



THE LAW SOCIETY
OF NEW SOUTH WALES

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20 April 2011

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By email: shelley.mccann@ato.gov.au

Dear Ms McCann,

Draft Determination TD 2011/D3

Thank you for your invitation to comment upon draft determination TD 2011/D3.

The Business Law Committee ('Committee') of the Law Society of New South Wales has considered the terms of the draft determination. The Committee endorses the submission made by the Law Council of Australia dated 19 April 2011, a copy of which is enclosed.

Subject to the qualifications set out in the enclosed submission, the Committee welcomes the views expressed in TD 2011/D3.

The Committee would appreciate being included in any discussions concerning the structures referred to in the penultimate paragraph of the submission of the Law Council of Australia.

Should you have any questions, please do not hesitate to contact Ms Lana Nadj, Policy Lawyer for the Business Law Committee, by phone on (02) 9926 0375 or by email to lana.nadj@lawsociety.com.au.

Yours sincerely

Stuart Westgarth
President



Law Council
OF AUSTRALIA

19 April 2011

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Dear Ms McCann

Draft Taxation Determination TD 2011/D3

1. This submission has been prepared by the Taxation Committee of the Business Law Section of the Law Council of Australia (**Committee**), in consultation with representatives of a number of its constituent bodies, including the Law Institute of Victoria (**LIV**) and the Law Societies of New South Wales, Queensland and Western Australia.

Summary

2. The Committee sees the release of TD 2011/D3 as a first, but potentially significant, step towards providing certainty for legal practitioners who wish to practice through an incorporated legal practice (**ILP**),¹ a structure which is currently available in a number of jurisdictions² and which will be available to legal practitioners in nearly all jurisdictions once the Legal Profession National Law is in place.³
3. However, there are a number of concerns and shortcomings.
4. First, at the consultation meeting held with the professional bodies on 23 March 2011 (**Consultation Meeting**) and earlier meetings with the smaller group more closely involved with the development of this initiative, the Australian Taxation Office (**ATO**) has referred to the approach taken in Income Tax Ruling IT 2540 as a concession. It is further suggested by the ATO that TD 2011/D3 is an extension of that concession. We disagree with that proposition. In any setting where people independently transact in partnership interests, or interests in ILPs, on the basis that they do not pay for those interests, and get paid nothing for them, there is no warrant for any taxation liability to arise. Quite correctly, when strictly

¹ Although this submission is focused on ILPs, many of the observations are equally applicable in other professional contexts.

² See, for example, Division 2 of Part 2.7 of the *Legal Profession Act 2004* (Vic).

³ Division 1 of Part 3.7 of COAG Draft of the Legal Profession National Law dated 15 December 2010.

applied, the taxation system accommodates that outcome. It is not a concession to accept this.

5. Second, the Committee shares the concerns, expressed by a number of participants at the Consultation Meeting that:
 - (1) **the scope of application of TD 2011/D3 is unduly narrow and, as a result, may not reflect the appropriate paradigm or provide the certainty required regarding the capital gains tax treatment of practitioners who practice through an ILP; and**
 - (2) **TD 2011/D3 does not address a range of other issues which need to be considered by legal practitioners who wish to incorporate.**
6. The Committee comments in detail on each of these matters below. However, before doing so, the Committee considers it appropriate to clarify the "paradigm" to which the draft tax determination, and any associated guidance, needs to apply.

The Relevant Paradigm

7. The vast majority of legal practices in Australia are still carried on as sole proprietorships or as partnerships. This is historical in the sense that legal profession regulation has traditionally prohibited incorporation and the sharing of profits with non-practitioners.
8. The size of partnerships varies considerably, and can range from 2 partners to large firms with hundreds of partners located throughout Australia.
9. The arrangements within partnerships can and do differ, however a not uncommon feature of medium to large firms is the "no goodwill partnership". The essential feature of a no goodwill partnership is that partners enter and exit the partnership without making or receiving any payment in relation to any goodwill of the partnership. The purpose of such arrangements is to attract people to become partners by reducing the barriers to entry.
10. Income Tax Ruling IT 2540 was seen as providing certainty that partners who entered and exited a no goodwill partnership on that basis would not derive an assessable capital gain in doing so.
11. At a minimum, it is that essential paradigm which the Committee seeks to preserve to facilitate the adoption of the ILP structure by members of the legal profession. However, it needs to be recognised that there are some features of operating in an incorporated environment that differ from a partnership environment and which need to be addressed if that paradigm is to be preserved. In particular:
 - (1) a company, as a separate legal entity, may retain profits whereas there is no ability to do so within a partnership;
 - (2) a share is a distinct item of property and would ordinarily be issued by a company for some, if nominal, amount;
 - (3) a company is not permitted to hold its own shares, so absent a transfer from one shareholder to another (which is unlikely to be feasible in the context of changes in ownership of a medium to large legal practice),

“exits” would be undertaken by way of buyback or capital reduction and cancellation, again for at least nominal consideration; and

- (4) the issue of shares by a company to an employee in respect of his or her employment is subject to the operation of the employee share scheme rules in Division 83A of the *Income Tax Assessment Act 1997* (ITA Act 1997). By contrast, there is no equivalent rule applying to interests in a partnership.

Scope of application of TD 2011/D3

12. Having regard to the paradigm outlined above, there are a number of features of TD 2011/D3 that result in it falling short of what is required to facilitate the adoption of ILP structures.

No consideration requirement

13. The first point is that while it is recognised that the constitution or shareholder agreement relating to an ILP might provide that “no or an immaterial payment is to be made for acquiring a share, disposing of a share or any change to the profit distribution entitlements attached to a share in the company”,⁴ the determination itself is limited to situations where “no amount is received as capital proceeds or paid as cost base”.⁵
14. At the Consultation Meeting, it was indicated that this was because the determination only addresses the operation of section 116-30(1) of the ITA Act 1997 and issues of market value do not arise where consideration is received.⁶ Further, it was suggested that, while it would generally be accepted that practitioners entering and exiting a legal practice on a “no goodwill” basis are dealing at arm’s length, neither IT 2540 nor the proposed determination would specifically address whether or not that is the case.
15. It seems to the Committee that the issue arises because of the market value provision which is the subject of the determination. However, if the determination was to consider the capital gains tax provisions more holistically, then it would be apparent that there are situations where market value can be deemed even though consideration is paid and/or parties are dealing at arm’s length. In this regard, section 159GZZZQ of the *Income Tax Assessment Act 1936* (ITA Act 1936) provides that, in determining the consideration for a buy-back (including for the purposes of Parts 3-1 and 3-3 of the ITA Act 1997), the seller is taken to have received an amount equal to the market value of the share if the purchase price is less than that amount. Likewise, section 116-30 of the ITA 1997 provides for market value consideration to be imputed in relation to the cancellation of shares in the context of CGT event C2.
16. Against that statutory background, the “concession” (so called) could properly be recast in the following terms:

⁴ TD 2011/D3, paragraph 2(e).

⁵ Ibid, paragraph 4.

⁶ Provided, of course, that the parties deal at arm’s length, see section 116-30(2) of the ITA Act 1997.

"A dealing in shares between shareholders in an incorporated professional practice, or between a shareholder and the incorporated professional practice, but for which no or a nominal amount is paid or received, is accepted as being arm's length (unless there are circumstances which indicate the contrary) and the market value of such shares is nil (where nothing is paid or received) or the nominal amount (where a nominal amount is paid or received)."⁷

Requirement that all shareholders are natural person practitioners

17. We understand from the Consultation Meeting that the thinking behind this requirement⁸ is that it is consistent with the requirements of IT 2540 and that allowing other shareholders would open up opportunities for income splitting that are beyond the scope of what the determination seeks to address.
18. The Committee observes that, at the time IT 2540 was introduced,⁹ legal profession regulation imposed significant limits on the ability of other entities to share in the profits of the legal practice, which explains its limited focus. Even then, IT 2540 recognised that an individual partner could achieve income splitting through an Everett assignment and confirmed that the (so called) "concession" in IT 2540 would not apply to that partner.¹⁰ Importantly, however, there was no impact on the "ebb and flow" treatment for the remaining partners.
19. There may be many valid reasons for practitioners to transfer their shares to a related party which have nothing to do with income splitting. While that is a debate for another day (see further at 4(c) below), at the very least it is critical that the actions of one practitioner do not imperil the treatment of all other practitioner shareholders. Rather, any loss of the "concession" (so called) should be visited on that practitioner in relation to his or her shares, consistent with IT 2540.

Active practitioner requirement

20. The same comments apply here as referred to in the previous section. Further, as discussed in the Consultation Meeting, partnerships have various organisational models, including arrangements where some partners are engaged full time in administration and practice development. There is no warrant for treating ILPs (or their shareholders) with these kinds of arrangements any differently.

No other assets requirement

21. As discussed in the Consultation Meeting, existing partnerships will have assets other than goodwill. These will ordinarily be practice related assets such as contractual rights (particularly under legal retainers), work in progress (for legal services rendered but not billed) and debtors (for legal services rendered and billed). Although most partnerships would not own office equipment or the like,¹¹ it is not necessarily universal. Presumably the thinking behind imposing a

⁷ To paraphrase and extend the formulation adopted in TD 2011/D3 at paragraph 4.

⁸ TD 2011/D3, paragraphs 2(a) and 19.

⁹ In 1989.

¹⁰ Taxation Ruling IT 2540, paragraph 29.

¹¹ Which are usually held by a service trust or company.

requirement that ILPs do not have any other assets was to align the value of a share with the value of goodwill (i.e. to be accepted as nil). However, with the recasting of the issue to which the determination applies as outlined in 3(a) above, this point should no longer be relevant.

Agreement of the parties

22. The requirement in paragraph 2(d) of TD 2011/D3 that the company adopts a constitution or shareholder agreement regulating admissions and surrenders/transfers of shares in the company is not problematic.¹² It should be clarified, however, that the agreement referred to in the second sentence of paragraph 4 of TD 2011/D3 is the constitution or shareholder agreement and not some separate agreement regarding the tax outcomes of dealings between them.

Other matters to be addressed

23. There are a number of other matters which need to be addressed, either in TD 2011/D3 itself or in related determinations. The first two items below are the most pressing. We would like to see a timetable for resolution of the broader issues identified in the third point.

Buybacks and capital reductions

24. As indicated in 2. above, transfers from an outgoing to incoming practitioner shareholder are unlikely to be a regular occurrence in the medium to larger legal firms to which the determination is most likely to apply. Rather, the likely scenario is an issue of shares to new practitioner shareholders, and a buyback or capital reduction of the shares held by existing practitioner shareholders, occurring at different points in time. These situations raise their own market value deeming issues which ought to be covered, preferably in the same determination, as outlined above (see 3(a)).

Employee share scheme rules

25. In the modern legal environment, new partners come from two sources, internal "promotions" of senior associates who are considered to have the requisite skills to contribute to the partnership, and lateral recruits being senior associates or partners from other firms. Further, once a firm incorporates, the status of its "partners" will change, and they will become employees (whether or not separately remunerated for their services).
26. While the determination addresses the transfer of shares to a lateral practitioner shareholder, the provision of shares to an employee of a company potentially brings the operation of Division 83A of the ITA Act 1997 into play. Ignoring any deferral, where the division applies, section 83A-25 would tax an employee on the

¹² Although note it is the shareholders rather than the company that "adopt" a shareholders agreement.

difference between the market value of the shares received and the consideration paid for it.¹³

27. If the "market value" of shares in an ILP for the purposes of Division 83A is not addressed, then it would potentially result in any employees being taxed on the market value of those shares even though when that person later exits the practice, he or she will not receive any consideration.¹⁴ It is unlikely that any employee would be willing to join a legal practice on this basis. It may also hamper any changes in the equity entitlements of existing practitioner shareholders, which is now a common occurrence in large legal partnerships.
28. However, if the TD 2011/D3 is amended in the manner suggested in 3(a) above, it should follow that the same treatment applies in the context of the employee share scheme rules.

Other matters

29. At earlier consultations with the ATO, it was noted that some partnerships, particularly small to medium practices, recognise goodwill using a set formula. It follows from the proposed determination, and ought to be accepted by the ATO, that such arrangements are arm's length and reflect market value. The Committee would like to see this addressed in a subsequent determination.
30. Further, while the Committee understands the concerns that the ATO has in relation to income splitting as a tax avoidance issue, there may be many valid reasons for a practitioner wishing to transfer their shares in an ILP to another entity unrelated to tax as the ATO has recognised in various rulings.¹⁵ Further clarity in this area would be desirable.
31. Finally, at a seminar held at the LIV following the release of the TD 2011/D3, the ATO speaker indicated that there are other "interesting" structures that have been adopted for legal and accounting practices that the ATO do not fully understand and raise some concerns. The LCA and its constituent bodies would appreciate the opportunity to discuss these matters further with the ATO in due course.

Further contact

32. If you have any questions in relation to this submission, please contact the Committee Chair, Ms Teresa Dyson on (07) 3259 7369 or via email Teresa.dyson@blakedawson.com in the first instance.

Yours sincerely



Bill Grant
Secretary General

¹³ While this is not expressly set out in the legislation, it appears to be the intended meaning of "discount", see paragraph 1.102 of the Explanatory Memorandum to the Tax Laws Amendment (2009 Budget Measures No 2) Bill 2009.

¹⁴ The individual may be entitled to a capital loss, but this is unlikely to offset the upfront taxation cost.

¹⁵ See, for example, IT 2330 at paragraph 37 and IT 2503 at paragraph 19.