INCORPORATION OF BARRISTERS' PRACTICES

MEMORANDUM OF ADVICE

I have been asked to express my views on three questions which have been raised for consideration by the Bar Council:

(a) whether incorporation of barristers' practices would result in any tax benefits to them;

(b) whether there are any benefits, or disadvantages, from incorporation in terms of limitation of barristers' liability;

(c) whether there are any other advantages or disadvantages for barristers, or the Bar, from barristers being able to incorporate their practices.

The expression "incorporation of barristers' practices" is a broad one, of somewhat uncertain denotation.

In some of the discussion to date it has been taken to refer to a barrister incorporating a company of which he or she is sole member and director, entering into a service contract with the company at a fixed salary, and causing the company to contract to provide the services of the barrister (as advocate or adviser) to clients for a fee corresponding to what the barrister would charge the client in the absence of the company arrangement. Under this arrangement there would be no direct contractual engagement (neither expressly nor in fact) between the barrister and the client, but the corporation would contract specifically to provide the benefit of the services of the barrister to the client, and the barrister

would perform the advocacy or advisory services. This is what I will refer to as the "bare model."

A slightly more complex model has the company owned not by the barrister but by the trustee of a trust for the benefit of the barrister and his or her family, or by a second company the shares in which are held by the barrister or by such a trustee. I will refer to this as the "family ownership model."

Summary of opinion

In my opinion, as a matter of practical reality incorporation of barristers' practices on the "bare model" provides no material tax advantages to the barrister concerned and affords no limitation of potential liability. While in practical reality no material tax advantage is conferred, I can see no other advantage in incorporation and the prima facie or "headline" benefit – the application to fee income of the corporate tax rate of 30% rather than the maximum personal rate of 45% plus levies – is a benefit the seeking of which can only, in my view, attract opprobrium to and diminish the standing of the Bar, and reduce its effectiveness as an advocate of public interests.

The family ownership model offers the opportunity to divert part of the income arising from the practice to a recipient who takes no part in the conduct of the practice – either family members, or a company owned by or trust for the benefit of family members or the barrister – and thereby to vest it in a party beyond the reach of a liability claim and one who is subjected to tax at a lower rate than that imposed on the barrister. However, in my view the advantages are illusory: if the barrister has taken the steps necessary to attract the operation of the Professional Standards Act, his or her liability absent incorporation is no greater than the liability of the recipient of the diverted income; and the reduction in the barrister's tax liability is one which would not survive a challenge by the Commissioner of Taxation which the Commissioner has foreshadowed would be made in such circumstances.

I consider that the "incorporation of barristers' practices" would confer no advantage on those who undertake it. While it may justly be said that it is no part

of the role of the Commissioner of Taxation (or the Commonwealth generally) to dictate to barristers any more than to any other category of taxpayer how they should organise the conduct of their business affairs ("It is not ... the function of income tax Acts or of those who administer them to dictate to taxpayers in what business they shall engage or how to run their business" – *Tweddle v FC of T* (1942) 180 CLR 1, 7), where positive steps must be taken both by the Bar Council and by barristers to effect a change in business structure, and where the change would confer no practical advantage and only the superficial appearance of a fiscal advantage, but would by reason of that superficial appearance be inimical to the standing and institutional effectiveness of the Bar, it would in my view be inappropriate for the Council to take those steps. I would recommend that Council not endorse the changes to the rules necessary to authorise "incorporation of barristers' practices."

Liability consequences of the bare model

It is of the essence of the bare model that what the corporation has the right to provide is the personal service and expertise of the barrister concerned. The client contracts with the corporation, not expressly with the barrister. That is not to say that it would be beyond the ingenuity of counsel for a dissatisfied client, or of a judge confronted with the arrangement, to find that there was a concurrent oral contract between the client and the barrister, under which the barrister agreed to perform the stipulated services in consideration of the promise to pay the fees to the corporation. While such a contract, and any contractual liability, could be expressly denied by the terms of a fee agreement, a term to that effect is unlikely to assist in the expansion of the barrister's practice.

Exclusion of contractual liability, and limiting such liability to the corporation, does not exclude all liability of the barrister for default in performance of the agreed services. It is not now open to contest that save so far as excluded by considerations of public policy a barrister owes a duty of care to those for whose benefit his services are provided (*Giannarelli v Wraith* (1988) 165 CLR 543, 555, 559; *D'Orta-Ekenaike v Victoria Legal Aid* (2005) 223 CLR 1); and so far as liability is so excluded, incorporation offers no incremental advantage over conduct of the barrister's practice as an individual.

If there is an event of liability it will arise from the actions of the barrister, and if those actions give rise to liability, that liability is visited on the barrister as well as on the corporation.

At a pragmatic level, the Professional Standards Act, and the Barristers' Scheme provide effective limitation of liability to any barrister who has properly secured and maintained professional indemnity cover (as is required for a practicing certificate). While there are excess amounts payable under such policies, the excess is unlikely to be more than would be the cost involved in defending an action on the part of a corporation "carrying on" the practice. (I do not understand it to be suggested that a company against which a claim was made would be abandoned to insolvency without defending the claim, or that the barrister would continue in practice as the employee of another, "phoenix" company.)

Corporations conducting a barrister's practice could be brought within the scope of the Barrister's Scheme by appropriate amendment, and the benefit of s 18 obtained, but no additional advantage over the present mode of conducting practice, as an individual, is apparent.

Liability consequences of the family ownership model

If the profit arising from a disparity between the salary and benefits (such as superannuation) provided to the barrister and the net fee income derived by the practice company were to be distributed to a holding company, or to family members or a trustee for them, there would be no direct liability for claims by dissatisfied clients of the practice. In that sense, the profits would be "sheltered" from liability.

If however the holding company is owned solely by the barrister – as has been suggested in the model advanced for consideration by the Bar Council – no eventual protection is afforded. For the reasons noted above, the barrister remains liable to the client despite the interposition of the company, and the barrister's assets, including the shares in the holding company, are available to creditors, whether by way of execution or through insolvency proceedings.

If the holding company is owned by or for family members, the shares in it are not assets available to the creditors of the barrister. Whether any distribution to the holding company is, in circumstances where the distribution is made to protect the distributed assets from creditors of the practice company, one recoverable by a liquidator of the practice company is a question which has yet to come under judicial examination.

Comparison with incorporation by solicitors

Much has been made in the discussion of the proposal for incorporation of the circumstance that solicitors, including some solicitors in sole practice, have been permitted to incorporate their practices and have done so without reported challenge from creditors or tax authorities. This discussion fails to take account of the differences between a solicitors' practice and a barrister's practice.

The attraction of a limited liability company as the vehicle for a solicitors' practice lies in the difference from partnership: a solicitor-director of a practice company is not personally liable for the negligent acts of another officer or employee of the company. Where the services of the practice are provided by more than one professional – including the case where the services are provided by only one solicitor in sole practice, assisted by an employed solicitor or by a clerk skilled in conveyancing or litigation support – there may be good reason for securing the conduct of the practice by an incorporated company, although the extent of the advantage actually obtained is diminished by the Professional Standards Act.

It is of the essence of a barrister's practice is a solo practice: it is that of the barrister concerned, and nobody else. There is no other person for whose acts the barrister is liable (the barrister assumes personal responsibility for the correctness of research or preparation done by a "devil" and neither at present nor under incorporation is the barrister liable for the acts of a leader or a junior). The liability advantage of incorporation for a solicitor does not obtain in the case of a barrister. There is no non-fiscal benefit to a barrister arising from incorporation.

Tax consequences of the bare model

The prima facie difference between the tax rate applicable to companies (30%) and the maximum rate applicable to individuals in sole practice (45% plus Medicare levies) is obvious, and much has been made of it in support of the case for incorporation. It is to be expected that much would also be made of it in the popular press if incorporation were assailed as promotion of tax avoidance on the part of the Bar.

The difference between tax rates applicable on receipt of the fees is however only a part of the tax effect of incorporating barristers' practices.

Statistical information on the incomes of barristers is not readily available, but the most recent ABS survey material (for 2007-8) reports a national average annual net income of $580,000 for silk and $195,000 for juniors. Anecdotal evidence suggests that post-GFC income levels have not exceeded that level. The average of course is derived from a wide range: a survey by the Victorian Bar in 2010 reported that 28% of female and 13% of male barristers earned less than $50,000 annually.

The tax payable by an individual taxpayer (including Medicare and NDIS levy) on an income of $135,000 is approximately $40,500 – the same as the tax payable by a company on the same amount of income. Below that level of income, the tax burden on the individual is lower than that on a company deriving the same net income. It has been suggested that the company would pay the barrister a salary of $80,000 (the point at which additional personal income is subject to a marginal tax rate of 37% rather than 30%) and make a profit of $55,000, resulting in a tax liability on the net fee and salary incomes of the barrister and the company of some $35,000 ($17,500 payable by the barrister and $16,500 payable by the company). The suggested tax saving is some $5,500.

Although there has been loose talk of the difference between the maximum personal tax rate of 45% and the company tax rate of 30%, and application of the difference of 15% to supposed incomes of barristers, even the most ambitious incorporation proposal does not suppose that the barrister would be paid no

remuneration by the company, nor that the barrister would be subject to the maximum personal rate on the whole of his or her professional income.

To the extent of the net income of the practice that exceeds $135,000 – and assuming the barrister's salary is kept at or below $135,000 – the reduction of tax (including levies) on receipt of fees is 17% of fees earned in excess of that sum. It is this difference which is propounded as the tax advantage of incorporation. To keep matters in a practical perspective, at $135,000 net practice income and a salary of $80,000, the difference in tax on net fee income is some $5,500; at the average juniors' income in 2008, of $195,000, it is some $15,700; at the average silk's practice income of $580,000 the difference is some $80,000.

In considering these figures, attractive as they at first are, it must be taken into account that there is some plausibility gap in the proposition that the value of the barrister's services to the company is $80,000 while the value of his or her services to the clients is the $195,000 or $580,000 recovered by the company. It is difficult to see any good reason why experienced counsel would accept $80,000 as a fair salary from the company and be complicit in charging clients $195,000 or $580,000 as the case may be (recognising that the latter figures are averages disguising a much wider range). To the extent that the salary paid to the barrister exceeds $80,000 the prima facie fiscal advantage is reduced: the marginal rate of tax on the increase in salary exceeds the corporate rate. It is, in short, essential to the case for a fiscal advantage from incorporation that the remuneration of the barrister be suppressed to the level of $80,000; but the suppression is difficult to support on any commercial ground.

Whatever may be the defensible level of diversion of net fee income from the barrister to the practice company, the notion that the diversion results in a fiscal advantage is, in my view, mistaken. Two underlying assumptions in the calculation of the advantage are, in my opinion, false, and vitiate the calculation.

The first assumption is that an arrangement whereby the barrister was remunerated by a salary of $80,000 but his services yielded to the company gross income substantially in excess of that amount and so a substantial profit (in the case of the suggested salary, and net fee income equal to the reported average net

fee income of junior counsel, a profit margin of more than 140% of the salary provided to the barrister) would survive challenge by the Commissioner of Taxation. In my view, it would be open to the Commissioner to make and defend a determination under Part IVA of the Income Tax Assessment Act 1936 that the profit be included in the assessable income of the barrister. Without descending too far into the technicalities of that Part, which has entertained the High Court on more than one occasion, the incorporation of the practice and its conduct by the company would comprise a s 177A scheme, the non-derivation by the barrister of income which absent incorporation would have accrued to him or her is a s 177C tax benefit, and no substantial objectively ascertained purpose for entering into the scheme can be advanced other than the obtaining of the tax benefit – since for the reasons above no commercial advantage, in terms of liability or otherwise, can be advanced. I do not think any judge of the Federal Court would hesitate in finding that the dominant purpose of incorporation was to obtain a tax saving.

It has been suggested that the Commissioner would not, or could not successfully, rely on Part IVA. I disagree. The Commissioner's attitude to diversion of income from sole practitioners to practice companies has not changed since he warned, in his ruling IT2503 (concerning medical practitioners), that any arrangement under which the company made a net profit would be attacked under Part IVA. For the reasons given above, I think he would in the bare model case succeed. Suggestions that the taxpayer is supported by decisions on the former general tax avoidance provision, s 260, such as *W P Keighery Pty Ltd v F C of T* (1957) 100 CLR 66, are insupportable: "Part IVA is to be construed and applied according to its terms, not under the influence of 'muffled echoes of old arguments' concerning other legislation," as the High Court said in *FCT v Spotless Services Ltd* (1996) 186 CLR 404, 414 in respect of another attempt to invoke the freedom of a taxpayer to "order his affairs so that the tax attaching ... is less than it otherwise would be" which was the foundation of the "choice" doctrine applied to s 260.

The second assumption is that it is only the tax on receipt of fees which need be taken into account. Only if the profit of the company were retained and

invested by the company would the tax on its profit be the only tax payable by those involved in the bare model of incorporated practice. If the profits are distributed to the barrister shareholder, tax is payable on the distribution. If the profits are made available to the shareholder by other means, such as direct or indirect loans (or any other payment reaching the barrister or any associate such as family members, directly or indirectly), tax is payable on a deemed dividend which cannot be franked and so is taxable at full rates and without credit for the tax paid by the company (Division 7A of Part III of the 1936 Act). A non-taxable withdrawal of funds drawn from the profits of the company can only be effected by way of a secured loan at relatively high statutory rate of interest, receipt of which is taxable to the company but is only deductible to the barrister if the funds withdrawn are used for income earning purposes. Imposition of tax on the interest more than offsets any tax benefit by way of reduction of tax on the net fee income.

While it cannot be said to be necessarily or a priori so, it is my observation in more than four decades of formal and collegiate advice to barristers on their affairs that only those in the latest stages of a long career have free investable funds not required to discharge liabilities (whether for loans or for unpaid tax) or to meet personal expenses. Most barristers have a firm desire to enjoy a lifestyle – expenses, holidays, motor vehicles and residences – commensurate with their fee earnings. Many have to resort to borrowings to finance their quarterly tax payments. The idea that a barrister generating net fees of $195,000 (or $580,000 in the case of silk) would be satisfied and able to meet personal commitments from a salary of $80,000, and to leave the rest of the net fees to be invested by the company, is not remotely plausible; in practice, the profits of the company would be drawn on by the barrister and in consequence would be taxable in his or her hands – with the result that the "saving" resulting from derivation by the company would be lost.

While the decision whether to sponsor an amendment to the rules to allow incorporation is a policy decision for the Council and not one for this advice, I would find it difficult to justify such a decision for the benefit of the very few senior members of the bar (or the few barristers of independent means) whose financial circumstances are such that they would have no need to draw on the

profits of the practice company. Moreover, in my observation, few if any of such barristers would regard it as appropriate to resort to incorporation of their practices or, were they to do so, to limit their salaries to $80,000.

Tax consequences of the family ownership model

Distribution of profits by way of franked dividend to a holding company would result in no tax liability to the holding company (the franking credits would offset the tax on the dividends), but would leave the profits "trapped" in the holding company and any attempt to liberate them to the barrister or his family for personal use would subject the profits to the same tax liabilities as are discussed above.

Distribution to family members rather than the barrister would prima facie secure the benefit of the lower marginal tax rates on the initial "slices" of income, although income distributed to minor children is taxed at the maximum personal rate (as a disincentive to income splitting) so that the opportunity to obtain that benefit is usually rather limited. But limited as the benefit may be, it is one to which the Commissioner is vehemently opposed, and it may confidently be expected that upon becoming aware of a distribution of the income of the practice company to family members the Commissioner would invoke Part IVA to tax the barrister on the income of the company.

Even in the case of profits retained and reinvested by the company, the Commissioner would, consistently with the stance he has taken in the past, rely on Part IVA to assess income equal to that of the company to the barrister, on the premise that but for the establishment of the "incorporated practice" the investment income would have been derived by the barrister, and its diversion to the company is principally actuated by the tax saving.

For the reasons given earlier, in my view the barrister would fail in a challenge to a Part IVA determination.

Self education expenses

During the course of discussion concerning incorporation of barristers' practices, some reliance has been placed on the announcement by the former Treasurer of proposed limits on the available deductions for self-education expenses. It has been suggested that the expenses to which the announcement was directed would be deductible as outgoings of a company but not as outgoings of a barrister.

Four things may briefly be said of this argument.

First, the primary target of the announcement was "large claims for expenses such as first class airfares, five star accommodation and expensive courses." The deductibility of such claims to barristers in sole practice is at best questionable; the costs of holidays disguised as, or incidentally including, seminars do not on investigation qualify for deductibility. The position is not improved by substitution of a company for a barrister as the party incurring the expense.

Second, the announcement was that of the former Treasurer (and appears on his website, not on the Treasury website). It was made during the dying days of the past Prime Ministership, as part of the then Treasurer's rhetoric directed at reclaiming the votes of disaffected core Labor voters. The present Prime Minister has disclaimed "class warfare" measures, and the Opposition Leader is no more enthusiastic about the proposal. Professional bodies are mounting a coherent campaign against the proposal. It appears relatively unlikely to be implemented.

Third, the proposal is no more than a press announcement. Even if the former Treasurer had retained office – not only up to but beyond the forthcoming election – the language of any amendment to the income tax legislation might be expected to vary significantly from that of the announcement, both as to the expenses allowable and as to the tax consequences for employers who outlaid amounts such as the announcement is concerned with.

Fourth, if the main objectively ascertainable advantage of incorporation was to secure a tax deduction for otherwise non-deductible expenses, the

Commissioner would be entitled to negate the deduction by the making of a Part IVA determination.

In short, I do not see the issue arising from the former Treasurer's announcement concerning self education expenses as one justifying support for incorporation of barristers' practices.

Conclusion

There are in my view no non-fiscal advantages arising from the bare model of incorporation and in practice few if any arising from the family ownership model.

In my view the theoretically available fiscal advantages of incorporation of barristers' practices are slight and in practice few if any practising members of the bar would be able to secure them, even if Part IVA were not invoked by the Commissioner of Taxation. So far as any tax saving could, or would, result from incorporation, the Commissioner would in my view be entitled to negate the tax saving by making appropriate determinations under Part IVA, and the barrister would have no significant prospect of having the determinations set aside.

Wentworth Chambers

22 July 2013

A H Slater