TEN 2ND ANNUAL
TRUSTS AND COMPANIES TAXATION SYMPOSIUM
Partnerships of Discretionary Trusts

Session 10

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1 A Little History

The ATO revived its interest in service trusts over a decade ago, just as new forms of professional practice were gaining regulatory and professional acceptance. The timing was unfortunate. It led to much wasted effort on all sides. It left ATO with nothing to regulate, practically, as those who could restructured.

For those able to incorporate, particularly in those places which did not impose heavy stamp duty on the transfer of a business to a company, an obvious solution beckoned. For larger practices, the perpetual succession of a company, the potential for no stamp duty on transfer of shares in a company, together with the ease of dealing and commercial acceptance of corporations, made that an obvious choice for professional practices of a certain size.

But it did not suit everyone, for example in those places where the transition would bear heavy stamp duty. Smaller practices, in particular, would not be overly burdened by alternatives to incorporation.

Nevertheless, the move towards incorporation of professional practices took the edge off the ATO's attack on service trusts.

It took a little while, for those intent on reducing business owners to quasi-employment, to find new ways of ignoring a taxpayer's right to choose the structures through which he earns income. And this is the most remarkable thing, that taxpayer alert TA 2013/3 is an attack upon a choice of structure, where the structures used are perfectly conventional.

Simply because those who regulate are employees, does not mean that all who are regulated must be reduced to the equivalent of employment.

One of the real tests of the ideological bent behind current activities concerning professional practice structures is the attempt to deny access to small business concessions under Division 152 *Income Tax Assessment Act* 1997. Given that the concessions there are given for the encouragement of small business, and that the structures adopted are far from complicated or unusual, it sits oddly that the ATO seeks to deny access to an express concession in the legislation meant to be beneficial to the class of taxpayers under examination by ATO at present.

2 Structuring

2.1 Terminology

A partnership of discretionary trusts is of course not that all. It is a partnership of companies, of individuals, or of a mix of companies and individuals, each of whom stands as trustee of a discretionary trust.

2.2 Pushing the envelope

The most extreme examples appear to involve a single company purporting to stand as trustee of two or more discretionary trusts, and claiming to be in partnership with itself, on account of each of the discretionary trusts.

That structure is respectably is supported by Kennedy J in *Gulland v Federal Commissioner of Taxation,*[1] *Rowley Holmes & Co v Barber,*[2] and by the acceptance (as a basis for argument) of that kind of structure in *Fagenblat v Feingold Partners Pty Ltd*.[3] It is supported by provisions such as section 57 *Trustees Act* 1962 (WA) and section 59 *Trusts Act* 1973 (Qd), which permit a man to sue himself in different capacities.

2.3 Nominee corporation

Perhaps the need for a corporation, and only one corporation, to face the public, as a well-understood business structure, can be accommodated in another way. It has been suggested recently that partnerships of discretionary trusts will usually be fronted by a corporation variously described as an “agent”, “manager”, “nominee” or “custodian”.

A single corporation, managing a business as agent for a partnership of the trustees of two or more discretionary trusts, would be simpler to justify to a court, than the additional complications of arguing that a single corporation stands as trustee for a number of discretionary trusts, and has contracted with itself as partner to do so.

2.4 How to describe and empower the nominee

There has been discussion of whether a person in such a position stands as trustee; whether that tends to prevent losses flowing from that “trust” onward to the true participants in the business; and how the matter should be treated for GST purposes.

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1 (1983) 72 FLR 362 at 379-380.
2 [1977] 1 All ER 801 at 806.
3 (2001) 49 ATR 18, [3]-[4], Pagone J (VSC).

In simpler times, it mattered not whether someone was called an “agent”, a “nominee”, or some other title. For income tax purposes, the Commissioner of Taxation took the benevolent view that losses could flow through to those who stood behind that entity.[4]

Those “laissez-faire” days appeared to come to an end with the advent of GST, with its requirement for paperwork quoting a unique Australian Business Number, and a focus (particularly in the finance industry) on what the true nature of relationships might be.

In short, it seems simpler and more advisable simply to describe the one entity that faces the public as being an “agent”, or “manager”, and for that agent to deal in its own name, whether or not disclosing that it acts as agent for several principals.

As soon as one begins to describe that entity as a “custodian” or a “nominee”, difficult questions of characterisation arise.

2.5 Perceived advantages

If the trustee of each of the discretionary trusts is a company with limited liability, there is the increased probability of being able to isolate personal liability to that company. Naturally, if we are setting up a trading concern, the trust involved should not own capital assets of a passive nature which can be exposed to the trading liabilities. Note, partners are jointly and severally liable for most tax debts.

The flexibility of a discretionary trust, as a vehicle to accommodate the changing financial needs of a family group, need not be stressed.

One of the features of partnership, however, that makes this an attractive vehicle is the CGT treatment. The 50% CGT discount under Division 115 *Income Tax Assessment Act* 1997 is available to trusts, but not companies.[5]

Following amendments by the *Tax Laws Amendment (Small Business) Act* 2007, it became possible in some cases not to count assets of a partnership in working out whether a partner met the net asset threshold for the purposes of Division 152, the small business CGT concessions.

While this is not all plain sailing, the important thing to note is that section 152-15(b) was replaced effective 1 July 2006. It had previously read, as to when a person satisfied the maximum net asset value test:

> *(b) If you are a partner in a partnership and the CGT event happens in relation to a *CGT asset of the partnership – the net value of the CGT assets of the partnership does not exceed $5 million.*

That made it very difficult for even modest combinations of families to structure as partnerships, so as to gain access to the small business CGT concessions.

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4 There was a (long ago withdrawn) ruling about aircraft leasing that exemplified this.

5 Section 115-10. I leave to one side the concessional treatment of life insurance companies for a limited range of assets.

At the same time that the $5 million cap increased to $6 million, section 152-15 was restated. The section now focuses on the sum of the net values of the CGT assets belonging to:

(a) the entity which made the capital gain;
(b) any entities connected with that entity;
(c) any affiliates of that entity or entities connected with such affiliates, but not so as to involve a double counting of assets referred to in the previous subparagraph.

A partnership is not a small business CGT affiliate of a partner.[6]

Care should also be taken that no one partner is treated as "connected with" the partnership in terms of section 328-125. For example, there should be no entitlement to a distribution of income of 40% or more to an individual partner.

Again, the precise terms of section 328-125 should be consulted, but there may be no difficulty where there are three equal partners, each being the trustee of a family trust connected with each of three unrelated families.

The small business CGT concessions are well-known, and are worth pursuing.

2.6 Drafting Issues

The major matters that should be considered in drafting a partnership deed (including any agency or similar arrangement) include the following.

Beginning with the agency, I have noted above reasons for preferring that the agent not stand as trustee. Of course, if there is significant property which will be held by the agent, consider suitable language to create immediately vested interests in that property for the partners for the time being.

I am not speaking here of a limited partnership, of the kind contemplated nowadays by State and Territory legislation. Thus we do not need to deal with the distinction between a general partner and a limited partner. However, that simply throws into relief the fact that each partner in a normal partnership is *prima facie* entitled to participate in the business. Each partner will have the appearance of being entitled to commit credit and to otherwise bind the co-partners. If these things are to be limited, at least as between the partners, there must be agreement as to who will manage the business, and as to what questions must be referred to the partners generally (for example, spending thresholds).

Make clear what assets are ventured into the partnership and what assets are held by an individual partner, for the use of the partnership. Failure to do so, particularly in a property joint venture arrangement, only leads to confusion and potential, unexpected revenue exposure.

There must be provision as to dispute resolution, failing which the partnership will be terminable at will, and without any attempt at formal dispute resolution.

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6 The actual words in section 328-130, and the example given under that section, do require some care in structuring. It should not be thought that partnerships of trustees of discretionary trusts will necessarily escape a conclusion that each partner is an affiliate of another where the trustees are bound by some familial or other arrangement that might lead to the conclusion that one will act in accordance with the directions of another, etc.

The partnership should contain a clause showing that it is to continue indefinitely, notwithstanding changes in membership. This will not prevent technical dissolution of a partnership each time membership changes, but rather provides the mechanism by which continuing partners assume to carry on business on change in personnel.[7]

Usually there is provision for pre-emptive rights, and at least a consideration of whether a restraint of trade clause is desirable.

If, as is often necessary, the business will require capital injection from time to time, the circumstances and respective sharing of that responsibility should be spelt out. The consequences of failure to meet a call should also be spelt out.

It often happens that a particular individual will take a lead in the affairs of the partnership. The issue of "salary" for a partnership comprised of individuals is fraught with contradiction. However, here we are talking about a partnership of corporate trustees of various trusts. Nevertheless, to avoid dispute, there should be express recognition of the need to pay a salary to any particular person, and a mechanism for review.

No amount of good legal drafting will overcome a poorly implemented structure. Once the partnership deed leaves your office, the partners should be looking for professional review on a regular basis. One way of reminding the businesspeople to do this is a clause in the deed, appointing a particular firm as the accountant or as the solicitors to the partnership. Whether this was actually enforceable has been tested, at least in the context of companies, and found to be wanting. Nevertheless, it does give a prompt to those conducting the business occasionally to seek guidance and review from the professional adviser.

2.7 Whether nominees actually conducting business

I have recently heard it suggested that ATO are contending that the corporate "agent" or "nominee", etc., is actually the entity conducting the business. There should be plain paperwork limiting the "agent" in specific terms to conducting the business on behalf of the partners. A person may conduct a business through his agent.[8]

I now turn to a short introduction to the ATO's recent interest, followed by two sections of this paper devoted to specific structuring considerations that have arisen in practice.

2.8 ATO View – Impediments to Partnerships of Discretionary Trusts

ATO issued a taxpayer alert TA 2013/3 which raises only three tax issues:

- Whether arrangements may be ineffective in "alienating" an individual's income.

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[7] A rather complicated recent example, which is nevertheless worth reading, is the lengthy decision of *Atwell v Roberts* (2013) 43 WAR 507 (Court of Appeal).

[8] *Ferguson v Federal Commissioner of Taxation* (1979) 37 FLR 310 at 324.

- Whether arrangements have unrecognised CGT consequences.
- Whether arrangements may involve a scheme to which Part IVA applies.

The primary concern I have had, in my dealings with ATO, has been the first of those issues. Specifically, ATO appeared intent on attacking transactions that, to me at least, appeared perfectly ordinary, and which were supported by the legislation of my State.

I do not know whether the approach has become any more sophisticated, but it did take ATO more than a year to issue a “no further action letter” in one matter where ATO cited the wrong provisions from my State’s *Property Law Act*, set those provisions up as a straw man, belted the hell out of the straw man, and ignored the correct provisions which justified the structure adopted by a professional practice.

All this meant that successive rounds of submissions had to be made to ATO, in terser and terser terms, ultimately with a view to having those initially dealing with the matter removed from further consideration of the matter. This involves cost and business uncertainty for the taxpayers involved. By the time that review was finished, there had been a further restructuring to avoid further adverse scrutiny (incurring State stamp duty) which made the enormous costs to both sides moot so far as the ongoing business was concerned.

I deal below with the defects in the taxpayer alert.

But first I deal in some detail with constraints on structuring, and with the lessons that might be learned from the most spectacular of recent decisions about the merits of structuring, *Kelly*.

3 Professional Practice – Choices Constrained by Rules

Take the barrister as an example.

A barrister must be a sole practitioner.

He must not practise in partnership.

He must not engage a legal practitioner to do legal work as his employee.

He must not practice as a legal practitioner director of an incorporated legal practice, or as a member of a multi-disciplinary partnership.[9]

The barrister is an extreme example.

But structuring must begin with what is legally possible.

In the case of a barrister in private practice, little can sensibly be done.

We are peculiarly privileged professionals, not grocers.i deal b

3.1 Solicitors

The forms of legal practice for solicitors appear, outwardly, less restrictive than for barristers.

3.1.1 Former restrictions on law business structures

For illustrative purposes, I will refer to Queensland law. Each jurisdiction has had its own history of acceptance of practice structures, and there is no analytical reason to look beyond one illustrative jurisdiction.

Formerly Queensland law restricted solicitors to practising either as sole practitioners, or in partnership.[10]

A solicitor was permitted to employ another solicitor, but an employed solicitor was not in "actual" practice.[11]

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9 *Barristers' Conduct Rules*, Rule 16. All references here are to Queensland rules and laws.

10 This was, in part, the product of the rule that a practitioner could not share with any unqualified person receipts from his practice: r.78 *Queensland Law Society Rules* 1987. It also followed from the prohibition on unqualified legal practice, and the system of practising certificates. As will be seen below, the "partners" might have instead (or as well) been co-trustees of a practice trust.

The former rule prohibiting sharing of receipt of legal practice with an unqualified person posed a formal, potentially fatal, hurdle to *Everett* assignments.[12] The solicitor needed regulatory consent.[13]

That point was put against the taxpayer in *Galland.*

But Mr Galland had his paperwork in order.[14]

Even under the old, restrictive rules, there was diversity in forms of legal practice.

It was not possible to have as a partner someone who was not a principal in practice.[15]

But groups of practitioners did associate, outwardly seen as partners, with trust arrangements.

I distinguish between:

a. practices conducted in trust, by principals outwardly appearing to be partners; [16] and

b. a partner standing as trustee of his share in the partnership.

As to the former concept: partners may together be trustees of a trust.[17] Each is a trustee, not the “partnership”. But it may be that trustees of a practice trust are no more than co-trustees, not partners.

As to the latter concept: a partner may stand, for some[18] or all[19] of his interest in the partnership, as trustee of a trust.[20]

Before the present liberalisation of law practice structures, we also saw service trusts, and dealings by a partner with his existing partnership interest.

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11 *Re AS Lilley, A Solicitor* (1894) 6 QLJ 87, 88 (Griffith CJ, Cooper & Chubb JJ concurring); followed *In Re McMillan* [1968] Qd R 247, 250 (FC).

12 In *Everett* the wife was a qualified person, so no question arose: *Commissioner of Taxation v Everett* (1978) 38 FLR 26, 30. (This is the intermediate appellate decision.)

13 Eg former r.78 *Queensland Law Society Rules* 1987.

14 *Galland v Commissioner of Taxation* (1984) 68 FLR 388, 389 & 393-394 (David Hunt J)

15 This seemed to be a product, not only of the rule against sharing receipts with unqualified persons, but also of the classes of practising certificates.

16 Section 11(2) *Trusts Act* 1973 (Qd) limits the number of trustees to 4 persons unless the Attorney-General has given licence for more trustees.

17 I find it difficult to state authority for this proposition, but see *Re Thompson* (1909) 28 NZLR 356 (Edwards J). Also, Heydon & Leeming *Jacobs' Law of Trusts in Australia* (7ed) para 1414 deals with the analogous position, for an unincorporated association:

> *At common law an unincorporated association has no separate identity and no legal persona, being no more than a combination of its members. At least in New South Wales there is no theoretical reason why all members cannot constitute themselves trustees, but this course has enormous practical difficulties.*

18 *Galland v Commissioner of Taxation* (1984) 68 FLR 388 (NSWSC, David Hunt J).

19 *Watson v Commissioner of Taxation* (1982) 61 FLR 268, 275 (WASC, Brinsden J). This was an instance of an executor holding his interest for a deceased estate, but I do not conceive that the result would have been different for a trustee.

20 Generally, see Ford & Lee *The Law of Trusts* para 4.2810: “A partner's total share in a partnership, or a fraction of a share, can be made the subject matter of a trust either by transfer to a trustee or by declaration of trust.” However, this text deals only with the position of an assignee or declarant, not with the position of someone who enters into partnership as trustee of an existing trust.

As to *Phillips* trusts:[21] It is now more than a decade since the Commissioner revived his interest.[22] It was largely in vain, since new practising structures became possible shortly afterward.

Under the old rules *Everett* assignments were possible with approval of the State regulator. They were of dubious assistance in the face of ruling IT 2540 ("Capital Gains Tax and Partnerships").[23]

3.1.2 Current restrictions on law business structures - Queensland

Under the current rules in Queensland, the basic permission to undertake legal work in section 24 *Legal Professional Act* 2007 (Qd) requires one of four things in the general run of private practice:

a. That the person engaging in legal practice be an Australian legal practitioner – this refers to an Australian lawyer holding a current practising certificate;[24]

b. Legal practice engaged in by an incorporated legal practice (or "ILP");

c. Practice only of foreign law by an Australian-registered foreign lawyer;[25]

d. A multi-disciplinary partnership (or "MDP") – this option requires some services beyond legal services to be provided.

The former prohibition on sharing receipts of legal practice with <u>un</u>qualified persons has gone. Rather there are prohibitions on sharing receipts with <u>dis</u>qualified persons, and with some convicts.[26]

It is necessary to work closely with the Queensland Law Society (or other regulator) if innovative structuring is proposed.

For example the QLS confirms that there remains difficulty with two corporations providing legal services in partnership.[27] This precludes a partnership of corporate trustees.[28] I have seen a suggestion in Victorian literature that a partnership of ILPs might be acceptable; and also that a nominee for a partnership might be an ILP. I find it difficult to comment on that.[29]

On the other hand, on the face of it (and uninstructed by specific knowledge of the practice of the Queensland Law Society), perhaps a multi-disciplinary partnership may comprise one or more

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[21] *Phillips v Federal Commissioner of Taxation* (1977) 13 A.L.R. 417 (NSWSC, Waddell J); on appeal *sub nomine Federal Commissioner of Taxation v Phillips* (1978) 36 F.L.R. 399 (Full Federal Court, Bowen CJ, Deane & Fisher JJ).

[22] For the history, and some context: refer Marks "Service Agreements: everything has its season" (2002) 36(9) *Taxation in Australia* 460-467. For the ATO's present position, see rulings IT 276 and TR 2006/2, and the booklet "Your service entity arrangements" (publication reference NAT 13086–04.2006).

[23] Paras 22-30. As to *Everett* assignments more generally, see rulings IT 2501 & 2608. The usefulness of *Everett* assignments was limited for anyone with a post-CGT interest. Nevertheless, there is a recent PBR on the register dealing with an *Everett* assignment, which was approved: authorisation number 1012514031526. Another recent PBR had the Commissioner accept a nil value of goodwill, for an *Everett* in a no-goodwill partnership: authorisation number 1012514194273.

[24] Section 6 *Legal Profession Act* 2007 (Qd)

[25] Refer section 24 *Legal Profession Act* for these three forms of practice.

[26] Sections 128 & 156 *Legal Professional Act* 2007(Qd), and r.40 *Australian Solicitors Conduct Rules*.

[27] QLS fact sheet "Practice Structures", version 1.0, dated 23 June 2011

[28] This specific question is dealt with in the fact sheet. The qualm is justified on my analysis. But note that the fact sheet also hints at the possibilities with a multi-disciplinary practice.

[29] Cf. section 2.2.2 *Legal Profession Act* 2004 (Vic), and Northeast "Partnerships of Trusts", Taxation Institute of Australia, 28 October 2008, headings 5.2 and 5.4.

Australian lawyers (that is, natural persons) in partnership with, for example, an incorporated town planning firm.

These are simply possibilities to explore, after understanding the rules and the Act, and then after consultation with the QLS (or other regulator).

The above is for illustrative purposes, only. The approach taken in each State and Territory must be considered against local laws and the regulator's practice.

3.2 Tax Agents

3.2.1 Former restrictions on tax agents' business structures

Surprisingly, there was litigation concerning structures for practicing as a tax agent. For example, the Tax Agents' Board of Queensland did not agree with a structure adopted in *Harts Pty Ltd v Tax Agents' Board of Queensland*.[30] A practical issue was how aggregators could structure practices intended for wider ownership.

Another issue under the former law was the restriction in section 251N(1) *Income Tax Assessment Act* 1936 on non-employees being involved in preparation of an income tax return.

The provision was complex and is difficult to summarise.

But a sole practitioner tax agent could not have an independent contractor work up the preparation of an income tax return. The independent contractor had to be brought "in-house" as an employee.

Section 251N was vague in relation to partnerships or companies registered as tax agents. It apparently facilitated independent contractors, such as service companies, providing labour to work up preparation of an income tax return.[31]

Sole practitioners, at the time, felt discriminated against.[32] (This disparity was pointed out to me by a sole practitioner who I represented before the former Tax Agents' Board of Queensland in a disciplinary matter in a disciplinary matter.)

3.2.2 The 2009 laws about tax agents

Today, practice structures for tax agents are dealt with by the *Tax Agent Services Act* 2009.

The new laws have been drafted in a more general way. That perhaps changes the landscape.

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30 97 ATC 2148.

31 Section 251N(2) which was replaced in about 2001 with subsection (2A).

32 As to the specific requirement for "employment", albeit in the context of an application for registration as a tax agent based on work as a sub-contractor, refer *The Tax Agents' Board of Queensland v Seymour* 90 ATC 4262 (Pincus J). That accountants continued to sub-contract in this way is evident from two cases in 2004, *Case 7/2004* 2004 ATC 180 and *Wadsworth v Tax Agents' Board of New South Wales* 2004 ATC 2374. In those cases, it is not apparent whether the alleged employer of the sub-contractor was a partnership or company, but the alleged employee (sub-contractor) suffered because he could not gain required experience as an "employee".

The prohibition on providing a "tax agent service" in section 50-5(1), where you are not a registered tax agent, continues. An element of the civil penalty provision is that "you charge or receive a fee or other reward for providing the tax agent service". This may technically extend to receiving a wage, something recognised by the Tax Practitioners Board.[33]

A "tax agent service" is any service that "relates to" various things, including ascertaining liabilities, obligations or entitlements under a taxation law. The only "out" is in the second limb of "tax agent service" that requires that the entity to whom you provide the services "reasonably be expected to rely on the service" for certain purposes. This allows for the case where an employee, or indeed an independent contractor, can say that the registered tax agent could reasonably be expected not to rely on the work provided by the employee or the independent contractor.[34]

Perhaps as a side wind, it now appears that the case of services being provided to the registered tax agent by a service entity may be covered by regulation 13. This provides for services to be provided "by an entity to a related entity" and between related entities of another entity. There are some curiosities about the way "related entity" is defined in regulation 13(3), including by using a definition in the *Corporations Act* which, in part, may possibly not apply (section 13 *Corporations Act*), and this may be fertile ground for dispute.

However, in any case, if the employees are in the service entity, and the service entity provides services on the basis that there will be careful review by the registered tax agent, or nominee, of work undertaken, there is unlikely to be the provision of tax agent services by the service entity.

In the context of the present discussion, Information Sheet TPB(I) 03/2011 is also interesting, concerning conducting business in the capacity of trustee of a trust. It says at paragraph 10:

> Two or more trusts can commence an enterprise (such as a tax agent or BAS agent business) together and form a partnership. The partnership is between the trustees on behalf of their respective trusts. Accordingly, the partners, for the purposes of tax agent or BAS agent registration, are the individual or corporate trustees of the trusts.

Thus the regulator indicates its acceptance, as legitimate, of a partnership of trustees of respective trusts, to conduct tax agent services.

It is not known whether that Information Sheet is being reviewed in light of the activities of the Commissioner of Taxation.

3.3 Liquidators

I briefly mention liquidators (as representative of insolvency practitioners more generally), because their appointments are personal.

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33 TPB Information Sheet, TPB(I) 13/2012, para 21.

34 This actually misstates the onus of proof, as it would appear that the prosecution would have to establish that it was reasonably to be expected that the person to whom services as an employee or independent contractor were provided would rely on those services. However a prudent professional would have the facts set up, noting particularly that the Tax Practitioners Board expresses itself unconcerned about employees doing work only in cases where there are sufficient numbers of registered tax practitioners in a practice properly to supervise the work. In other words, if an employee considers that his work is not being properly supervised, he would do well to resign, so as not to face prosecution for a civil penalty.

However, the remuneration of the liquidator extends to cost of employment of other staff, usually at lesser rates, to carry out the more mundane and routine matters associated with liquidation of a company.[35]

Typists, secretaries, and employed accountants are paid their salaries and wages, their agency fees, and drawings from the partnership in the ordinary manner. The liquidator seeks determination of his remuneration "out of which he must meet these expenses".[36]

Thus, a liquidator's remuneration could include remuneration for work done by a firm associated in a loosely grouped national affiliation.[37]

The point in *Re Reiter Brothers*[38] was that the arrangement, in the affiliated, national, accounting group was that work referred attracted a 10% commission for the liquidator. The interstate firm doing the agency work received 90% of the IPAA recommended fees.

The Court held it was proper for a liquidator to earn a commercial profit by his calling. However, since he had no interest in the capital of the interstate firm upon which to earn a commercial profit, he was not entitled to charge remuneration based on 10% of the agent's fee.

I only mention insolvency professionals because these are personal appointments.

The court is setting the remuneration of the liquidator in the cases mentioned.

It is not setting remuneration for a firm.

The liquidator's remuneration then has to accommodate the various proper charges made against it to get the work done.

Re Reiter poses an obstacle to loading charges into an associated entity, but my understanding of how work is charged is that no such inflation is intended.

3.4 Importance of legal structures

The adviser does not have a free hand in designing the optimal ownership structure for professional practice.

The consequence of getting this wrong can be that the structure is invalid and does not achieve the expected tax effect.

Thus, in *Jones v Federal Commissioner of Taxation*,[39] it was not possible at that time for the engineer, Mr Jones, to be in partnership with a non-engineer, Mrs Jones.

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35 I am paraphrasing Acting Master Chapman in *Davidson v Global Investments International Ltd* (1996) 128 FLR 74, 77.

36 Again, I am paraphrasing the actual language of *Re Trustees Executors & Co Ltd* (1984) 3 ACLC 475 at 479.

37 *Re Trustees Executors & Agency Co Ltd* (1984) 9 ACLR 497; *Re Reiter Brothers Exploratory Drilling Pty Ltd* (1994) 3 Tas R (NC) N10; (1994) 12 ACLC 430; BC9400381.

38 *Re Reiter Brothers Exploratory Drilling Pty Ltd* (1994) 3 Tas R (NC) N10; (1994) 12 ACLC 430; BC9400381

39 2003 ATC 2024

By the time of the AAT hearing, Mr Jones had abandoned the contention he was in partnership, and had to revert to claiming deductions for his wife's administrative services.

No one will thank you for setting up a structure that is not legally effective.

4 Kelly's Case

4.1 TA 2013/3 – first issue

The recent taxpayer alert says the Commissioner has three concerns about arrangements described in the alert whereby *an individual purports to alienate income attributable to their professional services to a trustee partner*.

The first concern is:

> *… the arrangement .. may be ineffective in alienating the individual's income.*

In each case, there has been something put against the professional as to the effectiveness of his transaction.

Think about it:

Everett – yes.

Galland – yes.

Jones – yes.

In *Case 2/*2004, in which I appeared for the marine pilot, the Commissioner unsuccessfully argued that the pilotage agreements were void.[40]

I cannot think of an occasion when it has not been put. It shows the value of having properly settled documents.

The most notable case in this category recently is *Kelly v Commissioner of Taxation.*[41] It is worth looking at this case.

4.2 The 20% transaction

Mr McFadzean was leaving the law firm.

On 29 June 2005, Mr McFadzean (and an associate) sold their respective interests in the partnership to the four trustees of the BCK Partnership Trust.

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40 [2004] AATA 349; (2004) 55 ATR 1082; 2004 ATC 112, [16]:
To paraphrase an assertion for the applicant, it is unreasonable to expect practical men of the sea to contract in terms settled by a Chancery Silk. Rather, this is the realm of printed form documents and salt spray. Whatever … [their] limitations, the documents were intended to have effect. In particular, it was intended that the company carry on a business of supplying the services of a licensed marine pilot as arranged by the Association; not that the company itself was a licensed marine pilot as asserted in some inappropriately worded documents.

41 2012 ATC ¶20-319 & ¶20-329 (Besanko J); (2013) 213 FCR 460 (Lander, Siopsis & Gilmour JJ)

The four trustees were the other partners of the legal partnership.[42]

But the retirement of a partner, whether or not there is an agreement for the partnership to continue, effects a dissolution of the partnership.[43]

Mr Kelly, and the other partners who gave evidence, insisted that BCK Partnership Trust had not become a partner in the firm.

Thus the trustees of the BCK Partnership Trust did not buy Mr McFadzean's interest, and that the continuing partners did not accept the trustees as partners in a newly constituted partnership.[44]

There was no alternative but that the trustees of BCK Partnership Trust had taken an assignment of an interest which ended on Mr McFadzean's retirement, shortly after the transaction was documented.[45]

A further difficulty arose. Mr Kelly could not show that the trustees of the BCK Partnership Trust paid Mr McFadzean. (It seemed another entity had.)[46]

It was thus not possible to conclude that an imperfect assignment should be treated as effective in equity. This was because Mr Kelly could not show that the trustees of the BCK Partnership Trust paid for the assignment.[47]

It was also not possible, absent proof of payment by the assignee, to argue a resulting trust.[48]

4.2.1 Documenting change

The documents did not assist Mr Kelly. (Other adverse issues were idiosyncratic to the transaction.)

Besanko J said this about the process of one partner leaving, and another being admitted in his place:[49]

> *It would have been open to Mr McFazdean to sell his interest in the BCK Partnership, in a practical sense, to a new partner where all the existing partners agreed to the admission of a new partner (s 27(1)(g) of the Partnership Act). I say in a practical sense because on a proper legal analysis the following steps would have been involved. First, the existing partnership would have been dissolved and the retiring partner would have accepted a sum of money by way of an accord and satisfaction for his interest in the partnership. Secondly, a new partnership would have been formed with the partnership interests reconstituted on the basis that the new partner would provide consideration to the continuing partners for the new*

42 There were complications later when the purported number of trustees exceeded the legal limit of four: s.11(2) *Trusts Act* 1973 (Qd).

43 *Commissioner of State Taxation (SA) v Cyril Henschke Pty Ltd* (2010) 242 CLR 508 [10]-[12]

44 2012 ATC ¶20-319, [176]

45 (2013) 213 FCR 460, [35].

46 2012 ATC ¶20-319, [179]

47 2012 ATC ¶20-319, [179]

48 2012 ATC ¶20-319, [188]

49 2012 ATC ¶20-319, [175]

> *interests that he or she obtained in the partnership. The consideration provided by the new partner might be the same as the consideration provided to the retiring partner by the remaining partners of the old partnership.*

This applied even if there was a "continuing partnership" clause in the deed.[50]

In the present case, it would have been interesting to have seen the transaction documented simply as a sale to the remaining four gentlemen (holding as trustees of the trust), those four agreeing with each other[51] that the firm should continue as reconstituted, and that the trustees should provide to the exiting party the sum due to him from them as remaining partners of the dissolved partnership.

Another possibility would have been for each of the continuing partners to have bought an interest from the retiring partner, in respective trust capacities for family trusts, those four men agreeing with each other that the firm should continue as reconstituted, and that the several trustees should provide to the exiting party the sum due to him from them as remaining partners of the dissolved partnership.

We do not know what happened here. There was evidence that the partners considered their arrangements achieved something effective, but this evidence was not useful.[52]

Documents which are plain, and which assist with the contentions that must later be put in Court against the Commissioner, are a good investment.

4.2.2 Argument that a trust could not be a partner

The taxpayer changed his position before trial,[53] and asserted the trust was incapable of being a partner (a truism, since a trust is not a juristic person).[54]

This was in the face of representations to the Queensland Law Society and ATO that the BCK Partnership Trust <u>was</u> a partner.[55]

What was not argued, doubtless for good reasons not apparent to outsiders, that the trustees of the BCK Partnership Trust were simply there in their dual capacity as partners (of the reconstituted firm).

Instead, it was argued that the trustees of the BCK Partnership Trust were purchasers of an interest in the partnership (but did not become partners).

This ran into the difficulty that the purchased interest could not be better than the interest when held by Mr McFadzean.

On Mr McFadzean's retirement from partnership, the partnership was dissolved and his interest converted to a debt for his share.[56] A person, taking an assignment of Mr McFadzean's interest

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50 *Commissioner of State Taxation (SA) v Cyril Henschke Pty Ltd* (2010) 242 CLR 508, [11]. As to drafting, see *Lindley and Banks on Partnership* (19ed), [10-39] & [10-40].

51 Section 50(1) *Property Law Act* 1974 (Qd), as to which see below.

52 2012 ATC ¶20-319, [180]

53 The *volte-face* is apparent from Besanko J's reasons. One need only read [50] – [52].

54 2012 ATC ¶20-319, [23]

55 2012 ATC ¶20-319, [51], [52]

56 Sections 42, 46 *Partnership Act* 1891 (Qd)

before dissolution, had only an entitlement to receive the share of partnership assets to which the assigning partner was entitled.[57]

But the income year in dispute was 10 years later.

This is why it was vital that Mr Kelly be able to prove some feature of the 20% transaction which could endure dissolution.

On the documents, he could not.

It need not be this difficult.

The simpler case, which I have seen in another matter, involved the remaining members of the firm taking up (as trustees of respective family trusts) specific percentages of a retiring member's share. This left these remaining partners contracting with each other; or, on another view, contracting with each other in several capacities (as contemplated by the *Property Law Act* (Qd)).

Section 50(1) *Property Law Act* 1974 (Qd) provides:

> *Any covenant, whether express or implied, or agreement entered into by a person with the person and 1 or more other persons shall be construed and be capable of being enforced in like manner as if the covenant or agreement had been entered into with the other person or persons alone.*

The Commissioner did not apparently appreciate this feature of Queensland law in the matter on which I advised.

But he cannot have it both ways. He has actually relied on s.50(1) to effectuate contracts between joint trustees, on the one hand, and each of those individuals personally, on the other hand.

In *Christie v Federal Commissioner of Taxation* 2005 ATC 2009 the Commissioner relied on s.50(1) to show a couple, acting as trustees, could employ themselves. Thus they had neglected to provide minimum superannuation guarantee contributions.[58]

Browne v Commissioner of State Revenue teaches that s.50(1) gives effect to the affected transaction, according to the terms of the transaction. The statute does not merely make a new bargain with fewer parties on one side, as the taxpayer argued unsuccessfully in *Browne.*[59]

The other statutory intervention in Queensland, of significance procedurally, is s.59 *Trusts Act* 1973 (Qd). A man may sue himself, in different capacities. He is to apply for directions before doing so, to accommodate representation of the divergent interests.

It is unclear how far TA 2013/3 takes account of regional differences, such as these Queensland statutory reforms.

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57 Section 34(2) *Partnership Act* 1891 (Qd)

58 There, the AAT declined to follow *Gulland v Commissioner of Taxation* (1983) 72 FLR 362, where the Supreme Court of Western Australia (Kennedy J) had held a man could contract with himself in different capacities absent statutory intervention. It may have been safer for the Tribunal to have confined itself to the actual basis of the decision, that a trustees could enter into a contract with each one of the trustees in their personal capacity, to employ them: [47].

59 [2004] 1 QdR 116, [12] (CA)

4.3 The 7.857% interests

Mr Kelly nevertheless met with some success.

He established transactions by which interests in the partnership totalling 7.857% were assigned to him, as trustee for his own trust, for value.

The numerous hurdles, set in his way by the documents and by the Commissioner, need not now be recounted. It should be assumed that the Commissioner took every conceivable point, including some which would have been inconvenient for conveyancing in Queensland if the court had risen to the bait.

Besanko J found the law to be (highlighting his Honour's words in italics):

- In *Everett*[60] the High Court held *that there had been a valid equitable assignment of an interest in the partnership and that interest carried with it the right to future income referrable to the interest. The income was the income of the trust estate and not income gained by personal exertion.*[61]
- *Everett is authority for the proposition that an assignment of part of an interest would entitle the assignee to receive the appropriate proportion of the partner's income attributable to that interest.*[62]
- *The assignee of part of a partner's chose in action may be a discretionary trust where the class of beneficiaries are the partner and his family.*[63]
- *It was open to a partner of the BCK Partnership to assign his interest, or a part of his interest, for consideration to a third party. If that was done, then the income referable to that portion would be assessable in the hands of the third party and not in the hands of the partner.*[64]
- *In the alternative to an assignment for consideration, a partner may declare a trust over part of his interest in a partnership and this will have the same effect as an equitable assignment.*[65]

Despite the reconstitution of the partnership on a couple of subsequent occasions, Besanko J saw no indication that the 7.857% interest held on trust had been diluted. This was despite the fact that new *choses in action* (comprising the fractional interest in the partnerships) were created on each occasion.[66]

This supports the Commissioner's view, in IT 2608, para 14:

> *... it is considered that arrangements which provide for a reinvestment of the assigned partnership interest in a reconstituted partnership are effective for*

[60] (1980) 143 CLR 440
[61] 2012 ATC ¶20-319, [148]
[62] 2012 ATC ¶20-319, [151]
[63] 2012 ATC ¶20-319, [153], citing *Commissioner of Taxation v Galland* (1986) 162 CLR 408
[64] 2012 ATC ¶20-319, [154]. His Honour then stresses the need to abide by specified formalities.
[65] 2012 ATC ¶20-319, [155]. His Honour again stresses the need to abide by specified formalities.
[66] 2012 ATC ¶20-319, [199]

> *taxation purposes. It will be accepted in such cases that there will be no need to execute a further deed of assignment where changes occur in the constitution of a partnership.*

Thus Mr Kelly was not assessed to the extent that interests in the partnership totalling 7.857% were held on trust.

4.4 Superannuation issue

There was a last minute issue, caused by Mr Kelly being the default beneficiary under the trust. It was held that deductions by the trust for superannuation were not properly allowable[67], but this is of subsidiary importance and idiosyncratic to this case.

4.5 Lessons from *Kelly*

Documentation is important. So is the flow of money, to match the supposed shape of the transaction.

The facts and actual documents presumably limited the ability to put more prospective arguments, in relation to the 20% transaction. The contentions on appeal were at odds with the documents, for that 20% interest.

Transactions so important to the life and workings of a firm (and its members) might be briefed out for external review, and to settle the deeds. Perhaps they were in this case, but we will never know.

67 *Kelly v Commissioner of Taxation (No.2)* 2012 ATC ¶20-329; upheld (2013) 213 FCR 460.

5 Reducing us to salarymen

Taxpayer Alert TA 2013/3 raises three tax issues:

- Whether arrangements may be ineffective in "alienating" an individual's income. This apparently refers to the kinds of documentation issues in *Kelly.*
- Whether arrangements have unrecognised CGT consequences. This apparently refers to the application of IT 2540 (no goodwill partnerships, in particular), and more recently to the intense discussion with ATO concerning the terms of TD 2011/26, TD 2011/D9 and TD 2011/D10.
- Whether the arrangements may involve a scheme to which Part IVA applies.

I have illustrated the first point above, in discussing *Kelly*, and by pointing out by reference to earlier cases that carping at the taxpayer's documents is a consistent thread in such litigation.

The second issue, about recognition of CGT, is diffuse.

a. Plainly, CGT events must be recognised.

b. Practitioners have obtained private rulings, cases of doubt, as to capital proceeds).[68] It is difficult to see that continuing in the long-term, if rulings are delayed or inexplicably become negative.

c. The phrase in IT 2540 that limits its application even for a dealing with an interest in a no goodwill partnership is: "where the partners' dealings with each other are at arm's length". IT 2540 does not protect most *Everett* assignments, as the assignment is not at arm's length, nor between partners. But it is simply a ruling.

d. TD 2011/26, TD 2011/D9 and TD 2011/D10, which concern incorporation of practices (and subsequent transactions), are restrictive, and of little practical use even for no goodwill firms. This was despite significant engagement by the professional bodies.

e. Structures other than partnerships of individuals offer more opportunity to access Division 152 concessions.[69] The application of Part IVA in order to close down access to Division 152, in cases involving no artifice, would be a concern.

The third issue is the application of Part IVA.

The novelty here is striking down a lawful business structure.

The author of TA 2013/3 seems to have forgotten the role that artifice has in determining the application of Part IVA. The s.177D factors are:

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68 On an *Everett* assignment, in a no goodwill partnership, see PBR Authorisation No. 1012514194273.

69 West "Taxpayer Alert 2013/3 Professional Practice Structures", presentation made 13 March 2014, slides 13-14. Accessed at: http://www.taxinstitute.com.au/seminar-presentations/taxpayer-alert-2013/3-professional-practice-structures-presentation

a. the manner in which the scheme was entered into or carried out;

b. the form and substance of the scheme;

c. the time at which the scheme was entered into and the length of the period during which the scheme was carried out;

d. the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;

e. any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;

f. any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;

g. any other consequence for the relevant taxpayer, or for any person referred to in paragraph (f), of the scheme having been entered into or carried out;

h. the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in paragraph (f).

If the business structure does what it says on the label, is functioning in accordance with the user manual, and is straightforward in delivering economic results which accord with legal form, the level of artifice is nil.

Although decided under an old provision like former s.260, *Deputy Commissioner of Taxation v Purcell* still rings out over the 90 years since its decision:[70]

> *The Commissioner next contended that, even if the declaration evidenced a real, genuine and valid transaction, yet it was struck by s 53 of the "Income Tax Assessment Act 1915–1916." If the argument be sound the assessment is, of course, unimpeachable. It is therefore essential to consider the true construction of s 53. The section, as the Chief Justice says, does not prohibit the disposition of property. Its office is to avoid contracts, etc, which place the incidence of the tax or the burden of tax upon some person or body other than the person or body contemplated by the Act. If a person actually disposed of income-producing property to another so as to reduce the burden of taxation, the Act contemplates that the new owner should pay the tax. The incidence of the tax and the burden of the tax fall precisely as the Act intends, namely, upon the new owner.*

The Commissioner now says he will revisit his prior acceptance of *Everett* assignments, at least where there were no strings attached to the assignment (or equivalent declaration of trust).[71]

70 (1921) 29 CLR 464, 473 (Gavan Duffy & Starke JJ). See also Rich J at 476: "It is difficult to say what is its precise scope and effect, but whatever its meaning it would be unreasonable to construe it so as to include a genuine gift which had the incidental effect of diminishing the donor's assets and income."

This cannot be a good sign in relation to other arrangements, of a straightforward nature, which every other businessman seems able to use with impunity.

The list of warning signs stated in the taxpayer alert, with my comments, is as follows:

Warning sign	**Comment**
The trustee does not actively engage in the conduct of the firm's practice and may not hold professional qualifications	Neither are the major shareholders of one of the two listed legal practices. This is normal.
The practice is carried on in much the same way as it had been before the trustee purported to become a partner, or would have been if the trustee had not purported to become a partner	The practice is now owned in a radically different way. The value-laden warning sign looks selectively at the fact that professional services are still being provided by professionals, not to the wider context of who is legally responsible
The individual renders substantial personal services to clients of the firm, the value of which cannot be attributed solely to the efforts of employees or income producing assets	There is much that can be said about this, but let's look just at "solely". "Solely" is not the test: IT 2330.
The individual has the same or similar roles, responsibilities and obligations as they had before the trustee purported to become a partner, or would have had if the trustee had not purported to become a partner	Again, a value-laden, imprecise criterion is used. See comment above.
No advice of the trustee arrangement is given to clients of the firm or other third parties	This is hardly decisive. But it can be cured easily. Clients are now used to dealing with professionals practising through companies, and notice of a trust will not surprise anyone who actually gets to the end of a Terms of Engagement letter.
The trustee arrangement does not result in any limitation of liability for the individual, or the individual is exposed to substantially the same level of business risk they were exposed to as a partner, or would have been exposed to, if they had been a partner	Bare claims that an arrangement results in asset protection benefits do not wash. There should be a proper assessment of whether a proposed structure in fact provides the claimed benefit.
The trustee arrangement does not assist in the provision of professional services by the individual.	Again, we have an imprecise, value-laden criterion.

[71] Cf rulings IT 2330 para 19, IT 2501 para 9. The latter says: "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." See also PBRs authorisation nos. 78291, 1012514031526.

Warning sign	Comment
The amount of salary or other remuneration payable to the individual is considerably lower than the income which they formerly derived from the practice, or would have derived if they had been a partner,	This is the nub of the Commissioner's concern. See below.
The individual has the ability to remove the trustee, revoke or alter the trust arrangement, or otherwise control the trustee's interest in the partnership	This may offend the "no strings" element of the approval of Everett assignments in IT 2501, para 10. The actual significance depends on the powers retained.

The Taxpayer Alert goes on to assert that there may be documentary and formal problems also present (as to which see above). See the various pitfalls, some tragically basic, apparently present in arrangements the Commissioner has seen: TA 2013/3 para 5.

Of greater concern, if the taxpayer's argument is that the trustee of the trust is receiving the normal reward of capital (as opposed to labour), is the absence of a contribution of capital to the firm.

For a normal firm, of even modest size, the firm will be generating income from the business. In ruling IT 2330, the Commissioner instructed his employees in these terms:

> *37. Not all income derived by professional people from the conduct of their professions can be said to be derived from the rendering of personal services. There are many large professional firms, e.g. accountants, engineers, architects, solicitors, etc. whose income is produced by the staff employed by them. In Henderson v. FCT 70 ATC 4016 : 1 ATR 596, for example, Barwick C.J. drew a distinction between the income of a professional practice carried on by a taxpayer personally and the professional firm of which Henderson was a partner and which employed some 295 persons. In FCT v. Everett 80 ATC 4076 : 10 ATR 608 the majority of the High Court expressed the view that the income of the taxpayer from a large legal partnership was not income from personal exertion in the same sense as the expression has been used in cases such as the doctors' cases, etc. Whether or not arrangements for the conduct of large professional firms under a trust structure are to be accepted for income tax purposes will depend upon whether they satisfy the matters referred to in paragraphs 18-32 above.*
>
> *38. The Court went on to say in the Everett case that it is not true of partners in general that they derive their income from personal exertion. On the other hand, in the doctors' cases the Court was clearly of the view that the character of the income involved in each case was income from personal exertion notwithstanding that there were partnerships involved. For the purposes of this Ruling partnership income will be treated as income from the rendering of personal services where it results from the personal services of the partners and not from the efforts of employees and/or income producing assets of the type illustrated by the Purcell case.*

As the Full Court held in *Kelly*, a director is not entitled to remuneration, unless expressly allowed.[72] There are many working directors, who control their businesses, and who hope by the product of their business to reap the reward of capital.

The level of contrivance in such a case is low.

The professions are rightly concerned that their businesses are being treated differently from the businesses of skilled, labour intensive trades, such as garment makers and builders.

David W Marks

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Inns of Court, Brisbane

28 July 2014

[72] (2013) 213 FCR 460, [114]