IT 139 - Tax avoidance: incorporation of architects' practice as private company

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TAXATION RULING NO. IT 139

TAX AVOIDANCE : INCORPORATION OF ARCHITECTS' PRACTICE AS PRIVATE COMPANY

F.O.I. EMBARGO: May be released

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REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1071765	PROFESSIONAL INCOME ARCHITECTS - PRIVATE COMPANY TAX AVOIDANCE ALIENATION OF INCOME INCORPORATION OF PROFESSIONAL PRACTICE	260

PREAMBLE Consideration was given to the question of whether the taxation treatment applied in Millard's case (1962) 108 CLR 336 should be extended to architects who incorporate as private companies.

FACTS 2. Shortly stated, the professional income returned by the company is treated as being derived by the individual practitioner or partnership. Similar treatment has been extended, in individual cases, to members of other professions and occupations e.g. bookmaking.

3. The official treatment of the income of certain private companies as the income of the individuals concerned has been confirmed by the High Court in the case of the bookmaker Millard and in the case of Dr Peate.

4. In the case of a firm of architects incorporated as a private company, it was established that from a certain date, all the professional activities formerly carried on by the partnership were carried on by the architects for and in the name of the company. In particular, it has been found that, from that date, the following steps have been taken:-

All letterheads, cheques, receipts and accounts have been in the name of the company.

All plans, specifications and contracts have been issued and signed in the name of the company.

In the case of plans in course of preparation the name of the company was inserted.

All advertisements publicly or privately for tenders have been in the name of the company.

The name of the company has been used exclusively by

the receptionist in answering inward telephone calls.

Except in the case of twelve firms who already had the full company name on their records, all firms with whom the company has accounts were requested to record the name of the company correctly.

RULING 5. After full consideration of the circumstances, it was decided that the income of the architectural business was derived, in fact, by the company.

6. That factual conclusion could be disregarded, for income tax purposes, only if the relevant arrangements were to be treated under section 260 as void against the Commissioner. As a general proposition, however, section 260 should not be applied to void an otherwise valid alienation of income, unless it is most clearly incapable of explanation by reference to ordinary business or family dealings.

7. For instance, it is considered proper to have recourse to section 260 to void a business arrangement which, though it may be legally valid, is so close to being a sham as to be outside the description of ordinary business dealing. In Millard's Case, for example, Taylor J. seems to have entertained doubts whether the agreement purporting to transfer the taxpayer's bookmaking business to a company was 'valid and effective according to its tenor' although, in view of section 260, he found it unnecessary to discuss this matter. Similary, in Peate's Case (1964) 111 CLR 443, Menzies J. described as 'formidable' the argument for the Commissioner that all the fees purported to be received by the company constituted income derived by the doctors for the purposes of section 17, although, here again, recourse to section 260 obviated the necessity of determining the question of derivation per se.

8. It is relevant to consider also the following extract from the judgment of Menzies J. in Peate v FCT (1964) 111 CLR 443 at page 459, in which Menzies J. set out his reasons why the happenings in that case did not constitute ordinary business dealing:-

> 'Lest, however, it should be thought from my emphasis upon the part played by Raleigh that it is only the interposing of Raleigh between Dr Peate and Westbank that prevents the arrangement as a whole being regarded as an ordinary business transaction, I should say that this is not my view. It is true that I do regard the incorporation of Raleigh and the seven other doctors' family companies as colouring everything that was done here but, even without this, I would have concluded that it was not an ordinary business transaction for a body of professional men who are entitled to sue for fees for medical services to transfer their practices, their libraries and their instruments to a company which would not sue for fees and to become that company's servants in the conduct of their profession, particularly in the circumstance

that, to the extent to which patients paid fees to the company, their expenditure was not rebateable under section 82F.'

9. The case of the architects was distinguished from that of Dr. Peate on at least two grounds, viz.-

(i) The arrangement consisting of the incorporation of a single 'operating' company was far less artificial than the formation of the group of family companies in the case of Peate's partnership and, accordingly, it is more readily explainable as ordinary business dealing.

(ii) So far as can be ascertained, the incorporation of the company did not put the architectural practice to any business disadvantage - as, for example, in regard to suing for outstanding fees.

In the circumstances, it was found that, from the relevant date, there was a prima facie case for accepting the alienation of professional income from the partnership to the company as ordinary business dealing. Accordingly, section 260 would not apply to void the alienation.

10. A similar view may be taken in the case of any other architectural practice incorporated as a company provided that -

(a) the parties have taken at least the same steps as were taken by the above company to ensure that all contracts, receipts, advertisements, etc., are in the name of the company; and

(b) the company complies with the requirements of the Council of the Royal Australian Institute of Architects concerning directors and controlling shares, as set out in the resolution cited in the Annual Report presented on 22 May 1963, viz. -

THE PRACTICE OF ARCHITECTURE BY LIMITED LIABILITY COMPANIES

'This subject has been actively considered and discussed by the Council for a number of years. Investigations in various places were undertaken, and as a result of further detailed discussion it has been finally resolved by the Council that it would have no objection to members practising through limited liability companies provided the directorate of each such corporation is limited to architects or members of closely allied professions and provided also that the controlling shares in each such corporation are held by architects.' (underlining inserted)

11. It should be clearly understood that the above ruling applies only to cases where the whole of an architectural practice has been incorporated as a company. Where, on the other hand, the arrangement is of a 'service company' character - i.e., where a partnership or private company has been

incorporated to render secretarial or other services to a firm of architects, claims for the deduction of service fees should be closely scrutinised in the light of section 51 and/or section 260.

COMMISSIONER OF TAXATION