satisfied where family members can share in the income. This is because the income is personal service income, which is as inalienable as your left foot - at least for tax purposes.

He relies on the decisions of the High Court in <u>Gulland, Watson & Pincus v. F.C.T.</u> (1986) 160 C.L.R. 55. These were, of course, decisions on their own facts. But they make it sufficiently clear that a sole practitioner can <u>never</u> assume that he can share his pre-tax income with his family in such a way as to make it income of theirs for tax purposes.

They were, of course, cases involving trusts and not companies. But where the company tax rate is less than the individual rate, the same may apply i.e. it is, arguably, impossible to determine any commercial benefit aside from potential tax saving. (cf. Sir Anthony Mason's judgment in Patcorp 140 C.L.R. at 253). Where the company rate is, however, as high as the highest personal tax rate, as may soon turn out to again be the case, it is harder to see that tax avoidance is a motivation. The family's right as shareholders to receive franked dividends is a right to share in after-tax income - no different to their receipts from the sole trader after he has paid his tax.

That brings me to the third requisite. Here we are departing from the realm of Statute and case law to what the Commissioner finds "acceptable". Insofar as pre-tax income is able to be diverted to family members, this third requisite is but a variant of the second.

But where it is after-tax income we are talking about, there seems no propriety in the requisite at all. Yet it is far from clear that the Commissioner accepts this distinction. Further the Commissioner departs from settled case law and the Statute in failing to distinguish between cases where a practitioner starts up for the first time, with a practice company, and those where the existing practitioner incorporates.

The latter - and only the latter - are arguably within Part IVA on its terms. The former are not. The cases have always - in strong dicta - excluded the application of S.260 to new sources of income. But in IT Ruling 2330, the Commissioner says

> "Until such time as it is shown by court decisions that the position is otherwise it is proposed to adopt the view that S.260 (and Part IVA) applies in cases of this nature (i.e. a professional who commences practice for the first time and is employed by a trust or company which provides his services)."

Mr. Mills, in his June paper, admits that "uncertainty exists in this area"; but expresses the - unsupported - view that "new sources of income are equally at risk of being caught by the provisions". In other words "caveat new barrister".

Mr. Mills' fourth criteria is that the only benefit for tax purposes should be that relating to superannuation.

In essence, the Commissioner is equating Practice companies with Administration companies. He will tolerate them as long as their only tax benefit is "super". But if, for instance, the Company provides a car for which it gets a deduction, and pays fringe benefits tax (at, as it happens, a lesser rate than income tax), the Commissioner will not allow it. In a draft ruling recently provided, the Commissioner says about this:

"5. The sole justification for accepting administration entities is to enable employee/partners access to section 23F superannuation benefits. This approach was accepted on the clear understanding that the remuneration that the administration entity would pay to an employee/partner would consist solely of a reasonable amount of salary, as defined in Taxation Ruling No. IT 2067. Thus, in accordance with that Ruling, the provision of cars and other fringe benefits are not to be taken into account in superannuation purposes. Accordingly, administration entities that provide cars and other fringe benefits to employee/partners are not acceptable within the arrangements previously accepted for income tax purposes.............

".... the Commissioner is not bound by anything in a Ruling."

8. It may be argued that such an arrangement for the provision of cars to employee/partners should be acceptable where the combined service/administration entity pays the fringe benefits tax liability. However, this would lead to the professional partnership obtaining an overall taxation benefit that was not intended. This is because the overall tax effect would be that, even though some fringe benefits tax might be paid, the professional partnership would obain an advantage by being able to deduct the full cost of the administration and service charges - which would reflect the full cost of the provision of cars to employee/partners - notwithstanding that the cars may be used by the partners partly for private purposes.

9. Given that service entities providing services to professional practices have been accepted in the past on the basis that the partners are not employees of the service entity, and bearing in mind the limited justification for the acceptance of administration entities, combined service/administration entities are also not acceptable within the arrangements previously accepted for income tax purposes."

Once again, we are in the area of what is acceptable - not what the law i.e. Statute and case law permits. Ian Gzell has said enough about Administration companies. I will say no more about them.

But as to Practice companies, two more things remain to be noted: -

1. The Effect of Imputation

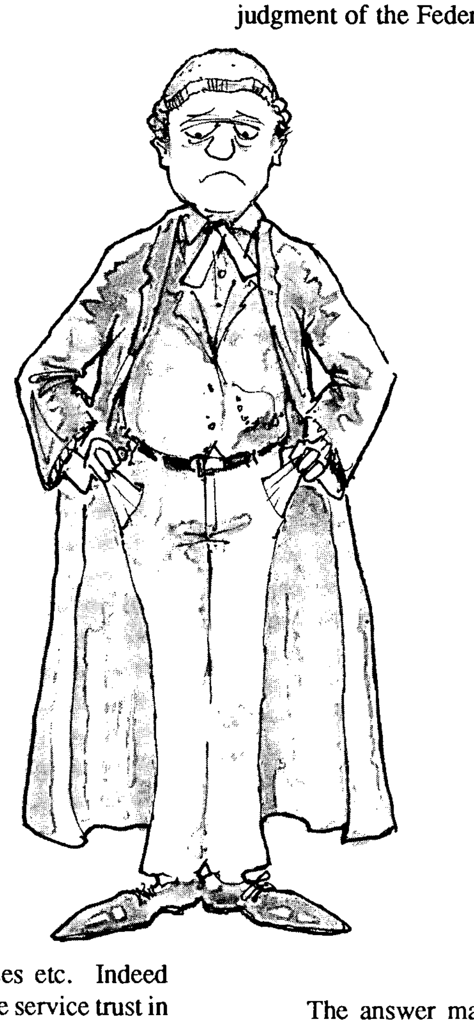
It is clear that appropriate dividends paid by practice companies can be franked. Where they are, the dividend will, in effect, be tax free to the shareholder. But where the shareholder's tax rate is 49% and the company's rate is 39%, the benefits of the company's lower rate will effectively be lost; the imputation being to the extent of 39% only. However, it may be said that now that Division 7 is gone, there is no obligation to distribute. Hence the funds may be kept in the company. That brings me to the second aspect.

2. How does the barrister use the surplus funds of the company?

The company can acquire such assets as it thinks fit. But it cannot make loans to shareholders or associates or otherwise pay out moneys for their benefit. Such loans or other payments will, by S.108 of the Income Tax Assessment Act, 1936, be deemed to be dividends and will not be "frankable" (if such a word exists). In other words, the S.108 deemed dividend is assessable income of the recipient, whether a shareholder or not, and he gets the benefit of no franking rebate.

Monies can be paid by the service company to relatives for services; or indeed to Service companies or trusts. That brings me to the second topic in this paper, namely Service entities.

The Service company or trust is distinguished by the Commissioner from the Administration company on the basis that the Service company or trust does not provide the professional person's own services to him. Thus no question arises of fringe benefits for the professional person himself.



Since the decision in Phillips' Case 20 A.L.R. 607, the Service entity has achieved some respectability. Typically, it employs staff and owns capital assets such as land, plant and equipment, and hires those to the professional. That it may do so where the charges are comparable to arm's length charges is established by Phillips' Case and accepted by the Commissioner.

It is worth reading what Mr. Mills had to say about Service entities in his June paper :

" These are entities that provide various services to a professional firm. The services could include provision of office furniture and equipment, non-professional staff, share registry services etc. Indeed these were among the services provided by the service trust in the Phillips' Case, where the Federal Court held that the firm in question was entitled to a deduction under subsection 51(1) for the service fees - notwithstanding that the effect of the arrangements was to divert income from the partners of the firm to those interested in the trust (the latter generally being directly or indirectly, members of partners' families).

Crucial to this decision was the finding that the service fees charged were realistic and not in excess of commercial rates. It was also accepted that there were sound commercial (non-tax) reasons for the arrangements. So, where these elements are present, it can be expected that service entity arrangements would be accepted. Of course, as indicated in Taxation Ruling No. IT 276, if there were grossly excessive payments for the services provided, the presumption would arise that the payments were not wholly made for business purposes; to the extent that they were not, an income tax deduction would not be allowable. You might ask whether the Commisisoner can deny a deduction where the parties agree to the level of payments, even if they are grossly excessive. Reliance for that sort of argument might be placed on the well known statement by the High Court in Ronpibon Tin N.L., and affirmed in Cecil Bros., that it 'is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income but only how much he has spent'. We do not, however, see that the statement has such a wide ambit.

In Phillip's Case itself, Fisher J. (who provided the main judgment of the Federal Court), after referring to Ronpibon Tin N.L., and pointing out that the payments were commercially realistic, made the point referred to above and I quote:

'....if the expenditure was grossly excessive, it would raise the presumption that it was not wholly payable for the services and equipment provided, but was for some other purpose.'

What, you may ask, would make the expenditure grossly excessive? We in the Tax Office don't have a clear answer to that. A mark up on cost that produces a result that is comparable to an arm's length or market price is acceptable. But what if it is twice, six times or perhaps ten times the cost? Another threshold question that arises in such cases is whether the matter is to be determined under general principles that have been evolved over many years on the interpretation of section 51 - or whether the new general anti-avoidance provisions of Part IVA provide a more ready and workable solution to the problem.

The answer may not be very different under either approach. In recent times I think we have seen developments in the Courts specifically in the area of subsection 51 (1)(i), e.g. a development that has involved the Courts moving away from accepting that the tax consequences of an arrangement will be determined solely by reference to the contractual agreement between two parties. That agreement will be a relevant factor, particularly where the parties are at arm's length, but there also appears to be a greater preparedness to look more closely at the commercial basis and the effect of, and the essential reason for, a transaction. To find this essential reason, a court may adopt a test of characterising the expenditure in question - is it predominantly incurred for earning assessable income or for other purposes?

In Ure, for example, the Federal Court looked at all the evidence surrounding the loan of money to see what the various purposes of the loan were. To the extent that it was for family or private purposes, interest on the loan was held to be non deductible.

More recently, Rogers J. seemed to recognise the judicial development taking place at least in relation to the second limb of subsection 51(1) when he stated:

'At present, the necessary degree of connection is commonly tested by application of the principles enunciated in the joint judgment in Magna Alloys & Research Pty. Ltd. v. F.C.of T. 80 ATC 4542 at p.4559:

"The controlling factor is that, viewed objectively, the outgoing must, in thecircumstances, be reasonably capable of being seen as desirable or appropriatefrom the point of view of the pursuit of the business ends of the business being carried on for the purpose of earning assessable income."

The application of the test has been the subject of recent exposition by the Full Court of the Federal Court in F.C.of T. v Gwynvill Properties Pty. Limited 86 ATC 4512. As was pointed out by Jackson J. (at p.4525), the authorities recognise 'that there should be some expenditure incurred and the carrying on of the business in question' (emphasis added). Later in his judgment, his Honour pointed out that the Court was not required, indeed not entitled, to take into account that the same economic result might have been achieved for the taxpayer if a difficult procedure had been adopted. He then went on (at p.4526) :

'Having said that, however, there seems no reason why the economic result achieved by the transactions may not be examined in order to cast some light on whether the outgoings by way of interest were capable of being regarded as being desirable or appropriate from the point of view of the business ends of the respondent's business as a property owner, developer, etc.' Robinson v. F.C.of T. 86 4784, 4794)

The message from these cases on section 51 that is worth recognising is that arrangements designed to 'achieve the greatest possible tax advantage', to use the words of Rogers J. in Robinson's Case, may not succeed under the general provisions, let alone under the anti-avoidance provisions, of the income tax law. Of course, section 260 and Part IVA have to be considered (the latter as a provision of last resort)."

It is clear enough from the judgments - particularly that of Fisher J. in Phillips' Case itself, that the payments must not be grossly excessive. But between "grossly excessive" and "normal commercial or arm's length" there seems to be a fair leeway. One thing is certain, however, namely that the Commissioner is not given power to reduce such deductions to such amounts as he thinks reasonable - cf. S.65.

S.260, of course, could not apply to a deduction properly available under S.51(1). That is the accepted result of the High Court's decision in Cecil Bros. (1964) 111 C.L.R. 430 - see the decision of the Full Federal Court in Oakey Abbatoirs 55 ALR 291 and, more recently F.C. of T. v. Janmor Nominees Pty. Ltd. 87 ATC 4813. This is, of course, subject to what the High Court may have to say in John's Case which was argued recently.

But, leaving aside for the moment the effect of Part IVA, it seems that unless the payment is so excessive as to make it impossible, objectively, to say that it is entirely for the service provided, it will be an allowable deduction - in full - under S.51 (1).

Part IVA is certainly to be reckoned with in this context. There is no doubt that it, unlike S.260, applies to deductions. But for it to apply, it must appear that the taxpayer, objectively, had a dominant purpose of obtaining the tax benefit which is the deduction. Where the service for which the payment in question is made is an essential service, such a dominant purpose will, it is submitted, only be apparent where the payment is grossly excessive. In other words, the test is probably no different, in practical terms, from that applicable to S.51(1). I stress, however that both Part IVA and S.51(1) apply in terms to part of a deduction.

The great benefit of a Service entity, of course, is that it involves an acceptable sharing by family members in income. Thus, anyone can be a beneficiary under the Service trust, a shareholder in the Service company or an employee of either.

A question commonly asked at the moment is whether, having regard to the reduction in company tax rates to 39%, a company may take income under the Service trust. My own view is that if the company is an existing beneficiary, there is no impediment to its becoming presently entitled to trust income this year - a fortiori if it has received such income in the past.

But if it is specifically added for that purpose, the Commissioner may well argue that Part IVA applies and that the income derived by the company as a beneficiary is income diverted, in effect, from other beneficiaries.

Let me finish precisely as Mr. Mills finished his June paper, with a part of his paper with which I am - reluctantly - in full agreement :

"I suggest that the topic of income splitting for professional people is one that has taken more time and interest of tax practitioners over many years than any other tax topic. The position is far from clear and I am sure that there will be further developments in future cases. Whether it be for your own affairs or for your clients, I suggest that restraint be exercised in attempts to save tax.

Part IVA has to operate in the real world. Recent commentators both here and in England have suggested that if a scheme or plan appears to offer tax savings that are too good to be true then the odds are that indeed, it is too good to be true." ❑