

JOINT SUBMISSION BY

**The Institute of Chartered Accountants in Australia, The Tax Institute,
the Institute of Public Accountants, CPA Australia and Taxpayers
Australia**

Draft Taxation Determination TD 2011/D9 and TD 2011/D10

TD 2011/D9: Employee share schemes: If a share in a 'no goodwill' professional practice company is acquired by a practitioner-shareholder (or a new practitioner -shareholder), will the Commissioner accept, for the purposes of determining whether that acquisition was at a discount within the meaning of subsection 83A-20(1) of the Income Tax Assessment Act 1997, that the goodwill of the company can be taken to have no value?

TD 2011/D10: Income tax: When considering the application of subsection 159GZZZQ(2) of the Income Tax Assessment Act 1936 to an exiting vendor practitioner-shareholder by a 'no goodwill' incorporated professional practice, will the Commissioner consider that the buy-back price is less than the market value of the shares merely because the price is calculated not to reflect the underlying goodwill of the company?

Date: 2 December 2011 (extended date)

Thank you for providing the Professional Bodies with an opportunity to comment on Draft Tax Determinations TD 2011/D9 and TD 2011/D10 ('Draft TDs').

The Professional Bodies would welcome the opportunity to discuss the issues raised in this submission further before the Draft TDs are finalised. Please contact the Tax Administrator at the Institute of Chartered Accountants in Australia (tel: (02) 9290 5751, email: tax.administrator@charteredaccountants.com.au) at your earliest convenience to arrange a discussion.

A. Background

We understand that these Tax Determinations have been drafted in the same context as TD 2011/26 which was drafted in response to representations made to the Australian Taxation Office ('ATO') by professional firms that, at that time, operated as "no-goodwill" partnerships. Those representations were to the effect that one of the disincentives to the incorporation of those practices evolved from the uncertainty regarding whether the approach outlined in IT 2540 for partnerships would be replicated for incorporated practices.

We understand that the ATO views the approach in IT 2540 as a concession offered by the Commissioner as to fact – that fact being the market value of a partner's fractional interest in the goodwill of the practice. We also understand that the trilogy of Tax Determinations, namely TD 2011/26, Draft TD 2011/D9 and Draft TD 2011/D10 are intended to replicate, but not extend, the same concession that IT 2540 offers partnerships, for incorporated practices where they satisfy certain conditions.

TD 2011/26 mainly applies to a situation where the shares in the practice company are transferred from one shareholder to another; whereas Draft TD 2011/D9 and D10 apply to the issue and redemption of shares respectively on entry to and exit from the practice.

In this context, the trilogy of Tax Determinations extends the concession offered by IT 2540 to partnerships to transactions involving the shares of the practice company but seek to place certain restrictions on its application.

We are grateful that the Commissioner seeks to extend the approach articulated in IT 2540 to practice companies. However, we remain concerned that these determinations seek to alter the prior approach allowed in IT 2540. That is, TD 2011/26 has sort to provide further conditions on IT 2540 and then replicate these new restrictions into the trilogy of Tax Determinations. The principle used is that the legal profile of the equity holder has now become a relevant factor as to when the Commissioner will apply IT 2540 and the Tax Determinations.

ATO officers have stated that this restriction on IT 2540 was implicit in that ruling because at the time the ruling was issued professionals were not allowed to operate through partnerships with partners who were other than natural persons. We consider that this is incorrect. In fact at the time Everett arrangements were common among our members, whereby while the partner was a natural person they did not hold the whole of the interest beneficially.

We note that a number of our members have provided strong feedback to us in relation to this matter. It is the view of the professional bodies that for the ATO to seek to retrospectively limit the clear words of a ruling 20 years after its issue, based on implied limitations that did not actually exist in relation to many of the taxpayers to which IT 2540 applied, is to risk public confidence in the administration of the tax system. In our view it is even more disturbing that this should occur where there is clear evidence that the ATO knew (or should have known) that the claimed implied limitations did not in fact exist for all taxpayers covered by IT 2540.

Although our opening remarks incorporate TD 2011/26, from here on our submission primarily focuses on the two Draft TDs (TD 2011/D9 and TD 2011/D10) only.

B. Submissions

B.1. Limited Application

As drafted, we submit that both Draft TDs are likely to have limited application as the concession will only be available in a very limited range of circumstances.

In particular, the requirement that Partner/Shareholders are restricted to 'active natural person practitioners' who must have both a legal and beneficial interest in shares / equity, is currently causing significant concern for practices that:

- Have non-natural person equity participants, as allowed by the relevant professional bodies; or
- May or may not have individual equity holders acting in the capacity of trustee, and may or may not have previously entered into Everett assignments. Shareholder / Partner private taxation arrangements would typically (correctly) not be known by or to the practice; or
- Have 'Fixed draw' equity participants who may have an interest in 'income' but not 'capital' of the structure or full voting rights; or
- Have Shareholder/Partners that have retired, or who are on sabbatical leave, extended leave or maternity leave etc.

Practically, the approach taken by the trilogy of Tax Determinations leaves professionals with significant uncertainty, as to how to continue with their existing structures. In effect, the approach taken means that unless the restricted market for shares (see further below at B.4) is taken into account to determine value, that practically, 'no goodwill' incorporated practices will not be established in the future and ultimately we believe existing practices will be forced to restructure.

For example, a professional firm would never establish a practice where:

- A new shareholder pays tax on a discount, pursuant to TD 2011/D9, on a share that cannot be sold by that shareholder for more than \$1, per the Shareholders' Agreement; and
- An existing shareholder, who only receives \$1 on buy back or cancellation of his / her / its share, pays tax on an attributed higher market value pursuant to TD 2011/D10.

In short, the discriminatory approach for certain 'no goodwill' practices results in:

- Artificial distortions to commercial transactions and market behaviour between arm's length parties; and
- No goodwill incorporated practices effectively being rendered unworkable as described above; and
- A failure to recognize that professional member organisations have invested significant resources in allowing for flexibility of structure to deal with the changes in the commercial landscape and the reasons for this commitment to change.

IT 2540 was released in 1989 as a sensible and practical way to deal with the interaction of the tax provisions to professional practices. As drafted, IT 2540 demonstrated a proper appreciation of issues facing professional practices by the ATO. Today, unfortunately, the issue of the trilogy of Taxation Determinations not only demonstrates a lack of understanding of the issues facing professional practices, but worse, purports to understand the context in which IT 2540 was issued, and use that as a basis now for restricting its application.

B.2. Retrospectivity

One of our main concerns is that if and when a final TD issues, it is proposed that it will generally apply retrospectively (refer to paragraph 6 of both Draft TDs).

Retrospective application is likely to be problematic for professional practices that have arranged their affairs in reliance on the plain words of IT 2540. We note that IT 2540 did not express any requirement for all of the partners of a professional practice to be natural persons. It follows that many professional practices, whether they operate as a partnership or an incorporated association would not be fully constituted by natural person partners.

These Partners/Shareholders would effectively be bound to the existing structure. The terms for entry and exit to such a professional practice would already be embedded in the constituent documents. In other words, the majority of structures are well established and not easily changed.

B.2.1. Grandfathering

On this basis, if there is to be a u-turn in the ATO's approach, we recommend that existing professional practices that have relied on the plain words of IT 2540 should effectively be grandfathered. Provided that those practices satisfy the expressed conditions of IT 2540, the Commissioner should continue to adopt an approach that is consistent with the approach taken in IT 2540 (regarding capital gains) and extend that approach to share buy-backs and employee share schemes.

B.2.2. Prospective application

At the very least, the conditions in the Draft TDs should only have prospective application to professional practices that have relied on the plain words of IT 2540. For example, the conditions required to be satisfied should only apply to shares acquired on or after the date that a final TD is issued.

B.2.3. Why the concern?

The retrospective nature of the changes to IT 2540 in relation to professional partnerships and the restriction of the reasoning applicable *mutatis mutandis* to incorporated practices is causing consternation in part because of the lack of guidance in the TDs about the ATO's practical position if an entity falls outside the terms of the TDs.

We note that in consultation meetings it has been posited by ATO officers that an entity falling outside the terms of the TDs will not automatically have a full market value approach applied. In these circumstances, it has been stated, the general provisions of the law will be applied to the facts as found. In circumstances where unrelated parties are dealing at arm's length, for example, it is possible that what is paid for the interests in the practice may be considered to be market value (see further comments on this point below at B.4.)

To the extent that paragraph 20 of TD 2011/26 and paragraph 20 of TD 2011/D9 are intended to express an opinion on these circumstances we wish to note that:

- It is not clear whether these paragraphs are general comments about all such dealings in all professional practice entities, or are restricted to dealings that fall within the limitations of the TDs (ie natural person practitioners etc).
- No equivalent paragraph appears in TD 2011/D10

In our view, insertion of an appropriately redrafted paragraph, or a further TD on the matter, should be considered. If nothing else, such a paragraph should at least provide negative assurance: that is a statement to the effect that simply because a practice entity falls outside the TDs does not mean that the Commissioner will automatically calculate a market value based upon a notional unrestricted secondary market for interests in the entity. Such a statement will at least prevent ATO officers automatically assuming that taxpayers who are outside the ruling should be assessed based on such a "market value".

B.3. The TDs should refer to equity rather than limit their application to the 'goodwill' component

We mentioned earlier that the Draft TDs would have limited application. One of the main reasons for this is that the entry to and exit from a professional practice is typically governed by terms set out in a constitution, Partners'/Shareholders' agreement or both ("**constituent documents**"). The terms of those constituent documents are generally binding in the past, the present and the future.

Typically, for a 'no goodwill' practice, there is either no cost, or only a nominal cost for Partner/ Shareholders upon entry to the practice. Similarly, Partners/ Shareholders exit under the same terms: no proceeds or only nominal proceeds are received by the exiting Partner/Shareholder.

In terms of the value of a share, the Draft TDs only address the 'no goodwill' aspect. However, the value of a share is based on all of the underlying assets in the practice company. Such assets would include work in progress and debtors etc. In our view, the Draft TDs ought to extend the approach that they adopt in respect of the value of goodwill to the value of the share. In other words the shares should be taken to have a nil value (or a value equal to the amount actually paid and received) if all of the conditions are met, not just the goodwill component.

B.4. Restricted market

In our view, extending the Draft TDs approach to the value of the shares rather than just limiting it to the goodwill component is appropriate because the shares in a practice company typically have a large number of restrictions. For example, the shareholders in a practice company are typically bound by the particular terms of the constituent documents. The shares have a very restricted market, partner – shareholders are not at liberty to buy and sell

the shares. Only a select group can be Partner/Shareholders. Importantly, there is no secondary market for these shares. The constituent documents would typically prevent any sale of shares other than as envisaged by those documents.

In our view, the main question for consideration is whether parties to these arrangements, who enter them *bona fide* and at arm's length, will be treated as paying or being paid market value for the purposes of the tax legislation. The reasoning in relation to an appropriate market value in these circumstances was well outlined in ATO Class Ruling CR 2004/42 (albeit in a different context). In that ruling the ATO stated (emphasis added):

63. Generally, the market value of an unlisted share is the arm's length value of the share as calculated in accordance with a method approved in writing by the Commissioner as a reasonable method of calculating the arm's length value of unlisted shares.

64. According to the Articles of McKinsey, the formula for arriving at the ABV of a share on a particular day is based on the definition of Book Value (BV) of a share, which is the net assets based on financial reporting divided by the total number of shares on issue. The ABV of a share on a particular day is determined by averaging on a day's basis, the BV on the most recent financial reporting date prior to and following that particular date.

65. In the general market, the ABV of shares may not accurately represent the market value of those shares. *However, because the Articles of McKinsey prohibit transactions in McKinsey shares at any value other than ABV and the SOP limits to whom the options and shares can be sold (essentially back to McKinsey), there is a restricted market. There is no other market in which McKinsey shares may be traded. Thus, providing the exercise price of the options does not include a premium over the market value, the ABV represents the market value as there is no other market in which the options or shares can be traded.*

66. Therefore, the Commissioner accepts that the ABV method is a reasonable method of calculating the arm's length value and that value is the market value of an unlisted McKinsey share for the purposes of subsection 139FB(1).

We consider that similar reasoning would lead to the conclusion that the market for interests in *bona fide* "no goodwill" professional entities is restricted and that the amount payable under the relevant constituent documents is the market value of the interest in the circumstances of the natural "ebb and flow" of Partners/Shareholders.

Whilst we acknowledge that it would be difficult for the ATO to specify all the circumstances in which parties would be taken to be dealing *bona fide* and at arm's length, we consider that the ATO could at least issue guidance material that indicated, in appropriate circumstances, when the above arguments would be accepted.

B.5. Requirement for all natural person practitioners

On the basis that the Draft TDs essentially have the purpose of expressing the Commissioner's view as to the value of goodwill in a 'no goodwill' practice, we fail to see how the profile of the Partner-Shareholder has any bearing on the value of the shares. For example, a condition in paragraph 3 of both Draft TDs requires that the original shareholders in the company are all natural person practitioners'. In our view, this condition is not warranted as the shareholder's profile would not affect the value of the goodwill, the value of the shares or the nature of the dealings between the parties.

We are also concerned that both determinations in their guidance (TD2011/D9 at 19 and TD 2011/D10 at 23), provide that if there is even one share held otherwise than as described the concessions in the draft TDs are not available. This creates significant uncertainty for taxpayers relying on the ruling as the ruling's application to them may be affected by factors of which they have no knowledge and control.

If a shareholder acts in breach of a clause in the organizations governing documents and assigns and interest to a 3rd party in an Everett arrangement, the organization may have no knowledge of this and the Taxpayer relying on the ruling will have no way of determining this. However, under the Draft TDs they would not be entitled to rely on the protections provided by these Draft TDs. They would potentially file returns based on a belief they were complying with the law relying on the Draft TDs only to find at a latter point in time they had a further liability to tax (in a circumstance where there was no economic gain).

This creates an unjust and unreasonable degree of uncertainty. We believe that at a minimum the taxpayer should only be affected if they were aware of the breach by the 3rd party. A more appropriate remedy for the Commissioner to adopt would be to deny such shareholder the access to the concessions provided in the Draft TDs without affecting any other shareholders.