An instinct for growth™

In Brief

Commentary by Professionals for Professionals

Part 2

This four part series provides no-nonsense commentary upon topical issues for professional services firms and the professionals that practice within them.

The series will provide a perspective upon:

- Allocation of Profit
  – A pathway to Greater Certainty
- Structuring a practice
  – Navigating the Maze
- Structuring for equity participants
  – Preserving the Return
- Partner compliance obligations
  – Keeping partners focussed.

Our comments are drawn from the personal experiences of the members of our Professional Services Industry Focus Group either as advisors to the Professional Practices or equity participants in those practices. The comments reflect the reality of the issues facing practices and the equity participants – not mere theory.

Structuring a Professional Practice

Navigating the Maze

In Part 2 we build upon the comments in Part 1 which focussed on Tax Office Guidelines on Profit Allocation. These guidelines provide rules that are relevant to how we may approach the structuring of a practice. With that in mind, we offer the following for consideration.

No one structure will suit every professional practice; and as such, it would be unhelpful were we to provide a recommendation for any one practice structure. Rather, this commentary (based on practical industry experience) will identify relevant factors so support you in making an informed decision about structuring your practice, particularly whether an existing structure may need to be reconsidered.

In the course of the decision-making process regarding structure, a number of critical threshold issues are common:

- Ease of entry and exit
- Attraction and retention of talent
- Flexibility of profit distribution arrangements
- The correct balance between external and internal funding of working capital
- The concept of goodwill and its place in modern day professional practices
- Facilitating the appropriate management of tax outcomes for partners

Bearing these in mind, the Australian taxation system's bias towards the taxation of capital in comparison with income – is relevant. The notion of "no goodwill" practices whilst growing in attraction at a practical and commercial level comes at the cost of tax inefficiency in terms of the total return over the period of "partnership". This is not to suggest wholesale reversion to goodwill practices, but to highlight trade-offs between structure types; for example, tax efficiency on exit vs. the attraction and retention of talent.

In terms of a professional practice there is an array of structuring options including:

- Traditional stand alone partnership of individuals;
- Partnership of individuals with a service entity;
- Partnership of entities such as discretionary trusts;
- Incorporated practice entity
- A unit or hybrid trust as a practice entity.

Each of these operating structures may also have alongside them an internal finance structure designed to introduce equity and external debt sufficient to fund the working capital requirement of the operating entity.

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Which style of structure is correct for any particular practice will depend upon the particular preferences of the professionals that operate within them and the core objectives which underpin the practice. As growth advisors, we seek to ensure that information relevant to the process is made available to decision-makers; ensuring they have confidence in their approach for the future. With that in mind, the following (non-exhaustive) list of matters that require careful consideration include:

- The Tax Office in its recent guidelines has made it clear that they are prepared to accept a measured level of income splitting.
- The taxation of proceeds on disposal of an interest in a professional practice is subject to certain concessions; which in particular circumstances can result in no tax being levied on the proceeds. A decision not to recognise goodwill takes those concessions out of play.
- Discretionary trusts provide flexibility in terms of tax management and are also efficient wealth creation and estate planning vehicles. The flexibility offered by discretionary trusts as a vehicle to hold equity is likely to be a relevant factor in attracting and retaining talent.
- Companies carry a maximum 30% tax rate and more importantly, track tax paid by reference to franking credits in a franking account. Properly managed franking credits as more appropriately viewed as an asset rather than the mere recording of a tax liability.
- Superannuation funds, whilst seemingly permanently under the spotlight, typically present the best tax profile both during accumulation phase and on withdrawal.
- An internal finance structure may provide some opportunity to preserve capital injected into a professional practice. A matter likely to be relevant to attracting and retaining talent.
- A company or unit trust as an operating entity provides the opportunity to invite non-partners to subscribe for equity.
- At least a modest level of external debt would reduce the capital commitment of new partners helping to manage a barrier to entry.

Whilst there are a number of other matters which could be referenced, those listed above are representative of the range of factors that should guide professionals when considering practice structures.

Given the dynamic environment of the professional services industry, it is crucial to acknowledge that proper planning will involve bringing together the features of several entity types. Hence, a structure which combines multiple entities possessing different asset protection, estate planning and taxation characteristics; is more likely to meet the requirements of a practice and the practitioners that practice within them.