"MADA NEWS" JUNE 2006 EDITION

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INTRODUCTION

Welcome to another edition of MADA News for 2006. We hope that you will enjoy the contents of this edition.

We would also like to thank all the MADA clients who have come along to support us during our Division of GP Business Critical Information Sessions Roadshow Tour. We also welcome a number of new clients on board who have attended our popular information sessions. We have enjoyed presenting in metropolitan Melbourne, regional Victoria and interstate as well! Look out for more informative seminars in the second half of this year coming your way soon!

Ms Jo Dawson of Hillross (our recommended financial planner) and Mr Li Cunxin (our recommended stockbroker) have also contributed to this edition of our newsletter.

If you have any comments in relation to the contents of MADA News, please do not hesitate to contact either Caroline Poon at our Elwood office on (03) 9531 6666 or Michael Waycott at our Kew office on (03) 9819 7308 or email us at caroline@madabayside.com.au; or michael@mada.com.au.

If you feel that this newsletter may be of interest to your colleagues, please feel free to pass it on.

TOPICS COVERED

1. Service Trusts – the Final Ruling!
2. Budget Wrap: A Windfall!
3. Superannuation Co-Contribution Scheme
4. Small Business CGT Concessions
5. Self Funding Instalment Warrants
6. Trauma Insurance: There is more to it than life and death
7. 2006 Budget Review and Equity Markets

SERVICE TRUSTS – the Final Ruling

As many of you are fully aware the, Tax Office released its long awaited final ruling on service trusts recently. The details in relation to safe harbour benchmarks in the final ruling are a dramatic turn around from those released as part of the Tax Office Guidelines on 'safe harbour benchmark rates' issued last May. Groups such as the AMA, CPA Australia and the Institute of Chartered Accountants should be congratulated for their hard lobbying in response to the draft ruling. Briefly, the safe harbour benchmark rates contained in the Tax Office Guidelines booklet issued last year were-:

	Mark-up
Labour Hire- temporary staff	5%
Labour Hire- permanent staff	3.5%
Equipment Hire (on Opening Written Down Value)	7.5%

Briefly, the final ruling does not contain the same stringent safe harbour benchmark rates instead providing the following two options to calculate the service fee-:

Option 1 – Costs Plus Mark-up

Labour Hire Arrangements (Inclusive of Superannuation)	30%
Equipment Hire (On cost of Equipment)	10%

Option 2 – Flat % of Professional Fee Income

Rural Practice	45%
Metropolitan Practice	40%

For our clients in General Practice, we have found that generally the second option is the preferred option. Where General Practices engage all non principal Associate GPs, their service fee payment (generally 40% to 45% of gross patient fees) is collected by the practice service entity, along with the principal GPs' service fee income that is generally comparable to the Tax Office safe harbour benchmark rates (listed above). In addition the practice service trust collects the practice PIP income.

Documentation is critical in any service entity arrangement. Any client of MADA, whether a medical or dental practice or an Allied Health Professional will have in place a properly worded, up to date signed Service Agreement. The terms of the agreement must be adhered to in practice. It is no good documenting the method of calculating and collecting the service fee within the Service Agreement and blithely use another method in practice. Potentially, the whole arrangement could to be struck out be the Tax Office if scrutinised during an audit situation.

The Tax Office has stated within its final ruling that *"Service Fees charged above these levels may result in an audit of the service arrangement as would be the cases where there is no clear connection between the service arrangement and the earning of income by the business".* If rates higher than the safe harbour benchmark rates listed above are used to calculate the service fee and you are audited, you will be asked to explain why the fees and charges are deductible and how they are connected with earning your income.

The above comments by the Tax Office as part of the final ruling do not necessarily mean that a different method of calculating the service fee cannot be implemented, documented in the Service Agreement and put into practice. If you can justify the diversion from the safe harbour benchmark rates and believe you have a reasonably arguable position backed up by appropriate documentation, different rates may be implemented.

The draft and final ruling has resulted in many service entities being closed down, as there are simply no commercial reasons to justify the arrangement. Many doctors whose service trusts do not provide significant services will need to close down their trust as a service provider. Examples here are Anaesthetists and other specialists that pay a central management group or sole practitioners with one receptionist or non principal (associate or assistant) doctors collecting 100% of their fees and paying back the practice they work at. Of course your trust may be used for other purposes such as investment in shares or property, etc.

The Commissioner has provided an extension of time until 30 April 2007 for clients to get there service trusts in order to comply with the final ruling guidelines or use an alternate method that must be well documented. This however is not a licence for clients to continue operating the service entity under an arrangement other than the Commissioners final ruling or the alternate approach until this date. All clients should have their service entity in order during the 2006 financial year. This includes a new service agreement prepared by a highly respected Melbourne city law firm familiar with the ins

and outs of such arrangement tailor made for the relevant practice. The details of the service agreement must also be put into practice not some other method.

If there are any queries or uncertainties or conflicting advice regarding the Commissioner's final ruling on service trusts, please contact Michael Waycott on 03 9819 7308 (Kew) or Caroline Poon on 03 9531 6666 (Elwood).

Budget Wrap: A Windfall!

In summary, the key changes from the Budget that affect our clients are-:

- A reduction in the personal income tax rates and an increase of the income tax threshold from 1 July 2007 with 2006 as a comparison -:

2007	Tax Rate	2006	Tax Rate
0 – 6,000	0%	0 – 6,000	0%
6,001 – 25,000	15%	6,001 – 21,600	15%
25,001 – 75,000	30%	21,601 – 63,000	30%
75,001- 150,000	40%	63,001 – 95,000	42%
150,000 +	45%	95,001 +	47%

- A major simplification of the superannuation system from 1 July 2007, which will potentially impact most retirement planning strategies; this includes-:
    - removal of tax on lump sum and income stream payments for people aged 60 or over as at 1 July 2007
    - removal of the Reasonable Benefits Limit (RBLs)
    - simplification of the way super benefits are taxed for people under age 60
    - introduction of limits to the amount of un-deducted (after tax) contributions that you can contribute to your super fund
    - removal of aged based super deduction limits for self – employed individuals contributing to super (this means the current rules for self employed individuals claiming a tax deduction of the 1st $5,000 plus 75% of the excess up to the aged based limit being abolished as at 1 July 2007)
    - maximum super contribution per member of $50,000. Note: this is the total of all contributions from all employers and contributions as a self employed individual NOT per employer as it currently stands

  - super contributions can be contributed up to the age of 75 which, is a change from the maximum age of 70

  - un-deducted contribution of $150,000 per member per annum from Budget night of 9 May 2006. Previously, this was unlimited.

- CGT Relief: Controlling interest

  - The controlling interest provisions for small business CGT concessions have decreased the controlling interest in an entity from 50% to 20%.

  - The cut off point to access the small business CGT concessions has also been changed from $5,000,000 to $6,000,000.

In summary, the best news to come out of the Budget for our clients is the changes to superannuation. The changes effectively mean that a person reaching the age of 60 after 1 July 2007 can access their super monies tax free either as a lump sum or via an Allocated Pension. In addition the abolishment of RBLs means that there is no limit to the amount of funds that can be allocated to members' balances and there are no adverse tax consequences in relation to pensions or lump sums withdrawn from a super fund where the member has an excess RBL.

SUPERANNUATION CO-CONTRIBUTION SCHEME

How would you like the Government to contribute $1,500 into superannuation on your behalf?

If you are eligible and make personal superannuation contributions, the Government will match your contribution with a co-contribution up to certain limits.

In the best case scenario, if an individual's total income (assessable income and reportable fringe benefits) is $28,000 or less and a personal contribution of $1,000 is made into a superannuation fund on their behalf (being an un-deducted contribution), the Government will co-contribute $1,500 provided certain conditions are met.

The co-contribution decreases the higher the total income is e.g. on total income of $38,000 you get $1,000 from the Government for $1,000 contributed. The co-contribution cuts out altogether at $58,000.

Government co-contributions are treated as un-deducted contributions and are not subject to tax when received by the superannuation fund and are not taxed as an end benefit or counted for RBL purposes when paid from the fund. Earnings however, are taxed like any other earnings in the superannuation fund i.e. at 15%.

Such contributions may apply to persons under 18 and persons up to 70 years of age.

The co-contribution is only available if you receive 10% or more of your total income from eligible employment i.e. work or the performance of a function or duty which results in the person being treated as an employee for superannuation guarantee purposes.

Employees earning under $450 per month, employees under 18 employed on a part time basis and self employed persons are now eligible for the co-contribution, together with those employed and subject to the superannuation guarantee.

Superannuation contributions which do not attract the Government co-contribution are:

- Employer contributions
- Salary sacrifice contributions, being employer contributions
- Deductible personal contributions (whether a deduction is claimed or not)
- Contributions made for a spouse
- Contributions for children

A tax return must be lodged and the Tax Office will use the information on your income tax return and contribution information from your superannuation fund to work out whether you are eligible. If you are, the ATO will automatically calculate the co-contribution amount and deposit it into your superannuation account.

The co-contribution has limited application to our client base, although it may be worth considering for spouses or children (including those under 18).

My daughter Jasmin (10) has done some part time work for MADA (she is a whiz at preparing power point presentations for the numerous seminars we have conducted to various Divisions of General Practice this year). Accordingly she will be paid for her time, I will contribute $1,000 for her into my self managed superannuation fund (where she is also a member) and the Government will give her $1,500. May as well start saving for retirement at this young, tender age!

Please contact Caroline Poon, Chartered Accountant on 03/9531 6666 at our Elwood office if you are interested in this strategy. Caroline is an Authorised Representative of Hillross Financial Services, AFSL Licence No. 232705.

Please Note: Many of the comments in this article are general in nature and anyone intending to apply the information to practical circumstances should seek professional advice to independently verify their interpretation and the information's applicability to their particular circumstances.

SMALL BUSINESS CGT CONCESSIONS

As we seem to be dealing with the purchase and sale of practices on more or less a weekly basis at the moment (whether a sale to a corporate or the introduction of a new owner doctor), we thought it opportune to run briefly through the small business CGT concessions and how to use them effectively. This area is extremely complicated and each set of circumstances is unique so we cannot stress enough that specific tax advice is sought in each instance.

It should be noted that often assets acquired before 20 September 1985 are pre-CGT assets and the realization of such assets is more often than not tax free and accordingly these concessions do not even have to be considered.

Most medical practices we see qualify for these concessions as they satisfy the basic conditions. These include a $5 million maximum net asset value test i.e. the maximum net asset value of assets that the taxpayer and connected entities own cannot exceed $5 million and the asset must be an active asset. (It should be noted that in the 2006 Federal Budget, this cut off point has been lifted to $6 million from 1 July 2007.)

It should be noted that active assets include goodwill (whether purchased or internally generated) and your practice premises.

There are four concessions, which are:

1. The 15 year exemption
2. The 50% reduction
3. The retirement exemption
4. The rollover

<u>15 year exemption</u>

This is the best concession to access but of course there are a number of conditions:

1. The entity continuously owned the asset for 15 years
2. If an individual, the individual retires or is permanently incapacitated
3. If the entity is a company or trust, it must have a controlling individual throughout the period the asset was owned and that individual must retire or be permanently incapacitated.

For a company, a controlling individual is one who exercises at least 50% of the voting power of the company and receives at least 50% of any dividends or capital distributions from the company.

For a trust, a controlling individual is one who is beneficially entitled to at least 50% of the total income distributions and at least 50% of the capital distributions made by the trust throughout the entire period the active asset was owned.

This 50% controlling interest will drop to 20% being a significant interest from 1 July 2007 (as proposed in the 2006 Federal Budget).

In addition to the above, the controlling individual is either 55 years old or more and retires or is permanently incapacitated and the company or trust makes a payment within 2 years of the sale.

Small business 50% active asset reduction

If one cannot pass the 15 year exemption rules, once the general 50% capital gains tax concession is applied (which can automatically be accessed by all types of entities bar a company provided the asset has been held for longer than 12 months), this exemption can then be accessed.

This is great news for individuals or discretionary trusts as automatically 75% of the gain is exempt.

It is more complicated if your practice is operated through a company, hybrid or unit trust structure as a further capital gain is crystallised if the funds relating to the active asset exemption are withdrawn from the company or trust. Further, in the case of a company, the company may have to be liquidated in order to access this exemption in the most tax effective manner.

But if you are a company or unit trust, you may choose not to take advantage of this concession but simply apply the retirement exemption instead.

Small business retirement exemption

There is a lifetime 'retirement exemption limit' of $500,000, which applies to the amount of the capital gains, which may be exempted under this concession.

If individuals or discretionary (family) trusts do not comply with the 15 year exemption then this allows you to still crystallize a capital gain tax free.

An example may help:

Under 55

Capital gain	$200,000
General exemption (held longer than 12 months)	($100,000)
Active asset exemption	($50,000)
Retirement exemption (paid into super fund)	($50,000) *

NO TAX PAYABLE

*Rolled over into a super fund and preserved. Counted towards the Reasonable Benefits Limit (RBL) but is a CGT exempt amount, so amount is exempt from tax.

Over 55 but not retired

As above but no requirement to roll 25% into a superannuation fund and in many instances can access immediately depending on the right set of circumstances.

The rollover

The small business asset rollover allows an entity to defer the making of a capital gain if it acquires replacement assets within a certain time frame, generally two years after the capital proceeds are received. This concession is generally not used in relation to the sale of a practice to corporates as the owner is then engaged by the corporate for a number of years.

Summary

The small business CGT concessions coupled with the retirement exemptions are complicated and unique to each set of circumstances.

It is possible to use these concessions to access capital gains tax-free in a variety of instances. In relation to companies and hybrid or unit trusts, gains can be accessed with the concessions applied to minimize the tax liability.

Further, on a restructure into a practice hybrid trust when the business income test is met i.e. the ratio of owner doctors is less than non owner doctors, the tax paid on the crystallization of the capital gain from transferring the business from the old structure to the new structure may be minimized.

The contents of these articles are general in nature and are not advice that applies to any particular client situation. Whilst every care has been taken in their preparation, specific advice should be obtained before proceeding with any suggestion or recommendation made.

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Self Funding Instalment Warrants

In this edition of MADA News, we look at Self Funding Instalment Warrants, another growth investment.

But first – what is an instalment warrant? An instalment warrant is an option to buy shares in a company listed on a stock exchange. The instalment warrant is not issued by the company itself (such as BHP) but by a financial institution (such as Macquarie Bank). If you drill down to the underlying components of a warrant you are effectively buying a share, a loan and a put option (which is designed to protect your capital).

The main reasons why you would invest in warrants are:

- Achieve a leveraged exposure which for a self managed superannuation fund means you are effectively borrowing within the fund
- Diversifying your exposure to the sharemarket as you can buy warrants in more companies with the same money than if you had purchased shares directly
- Generate an income stream through dividends and franking credits
- Protect the value of your share portfolio.

However there are also risks involved with instalment warrants which include:

- The underlying asset fails to perform as you expected.
- When investing in instalments, the maximum amount at risk is your initial investment (plus transaction costs). You are not obligated to repay the loan unlike other forms of borrowing, such as margin lending.
- Instalments offer a leveraged exposure to sharemarket, therefore profits and losses are magnified.

A type of instalment warrant commonly used by self managed superannuation funds (SMSFs) is the Self-Funding Instalment (SFI). For these warrants, the term is longer than other types of warrants, sometimes between 5 and 10 years, and holders receive dividends from the underlying shares which are used to reduce the loan.

As an SFI holder, your assessable income will include an amount equal to the cash dividends paid on the underlying securities, increased by the amount of franking credits attached to those dividends, even though the holder does not physically receive the dividends. If the franking credits exceed the amount of tax payable, holders who are complying SMSFs may be entitled to receive a tax refund.

The term “Self Funding” relates to the dividends being used to service the loan. As the loan accumulates interest, the dividends are paid into the loan to cover the interest liability, and any surplus reduces the loan balance. At the maturity of the warrant you have three main options being:

- sell all shares, repay the outstanding debt, take your profits
- roll the options for a further period (if available)
- a combination of the above options.

Let’s take a look at how instalments work in practice.

Case Study: Background

- Greg and Anna aged 45, plan to retire in around 20 years have their own SMSF
- They make contributions of around $50 000 into their fund each year
- They are comfortable with gearing conservatively into blue chip shares.
- They believe that XYZZ shares represent a solid long term investment with an attractive fully franked dividend yield.

- They invest in the XYZSMU (a self funding instalment warrant) in order to maximise the franking credits in their super fund and to enhance their exposure to any capital gain over the long term.

Inputs

- A $50,000 investment into XYZSMU is forecast to generate around $1,463 in excess franking credits on an annual basis
- This means that Greg and Anna can make a contribution of $9,700 into their super fund that they will not have to pay contributions tax of 15% on.
- If XYZ continues to pay high, fully franked dividends, an investment in the XYZSMU will continue to generate excess franking credits year on year until maturity in June 2012.

A comparison of investing the $50,000 into XYZ shares or $50,000 into XYZ self funding instalment warrants is detailed below:

	XYZ	**XYZSMU**	**Calculations**
Investment	$50 000	$50 000	
Price*	$32.00	$16.80	*Primary Market Price*
Units purchased	1,562	2,976	*Investment / Price*
Dollar Exposure to total shares	$50 000	$95,232	*No of units x Share Price*
Forecast Dividend Income**	$2,592.92	$4940.16	*Units x Forecast Dividends*
Forecast Franking Credits – 90% F	$1,000.13	$1,905.49	*Dividends x 3/7*
Gross Taxable Income	$3,593.05	$6,845.65	*Income + Franking Credits*
Potential Interest Deductions	N/A	$3,898.56	*Assume 12 months interest*
Taxable Income	$3,593.05	$2,947.09	*Income – Deductions*
Tax Payable (15%)	$538.96	$442.06	*Taxable Income x 15%*
Excess Franking & Tax Credits	$461.17	$1,463.43	*Franking Credits – Tax Payable*
Contributions / Earning Shelter	**$3,074.4**	**$9,756.18**	*Excess / 15%*

We are happy to discuss specific investments with MADA clients on an individual basis.

Trauma Insurance: There is more to it than life and death

Risk management, and in particular personal insurances, is a vital ingredient of any comprehensive financial plan. Personal insurances help to ensure those who depend on you will not be financially disadvantaged in the event of your death, a medical crisis or your disablement. Most people purchase their house, car, and health insurance without giving it much thought, but it is a well known fact most people are either underinsured or uninsured for events such as death or disablement. While many people have life insurance, should they die, or total and permanent disability or income protection insurance should they be unable to work for a period of time, an often overlooked but valuable insurance is trauma insurance.

With the remarkable advances in modern medicines, more and more people are surviving major traumas such as heart attack, cancer and coronary artery surgery. However, the recovery period and the cost of care associated with such illnesses normally places extreme financial strain on the person suffering the illness.

For this reason a form of insurance known as “Trauma or Critical Illness Insurance”, “Crisis Care” or “Dread Disease Cover” has been developed. This insurance pays a lump sum to the insured person upon diagnosis of one of a number of specified conditions. Such a payment will assist you and your dependants to be financially secure. While the payment may be used in any way you like, you may wish to pay for medical expenses not covered by Medicare or your health fund, to clear any liabilities you may have, or to take care of bills and expenses.

This type of insurance pays a lump sum in the event you experience one of the specified traumas in the contract. There are usually between 20 and 30 ‘trauma events’, but the vast majority pay out on the main traumas – those being cancer, heart attack, coronary bypass surgery and stroke.

Trauma insurance can include cover for:

Alzheimer’s disease	Blindness
Cancer	Chronic lung disease
Coma	Deafness
Heart attack	Kidney failure
Loss of limbs	Major head trauma
Organ transplant	Multiple sclerosis
Paralegia	Parkinson’s disease
Severe burns	Stroke

Certain events will be excluded including death within 30 days of the event, deliberate self inflicted harm; and injuries arising from an act of war. Cover for these events are usually subject to a 90 day waiting period. That is, the policy must have been in place for 90 days before a claim can be made, and preexisting illnesses will not be covered. Trauma premiums paid are not normally deductible. However, the proceeds of the policy which are paid to the insured will not be subject to tax.

So is this type of insurance for you, and how much is appropriate? This is something you should discuss with your financial planner and if you have a suite of life, total and permanent disability and income protection insurance to meet your needs there may be limited need. However, we see a significant need for this type of insurance should you have a non working spouse.

As an example, Joe is a medical practitioner and has the following insurances:
$1,500,000 of life insurance to pay off the mortgage, cover the school fees and meet his family’s ongoing cost of living should he die
$13,000 per month of income protection insurance to meet his family’s ongoing cost of living to age 65 and also fund his and his partner’s retirement

$500,000 of total and permanent disability insurance should he be totally disabled and unable to ever return to work to pay off the mortgage and cover school fees.

Joe's partner Matilda is a stay at home mum and has the following insurances:
$500,000 of life insurance to meet the cost of ongoing care of their children should she die.

The big gap in this plan is the scenario where Matilda is diagnosed with a critical illness such as cancer. She is not terminally ill but has a number of years of hard work in front of her to beat this illness. Joe would like to take the time off work to help her through this journey but he can't as the mortgage, school fees and other bills still need to be paid. Joe can't claim against his income protection insurance as he isn't the one sick and Matilda could never have acquired income protection insurance as she wasn't working. What is needed in this situation is trauma insurance on Matilda's life. If Matilda had a trauma insurance policy on her life she would have received a lump sum payment and this would have allowed Joe to take time off work to support her through her illness and their standard of living would have been maintained.

So, how much is enough? As a starting point we look at the equivalent of 2 times the annual after tax income of the working spouse, but this obviously depends on what other assets you have that can generate income for you.

If you think this is something you need we are happy to explore this with you further.

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The information contained in these articles are of a general nature only. No account has been taken of the investment objectives, financial situation or particular needs of any person. Before making any investment decision, individuals will need to consider, with or without the assistance of a financial planner their own particular needs, objectives and circumstances to avoid the risk of making inappropriate investment decisions and a Statement of Advice should be prepared.

2006/07 Budget Review and Equity Markets

The 2006/07 Budget is clearly stimulatory for the economy. On a simple comparison between years, the fiscal surplus for 2006/07 of 1.0% follows a larger 1.7% surplus in 2005/06, a net stimulus of 0.7% for GDP. Furthermore, there is spending in the last month of 2005/06 worth 0.2% of GDP, bringing the fiscal stimulus in this Budget to no less than 0.9%.

<u>What does it mean for equity markets?</u>

The key initiatives announced in the Budget that have notable implications for the Australian listed market are as follows:

- Reductions in the tax rates on personal income as well as increases to the thresholds for each tax rate;
- Accelerating the depreciation allowance for eligible business investment;
- Abolition of the Reasonable Benefit Limit (RBL) and age based contribution limits, and the elimination of tax of benefits paid to retirees from taxed superannuation funds.

The key initiatives in the 2006–07 Budget are expected to provide a balance between increased retail spending, a boost to investment, and increasing the attractiveness of retirement savings. The sectors of the Australian equity market we believe will benefit from these key initiatives are:

- Discretionary Retail - Changes to personal income tax will provide some welcome relief to retail spending and as such there will be boost to the retail sector, however it is not likely to see the same strong impetus to spending seen after the payment of the "baby bonus" in July 2004.

- Engineering/Industrial Services - The increased funding for infrastructure ($2.8bn over four years for road, rail and water) is a clear positive for engineering services and nonresidential building companies. This expenditure is likely to add strength to the argument that the non residential construction and engineering construction cycle is likely to last longer than consensus estimates.

- Mining/Mining Services/Infrastructure/Telecommunications - The proposed changes to depreciation rates for firms will favour those companies with new and large CAPEX programs in the coming few years, or investment which has a long gestation period.

- Financial Services - What the changes mean is an increased incentive to build up the retirement nest egg in super and an increased need for associated investment advice. This is generally positive for financial services companies.
- Childcare - The child care initiatives announced in the 2006 Federal Budget are largely in keeping with the trends in recent budgets which have highlighted the need for higher workforce participation to maintain Australia's higher living standards, as the proportion of the working population decreases over time. As part of this push to increase the participation of mothers in the workforce, in this budget the Treasurer has announced the following initiatives aimed at families and childcare:

  - Large family bonus of $10 per fortnight is to be extended to families after the 3rd child (previously only available for families with 4 or more children).
  - From 1 July 2006, families will now be able to earn up to $40,000 and receive the maximum Family Tax Benefit Part A amount. This is an increase on the previous limit of $37,500.

- Extra child care places, up to a total of 25,000 by 2009, is to be achieved by removing the limit on the number of subsidised outside school hours care and family day care places. There will be no limit on funded places which means that any new service set up by any eligible group will be funded.

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