TAXATION RULING NO. IT 2503

INCOME TAX : INCORPORATION OF MEDICAL AND OTHER PROFESSIONAL PRACTICES

F.O.I. EMBARGO: May be released

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REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1211408	PROFESSIONAL PRACTICE COMPANIES MEDICAL PRACTICE COMPANIES SHAREHOLDERS & DIRECTORS GOODWILL INVESTMENTS BASIS OF ACCOUNTING HOSPITAL SESSIONAL FEES RETAINED EARNINGS PRACTICE TRUSTS SERVICE TRUSTS TAXABLE INCOME LOSSES KEYMAN INSURANCE	260 PART IVA

OTHER RULINGS ON TOPIC : IT 25, IT 139, IT 2024, IT 2277, IT 2330, IT 2494

PREAMBLE This Ruling reviews the guidelines set out in Taxation Ruling No. IT 25 which dealt with medical practice companies established to take over the activities of medical practices so as to provide superannuation benefits for their employees. The instructions contained therein should continue to be applied unless inconsistent with this Ruling. The companies covered by this Ruling are those formed by professional persons such as medical practitioners, legal practitioners, accountants, engineers, architects, etc., where the ethical and statutory governing bodies of the profession permit members to conduct their professional activities through incorporated bodies. The practice companies may be established to take over all the professional practice, excluding any part required by law to be performed by individuals, for example, audit and liquidation functions.

2. This Ruling relates only to those practice companies whose income flows directly or predominantly from the rendering of personal services by the professional practitioner, as discussed at paragraphs 36 and 37 of Taxation Ruling No. IT 2330.

RULING 3. As a result of representations from various professional bodies etc., the incorporation of professional practices has, for some years now, been accepted by the Australian Taxation Office where:-

(i) there is nothing in the relevant State or Territory law

to prevent incorporation;

(ii) there are sound business or commercial reasons for incorporation;

(iii) there is no diversion of income from the personal services of the professional practitioner to family members or other persons; and

(iv) the only advantage for income tax purposes is access to greater superannuation benefits.

4. A number of other matters relating to the incorporation of professional practices have been submitted for decision.

Taxable Income of the Company

5. As already indicated, the incorporation of professional practices is accepted for income tax purposes where, inter alia, incorporation does nothing more in relation to income tax than reduce a professional's income by the amount of an appropriate superannuation cover. This position was confirmed by Dawson J. in FCT v Gulland 85 ATC 4765 at page 4797:

> "Of itself and without more, the establishment and operation of a superannuation fund, notwithstanding the opportunity it offers to deduct from assessable income contributions to the fund on behalf of an employee, will not attract s.260." (emphasis added)

6. Generally, this would mean that a practice company should have no taxable income. The total income for a year, after expenses, should have been fully paid out to the professional person by way of a salary.

7. It has been put to the Australian Taxation Office that in practice, however, it is not always possible to achieve this result within the confines of a year, i.e., it is simply not practicable in many cases for the practice company to ascertain its income and determine its allowable income tax deductions by 30 June each year. In the result, it is not possible to determine with accuracy what amount should be paid out by way of salary to the professional practitioner and what amount should be set aside as superannuation cover so as to produce a nil taxable income in the company.

8. A further difficulty arises when the taxable income exceeds the accounting income, for example, where tax deductions for entertainment expenses are denied.

9. Because of these and other similar factors the return of income for the practice company may disclose a taxable income.

10. The retention of profits in the practice company is generally not acceptable. Where profits are retained, salary payments and, therefore, superannuation contributions will be reduced accordingly. Although at times the tax rates on the salary in the hands of the professional and the profits in the company may be the same, the purported main object of the incorporation, obtaining superannuation, will be frustrated. In effect, any retained profits will put in doubt the very basis on which the

arrangements have been put forward and accepted, viz., the provision of superannuation benefits.

11. However, where a bona fide attempt has been made to break even but the practice company returns a relatively small taxable income because of the above or similar difficulties, the company should distribute all its taxable income, to the professional person by way of franked dividend, in the following year. This procedure is to be applied to practice company returns of income for the year ended 30 June 1989 and subsequent years.

12. On the other hand, a practice company that makes little or no attempt to distribute the whole of its income to the professional person by way of salary prior to the end of its financial year, or retains income in the company, will not be taken to have made a bona fide attempt to comply with the guidelines. Cases have arisen where the salary paid by the practice company to the professional practitioner is far below that contemplated in the guidelines and the overall result is that the total tax payable by the professional practitioner and the company is significantly less than that which would otherwise be payable. The prima facie conclusion that emerges is that incorporation has been undertaken for the purpose of minimising income tax. In cases of this sort the income from the practice should be treated as that of the professional practitioner involved and reliance placed on Part IVA.

13. These procedures will apply regardless of any variations in the marginal tax rates for individuals and companies and even at times when the rates are the same.

14. A practice company that produces a taxable income will, of course, incur an income tax liability. Where, as a result of factors such as those contemplated in paragraph 8, the company has insufficient funds to meet the liability, one suggested solution is for the professional person to loan funds interest-free to the company to pay the income tax. This arrangement is acceptable provided the loans are not repaid by the practice company but are subsequently written off without the professional person seeking a deduction in respect of the write off. Effectively, the arrangement would then result in the income tax liability of the practice company being paid by the professional person in a non-deductible way.

Practice Company Losses

15. It is common for professional practitioners to incorporate part way through a financial year. Where this takes place towards the end of the year, the income of the practice company may not be adequate to cover the superannuation contributions, which have been calculated on an annual salary basis. This generally results in a loss being incurred by the company in its first year of operation.

16. If such a loss is returned by the practice company it should be recouped in the following financial year before any salary is paid to the professional practitioner.

Shareholders and Directors of Practice Companies

17. Another issue is whether or not this Office would have any

objection to the participation of the spouse of a professional practitioner in a practice company e.g., the holding of shares in the company or by acting as a director. It has been said that other professional practitioners are unwilling to accept the responsibility of shareholding in the practice company and approval has been sought for other persons, including relatives of the practitioner, whether qualified or not, to hold shares for the practitioner and take on those roles which confer particular duties and liabilities on directors under the companies legislation.

18. In South Australia, for example, the Medical Practitioner's Act 1983, which came into force on 11 August 1983, permits a company whose sole object is to practice medicine to be registered as a medical practitioner. That Act requires that the directors of the company must be natural persons who are medical practitioners. However, where there are only two directors one may be the medical practitioner and the other a prescribed relative of that medical practitioner. A prescribed relative is defined for this purpose as a parent, spouse, child or grandchild of the medical practitioner. The Act further provides that no share issued by the company, and no right to participate in the distribution of the profits of the company, is to be owned beneficially otherwise than by a medical practitioner who is a director or employee of the company or a prescribed relative of that medical practitioner. This would seem to enable the diversion of income to a prescribed relative.

19. Notwithstanding the South Australian or other similar provisions, the holding of a share or the position of director by someone other than the professional practitioner is acceptable for income tax purposes only where it is allowed by the relevant law or by-laws and there is no diversion of income to that person. In these circumstances it would not be appropriate for the non-professional director to receive remuneration as a director in any form, profits or superannuation benefits.

20. This is not to say, however, that a practice company cannot make arm's length payments to relatives for bona fide services rendered or supplied (other than services as a director as discussed in paragraph 19). It is common for a professional practitioner to employ their spouse in their practice and an income tax deduction is allowed for reasonable remuneration and other benefits paid to the employee. If the practice company continues to employ the spouse, income tax deductions would be similarly allowable to the company.

Goodwill

21. It has been proposed that when professional practitioners incorporate their practices the practice company purchase the goodwill of the professional's practice with funds borrowed from the professional's family trust. The question asked was whether this Office accepts those arrangements if interest is payable to the trust.

22. In the context of the guidelines that provide for the shares in the practice company to be held for the benefit of the professional practitioner, it is difficult to see why the company should pay an amount to the professional practitioner for goodwill. The normal arrangement would seem to be that the

professional practitioner would transfer all the assets of the practice, including goodwill, to the company in return for shares that reflected the value of the assets. Under this arrangement, it could be expected that rollover relief under section 160ZZN of the Income Tax Assessment Act would, generally, be applicable.

23. Interest on money borrowed to purchase goodwill in the situation described above, whether borrowed from an arm's-length entity or otherwise, will not be accepted as an allowable deduction. This will not apply to situations where the practice company is purchasing, including goodwill, an arm's-length practice at commercial rates provided that no diversion of income or other unacceptable consequences result.

Investments

24. The purchase of income producing property by an incorporated professional practice is not generally acceptable. In a case submitted to this Office the reasons given for the purchase of the property by the practice company rather than by the professional practitioner were that a lesser marginal rate of land tax applies to companies and that access to the property would be limited should a case of professional negligence be taken against the professional practitioner.

25. The guidelines have been formulated in the context of the conduct of a professional practice by a corporate body in order to provide the practitioner with a level of superannuation benefits higher than would be available to a sole practitioner or partner. It was not intended that property from any source other than the practice would be held by the practice company. The practice company may own assets used in the conduct of the practice, for example, offices. Where a practice company holds unacceptable investments, the income from the practice should be treated as that of the professional practitioner involved and reliance placed on Part IVA.

Basis of Accounting

26. It was explained in Taxation Ruling No. IT 25 that, as medical practitioners who incorporate their practices will retain personal accountability for medical services provided by the company, the personal nature of the services rendered by the medical practitioners will not differ in incorporation from that extended by them in partnership or in sole practice. A similar situation exists in the other professional practices referred to in this Ruling. Accordingly returns for practice companies should be lodged on a cash basis.

27. This requirement has been questioned on the basis that the accounting requirements under the companies legislation are that the companies return their income on an accruals basis.

28. This matter was raised at first instance in Gulland v. F.C. of T., 83 ATC 4352. In that case the medical practice was carried on by a trustee and returns were lodged on an accruals basis. At p.4362 Kennedy J. said:-

> 'So far as this qualification is concerned, it appears to me to be clear, and it was not really challenged, that, in the light of FCT (S.A.) v. Executor, Trustee & Agency Co. of

> S.A. Ltd. (Carden's Case) (1938) 63 CLR 108 and Henderson v. FCT 70 ATC 4016; (1970) 119 CLR 612, the method of accounting calculated to give a substantially
> correct reflex of the taxpayer's true income is that based on cash receipts and payments and not on accruals'.

29. Although the extract refers to the calculation of the particular appellant's taxable income, i.e., Dr. Gulland's, it is seen as supporting the view that the taxable income of a practice company generally should continue to be determined on a cash basis.

Sessional Fees From Public Hospitals

30. Submissions have been made to this Office that sessional fees paid by public hospitals to medical practitioners who have incorporated their medical practices should be included in assessable income of the companies rather than in the income of the practitioners. The object, of course, is that if the sessional fees are included in assessable income of the companies the fees, if ultimately paid out as salaries, may be taken into account in determining superannuation benefits of the employee medical practitioners.

31. In the various States it appears that generally the hospitals have authority to contract for sessional services with medical practitioners only, i.e., contracts must be between the doctor and the hospital and not with his or her medical practice company.

32. Where a hospital has authority to and does contract with a medical practice company for the services of the doctor employed by the company, the sessional fees paid by the hospital for those services would be assessable income of the company. However, where a contract is between a hospital and the medical practitioner the fees would be assessable income of the medical practitioner and should be included in the medical practitioner's own return of income.

Keyman Insurance

33. Generally, premiums for keyman insurance would not be deductible in practice companies as those companies should terminate on the death or permanent incapacity of the professional practitioner. However, in practices where such termination would not occur, for example where there is more than one professional practitioner in the practice company, keyman insurance will be acceptable as long as that insurance complies with the guidelines set out in Taxation Ruling No. IT 155.

Practice Trust

34. Where a professional practitioner wishes to operate a practice through a trust structure no objection will be taken provided the trust structure achieves the same result for income tax purposes as the basis upon which incorporation of professional practices has been accepted. In particular, it should be ensured that the professional practitioner is the sole beneficiary of the trust.

Service trusts or companies

35. Taxation Ruling No. IT 25 dealt with the use of service trusts or companies. The instructions contained therein should continue to be applied. Essentially it will be necessary to be satisfied in each case that the service for which payment has been made has in fact been provided and that the amount paid is reasonable for the provision of the particular services.

COMMISSIONER OF TAXATION
3 November 1988