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Income Tax Aspects of Incorporating a Legal Practice:

An ATO Response

A response to the concerns raised by the legal profession at the
Legal Practitioners Working Party, 8 December 2008



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INTRODUCTION:

The ATO established the *Legal Practitioners Working Party* ('LPWP') in July 2008. This working party was established in order for the ATO to maintain and further develop its relationship with the legal profession. The professional representatives on the LPWP have raised their member's concerns regarding the tax issues of incorporating a legal practice partnership through the LPWP. Although this working group was not set up as a group to resolve technical issues, the ATO considered that this is an appropriate forum to respond to the submissions we have received and further clarify our position that has already been articulated to the legal profession.

The concerns raised to the *LPWP at the meeting held on 8 December 2008 resulted in the following action items. This paper has been prepared in response to those action items:*

- **Why the market value substitution rules apply? (i.e. the basis on which the triggers are met)**
- **Why the existing administrative practice around no goodwill arrangements for entry/exit of partners doesn't follow into incorporation arrangements?**

In relation to the triggers for the application of market value substitution rule and the extension of the approach in IT 2540 on entry/exit of partners in no goodwill partnerships, we have concluded that the ordinary capital proceeds rules, rather than the market value substitution rules, apply to capture as capital proceeds the market value of the shares received (or entitled to be received) on incorporation. The approach in IT 2540, dealing as it does with scenarios based on partners paying or receiving nothing for goodwill on entry/exit, is not considered relevant to the incorporation of a legal practice as that involves the complete replacement of the partnership interests in return for property (shares) and those shares have an actual value based on income generation potential. This is despite the fact that the partners may not recognise goodwill as between themselves.

The outcome of this approach is illustrated in our analysis of the incorporation example provided by the Law Institute of Victoria (LIV), which is outlined at **page 15**. We note in relation to that example, where there is a simple incorporation and no other changes, CGT roll-over under subdivision 122-B is available to defer any capital gain. [**Page 14**]

- **Are there any Employee Share Scheme issues (Division 13A)?**

Regarding employee share scheme issues, we have concluded that the shares received on incorporation in replacement for the partnership interests, if received in the same proportions, are not received 'in respect of employment'. Even if they were received in respect of employment, in the simple incorporation situation as proposed in the LIV example, there would be no 'discount'. [**Page 17**]

- **Are there any GST issues that need to be considered?**

In relation to GST issues, a range of possible implications have been considered in the supporting document ***GST Treatment of Incorporating a Legal Practice***

This paper, ***Income Tax Aspects of Incorporating a Legal Practice: An ATO Response*** represents the ATO View on the income tax issues of Incorporated Legal Practices.

The ATO does not propose to provide any further indicative advice on this matter. Firms wishing to obtain interpretative advice on their own circumstances are invited to lodge a Private Binding Ruling application.

FEATURES OF LEGAL PRACTICES

The submissions received from the LIV, LCA and the SA Law Council have shown that when a legal practice is run under a partnership structure, the manner in which the practice is run can vary significantly between firms. The ways in which partners in a partnership deal with each other can differ according to:

- The way new partners are admitted;
- The way existing partners are expelled;
- The retirement of a partner;
- The management and control of the partnership;
- Performance management of the current partners;
- The entitlements an existing partner has to the profits of the partnership; and
- The manner in which an existing arrangement between the partners of the partnership can be altered.

The manner in which the partners in the partnership are required to conduct dealings with each other are usually explained in the partnership agreement. It is our understanding that these documents can vary significantly between legal practices. The submission by the LCA demonstrates the complexity of these arrangements and the various ways that legal practices can vary. Paragraphs 10 to 14 highlight some of the ways partners agree to deal with each other:

10. As to expulsion of an existing partner:

(a) there may be defined events upon which an expulsion occurs merely because the event has occurred, an example being bankruptcy of a partner or a partner being convicted or a serious criminal offence. The events that could constitute an automatic expulsion vary from law firm to law firm; and

(b) there may be expulsions upon a decision of an authorized decision making body or organ of the law firm – again, usually the law firm as a whole. An example of this type of expulsion would be a partner who has lost the confidence of a requisite majority of partners of the law firm who exercise their power under the law firm's constituent documents or governing rules to terminate the relevant partner's membership of the law firm. Once again, the precise terms on which such an expulsion could occur vary from law firm to law firm.

11. As to division of law firm profits, again arrangements can vary from law firm to law firm. Some firms have equal sharing of profits, others have unequal entitlements and some have fixed profit share partners (sometimes called salaried partners) and some have a combination of unequal equity entitlements and fixed profit shares. Those law firms with unequal profit sharing arrangements can have a variety of bases upon which the entitlements to profit in any year are set.

Examples include:

- (a) by reference to equity points or shares allocated to the partners for that year;
- (b) by reference to some measure of performance in the law firm business for the relevant year or a relevant prior period;
- (c) by reference to the period of time that the person has been a partner of the relevant firm; and
- (d) by reference to a combination of a numbers of bases

12. Particularly for those law firms that have unequal sharing of profits, it is common for proportionate entitlements to law firm profits to vary from time to time among the partners. The means by which changes to entitlements to law firm profits are effected also varies from law firm to law firm and examples of approached taken include:

- (a) changes to profit entitlements by means of a discretionary allocation of a proportion of the annual profits by way of a bonus. Law firms that distribute profit in this way usually link discretionary bonuses to some measure of performance in the law firm's business;
- (b) tying entitlements to law firm profit to equity points with equity points re-allocated from time to time based on a variety of criteria including performance in the law firm's business;
- (c) tying entitlements to law firm profit to equity levels that are based on an automatic, lockstep, arrangement whereunder new partners are allocated a base level of equity in the firm which increases either automatically or upon other agreed bases; and
- (d) setting entitlements to aggregate law firm profit on the basis of separate (notional) profit pools that form the aggregate law firm profit and setting entitlements to those profit pools in differing ways by reference to either fixed or discretionary criteria.

13. Voting entitlements, and entitlements to participate in the management of the law firm, can also vary from law firm to law firm. Some law firms authorize boards or committees of partners to undertake particular tasks and reserve some functions to a vote of the whole partnership. Where the line is drawn between what a limited number of partners can do and what must be done by the law firm as a whole can vary.

14. As to changing the constituent documents or the rules by which a law firm is governed, arrangements can vary but it is not uncommon for a vote of all partners to be conducted and a requisite majority of partners present and voting support the change.

In addition to those arrangements, legal practices run as a partnership can operate on the basis that goodwill (and equity interest) in the partnership is a recognised asset. More commonly, medium to larger firms operate on the basis that goodwill is not recognised.

‘GOODWILL’ LEGAL PRACTICE PARTNERSHIPS

Generally, a ‘goodwill’ partnership requires a new partner to pay a purchase price for their share of the goodwill (and equity) in the legal practice. Similarly, an outgoing partner is entitled to be paid for the goodwill (and equity) when their partnership interest is sold upon retirement or expulsion either to a newly admitted partner or back to the legal practice. In a ‘goodwill’ partnership changes made to existing entitlements and/or obligations can affect the payments the partners have made when entering into the partnership.

‘NO GOODWILL’ LEGAL PRACTICE PARTNERSHIPS

In a ‘no goodwill’ partnership a new partner is usually not required to pay any purchase price for their share of the goodwill (and equity) in the legal practice they are acquiring. Similarly, an outgoing partner is not entitled to be paid for the goodwill (and equity) when their partnership interest is sold either to a newly admitted partner, or back to the legal practice upon retirement or expulsion from the partnership. All of the arrangements discussed previously are capable of being replicated in a ‘no goodwill’ partnership without any payment for goodwill.

In some ‘no goodwill’ partnerships, a financing arrangement that requires partners to contribute money by way of a loan to the partnership may be entered into, rather than buying into the partnership’s goodwill. A ‘loan’ has been defined as the delivery by one party to, and receipt by, another party of a sum of money upon agreement express or implied to repay it with or without interest (*McGain v FC of T* (1965) 112 CLR 523). In essence, it involves a payment and an intention to repay an amount of money at some future time. The fact that the partners may not receive an interest component does not affect the substance of the loan, although it appears that the purpose of the loan is that of a capital contribution to fund the working capital of the partnership. Where the underlying economic ownership remains unchanged upon conversion of the partnership to the ILP and the loan remains between the individual partner and the ILP it is likely that there will be no compliance issues surrounding Division 7A of the *Income Tax Assessment Act 1936*.

CAPITAL GAINS TAX

All legislative references are to the Income Tax Assessment Act 1997 (Cth) unless otherwise stipulated.

Capital gains tax (CGT) will apply to produce a capital gain or a capital loss to a taxpayer if, and only if, a CGT event happens (section 102-20). There are certain typical activities that arise out of the incorporation of legal practices which can trigger a CGT event. These activities include the transfer of an individual's partnership interest into an Incorporated Legal Practice ('ILP'), for which shares in the incorporated practice are received.

When a partnership legal practice chooses to incorporate and a CGT event is triggered the normal CGT rules regarding the calculation of the capital gain (or loss) will apply. The restructure of a partnership to an ILP structure brings with it the potential disposal of goodwill by the former partners to the new incorporated entity. This triggers CGT event A1 (section 104-10). This could potentially give rise to a capital gain if the capital proceeds from disposal are more than the asset's cost base. A capital loss could result if the asset's reduced cost base is more than the capital proceeds (subsection 104-10(4)). The relevant gain or loss would be recognised by the partners.

When calculating the cost base (or the reduced cost base in the case of a capital loss) the general rules contained in Division 110 and Division 112 will need to be applied. Generally, the first element of the cost base of an asset is the actual money paid (or required to be paid), or the property given (or required to be given) for the acquisition of the asset (section 110-25). The first element of the cost base is substituted with the market value of the asset (at the time of acquisition) where the taxpayer did not incur any expenditure to acquire the asset or incurred expenditure which cannot be valued in whole or in part, or did not deal at arm's length with the other entity in connection with the acquisition (section 112-20).

When calculating the capital proceeds, the general rules contained in Division 116 will also need to be applied. The capital proceeds from a CGT event are the total of the amount of money a taxpayer has received, or is entitled to receive, in respect of the event happening, and the market value of any other property the taxpayer has received, or is entitled to receive, in respect of the event happening (worked out as at the time of the event - section 116-20). These rules are modified by the market value substitution rules in section 116-30 where no capital proceeds are received from a CGT event, or some or all of the capital proceeds received from a CGT event cannot be valued. The market value substitution rules also apply where the capital proceeds received are more or less than the market value of the asset and the asset was disposed of in a non-arm's length dealing.

When considering the CGT implications of incorporating a legal practice consideration must be given to whether the partnership is a 'goodwill' or 'no goodwill' partnership.

GOODWILL AND CGT

Goodwill is a CGT asset for the purposes of Part 3-1 of the Income Tax Assessment Act 1997 (paragraph 108-5(2)(b)). Taxation Ruling TR 1999/16 Income tax: capital gains: goodwill of a business explains the Commissioner's view on the CGT provisions in Part 3-1 of the Income Tax Assessment Act 1997 and how they apply to a taxpayer who conducts a business with goodwill. At paragraphs 9 to 15 of TR 1999/16 the meaning of goodwill is considered:

9. 'Goodwill' for the purposes of the definition of 'CGT asset' in section 108-5 has the meaning it bears under the general law. It is the legal definition of goodwill as explained by the High Court in *FC of T v Murry* 98 ATC 4585, rather than its accounting and business definitions, which applies.

10. The legal meaning of 'goodwill', according to the majority justices of the High Court in the *Murry* case, has three different aspects namely property, sources and value.

11. In this Ruling 'goodwill' is the legal concept described by the High Court majority in paragraphs [4] and [12] to [52] of their judgment (98 ATC at 4587 and 4589-4596; 39 ATR at 132 and 134 - 145). It is not appropriate to single out only one of the aspects of goodwill and to regard that aspect as being 'goodwill' for legal purposes. Rather, it is the overall concept described by the High Court majority which constitutes the legal meaning of 'goodwill'.

12. As explained more fully at paragraph 85 of this Ruling, goodwill is the product of combining and using the tangible, intangible and human assets of a business for such purposes and in such ways that custom is drawn to it. The attraction of custom is central to the legal concept of goodwill. Goodwill is a quality or attribute that derives among other things from using or applying other assets of a business. It may be site, personality, service, price or habit that obtains custom. It is more accurate to refer to goodwill as having sources than it is to refer to it as being composed of elements. Goodwill is a composite thing. It is one whole. It is an indivisible item of property that is legally distinct from the sources from which it emanates. It is something that attaches to a business and is inseparable from the conduct of a business. It cannot be dealt with separately from the business with which it is associated.

13. What goodwill means depends on the character and nature of the business to which it is attached. Goodwill differs in its composition in different trades or industries and in different businesses in the same trade or industry. One or more sources of goodwill may preponderate in one business and another source or sources may be prominent in another business.

14. Goodwill is not a series of CGT assets that inhere in other identifiable assets of a business. Goodwill, being a composite thing, attaches to the whole business. It does not attach separately to each identifiable asset of the business. Nor is there an element of goodwill in each identifiable asset of a business.

15. Goodwill is a species of intangible property. It can only exist in connection with the conduct of a business, even though it may not necessarily appear in the books of account and financial statements of the business.

Taxation Ruling TR 1999/16 also explains how the CGT rules apply to goodwill in a partnership context. At paragraph 148 it states:

148. A disposal of a partner's **entire** interest in a partnership in which the partners conduct a business is a change of ownership of the partner's interest in the partners' business. The entire interest of the partner in the partnership carries with it all the rights and benefits attaching to that interest including the partner's interest in the assets and other things used in the business. Any capital gain made on disposing of the partner's interest in goodwill is a capital gain attributable to the goodwill of the business.

149. A disposal of **part** of a partner's interest in a partnership, being a partnership in which the partners carry on business, effects a change in the ownership of the partner's interest in the business. This is so because the partner assigns or transfers a chose in action – being a share of their interest in the partnership - which carries with it all the rights and benefits attaching to that share including a share of the partner's beneficial interest in each and every asset of the partnership. In referring to a partner's ownership of an interest in a business, we take section 118-250 to refer to ownership of an interest in the assets (including goodwill) and other things (such as knowledge and information) used in the business activities or transactions. Any capital gain made on disposing of part of the partner's interest in goodwill is a capital gain attributable to the goodwill of the business.

This reaffirms that it is the partner's relevant interest in the partnership asset that is the most relevant asset for the purposes of CGT. As a partnership is not a separate legal entity from the individual partners, capital gains and losses are calculated for each partner's interest in the partnership.

INCORPORATING A GOODWILL PARTNERSHIP

'Goodwill' partnerships, which are often smaller legal practices, would require a new partner to pay consideration upon entry into the partnership / legal practice and receive a payment upon exit of the partnership / legal practice. For the purposes of CGT these amounts would constitute the cost base (or reduced cost base in the case of a capital loss) and the capital proceeds.

As indicated in the submission by the Law Institute of Victoria (LIV), the amount of consideration a new partner would be required to provide upon entry and the payment the partner would receive upon exit could be calculated in accordance with a formula contained within the partnership agreement. Using such a formula would amount to the parties calculating their interests in the partnership on an arms-length basis and would, absent other indicia, be considered the market value of the interest in the partnership.

In these circumstances the ATO agrees with the LIV that where a 'goodwill' partnership incorporates and the same methodology is adopted by the ILP to value the shareholder's interest in the shares being acquired in exchange for their partnership interest, then the market value substitution rules are unlikely to apply as the dealing would be at arm's length (ie the parties are dealing as it would be expected that willing but not anxious vendors and purchasers would deal). The price determined by the formula stipulated in the partnership agreement and shareholder's agreement would also generally be considered to be the market value of such interests.

INCORPORATING A NO GOODWILL PARTNERSHIP

When a no goodwill legal practice run as a partnership chooses to incorporate, a fundamental change in the nature of the business structure occurs. The partners are replacing their interests in the partnership legal practice for shares in a company. The ATO acknowledges that the rationale for not recognising goodwill in a legal practice is to reduce the barriers to entry of the firm so that those legal practitioners with the appropriate legal skills are not excluded from becoming a partner based on their personal economic position.

The submissions received by the ATO from the legal profession have expressed concern over the application of the market value substitution rules when an ILP is used to replicate a 'no goodwill' practice. If the legal practice is a 'no goodwill' partnership the partners would not be required to pay for the goodwill when admitted into or departing from the practice. If this were replicated into an ILP, this means the 'partners' would not be required to pay for their shareholdings.

Prima facie, certain CGT issues arise from the incorporation of a legal practice. While the submissions refer to the application of the market value substitution rules, in fact the application of the principal capital proceeds rules in section 116-20 can give rise to a similar outcome – the market value of what is received for the partnership interest must be recognised and shares in an ILP may have a value even where goodwill is not recognised by the partnership or the company.

STANDARD APPLICATION OF THE CAPITAL PROCEEDS RULES

Where the former partner receives shares in return for the transfer of his partnership interest, those shares will form the capital proceeds for the disposal of the partnership interest, quantified as 'the market value of any other property you have received or are entitled to receive in respect of the event happening'.

The market value of those shares is a question of fact and a valuation issue. IT 2540 at paragraphs 26 and 27 addresses CGT issues arising from Everett assignments in 'no goodwill' partnerships. Reference is made in the IT to *Reynolds v Commissioner of State Taxation (WA)* 86 ATC 4528 which concerned the valuation of an assigned partnership interest on which ad valorem stamp duty was payable.

Despite the other assets of the partnership being held in administration and service entities and goodwill not being recognised by the partnership, Burt CJ held:

'the assigned partnership interest was of value; its value derived from the value of the right that was attached to the partnership interest to receive a proportionate share of the future income of the partnership.'

The ATO agrees with this analysis and considers it is equally relevant to a partner's transfer of his partnership interest to an ILP. Even though the partnership (or the company that succeeds it) may not recognise goodwill, the shares the partner receives in return for his partnership interest may have a value based on the ILP's potential to generate future income and the shareholder's right to share in that income. Even if the capital contribution for the share is stated to be capped at \$1, on Burt CJ's analysis in *Reynolds'* case, that still cannot compel the conclusion that the value of the share is only \$1.

Further guidance on market valuation for tax purposes is available on [ato.gov.au](http://www.ato.gov.au) using the following link: <http://www.ato.gov.au/print.asp?doc=/content/00161737.htm>

Particularly relevant are the sections on valuation of businesses and unlisted shares. The material also notes that the Commissioner can issue private rulings on market value. While the material indicates that the sorts of issues that will arise in valuing no goodwill practices will be inherently complex, it does not support the view that therefore there would be no market value in such practices.

Other factors are also relevant in considering the amount of capital proceeds. Where:

- a partnership incorporates and a partner does not directly receive all the shares commensurate with his previous partnership interest (for example, if his family trust also receives shares in the company which are attributable to his former partnership interest), or
- a partnership incorporates and a partner receives all the shares commensurate with his previous partnership interest but does not receive all those shares in the same capacity as he held his partnership interest (for example, if he receives some portion of the shares as trustee for his family trust),

the partner has directed that part of the consideration for the disposal of his partnership interest be received by another entity, for example the family trust, or himself in the capacity as trustee of the family trust. In his capacity as trustee of the family trust, the partner is taken to be a different entity from the partner as an individual (section 960-100). In these circumstances section 103-10 will apply because the partner's capital proceeds for the event includes the shares applied for his benefit or as he directed.

The SA Law Society submitted that there was actually no disposal of goodwill on the basis that any goodwill 'would be personal to the individual "partners" which cannot as a matter of fact be transferred'.

Whilst this may be true for a legal professional trading as a sole trader, we do not accept this to be the case for the national firms or larger partnerships. As stated in paragraph 12 of TR 1999/16 'The attraction of custom is central to the legal concept of goodwill. Goodwill is a quality or attribute that derives among other things from using or applying other assets of a business'. The individual partner's skill and reputation may be a part of the service of the practice that attracts custom. However, in the case of a partner in a national firm or larger partnership, the custom they attract is not their individual goodwill. Collectively the partners of the firm will generate goodwill for the firm, not themselves.

MARKET VALUE SUBSTITUTION RULE

The market value substitution rule could apply on the incorporation of a legal practice if there were no capital proceeds for the CGT event (section 116-30(1)), however given shares are received for the partnership interest, that provision doesn't apply. Even if the shares are received by others (family members or associated trusts as outlined above) the capital proceeds will be considered to have been received by the partner, as the shares would be issued as the partner had directed (section 103-10).

Where there are capital proceeds, but the proceeds can't be valued (section 116-30(2)(a)) then the capital proceeds will be replaced with the market value of the partnership interest. Naturally valuation issues are a question of fact, and depend on the particular circumstances of a case. We consider it unlikely that the shares could not be valued given the totality of the shares issued should be equivalent in value to the totality of the partnership interests transferred to the company, and the partnership interests acquired by the company will sometimes have to be valued for stamp duty purposes (to the extent that the interests represents dutiable property,

such as goodwill in NSW even though it might not be recognised by the partners themselves - see *Foster v Commr of Stamps* [1966] WAR 144 and *McFadden v Commr of Stamp Duties (NSW)* 80 ATC 4343).

The shares should be capable of valuation on the same valuation basis that unlisted shares can be valued.

In the article by Helen Hodgson 'The CGT aspects of Everett assignments', she suggests that partnership interests may not be able to be valued because of the mutual covenants the partners enter into (to work in the partnership, owe a fiduciary obligation to the other partners etc). Given that these covenants are ancillary to and support the real value of the partnership, and the partnership interests overall are capable of valuation for stamp duty purposes, we do not accept the argument that such interests cannot be valued.

DEALING NOT AT ARM'S LENGTH

Where there are capital proceeds which are more or less than the market value of the partnership interest, and the former partners and the incorporated practice did not deal at arm's length in connection with the CGT event, the capital proceeds will be replaced with the market value of the partnership interest.

If a portion of the shares which would otherwise have been allocated to a former partner, were allocated instead to members of his family, and it was thought by the former partner that such an arrangement did not constitute his capital proceeds from the CGT event (a proposition which we consider clearly wrong based on section 103-10), on the assumption the partnership and the company were of equal value, the portion of the shares the former partner did directly receive would have a lesser value than the partner's former partnership interest.

While the normal test of an arm's length dealing is the sort of dealing which would be expected to occur between willing but not anxious parties, the test can extend beyond that to where one of the parties is indifferent to an outcome that the other party seeks for reasons not essentially to do with the deal (see *Collis v FCT* 96 ATC 4831). If a partner in a partnership that is incorporating directs the issue of shares attributable to his partnership interest away from himself, the company itself could be expected to be indifferent to who the shares were issued to, as long as the company received the equivalent partnership assets. If the partner who directed the issue of shares away from himself did so on the presumption that the directed shares would not constitute his capital proceeds for his disposal of his partnership interests, that would be a very strong indicia of a non-arm's length dealing so that the partner's capital proceeds from the event would be the market value of his partnership interest.

Where \$1 is fixed as the cost of shares based on carrying forward the existing no goodwill approach from the partnership, we do not accept that the reasoning in IT 2540 applies, for the reasons outlined in the following section.

2. APPLICATION OF IT 2540 TO ILPS

All legislative references are to the Income Tax Assessment Act 1997 (Cth) unless otherwise stipulated.

IT 2540 Income Tax: Capital Gains: Application to disposals of partnership assets and partnership interests addresses the disposal and acquisition of partnership interests in the context of 'no goodwill' partnerships where partners neither pay nor receive anything on entry into or exit from the partnership. The Commissioner explains that:

8. There are two broad circumstances that need to be considered in relation to the application of Part IIIA at the partner level on the disposal of partnership assets. The first is the application of the Part on the disposal of a partner's interest in the partnership, whether in whole or in part. The second issue concerns the consequences, in terms of Part IIIA, for the individual partners who have an interest in the assets of the partnership where there is a disposal of one or more of those assets.

(1) Disposal by a partner of an interest in the partnership assets on the disposal of a partnership interest

9. On the acquisition or disposal of a partnership interest it will be necessary for a partner to account for his or her interest in the partnership assets. The disposal of the partnership interest generally means that there is a disposal of the partner's interest in each of the individual partnership assets. Subject to what follows, in order to determine any capital gain or capital loss to the partner in respect of his or her interest in each of the assets, it will be necessary to determine the portion of the disposal proceeds attributable to each of those interests. Similarly, on the acquisition of a partnership interest, the consideration paid should be apportioned to the interests in each of the partnership assets acquired, so that on their subsequent disposal, the capital gain or capital loss to the partner can be determined.

10. A partner's interest in the partnership and in the partnership assets may change from time to time. This could occur on the admission to, or retirement from, the partnership of any of the partners. To the extent that a partner's original interest has changed, there may have been a part disposal of his or her interests in the partnership assets (for instance, where there is an admission of a new member to the partnership) or the partner may have acquired additional interests in the partnership assets (for example, where another partner retires from the partnership). Thus, although a partner's original interest may have been acquired prior to 20 September 1985, the partner may have acquired new interests in assets since that date. Therefore, at the time of disposal of his or her partnership interest or of particular partnership assets, the partner may be disposing of assets acquired before 20 September 1985 and other assets acquired (partly or wholly) on or after that date. This follows from the central theme of this Ruling, that is, in looking at the disposal of a partnership interest or a partnership asset, Part IIIA applies to the individual partner on the basis of what asset that partner owns, the date on which the partner acquired the asset and any consideration given in respect of its acquisition.

11. It should be noted that for the purposes of the capital gains tax provisions the retirement or admission of a partner does not necessarily affect the other partners' continuing interests in the partnership assets or in the partnership as a whole. The continuing interest means that part of the interest in each of the partnership assets and the partnership itself which a partner has after the admission or retirement and which the partner also had before the admission or retirement.

12. In cases where the number of partners in a partnership is small, the cost base and acquisition date of a relevant partner's interests in the partnership assets should be able to be determined without undue difficulty.

With particular relevance to the CGT treatment in legal practices that do not recognise goodwill, the Commissioner further states that:

13. For large partnerships, which can have memberships numbering in the hundreds (for example, some major legal and accountancy partnerships) the situation is potentially more complex. In some cases, the potential problems are overcome because the ownership of the assets used by the partnership is vested in a service company or trust. In other cases, it will generally be accepted, provided the evidence reasonably supports the conclusion, that the partners are dealing with each other at arm's length. Any consideration paid or received on the acquisition or disposal of an interest in the partnership will be used for Part IIIA purposes in determining the cost base or disposal proceeds of the interests in the partnership assets that the partnership interest represents. This will mean that if, for example, the partnership arrangement is such that no amount is payable for the acquisition or disposal of goodwill, it will be accepted for the purposes of Part IIIA that the value of the goodwill is nil. This treatment will also apply to partners of smaller partnerships who deal with each other at arm's length, where those dealings take place in an ordinary commercial context.

14. In the case of large professional partnerships, where the partners' dealings with each other are at arm's length, **it will only be** where consideration is paid by a partner on entering the partnership or **where a partner receives a payment on leaving the partnership that Part IIIA will have any practical effect.** Where consideration is neither paid by a person on entering the partnership, nor received on retirement from the partnership, the partner will not realise a capital gain or incur a capital loss on the disposal of particular assets. However, as noted above, the admission or retirement of a partner may affect the proportionate ownership of the partnership assets by the individual partners and therefore may affect the extent of a continuing partner's interest in the partnership. This would be relevant in the event of a subsequent disposal of the partnership assets for consideration, or where consideration is paid to a partner on retirement from the partnership. [emphasis added]

The Commissioner accepts in that IT that where the partnership agreement stipulates there is no payment for goodwill, the dealings take place in 'an ordinary commercial context' and 'provided the evidence reasonably supports the conclusion', he will agree that the parties are dealing at arm's length (paragraph 13).

The LIV, LCA and SA Law Society have expressed to the ATO that they believe that this is the correct treatment for the treatment of 'goodwill' partnerships which incorporate. However, the submissions do not acknowledge that the treatment with which they agree is confined to circumstances where no capital proceeds are received – see the sentence following the bolded part in paragraph 14 of the IT. Where a partnership is incorporated, capital proceeds are received in the form of shares. This is inherent in the potential application of Subdivision 122-B roll-over.

The statements made in IT 2540 were made with reference to the retirement or admission of partners in the normal ebb and flow of the life of a partnership, that is, presumably, the occasional retirement or admission of small numbers of partners. Those statements were not made with reference to a wholesale reframing of the ownership structure and they do not suggest that there are no CGT implications for a leaving partner in receipt of capital proceeds. Furthermore, the statements do not cover the wholesale reframing of the ownership structure that might involve an ostensible admission of new partners (such as the family trusts of the former partners), where there may be no demonstrable contribution that those family trusts will make to the generation of income by the partnership.

The approach in paragraph 13, that the goodwill would be valued at nil if that is what the partners, acting at arm's length, agreed to pay, is confined to the circumstances specifically addressed in the IT and is not relevant to a complete replacement of partnership interests by shares.

Where shares are received for the disposal of an interest in a 'no goodwill' partnership, we consider that the analysis outlined in *Reynolds v Commissioner of State Taxation (WA)* applies and that those shares are likely to have a value, even if goodwill is not recognised by the company.

CGT ROLL-OVER

That the fundamental restructure of a partnership into a company could result in CGT consequences is provided for in Subdivision 122-B. The partners can choose roll-over and defer any taxation consequences where they maintain their underlying economic ownership of the former partnership assets and the shares they receive are equivalent in value to the partnership interests they give up. In a straight partnership interest for share swap, Subdivision 122-B should be expected to apply such that the partner will be sheltered from any CGT arising from the disposal of his partnership interest.

For Subdivision 122-B to apply it is necessary that all of the partners in the partnership choose to obtain roll-over relief (section 122-150). The rules for when the partners are required to make this choice are provided for in section 103-25.

However Subdivision 122-B will not apply where certain requirements are not met. These include where the market value of the shares received are not substantially the same as the market value of the assets disposed of (the same value test in subsection 122-130(3)), and where the shares received are not owned in the same capacity as the partnership assets were owned (the same ownership test in subsection 122-135(1)).

To the extent that small variations in economic ownership might be necessary, for example, to adjust for earnings entitlements between the original partnership interests and the new shares, the Commissioner may consider (on a case by case basis) that the risk of the roll-over conditions not being met is not significant. The Commissioner cannot, however agree, that the substantive requirements of the roll-over provision need not generally be met across the board.

If the restructure does not meet the roll-over conditions, the former partners of the partnership who proceed with incorporation can expect that we will be interested in determining the correct capital proceeds for the CGT event that happens over their former partnership interest. This will especially be the case where shareholders who were not previously partners in the partnership receive shares from the incorporation.

INCORPORATION EXAMPLE - CGT

The submission made by the LIV provided an example that considers the application of the CGT market value substitution rules to a 'No Goodwill' legal partnership practice which chooses to incorporate.

The example assumes the following facts:

- 10 equal partners in a 'no goodwill' practice;
- All partners pay tax at top marginal tax rates;
- Each partner pays \$1 on entry into the practice and each receives \$1 on exit;
- Each partner lends \$150,000 on admission to the practice and is repaid \$150,000 (and nothing else) on retirement;
- Assume the practice value (including goodwill) is worth \$2 million on admission and that the practitioner acquires a 10% interest; and
- Assume at exit that the practice value (including goodwill) is worth \$3 million, or \$300,000 for a 10% share.

When the partners dispose of their interest in the partnership legal practice and become an ILP they will receive shares in exchange for giving up their rights in the legal partnership practice. In line with our analysis above, these shares will form the capital proceeds for the disposal of their partnership interest (section 116-20).

Even though the partnership is a 'no goodwill' practice and the partners only pay and receive a nominal value of \$1 upon entry and exit into the practice, the fact that the partnership does not recognise goodwill does not mean that it does not exist, and further, given it may exist, that it does not have a value. In accordance with Reynolds v Commissioner of State Taxation (WA) the capital proceeds will equal to the practice value (including goodwill) upon exit of the practice (\$300,000). Similarly, the cost base will be equal to the practice value when the partners acquired their 10% interest in the partnership (\$200,000). This will result in a capital gain of \$100,000 for each of the partners. Assuming the capital gain is a discount capital gain in accordance with Division 115, the capital gain realised by the partners will be \$50,000. At the highest marginal tax rate of 46.5% this equals a potential tax liability of \$23,250 for the partners upon incorporation.

The CGT consequences of the incorporation may be deferred by the roll-over provisions in subdivision 122-B. Rollover relief is available where:

- All of the partners in the partnership elect to choose roll-over;
- The partners only receive shares in the ILP as consideration for the disposal of their partnership interests;
- The shares they receive are not redeemable shares;
- the market value of the shares received are substantially the same as the market value of the assets disposed of;
- the partners own all of the shares just after the disposal of their partnership interest
- the shares received are owned in the same capacity as the partnership interests were owned; and
- the partners and the company are Australian residents.

Assuming the above mentioned conditions are satisfied the capital gain that the partners made when converting their partnership interest into an ILP would be deferred until a later date.

Therefore the CGT consequences of a simple incorporation of a partnership, without other changes, can be expected to be deferred by roll-over under subdivision 122-B.

3. DIVISION 13A – EMPLOYEE SHARE SCHEMES

All legislative references are to the *Income Tax Assessment Act 1936 (Cth)* unless otherwise stipulated.

ALERT

*This response considers the ATO view on the application Division 13A as it is currently enacted. This response does not consider the Exposure Draft **Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009: Employee share schemes**. In accordance with Practice Statement Law Administration 2004/6 the ATO does not give indicative interpretative advice on legislation prior to its Royal Assent.*

Where a partnership carries on a business and the business is transferred to a company which employs the former partners, will the shares issued to a former partner as consideration for the acquisition of the business be shares acquired under an employee share scheme (ESS) for the purposes of Division 13A of Part III of the ITAA 1936 (Div 13A)?

A share will be acquired under an ESS where it is acquired (within the meaning of section 139G of the ITAA 1936) and in the way described in section 139C of the ITAA 1936.

Section 139G of the ITAA 1936 relevantly provides that a taxpayer (person) will acquire a share if another person allots the share to the person, thus shares issued to a former partner will be acquired within the meaning of section 139G of the ITAA 1936.

Section 139C of the ITAA 1936 relevantly provides that a taxpayer will acquire a share under an ESS if the share is acquired by the taxpayer:

- in respect of, or for or in relation directly or indirectly to, any employment of the taxpayer or an associate of the taxpayer; and
- the consideration for the acquisition is less than the market value of the share at the time it is acquired.

Section 139FB(1) of the ITAA 1936 relevantly provides that where a share is not quoted on an approved stock exchange on a particular day, the market value of the share is its arm's length value:

- as specified in a written report ... given to the person from whom the taxpayer acquires the share by a person who is a qualified person in relation to valuing the share (see section 139FG of the ITAA 1936); or
- as calculated in accordance with any other method approved in writing by the Commissioner as a reasonable method of calculating the arm's length value of unlisted shares.

Whether Div 13A applies to the shares acquired by a former partner on incorporation will necessarily depend on the particular facts and circumstances.

IN RESPECT OF EMPLOYMENT

Whilst the employment connection test contained within subsection 139C(1) of the ITAA 1936 has not been considered by the courts, a similar employment connection test appears in the *Fringe Benefits Tax Assessment Act 1986* and the courts findings in relation to this test are considered relevant for the purposes of subsection 139C(1) of the ITAA 1936.

In *J & G Knowles & Associates Pty Ltd v. Federal Commissioner of Taxation* (2000) 96 FCR 402; 2000 ATC 4151; (2000) 44 ATR 22 it was noted that the term 'in respect of employment', includes benefits where there is a sufficient or material, rather than a causal connection or relationship between the benefit and the employment.

Thus, in order to find that the shares acquired by an employee, on the incorporation of the business, are acquired in respect of employment, there needs to be a sufficient or material, rather than a causal connection or relationship between the acquisition of the shares and the employment of the employee.

INCORPORATION EXAMPLE – EMPLOYEE SHARE SCHEMES

The submission made by the LIV provided an example that considers the application of the Division 13A Employee Share Scheme provision to a legal partnership that chooses to incorporate their practice.

The example assumes the following facts:

- 10 equal partners in a 'no goodwill' practice;
- All partners pay tax at top marginal tax rates;
- Each partner pays \$1 on entry into the practice and each receives \$1 on exit;
- Each partner lends \$150,000 on admission to the practice and is repaid \$150,000 (and nothing else) on retirement;
- Assume the practice value (including goodwill) is worth \$2 million on admission and that the practitioner acquires a 10% interest; and
- Assume at exit that the practice value (including goodwill) is worth \$3 million, or \$300,000 for a 10% share.

Where immediately prior to incorporation of a business, that was operated as a partnership, a taxpayer:

- had a 10% interest in the partnership; and
- on incorporation they become an employee of the new company; and
- they receive the same portion (10%) of the shares in the new company as consideration for giving up or surrendering their ownership interest,

the acquisition of shares by the taxpayer would arguably lack the requisite sufficient or material connection to their employment to find that the shares were acquired in respect of the employment of the taxpayer.

However, if the taxpayer ended up with 15% of the shares, it is reasonable to assume that they acquired the additional 5% for some other purpose. If that other purpose is considered to have any connection with employment, either partly or wholly, then some or all of the extra shares represented by the additional 5% could have the requisite sufficient or material connection to employment.

ACQUIRED AT A DISCOUNT

Where a share is acquired in respect of employment, the consideration (if any) given for the acquisition needs to be less than the market value of the share at the time it is acquired for the share to be acquired under an ESS.

Where it is established that a share is not acquired in respect of employment, it is not necessary to consider whether the consideration given to acquire the share is less than its market value at the time of acquisition (ie whether the share has been acquired at a discount).

Where as above, a taxpayer receives 15% of the shares on the giving up or surrender of a 10% interest in a partnership and all of the extra shares are acquired in respect of employment, the shares will be acquired at a discount if the consideration paid or given for the extra shares is less than the market value of those shares at the time of acquisition.

For the sake of completeness, where a former partner receives 10% of the shares in a new company on the giving up or surrender of a 10% interest in a partnership, and it is established that the shares are not acquired in respect of employment, the consideration they give for the shares (the partnership interest) is considered to be the market value of that interest at that time, and arguably the market value of that interest necessarily equals the market value of the shares acquired such that there is no discount.