

# PROFESSIONAL STRUCTURES

## SERVICE TRUSTS AND INCORPORATIONS

**WHAT DOES IT MEAN FOR YOUR LEGAL PRACTICE?**

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29 MARCH 2006

In June 2005, the Australian Taxation Office (ATO) published its long awaited paper on Service Arrangements, "How you can review whether the payments made under your service arrangements are commercially realistic and reasonably connected to your business" (Draft ruling TR2005/D5).

The release of this paper, although only draft caused Professional Practices to assess their current arrangements, and made incorporation of Professional Practices a very hot topic, (at the date of writing this paper the ATO had yet to release its final Income Tax Ruling on Service Trusts).

Before assessing what the impact of this paper is on Professional Firms, it is important to first understand how Professional Firms, including Legal Practices have been traditionally established.

Prior to 1 July 2001, Legal Firms for professional reasons were unable to be incorporated, consequently their business was set up as a Sole Practitioner or a Partnership. It was not until 1 July 2001, that the Legal Practitioners Amendment Act allowed Legal Firms in New South Wales to become incorporated, thereby providing Practitioners with an avenue for limited liability protection.

As incorporation was not permitted until recently, most Professional Firms were established as a Partnership or Sole Practice, with a Service Trust attached. (Refer Annexure 1)

The purpose of the Administration Service Trust was to firstly provide the Practice with administration and secretarial services, secondly it would also acquire the fixed assets required by the Professional Practice in order for it to operate. As the Professional Practice/Partnership had unlimited liability, having assets acquired by the Administration Service Trust, helped to protect these assets from third party claims. On the surface this appeared to be an effective way of establishing a Professional Practice.

The Administration Services Trust was usually established as a Unit Trust (even occasionally as a Discretionary Trust) with the units held by Discretionary Family Trusts. The Administration Service Trust would charge the Professional Practice for services, based on costs incurred, plus a mark up (profit element). This arrangement effectively allowed income earned by the Professional Practice to be diverted from the Practice, through the Service Trust to the Partners' Family Trust. This allowed income to be taxed at more effective rates, as often the beneficiaries of the Discretionary Family Trusts were on significantly lower tax rates than the Partner (sometimes referred to as income splitting).

Referred to as a "Phillips Trust Arrangement", and accepted under Income Tax Ruling 276, this became the accepted means by which a Legal Professional Firm would structure itself, allowing firstly for the protection of assets and secondly as an effective tax planning measure.

This has been the generally accepted principle for the last 30 years. Although the ATO was not in favour of such arrangements, they had effectively allowed for their use by not doing anything to stop them.

The Commissioner accepted the "Phillips" decision as service fees charged by the Administration Service Trust were considered realistic and commercial and it considered that there were sound reasons for the arrangement, quite apart from any tax savings that may arise.

Over the years Professional Practices have relied upon the principles raised in "Phillips" case to establish Administration Service Trusts, and to charge fees to Professional Practices, for the service so performed. However, markups used on expenses have often greatly varied from the principles relied upon in "Phillips".

It is not uncommon today to find the Administration Service Trusts marking up all wages 50%, rental and lease costs 20% and all other costs at least 20% if not more. In fact it is not unusual to have situations today where the Administration Service Trust is generating the majority of the group profit.

Over the years there has been considerable variation from the principles raised in "Phillips Case" to a point where the ATO has viewed the use of Service Trusts as a form of tax evasion. To combat the use of Service Trusts the ATO released its long awaited paper on Service Trusts and their future operation.

Under TR2005/D5, the ATO states that they "understand that it is common for professionals to view service arrangements as an effective means of protecting personal assets from professional negligence actions". The ATO's concern was whether service fees are deductible under Common Tax Law.

Contained within the paper issued by the ATO, were what they considered to be realistic mark up percentage to be applied. Their percentages were based on reviews undertaken of publicly listed labour hire and equipment hire companies.

In summary, the ATO came up with the following:

*Commercially realistic mark up percentages*

CATEGORY	NET MARK UP
Labour hire - Temporary staff	<5% on direct and indirect costs.
Labour hire - Permanent staff	<3.5% on direct and indirect costs.
Recruitment	<5% on direct and indirect costs.
Equipment	<9% on the written down value of the assets used.
Rent	0% rent is at market rates.

The suggested mark ups, would limit the profit generated by the Service Trusts to around 3%-5% of fees charged. Consequently, where the costs incurred by the Service Trust were say \$2 Million, the estimated annual profit generated is \$60,000-\$100,000. This I would suggest is significantly less than the current profit being generated by many Service Trusts. In addition to the markups noted above, the ATO also detailed the compliance matters that needed to be adhered to, including documentation and the like. I believe it would be difficult for most Service Trusts to fully comply with these guidelines as they are quite onerous.

The ATO despite not having released their final ruling have advised that Professional Practices have until 30 June 2006 to review their current structures and implement changes, as needed. In fact the ATO has already said that if they were to conduct an audit of your Practice they would first look at reviewing what changes have been made since July 2006, before determining what further action may be taken.

With this in mind Legal Firms are now considering incorporating their Practices, and subject to Capital Gains Tax considerations, having a portion of the Practice being held by the Family Trust. (Refer Annexure 2)

Annexure 2 shows a much more effective means by which a Professional Practice could be established and in many situations this structure would allow for a greater income stream to be legally channelled through to Discretionary Family Trusts, thereby allowing for more effective tax planning.

Subject to goodwill issues (refer below) there is nothing to say that the majority of the equity in the Incorporated Practice cannot be held by the Family Trusts. However to ensure that control remains with the Partners it is important that at least two classes of shares are created. Say ordinary or "A" class shares, held by the Partners, that carry all voting and control, and "B" class shares that have no voting rights, but rights to dividends.

It is important that there are two classes of shares, as control of an Incorporated Legal Practice must remain with registered Legal Practitioners.

The primary issue to initially overcome when using this structure is concerned with Goodwill and Capital Gains Tax.

If you are a “Non-Goodwill” Practice, which many Practices have written into their Partnership Agreement, then I believe that transferring of ownership to a Family Trust does not cause any real CGT issues. However, if this is not the case, then you need to assess the impact of CGT on your proposed incorporation.

CGT is a key determinant in implementing any new structure and its impact needs to be carefully considered. Where Goodwill is an issue for your Practice, then wherever possible the restructure should be done in such a way so as to take advantage of the CGT rollover provisions, discounts and small business exemptions. In addition, you need to also consider the CGT consequences that could result in the future with the admission of new Partners and exit of existing Partners.

The CGT considerations are extensive and time does not permit these to be discussed in detail today, it is really a matter you need to discuss and have reviewed by your professional advisors. That said, I will try to explain some of the CGT consequences.

Presently, assuming you are a three Partner Practice, each Partner holding an equal share and the net assets of the Partners and the Practice are less than \$5 Million. If one Partner was leaving and being paid an amount for Goodwill (that resulted in a gain) then the Partner could reduce the tax payable in relation to this gain by using the small business tax concessions. If instead of being in Partnership the interest was held in an incorporated entity, then the existing shareholder could not use the small business tax concessions.

The reason being that as a Partner, one looks at their own interests, whereas, as a shareholder one has to be a controller (a controller is someone who holds 50% equity).

In Annexure 3, I have done a very basic example to show how a change in structure may have some adverse capital gains tax consequences. The rules are complicated and need to be very carefully reviewed.

I am of the firm belief that it is becoming more and more difficult to sell goodwill to incoming Partners and that over time this will only continue to worsen. Consequently it may be appropriate to consider today adopting a "no goodwill" Practice.

Putting the goodwill issue aside, incorporation is a very effective means of getting around the ATO's Service Trust provisions and also an effective means of having the potential to move a greater portion of income to Family Trusts and associated entities. Besides this however, there are a number of other benefits that may also arise as follows:

- a) Liability under a Partnership structure is unlimited and joint and several. Under an incorporated structure liability is limited to one's equity (in addition to the liability a person carries as a Director of the company). Creditors of the company usually only have access to the business assets of the corporation. The benefit of this should never be understated.
- b) As a Partner of a Partnership, you are not an employee, therefore, if you make a superannuation contribution you can claim as a tax deduction the first \$5,000 plus 75% of the excess above \$5,000 (up to your aged based limit). If however, you were an employee of the company you can structure your salary package to suit your needs and all super contributions (up to your age based limit) are fully deductible.

Presently if you are 49, the maximum amount you could put into superannuation is \$38,702, as a Partner (self employed) you would need to make a contribution of \$49,936 to generate a tax deduction of \$38,702.

- c) Over time the financial affairs of the company should become more streamlined. Rather than operating accounting systems, bank accounts etc for a Partnership and Service Trust, you only eventually need a single accounting system. This should potentially lead to a reduction in administrative staff.
- d) Non-deductible expenditure, such as entertainment and employee provisions are effectively provided for at a tax cost of 30% rather potentially 48.5% as companies have a lower tax rate.
- e) Professional Practices require working capital to fund debtors, work in progress and the like. Whilst bank finance is used to assist with this, Partners invariably provide working capital loans and are unable to draw down their entire profit allocation. This effectively means that the Partner is providing their funding to the Practice at their effective personal tax rate, normally 48.5%. However, under a corporate structure, this is effectively provided for at a tax rate of 30%. This difference in tax rate could provide substantial tax savings. Also, as a Partnership grows the working capital requirements also increase, it is not possible to draw down 100% of the annual profit, although the Partner must include it in their taxable income.
- f) In the first year of incorporation income tax payments due on assessable operating profit are deferred for up to 22 months. If incorporation occurred on 1 July 2006, the corporation would not have to pay income tax on their profits until April/May 2008.

- g) Employee entitlements in a corporate structure are provided for at an after tax rate of 30% as opposed to the Partners' marginal tax rate under a Partnership structure.
- h) There is potentially a greater income flow to the family trusts under a corporate structure and the income received by the family trust would be fully franked dividends, as tax has already been paid by the company.
- i) Once incorporated and the correct bank documentation has been put in place then there is no need to change the documentation when a Director (Partner) leaves or enters. As the loans are provided to the company a change in the Directors/shareholders does not usually require documentation to be redone and stamped. This can lead to substantial savings in bank fees and stamp duty.
- j) If incorporated, the legal firm could consider developing an employee share scheme, as a means of retaining good employees. Also, bonuses could be paid as dividends instead of salaries thereby leading to savings in payroll tax.
- k) Partners now Directors/employees may be able to save money having motor vehicles owned by the company and subject to Fringe Benefit Tax.
- l) Once incorporated, the legal firm would no longer need to be concerned about the new Service Trust Rules.
- m) Once incorporated, when a Partner enters or exits stamp duty will only apply to the transfer value of the shares at a rate of \$0.60 per \$100 dollars. The transfer of goodwill between Partners is subject to stamp duty at advelorum rates.

Incorporation can offer many advantages, costs savings and tax savings and potentially a much simpler structure going forward. However, it is not all good news. As with all things there are costs and risks to be considered as follows:

- a) A Partner or sole Practitioner is not an employee, consequently notional salaries paid are not regarded as wages and salaries under the Payroll Tax Act. Once incorporated such payments would come within the definition of wages and would need to be included when calculating payroll tax liabilities. Although a tax deduction, the increase in payroll tax liability could be substantial. Assuming wages to other staff already exceed \$600,000 then if \$500,000 was paid as wages to Directors (formerly Partners) this would give rise to an additional payroll tax liability of \$30,000.
- b) If incorporated, the wages (notional salary) paid to the Director would be subject to PAYG Tax (ie taxed first before it is paid). Super at a rate of 9% would need to be paid (at least quarterly) and be included in the payroll tax calculations.
- c) Workers compensation insurance premiums would increase due to increased wage costs, noted above. Also, the current discounts your organisation receives today, would not be available for the first two years of the company's operations.
- d) As the Directors (Partners) are now drawing salaries they can no longer make deductible personal superannuation contributions.
- e) The payment of franked dividends to shareholders is limited to the income tax paid by the company. As there is no income tax initially paid for 18-20 months there will be a limit as to what can be tax effectively paid (NB: The ATO does give a concession to a company in its first year of operation. It allows a company to pay a dividend in the first year even though no

tax had been paid, provided the franking credit is limited to the tax that will be paid on the company's income for that year).

- f) Capital gains tax could be an issue, especially with the transfer or issuing of shares to the family trust.
- g) Your Partnership Agreement will need to be re-written and will need to incorporate how shareholders enter and exit the corporation.
- h) Initially administration costs will increase as the new entity is established, leases are transferred, debtors are recovered, assets are sold, stationery is re-done, bank facilities re-drafted etc. However, this should be a relatively short term inconvenience.
- i) The impact of work in progress (WIP) and how it will be brought to account and over what time frame needs to be carefully considered. WIP should not be automatically transferred to the newly incorporated Practice, as this will suddenly create an income tax issue for the old Practice. As WIP is recovered it will be income to the old Practice, so you need to carefully manage how this is brought to account. For a Practice with considerable levels of WIP this may need to be brought to account as income over several years.
- j) Dual debtor's ledger's will need to be maintained, one ledger for debtors of the old Partnership and one for the newly incorporated entity. Debtors are never rolled over to the incorporated entity because if for some reason the debt is not able to be recovered, then only the entity that originally raised the invoice is allowed to claim the deduction for it not being recovered.

- k) Undertaking cash flow projections for a 2-3 year period is paramount as there are significant tax deferrals and the like. It is extremely important that you fully understand when taxes will become due, their likely quantum and the availability of franking credits to permit fully franked dividends to be paid.

Whilst incorporation may sound good, there are many factors that you need to consider and carefully cost.

*So what does all this mean?*

The release of the draft determination made us all suddenly question the operations of our service trusts, how they generate income, the level of profit and their effectiveness.

I also believe this has caused us all to look much closer as to why we operate the way we do. This is good.

The changes to personal income tax rates have also caused us to question how income is earned and by whom, and the effectiveness of our structures for splitting income. This is also good.

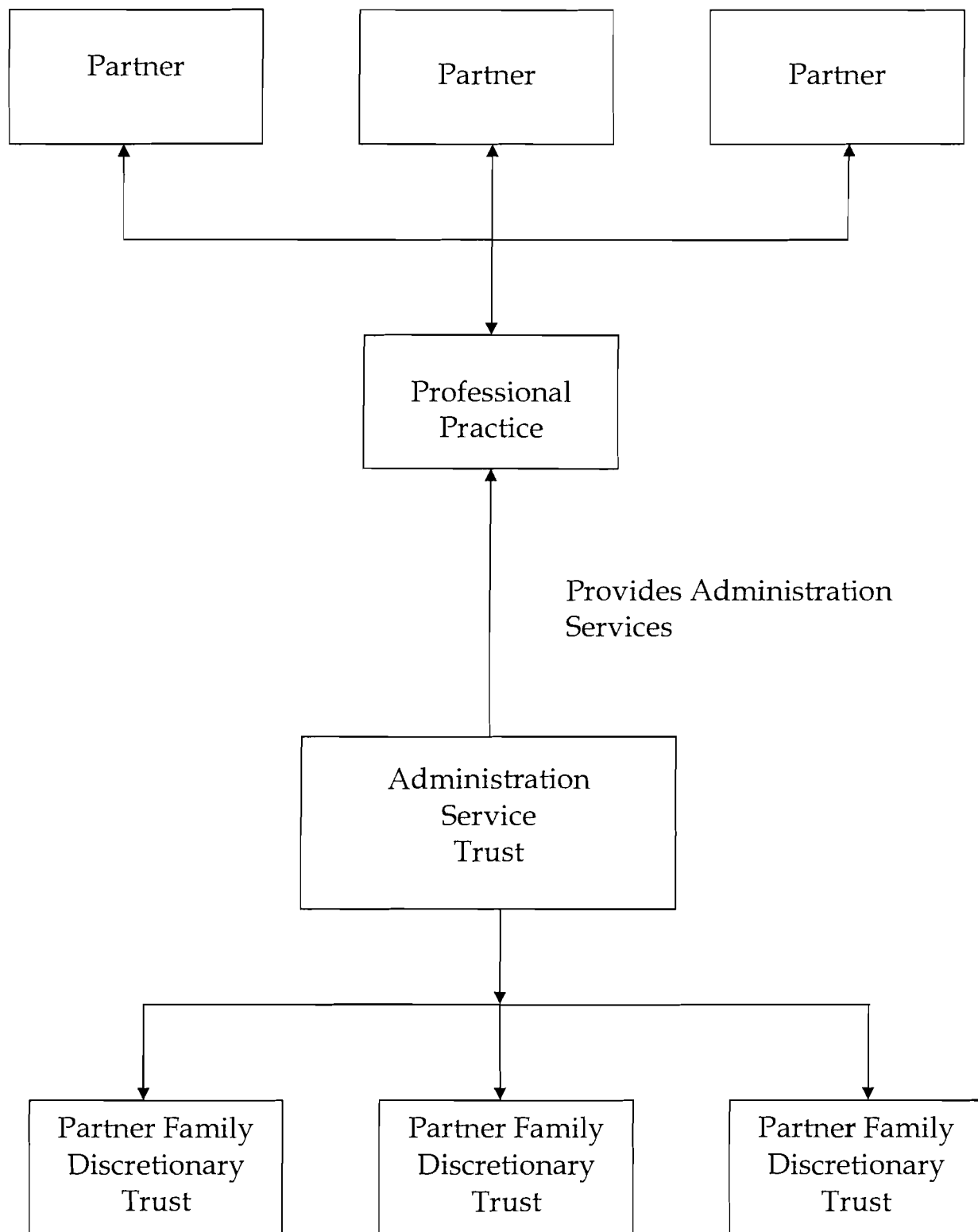
Every Practice's circumstances and those of the Partners are different, and the advantages and disadvantages of incorporation will not be the same, they need to be assessed on a case to case basis, to determine the most appropriate structure to meet your current and future requirements.

The purpose of this paper is to hopefully help you understand some of the implications of incorporation and to assist you in your thought process.

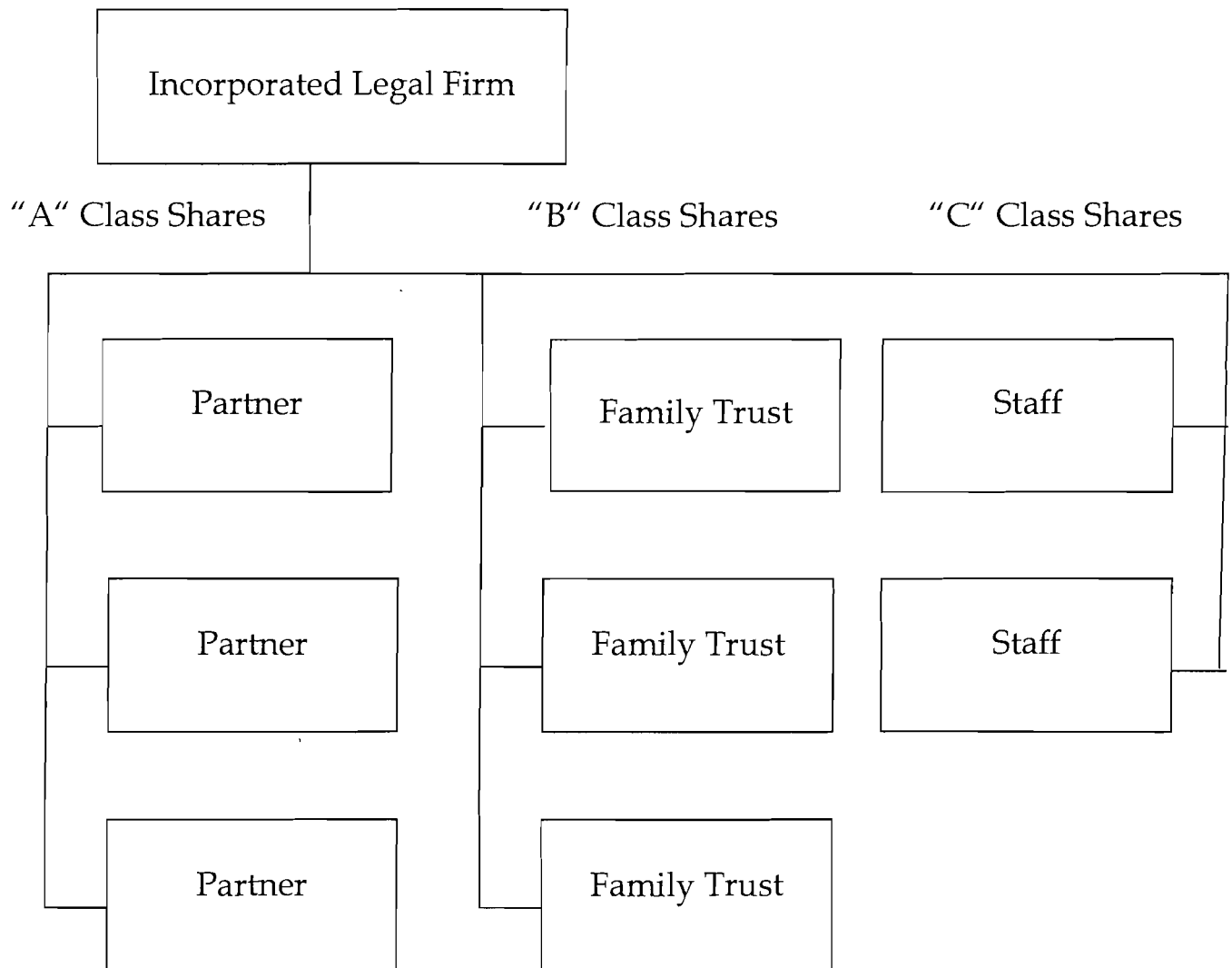
If you are considering changing your current structure and incorporating, it is imperative that you seek professional assistance to ensure that the matters noted above have been carefully considered and quantified and that part IVA of the ITAA 1936 has been properly considered.

Above all, whatever you chose to do, try to ensure that it is simple to implement and easily allows for the future exit and entry of new Directors (Partners).

### Typical Professional Structure



### Proposed Future Professional Practice Structure



- "A" Class shares - Have full voting rights;  
 - Retain control  
 - Receive nominal franked dividends
- "B" Class shares - No voting rights  
 - Receive majority of franked dividends
- "C" Class shares - Redeemable for par  
 - Receiving bonus by way of franked dividend.

Important to ensure that control remains with the partners. Do not want to have associated entities involved in decision making process.

**Capital Gains Tax  
Sale of Goodwill**

Assumption:	Partner's cost of Goodwill	\$100,000
	Post 19/09/1985 purchase	
	Partner's sale of Goodwill	\$350,000
	Small business CGT concessions meet	
	Partnership interest held for more than 12	
	months.	
	Partners tax rate 48.5%	

*i) Partnership Structure*

Sale price of Goodwill	\$350,000
Cost price of Goodwill	<u>(\$100,000)</u>
Capital Gains	\$250,000
Less 50% reduction as held for > 12 months	<u>(\$125,00)</u>
	\$125,000
Less 50% small business CGT concession	<u>(\$62,500)</u>
Assessable Capital Gains	<u>\$62,500</u>
Estimated tax	\$30,312

*ii) Corporate Structure*

Sale price of shares	\$350,000
Cost price of shares	<u>\$100,000</u>
Capital Gains	\$250,000
Less 50% reduction as held for > 12 month	<u>(\$125,000)</u>
Assessable Capital Gains	<u>\$125,000</u>
Estimated tax	\$60,625

## Service Trusts

### *Documentation required to substantiate the commercial benefit*

- Service agreement;
- Document showing how the service entity arrived at a pricing structure for the services;
- Tax invoices for the service fees charged;
- Evidence of payment;
- Calculation statement showing how the service fee was calculated for the period, including details of how any mark ups have been applied;
- Minutes of meetings concerning the service entity;
- Budgets, business plans and organisational charts;
- Detailed profit and loss statements and balance sheets;
- Deed of Trust for the service entity;
- Resolutions by the service entity about distributing profit;
- List of personnel employed by the service entity;
- Employment contracts, timesheets and other personnel records;
- Relevant insurance contracts;
- Relevant leases and or rental agreement in the correct name;
- Bank accounts in the correct name;
- Supplier's invoices charged to the correct entity.