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Tax, Super and Your Legal Practice: An Essential Update

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"Structuring Professional Practices"

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Scope of Paper

This paper is designed as a broad overview of issues affecting structuring and restructuring of professional practices, with a particular emphasis on the Australian federal taxation system. Being prepared for the Law Society of Newcastle's "Tax, Super and Your Legal Practice" Seminar, the content is directed specifically to legal practitioners; however the topics discussed have application to other professionals such as accountants, doctors and veterinary practices.

The paper covers general considerations when selecting a practice structure, the range of available structures, characterisation of the purpose of the structure, the Income Tax Ruling system, the Personal Services Income regime, Australian Taxation Office guidelines on the application of Part IVA, *Income Tax Assessment Act 1936* to professional firms, tax issues on acquisition and disposal of interests in "no goodwill" practices, the use of service entities in professional practices and roll over relief available on restructure of a professional practice.

The paper is not intended as a complete statement on all structural issues potentially affecting professional practices. Detailed content is not provided with respect to bankruptcy, family law property proceedings, Division 7A of the *Income Tax Assessment Act 1936*, asset protection or the assignment of interests in a professional practice, including *Everett* assignments.

Issues associated with professional practice structures are many and varied, and could fill several papers the length of this one. Moreover, tax, legal and other issues faced by professional practices will always be dependent on context. This paper should therefore not be used as a substitute for appropriate advice tailored to the particular circumstances of a given professional practice.

Structuring Professional Practices

Today, there is more choice than ever in the range of practice structures available to professionals. Equally, however, the number of regulatory and administrative factors affecting professional practices has never been greater. The Australian Taxation Office ("ATO") is particularly concerned with the tax effect caused by various structural arrangements, particularly as they relate to tax minimisation strategies contrary to policy intentions of the governing law.

The Commissioner is interested in ensuring personal income of a professional is not taxed at improperly low rates. Income shifting arising from service entity arrangements has also been subject to scrutiny. The Commissioner is also keen to ensure tax liabilities arising on restructure of a professional practice are correctly reported and paid.

Tax, of course, is not the only issue that needs to be considered in structuring or restructuring a business. The following will also bear some influence on the choice of practice structure:

Professional Bodies and Regulatory Requirements
It is critical to understand and comply with structural requirements imposed by various bodies and regulators of the relevant profession.

Legal Effect of Chosen Structure
The form in which a professional practice is structured will have implications for the following areas of the firm's administration:

i. Asset Protection
The chosen structure should adequately protect the personal assets of practitioners from third party claims against the firm, and safeguard the assets of the practice in the event of relationship breakdown affecting a practitioner;

ii. Tax Planning
The chosen structure should allow the practice to minimise tax lawfully, including through access to appropriate Capital Gains Tax concessions and discounts where Capital Gains Tax Events are likely to occur with respect to the practice;

iii. Entry and Exit
The expectation of admission and retirement of practitioners should be reflected in a structure that allows for appropriate changes in ownership and a governing agreement that clearly defines the process for changes to occur;

iv. Funding Options
Related to entry and exit issues, practice structure should be designed to allow for debt and equity funding suited to the business' needs.

The preceding categories represent broad issues to be taken into account on a case by case basis when structuring or restructuring a professional practice. In many cases there may be no "ideal" practice structure, but rather a choice between competing advantages and

disadvantages. Professional advice ought always to be sought before a structure is established.

The following structures (or a combination of several) may be adopted depending on the needs and goals of practitioners:

i. Sole Trader

No separation of legal identity between business and practitioner. Not especially popular amongst professionals for reasons of limited asset protection and tax planning options, however this is the only structure available for barristers pursuant to Rule 16 of the *New South Wales Barrister' Rules*.

ii. Partnership of Individuals

No separation of legal identity between business and practitioners. Each practitioner has a beneficial interest in all assets of the business. Generally, each partner is jointly and severally liable for the obligations of the partnership. Limited tax planning and asset protection opportunities, mostly remains as a relic of a time when professional organisations required professionals to practice as a sole trader or a partnership of individuals.

iii. Company

Separation of legal identity between business and practitioners. Tax planning advantages from the structure's capacity to retain profits and distribute to shareholders at a time of directors' choosing, and predictable flat rate of tax for business profits. Some tax disadvantages relative to other structures from limitations on access to Capital Gains Tax discounts. Relatively simple to add equity holders with issue or transfer of shares.

iv. Discretionary Trust

Vehicle used to separate practitioners from business, provided that practitioners do not act as trustee. Not a legal entity in its own right, however increasingly treated as such by the ATO and others. Some tax planning advantages from ability to distribute profits to a range of beneficiaries, however limited control over the timing of distributions. Capable of accessing Capital Gains Tax discounts unavailable to companies.

v. Partnership of Discretionary Trusts

Similar benefits and disadvantages of a single discretionary trust, but useful for multiple practitioners to direct shares of income to discretionary beneficiaries. Important that any distribution of practice income to non-practitioners is not an artificial arrangement to avoid tax (discussed infra).

vi. Mixed Partnership

A partnership may be formed by any combination of different legal entities. The exact benefits and drawbacks of mixed partnership arrangements will depend on the constituent members and the business of the practice.

vii. Unit Trust

Vehicle used to separate practitioners from business, provided that practitioners do not act as trustee. Tax advantages from access to Capital Gains Tax discounts, however some limitations from requirement to distribute all income to beneficiaries annually to avoid assessment at highest individual rate of tax. Similar advantages to a company in simplicity of adding equity holders.

Bona Fide Commercial Purpose of Practice Structure

Where a restructured practice appears to offer a tax advantage over the business' previous legal form, the tax benefit may not be allowable if it cannot be demonstrated that the restructure was for bona fide, non-tax related commercial reasons. To this point, the cases of *Tupicoff v The Commissioner of Taxation* [1984] FCA 353 and *Federal Commissioner of Taxation v Mochkin* [2003] FCAFC 15 should be compared.

In *Tupicoff*, the Full Federal Court found a commission agent business restructured from a sole trader to a company to be void against the Commissioner on grounds that the particular structure in question did not achieve the taxpayer's stated goal of protecting personal assets from claims for negligent misstatement. In view of the fact that the restructure could not be objectively viewed as a genuine attempt at asset protection, the taxpayer lost the tax benefit of earning income in the company, and was assessed on this income in his own hands.

A different outcome was reached in *Mochkin*. The Full Federal Court in that case concluded that a restructure from sole trader to company was motivated by a genuine desire to protect the taxpayer from personal liability to clients, and that the revised structure did in fact achieve this end. The corresponding tax benefit of the restructure was therefore incidental to the purpose of the restructure and not an improper minimisation of tax open to the Court to undo.

Income Tax Ruling System

In dealings with the ATO it is important to understand the operation and legal effect of the Commissioner's public rulings.

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

The Commissioner has issued various rulings and guidance notes that may have implications for practice restructure.

The rulings are the Commissioner's views on the interpretation of the Income Tax Assessment Acts and associated taxation law. The taxpayer, of course, has the right to argue their view of the tax law. The concern, however, is if the taxpayer's position is litigated and the taxpayer's view is not confirmed by the courts, penalties may be greater as it may be difficult to establish that the taxpayer had a reasonably arguable position. This can have a major impact on the quantum of any penalties that may be incurred.

The taxpayer has a right to apply for a private ruling and argue their position with the ATO internally, which may limit exposure to expensive litigation and the penalty regime. Anecdotally, there appears to be some reliance by the courts on the Commissioner's rulings as a guide to the tax law.

In summary, any taxpayer going against a public or private ruling needs to be fully informed and aware of the risks of such action.

Personal Services Income Regime

Where work is performed by an individual and the consideration payable for that work relates predominantly to their personal effort or skills, the income earned may be considered "personal services income" or "PSI".

The PSI provisions are contained in Part 2-42 of the *Income Tax Assessment Act 1997*. Broadly, the regime treats income generated by an individual that is 'mainly a reward for [their] personal effort or skills' to be the personal income of that individual (subject to other factors outlined infra), and not income of the contracting entity in which they work. In practice, this means the income of a professional practice, to the extent that it is produced by application of the personal skill or effort of a practitioner, may be taxed in the hands of that practitioner regardless of the legal identity of the practice.

The application of the PSI rules is a two stage process. First, an entity must determine whether income received is a reward for personal effort or skills. This is a question of fact, and will most likely be the case where a professional performs all or substantially all of the work themselves rather than employing subordinate professional and administrative staff.

Once PSI income is found, the entity must determine whether the characteristics of this income satisfy one of five tests, being the "results test", the "80% rule", the "unrelated clients test" the "employment test" and the "business premises test". Most legal practitioners will not fall within the PSI rules by operation of the 80% rule, which is passed only where more than 80% of all PSI comes from one client, including their associates. While all the tests should be considered, of most significance to legal practitioners is the results test. Only the results test will be examined in further detail here.

Pursuant to section 87-18 of the *Income Tax Assessment Act 1997*, the results test is met if income is received for producing a result, the entity is required to supply the plant, equipment or tools necessary to perform the work to produce the results and the entity is, or would be, liable for the cost of rectifying any defect in the work performed.

In most instances, legal practitioners will provide the equipment necessary to complete their own work, such as computers, photocopiers and subscriptions to case reports and

commentary. Income Tax Ruling TR 2001/8 provides that 'the cost of rectifying any defect is inclusive of rectification achieved by the service acquirer pursuing a legal remedy for damages, in circumstances where the defect is incapable of physical repair.' In the case of legal practitioners, risk of liability for losses flowing from defective advice or representation in action for professional negligence would appear to satisfy this test.

For most legal practitioners the first limb of the results test, that income be received for producing a result, will be the subject of most scrutiny. This is a question of fact, answerable by asking whether fees will be paid regardless of outcome. In cases where a client engages the practitioner to produce advice on a specific issue, it is arguable that income is received for producing a result. Litigation may present some difficulties in classification. Under ordinary circumstances, the client engages legal representation for preparation and appearance at trial, and is liable for their fees regardless of the outcome of proceedings. The situation is arguably different, however, where the practitioner is engaged on a conditional or "no-win/no-fee" basis. In these circumstances, professional fees will only be recoverable on achievement of a particular result. In the case of income derived from a retainer arrangement, fees payable are not attributable to a specific outcome and may, for that matter, be payable without application of a practitioner's expertise. It is therefore possible in some instances that retainer income does not satisfy the definition of PSI and, for circumstances in which it does, will not meet the results test.

Whether an entity's PSI satisfies the results test can only be answered by examination of all PSI earned in the financial year. Subsection 87-18(3) provides that the test will be passed where at least 75% of all PSI earned satisfies the results test. Where an entity passes the results test, all PSI of that entity (including any portion of the total not counting towards the threshold in subsection 87-18(3)) must be assessed for income tax in the hands of the practitioner responsible for producing that income.

The application of the PSI provisions can be complicated, however their effect on a professional practice can be demonstrated using the following simple example given in section 84-5 of the *Income Tax Assessment Act 1997*:

> Jim works as an accountant for a large accounting firm that employs many accountants. None of the firm's ordinary income or statutory income is Jim's personal services income because it is produced mainly by the firm's business structure, and not mainly as a reward for Jim's personal efforts or skills.

This situation may be different where Jim works for a much smaller firm and completes all or substantially all of the work for his clients by application of his own knowledge and skills, where that work is performed to meet a specific result such as preparation and lodgement of a tax return. In that case, the fees earned from that work may be Jim's PSI and directly attributable to him for income tax purposes without regard to his proportionate entitlement to income otherwise due from the firm.

While the PSI regime may erode the distinction in identity between practitioner and practice for tax purposes, it is important to remember that the legal distinction remains when legal title to assets is considered. Therefore, while income of a company may be taxed in the hands of a professional providing PSI services, the personal assets of the practitioner remain separate from the business structure. In this case, an asset protection advantage may be achieved by incorporation even though the tax advantage of such a restructure is negligible.

ATO Guidelines on Application of Part IVA, *Income Tax Assessment Act 1936* to Professional Firms

Part IVA of the *Income Tax Assessment Act 1936*, frequently referred to as the "general anti avoidance" provisions, contains the Commissioner's "catch all" powers for identifying and recovering under reported tax liabilities where such under reporting is not otherwise made expressly unlawful by operation of the tax law. Part IVA operates by identifying, using the terminology of the statute, a "scheme" that has the effect of causing a taxpayer to obtain a tax benefit otherwise not reasonably available to the taxpayer. Where a scheme is identified, the Commissioner may amend the tax return of the offending taxpayer to reverse the effect of the tax benefit. Penalties and interest may also be applied in connection with the amendment.

In considering professional practices, the Commissioner's chief concern is the attribution of income of the business for taxation purposes to individuals or other legal identities aside from a practitioner chiefly responsible for generating income. In such cases, income splitting amongst a practitioner's associates may be used to achieve a lower liability to tax than if the income had been taxed solely in the hands of the practitioner. These cases may constitute a scheme for Part IVA purposes.

In recognition of the risk of artificial reductions in tax on professional income, the ATO published guidelines titled "Assessing the Risk: Allocation of Profits Within Professional Firms" to clarify the circumstances in which the Commissioner will and will not investigate income distribution practices of a professional practice for taxation purposes with respect to the general anti avoidance provisions. Electronic copies of the full guidelines may be found on the ATO website at https://www.ato.gov.au/business/income-and-deductions-for-business/in-detail/professional-firms/assessing-the-risk--allocation-of-profits-within-professional-firms/.

The guidelines apply to all professional practice structures comprised of legally effective partnerships, trusts and companies. The practitioner responsible for generating income of the business is referred to throughout the guidelines as the "individual professional practitioner" or "IPP". The guidelines only apply to non-PSI income, on the basis that PSI income is automatically attributed to the relevant IPP and not available for distribution to any other entity.

The guidelines set out three benchmarks by which the risk of Part IVA applying to a professional practice can be estimated. Assuming an IPP and their associated entities satisfies at least one of the benchmarks, the Commissioner will not investigate the IPP on the issue of practice income distribution for potential breach of Part IVA. This general rule is subject to other information brought to the Commissioner's attention indicating a possible breach of Part IVA.

The guidelines make clear that a failure to meet a single benchmark will not automatically result in the ATO making a finding of a breach of Part IVA. Rather, failure to meet any of the benchmarks may result in the Commissioner seeking further information from the IPP relating to distribution of practice income. The Commissioner is empowered to find a taxpayer in breach of Part IVA upon review of this material. The taxpayer is entitled to challenge any such finding, first through internal review and then by appeal to the Administrative Appeals Tribunal or by judicial review.

The benchmarks are set out by the guidelines as follows:

1. Appropriate Remuneration:

   This benchmark is satisfied where the IPP receives 'an appropriate return for the services they provide to the firm.' An "appropriate return" is given by the guidelines to be, at minimum, 'the level of remuneration paid to the [lowest paid member of the] upper quartile of the highest band of professional employees providing equivalent services to the firm.' Where there are no employees performing similar work to the IPP, market remuneration paid to employees in comparable firms or industry benchmarks may be used.

   Where an IPP's remuneration is "appropriate" in this way, the Commissioner considers they are paying an amount of tax ordinarily payable on remuneration for the services provided by someone of the IPP's standing and experience. Provided this is the case, any other income to which the IPP and their associates is entitled may be distributed amongst the IPP's associates without risk of audit for breach of Part IVA.

   The guidelines provide some indication of how to compare services provided by IPP's and non-IPP staff of the business. Remuneration for the purposes of the benchmarks must include remuneration of all kinds, including superannuation contributions and the value of any Fringe Benefits received by the parties subject to the comparison.

2. 50% Entitlement

   The second benchmark is satisfied where 50% or more of the income from a professional practice to which the IPP and their associates are collectively entitled is taxed in the hands of the IPP. As with the first benchmark, income for the purposes of the 50% entitlement test includes remuneration in any form, including the value of any non-cash benefits granted in connection with the IPP's work. Where more than 50% of the collective entitlement to income of the IPP and their associates is assessable to the practitioner, the balance may be distributed amongst associates without further review by the Commissioner.

3. 30% Effective Tax Rate

   The third and final benchmark is satisfied where both the income of the firm to which the IPP is entitled and the income from the firm to which the IPP and their associated entities are collectively entitled is taxed at an effective rate of 30% or higher. Put another way, this benchmark will be satisfied where the IPP pays greater than 30 cents in the dollar tax on their share of income from the practice and the IPP and their associates collectively (although, for each of the associates, not necessarily individually) pay greater than 30 cents in the dollar tax on all income distributed from the practice.

   The process for working out the effective tax rate applicable to income of the professional practice is detailed in the guidelines.

As noted above, where no benchmark is passed, the Commissioner may seek further information from the practice or the IPP personally to determine whether the arrangement breaches Part IVA. It is therefore vital to maintain proper accounting records, including

minutes recording the particulars of management decisions relating to distribution of income, to have contemporaneous evidence in support of the commercial legitimacy of any income distribution arrangement.

Tax Treatment on Entry and Exit to "No Goodwill" Practices

On 4 May 2016, the ATO issued guidelines titled "Administrative Treatment: Acquisitions and Disposals of Interest in 'No Goodwill' Professional Partnerships, Trusts and Incorporated Practices". These guidelines replace Income Tax Ruling IT 2540, which addressed changes in ownership in no goodwill partnerships, and Taxation Determination TD 2011/26, which dealt with changes in ownership in no goodwill incorporated practices. The new guidelines unify the ATO's treatment of acquisition and disposal of interests in no goodwill practices structured as partnerships, trusts and companies. The guidelines may be found on the ATO website at https://www.ato.gov.au/business/income-and-deductions-for-business/in-detail/professional-firms/administrative-treatment--acquisitions-and-disposals-of-interests-in--no-goodwill--professional-partnerships,-trusts-and-incorporated-practices/.

The guidelines define no goodwill practices thus: 'In a 'no goodwill' professional practice the practitioner entities agree that when a new practitioner entity is admitted into the practice they are not required to pay an amount which reflects a value for any goodwill of the practice. Further, when the practitioner exits the practice, they are not entitled to receive a payment which reflects a value for any goodwill of the practice.'

Where a professional practice meets the guidelines, the Commissioner will treat the value of the practice interest acquired or disposed for Capital Gains Tax purposes as being the actual amount paid or received (even where this amount is nil), the market value of employee shares for purposes of calculating discount on the issue of those shares to be the amount paid (even where this amount is nil) and the market value of shares in the practice acquired in an off-market buy back to be the amount paid (even where this amount is nil). In practice, the guidelines simplify and provide certainty to valuations in these circumstances that may otherwise be subject to market value substitution rules.

To qualify for the treatment specified by the guidelines, a business must be a "professional practice" as defined by the ATO. The guidelines provide that a business will be a professional practice if 'practice income is derived mainly from the provision of services involving the exercise of specialised knowledge and skill, excluding services that are commonly considered to be provided by tradespersons…; and the conduct of its members would normally be regulated by legislation, regulations or other professional standards of conduct and ethical behaviour administered by a professional body or association or regulatory authority.'

The guidelines apply only to acquisition or disposal of an interest in a professional practice where the amount paid for goodwill is nil or a nominal amount, and where the governing documents of the professional practice (such as, for example, the partnership agreement or company constitution) have no further provisions relating to consideration for practice interests or provide that goodwill on acquisition or disposal of an interest will be nil.

The disposing and acquiring entities must, but for their common involvement in the practice, deal with each other on arm's length terms, and both the governing documents of the practice and the circumstances of the transaction giving rise to the change in interest must support a

conclusion that the parties are acting at arm's length.

The Commissioner's treatment of no goodwill professional practices should be taken into account when new practitioners are admitted or existing practitioners retire. In particular, evidence demonstrating the no goodwill nature of the practice and arm's length relationship between the parties should be maintained over the life of the business and at the time that interests change hands to provide a contemporaneous record supporting reliance on the guidelines.

Use of Service Entities in Professional Practices

A "service entity" is a structural arrangement employed from time to time in professional practices whereby the business of the firm is carried on by one legal identity while assets used in the business are legally held by another entity. The practicing entity contracts with the asset owning entity (the service entity) for use of the assets in connection with the business, and pays a fee for doing so. Generally both entities are controlled by the same party and the structure is used to minimise the risk to business assets of third party claims.

The ATO acknowledges the popularity of service entities and the commercial utility in adopting this model. The Commissioner's concern, however, is that the service fees payable, which are tax deductible in the hands of the practicing entity, will be excessive in the circumstances and constitute a scheme to improperly reduce income tax payable by the practice. To clarify instances in which a service entity arrangement may be investigated further, the ATO issued business guidelines titled "Your Service Entity Arrangements" in April 2007. The guidelines may be found on the ATO website at https://www.ato.gov.au/Print-publications/Your-service-entity-arrangements/.

In particular, the Commissioner considers arrangements in which service fee expenses exceed $1 million, arrangements in which service fee expenses represent over 50% of gross practice fees and arrangements in which net profit of the service entity or entities represents over 50% of the combined net profit of all entities involved to be of particularly high risk of unacceptable tax minimisation and worthy of further review.

Where a service entity arrangement is used, the guidelines make clear that there must be commercially justifiable reasons for employing the structure that go beyond mere tax advantage. In addition to a commercial justification for the arrangement, a practice must also be able to demonstrate that the service fee amount is acceptable in the circumstances. The guidelines provide indicative rates for acceptable service fees for particular services. In the event the indicative rates are not reflective of the realities of the service entity arrangement, the guidelines note market prices for equivalent services or comparable profits for providers of similar services may be used to justify fees paid.

Professional Practice Restructuring Roll-Over Relief

When a practice changes over time its original structure may no longer suit the needs of practitioners. In this case, a number of concessions and offsets exist to minimise the tax consequences of a restructure.

1. Roll-over of partnership of individuals into company

Roll-over relief is available under Subdivision 122-B of the *Income Tax Assessment Act 1997* where a partnership of individuals restructures into a company. There are restrictions in the roll-over in that:

(a) each of the former partners must own shares in the company after the transfer of the partnership assets to the company; and
(b) each former partner must own those shares in the company in the same capacity as the partner held his or her partnership interest.

2. Partnership of trusts rolls into company

Roll-over relief is also available for a restructure of a partnership of trusts to a company.

3. Small Business Restructure Roll-over

The changes that came into effect from 1 July 2016 for roll-over relief for small businesses are of great assistance and bring further options for any eligible professional practice restructure. To be eligible for this roll-over relief there are six conditions to be met as outlined in section 328-430 *Income Tax Assessment Act 1997* as follows:

i. Genuine Restructure
The transaction must be of a genuine restructure of an ongoing business. The Commissioner's view of what a genuine restructure of an ongoing business is set out in Law Companion Guideline LCG 2016/3. In effect, the determination of whether there is a genuine restructure will be a question of fact answerable by surrounding circumstances. The following factors may be taken into account:

- Whether the restructure is a bona fide commercial arrangement undertaken to facilitate growth, diversification and the need to adapt to changed conditions or to reduce administrative burden and compliance costs;
- Whether the restructure is an economic realisation of assets as against divestment of such assets;
- Whether the economic ownership of the business and its restructured assets is maintained;
- Whether the small business owners continue to operate the business through a different legal structure;
- Whether the new structure is one which would likely have been adopted had the small business owners obtained appropriate professional advice when initially setting up the business.

In addition to the above, section 328-435 sets out a safe harbour rule that provides the transaction is a genuine restructure where, in the three year period after the transaction takes effect:

(a) there is no change in ultimate economic ownership of any of the significant assets of the business (other than trading stock) that were transferred under the transaction;
(b) those significant assets continue to be active assets, and

(c) there is no significant or material use of those significant assets for private purposes.

ii. Parties to Transaction are eligible entities

The roll-over is only available where each entity which is a party to the transaction satisfies one or more of the following for the income year of the transfer:

(a) it is a small business entity;
(b) it has an affiliate that is a small business entity;
(c) it is connected with an entity that is a small business entity;
(d) it is a partner in a partnership that is a small business entity.

Note that, with effect from 1 July 2016, the proposed increase in the aggregated turnover threshold for a small business entity from $2m to $10m will apply to this roll-over. However, neither the transferor nor transferee can be an exempt entity or a complying superannuation fund.

iii. Ultimate economic ownership of the asset must be maintained

The transaction cannot have the effect of materially changing:

(a) the individual(s) which have the ultimate economic ownership of the asset;
(b) where there is more than one individual, each individual's share of that ultimate economic ownership.

Where a discretionary trust is involved, section 328-440 provides that this condition will be considered to be satisfied where:

- immediately before and/or after the transaction took effect, the asset was included in the property of a non-fixed trust that was a family trust; and
- every individual who, just before and just after the transfer took effect, had ultimate economic ownership of the asset was a member of the family group of that family trust.

iv. The asset transferred is an eligible asset that satisfies the active asset test

The asset being transferred is a Capital Gains Tax asset (other than a depreciating asset) and at the time of transfer is:

(a) where the party to the transfer is a small business entity – an active asset;
(b) where the party to the transfer is an entity that has an affiliate or connected entity that is a small business entity – an active asset that satisfies the conditions for a passively held asset in section 152-10(1A);
(c) where the party to the transfer is a partner in a partnership – an active asset and an interest in an asset of that partnership.

While a depreciating asset is excluded from being an eligible asset, roll-over relief is effectively provided for such assets under item 8 of the table in section 40-340(1). This active asset requirement effectively prevents the transfer of loans to shareholders to avoid the application of Division 7A of the *Income Tax Assessment Act 1936*.

v. The parties to the transfer satisfy the residence requirement
Both the transferor and transferee to the transaction must be a resident of Australia as follows:

(a) an individual or company that is an Australia resident;
(b) a resident trust for CGT purposes;
(c) a corporate limited partnership that is a resident for tax purposes under section 94T of *Income Tax Assessment Act 1936*;
(d) if the entity is a partnership (other than a corporate limited partnership) – at least one of the partners is an Australian resident.

vi. The Choice is made
The election to choose the roll-over to apply must be made by the transferor and the transferee.

Section 328-450 sets out the purpose of the legislation is that such a roll-over will be tax neutral and there will be no income tax consequences arising from the transfer of the asset. While this may not prevent the potential application of Goods and Services Tax, stamp duty or Part IVA, it will include the potential application of Division 7A of the *Income Tax Assessment Act 1936* where the transfer may otherwise have been treated as a deemed dividend.

The Capital Gains Tax effect of applying the roll-over is as follows:

(a) the asset is treated for Capital Gains Tax purposes as being transferred for an amount equal to the transferor's cost base just before the transfer, thereby preventing any capital gain or loss from arising;
(b) any pre-Capital Gains Tax asset maintains its pre-Capital Gains Tax status; and
(c) unlike other roll-overs, there is no deemed acquisition back to the date of the original acquisition by the transferor; the transferee will be treated as having acquired the Capital Gains Tax asset at the time of the transfer.

Law Companion Guideline LCG 2016/2 provides further details of the consequences of roll-overs and other examples. The roll-over relief includes an application for trading stock, revenue assets and depreciating assets pursuant to sections 328-455 and 40-340 of the *Income Tax Assessment Act 1997*.

4. Stamp Duty

As from 1 July 2016, New South Wales stamp duty is no longer payable on the transfer of business assets such as the goodwill of a business if the business supplied and provided services in New South Wales, or intellectual property that has been used or exploited in New South Wales.

Concluding Remarks

Arguably, the law in this area is particularly focussed on the substance of each arrangement over form. It is therefore crucial to ensure that the practical realities of the business' operations align with its legal form if the benefits of the form are to be relied on. In all cases, management records, business stationery, representations made by staff of the practice and

other contemporaneous records will paint an objective picture of the operations of the firm which may be called upon in the event of a dispute with respect to practice structure.

The issues arising in connection with structuring and restructuring professional practices are varied, and their resolution may be complicated in practice. Despite this, thorough consideration of the appropriate practice structure presents significant opportunities to lawfully minimise tax, safeguard the personal interests of practitioners and facilitate future growth and reorganisation of the business.