“MADA NEWS” AUGUST 2006 EDITION

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INTRODUCTION

Welcome to another edition of MADA News, the first for the new financial year! We hope that you will enjoy the contents of this edition.

We are enjoying continued success with our Division of GP seminars and thank all the Divisions for their support and encouragement. Our second series of seminars will be spread over the next twelve months and we trust we will continue generating positive feedback and goodwill.

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. Renovating rentals: repairs and improvements
2. The new 30% child care tax offset
3. The new 25% entrepreneurs’ tax offset
4. Gearing up to contribute to super in light of the 2007 Budget proposals
5. Business insurance – is it right for you?
6. 2005/06 Year in review and outlook 2006/07
7. Australasian Media Sector

Renovating rentals: repairs and improvements

The ATO has released a document aimed at rental property owners to assist them with claiming deductions for repairs.

The "Rental Properties 2006" guide is available from the ATO website at www.ato.gov.au.

What is a deductible repair?

A repair is usually 'occasional' and 'partial'. Repairs typically replace a part of something or restore something to its original working order.

For example, a repair includes fixing a window that has been broken, or restoring an air conditioning unit to proper functioning where parts have worn out or deteriorated and have to be replaced.

Isn't updating a worn-out kitchen or replacing the threadbare carpet a deductible 'repair' to the property?

If you need to replace something entirely, like a complete set of kitchen cupboards, this suggests that it is not a repair.

Some activities which are often mistaken for deductible repairs include:

- insulating a property;
- repainting a house that had defective paint work at the time it was acquired;
- replacement of an entire structure or unit of property, like a complete fence or shed, a stove, or worn out kitchen cupboards; and
- extending the size of a house.

The new 30% child care tax offset

The introduction of the child care tax offset is to enable eligible parents to claim a 30% tax offset for their out of pocket child care fees i.e. fees incurred for approved child care less child care benefit entitlement from Centrelink, up to a maximum of $4,000 per child. The offset is not means tested.

The offset can be claimed for the first time in the 30 June 2006 income year in respect of approved child care fees incurred in the previous income year i.e. 30 June 2005).

It is a non refundable offset. This means that where a taxpayer does not have sufficient tax payable to absorb the entire tax offset, the unused portion cannot be claimed. However the unused portion can be transferred to the taxpayer's spouse.

"Approved child care" only qualifies and includes most long day care, family day care, before and after school care, vacation care, some occasional care and some in home care. Some child care is registered care and you cannot claim the rebate for this type of care. Registered care is provided by nannies, grandparents, friends and relatives. Some private pre schools, kindergartens, occasional care centres and outside school hours care centres that are registered with the Family Assistance Office also provide registered care and accordingly do not qualify.

To claim the rebate in your 2006 tax return you will need to keep and provide the following records:

- Your end of financial year Child Care Benefit letter sent to you by the Family Assistance Office for the period 1 July 2004 to 30 June 2005.
- A summary statement of expenses incurred and dates of the child's enrolment period supplied by the child care provider; or
- Receipts, cheque butts, credit card statements or bank statements showing payments to child care provider.

The new 25% entrepreneurs' tax offset

From 1 July 2005 i.e. for the 30 June 2006 income year, eligible taxpayers will be able to claim a maximum (non-refundable) tax offset equal to 25% of so much of their basic income tax liability that is attributable to net business income derived from a Simplified Tax System ("STS") business.

An individual claims this offset under the following conditions:

1. The individual is either an STS sole trader, a partner in an STS partnership or a trustee or beneficiary of an STS trust.
2. The relevant STS entity has an STS group turnover of less than $75,000 for the income year and an amount of net STS income for the year.
3. The individual's assessable income for the year includes an amount of net STS income.

The offset applies to net STS income i.e. the entity's STS annual turnover for the year less entity's deductions attributable to that turnover. Where an STS entity has a net STS loss for an income year, there will be no entitlement to claim the 25% entrepreneurs' tax offset.

Gearing up to contribute to super in light of the 2007 Budget proposals

As a result of the Budget announcements on 9 May 2006; from 1 July 2007, we expect superannuation to be able to be withdrawn tax free once you reach age 60.

This begs two questions.

Firstly, should we change our current loans to interest only, cease repaying principal and reallocate those principal prepayments to superannuation? This would enable a tax deduction of up to 46.5% to be claimed, and then funds withdrawn from superannuation at age 60, tax free, to pay off the loans. Each situation and set of circumstances needs to be looked at whether you are close to 60 or not.

The strategy works for some, but not everyone. It is extremely sensitive to changes in interest rates and super fund earnings. Tax rates along with investment risk also affect the outcome. Your willingness to take on these risks must be considered.

Scenario 1 shows you are $76,387 better off if you are over 50, have only 10 years left to run on your loan of $400,000 and you withdraw your super when you turn 60. This assumes a tax rate of 41.5%, interest rate 7.57% and growth rate in the super fund of 8%.

If you are on a lower tax rate and have longer to go till retirement, this strategy may not work for you. In Scenario 2, changing the loan term to 20 years and the age to 40 resulted in you being $24,408 worse off!

The second question to be considered is; should you borrow further to contribute to superannuation. Scenario 3 shows how this would work for someone aged 50 at 1 July 2007, with a marginal tax rate of 46.5%, borrowing at an interest rate of 7% to contribute $100,000 to super with growth at 7%. This is over a 10 year time period and contributions drop to $50,000 in 2012 with interest being capitalised on the loan. Note that interest on amounts borrowed to pay self employed persons' contributions is not tax deductible but interest borrowed to pay employer contributions (via a trust or company) is tax deductible.

As you can see by year 10, superannuation has grown to $930,668 with an outstanding loan of $304,346 to be repaid, a net of $626,322!!! Not bad!! This is on the assumption that the loan for $100,000 reduces to $53,500 due to the tax savings of $46,500 being deposited straight on to the loan.

Scenarios 1 and 2

	Scenario 1	**Scenario 2**
Mortgage	400,000	400,000
Home loan term	10 years	20 years
Age	55	40
Tax rate	41.50%	41.50%
Interest rate	7.57%	7.57%
Fortnightly repayment	2,196	1,489
Fortnightly repayment (int only)	1,164	1,165
Additional pretax dollars per fortnight	1,763	555
Salary sacrifice the full amount	45,839	14,430
Assumed growth rate	8%	8.00%
Increase in super after 10 years	609,602	605,655
Extra loan interest	133,215	230,063
Repay loan	400,000	400,000
Better off by	**76,387**	**-24,408**

Scenario 3

		1	2	3	4	5
		2007	2008	2009	2010	2011
Super						
Start		100000.00	90057.50	185473.42	286566.59	393674.80
Additional		0.00	100000.00	100000.00	100000.00	100000.00
Cont Tax		15000.00	15000.00	15000.00	15000.00	15000.00
Growth		5950.00	12254.03	18933.14	26009.66	33507.24
Tax		892.50	1838.10	2839.97	3901.45	5026.09
End	100000.00	90057.50	185473.42	286566.59	393674.80	507155.95
Loan						
Start		53500.00	57245.00	118497.15	184036.95	254164.54
Additional		0.00	53500.00	53500.00	53500.00	53500.00
Interest		3745.00	7752.15	12039.80	16627.59	21536.52
Repayment		0.00	0.00	0.00	0.00	0.00
End	53500.00	57245.00	118497.15	184036.95	254164.54	329201.05
Difference		32812.50	66976.27	102529.64	139510.26	177954.90

		6	7	8	9	10
		2012	2013	2014	2015	2016
Super						
Start		507155.95	582360.48	662039.68	746459.79	835902.90
Additional		50000.00	50000.00	50000.00	50000.00	50000.00
Cont Tax		7500.00	7500.00	7500.00	7500.00	7500.00
Growth		38475.92	43740.23	49317.78	55227.19	61488.20
Tax		5771.39	6561.04	7397.67	8284.08	9223.23
End	100000.00	582360.48	662039.68	746459.79	835902.90	930667.87
Loan						
Start		329201.05	380867.63	436150.86	495303.92	558597.70
Additional		26750.00	26750.00	26750.00	26750.00	26750.00
Interest		24916.57	28533.23	32403.06	36543.77	40974.34
Repayment		0.00	0.00	0.00	0.00	0.00
End	53500.00	380867.63	436150.86	495303.92	558597.70	626322.04
Difference		201492.85	225888.82	251155.87	277305.20	304345.84

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

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Business insurance – is it right for you?

The impact of your business partner's death or inability to work will affect your hip pocket too.

Business insurance and associated buy/sell agreements are common place in many small businesses. They allow for the smooth exit of a business partner in the event of death or inability to work through sickness or injury. The lack of this succession planning strategy by many medical practices leave us concerned as to the risk to which these practices are exposed.

Jane Jones and Pete Piper are both GP's and own the Local Family Medical Clinic. There are 3 other fulltime GP's in the practice. The structure of the practice is that each of the 5 GP's receives 100% of their billings and pay 40% of those billings as a service fee to the Local Family Unit Trust (LFUT) which is owned 50% each by Jane and Pete's family trusts.

Scenario 1

In the event of Jane's death, her family trust still owns 50% of the units of Local Family Unit Trust and will continue to receive 50% of the profits despite Jane having passed away. This may or may not be a suitable ongoing situation for Pete but how does he pay Jane's family trust out so that he effectively owns and controls 100% of the practice.

Pete and Jane

	In a normal year ($)		**In the event of Jane's death ($)**	
	Pete	**Jane**	**Pete**	**Jane**
Patient billings	150,000	150,000	150,000	0
Less Service fee paid to LFUT	(60,000)	(60,000)	(60,000)	0
Net income	90,000	90,000	90,000	0

Local Family Unit Trust

	In a normal year ($)	**In the event of Jane's death ($)**
40% service fee from all GP's	300,00	240,000
Operating costs	220,000	220,000
Profits for distribution	80,000	20,000
Distribution to each family trust	40,000	10,000

Jane will never be able to work in the practice again but her family trust will continue to receive its 50% share of the profits. How can Pete afford to buy Jane's share of the units?

The solution – a buy/sell agreement funded by appropriate business insurance to allow Pete to purchase the units in the Local Family Unit Trust from Jane's family trust. This will allow Jane's estate to realize the value of the business and allow Pete 100% control.

Scenario 2

Pete has had a bad skiing accident and is unable to work for 12 months. Pete has income protection insurance so his family's standard of living is maintained. The practice has been unable to secure a locum to service Pete's patients. Each of the 5 GPs pays $60,000 per annum to the Local Family Unit Trust (being 40% of their billings). With Pete not working the income of the trust has dropped from $300,000 to $240,000 for the year and the flow on effect means that the profit has dropped from $80,000 to $20,000. The impact on Pete and Jane is as follows.

Pete and Jane's income

	In a normal year ($)		With Pete not working ($)	
In a normal year	**Pete**	**Jane**	**Pete**	**Jane**
Patient billings	150,000	150,000	0	150,000
Income protection insurance claim	0	0	67,500	0
Less Service fee paid to LFUT	(60,000)	(60,000)	0	(60,000)
Income	90,000	90,000	67,500	90,000

Local Family Unit Trust

	In a normal year ($)	With Pete not working ($)
40% service fee from all GP's	300,00	240,000
Operating costs	220,000	220,000
Profits for distribution	80,000	20,000
Distribution to each family trust	40,000	10,000

Despite no change in Jane's ability to work she will earn $30,000 less from distributions from the trust (as will Pete). How do they overcome this temporary problem.

The solution – business expense insurance. Many people have income protection insurance to protect their income but they should also consider business expense insurance to pay the expenses of their business should they be unable to work. In this situation, both Jane and Pete should have business expense insurance which could pay the expenses of the business while Pete was unable to work.

If you think insurance to fund a buy/sell agreement or business expense insurance to help keep the business going is needed in your practice, remember, every business is different and one size does not fit all. There are complexities around the ownership of the insurance policies, the type of risks that should be covered and the trigger events that cause the buy/sell agreement to come into play. All issues need to be agreed to by all parties. Also remember, your solicitor and your financial planner must work together closely to ensure that the agreement and any insurance policy are heading in the same direction. If you are seeking advice in this area make sure your financial planner is experienced in this area of insurance as it is complex.

2005/06 – year in review and outlook for 2006/07

The past financial year has seen the Australian economy continue to expand at a moderate rate. The current rate of economic growth of 3.1% has been sufficient to allow unemployment to fall to a 30-year low, but has led to some additional pressure being placed on inflation and interest rates.

While sections of the economy, such as the mining industry, continue to enjoy boom-like conditions other sectors such as retail spending and housing construction have become very subdued. The pattern of activity has created a somewhat “2-tiered” economy, where conditions vary considerably between industries and geographical regions.

Australian equities

Although finishing the financial year in a flurry of volatility, the Australian sharemarket again provided investors with a very healthy return. Over the course of the financial year, average returns were 23.9%. This is the third consecutive year in which returns have exceeded 20%. As has been the case over the past 3 years, the share price growth was underpinned by solid company profits. As such, the increase in prices is not considered excessive. The growth in share prices was not uniform. The mining and energy sectors were again standout performers over 2005. Record high crude oil prices and continuing increased demand from China saw the prices of most commodities on world markets soar, before a minor correction in the final month of the financial year. Reflecting the change in the pattern of economic growth away from household consumption, the consumer discretionary sector didn’t match the rest of the market with an increase of just 8%. The weakest performance though came from the telecommunications sector with a worsening in the earnings outlook for Telstra largely behind the poor showing of this industry.

Listed property

The strong performance of domestic listed property continued in 2005/06, with the sector generating an 18.1% return. Attractive yields together with the sector’s stability relative to an increasingly volatile equity market saw it generate considerable buying support. Industrial property was the star performer of this asset class, with industrial trusts posting a 25% gain in price. Retail (shopping centre) trusts were far more subdued, finishing the year just 1.2% higher as retail sales showed little growth. The office sector showed a slightly better performance with a 4% gain and this sector remains well positioned to benefit from the continued strong employment growth evident towards the end of the financial year.

International equities

Movements on overseas sharemarkets were also very healthy but slightly below those recorded in Australia. International equity investments that were hedged (ie protected from any variation in value due to changes in the value of the $A) provided investors with a positive return of 17.4%.

Investors with unhedged investments experienced a slightly higher return of 19.9%, as a small decline in the Australian currency added value to overseas holdings. Emerging or developing countries provided particularly good returns over the year. The MSCI Emerging Market Index rising by 39%. Japan, where returns to investors were 38%, was also a stand out performer with its economy now generating sustained economic growth. Returns in North

America were less spectacular, but still positive, as economic growth continued there at a solid pace despite higher interest rates.

Australian fixed interest & cash

Concerns over inflationary pressure stemming from the strong global economy and booming commodity prices prompted the Reserve Bank to tighten monetary policy once last financial year (in May). This tightening saw the overnight cash rate rise from 5.5% to 5.75%. These concerns over future inflation, together with the fact that the actual inflation rate reached the upper limit of the Reserve Bank's 2% to 3% target range in the March quarter, saw longer-term bond yields adjust upwards. The 10-year Government bond yield finished the year at 5.8%, from 5.1% at the start. The higher bond yields saw the price of fixed interest investments fall, restricting returns to investors to just 3.4% over the year.

International fixed interest

Bond yields also moved higher across the globe in the second half of the financial year, as markets reassessed the outlook for inflation. Progressive tightening in monetary policy by the United States Federal Reserve (which saw U.S. cash rates rise from 3.25% to 5.25%) also contributed to the more pessimistic outlook for longer term interest rates. With bond yields on the rise, the value of fixed interest investments declined. This saw the international fixed interest asset class deliver a barely positive return of 0.9% over the financial year.

Outlook for 2006/07

Investors should not expect the same magnitude of equity market returns this financial year as has been enjoyed for the past 3 years. In Australia, the more subdued economy will limit the impetus from profit growth. Nonetheless, current dividend yields and reasonable share price valuations provide the prospect of continuing solid returns. Various sectors, particularly those exposed to commodity prices, may still have the ability to surprise on the upside.

With international sharemarkets yet to return to previous peak valuations, expectations of continued solid economic growth does offer the possibility of a further rally in share prices on overseas markets. However as is the case within Australia, uncertainties over inflation and commodity prices may add to volatility over the next 12 months.

The opportunities for out-performance from either domestic or international fixed interest investments would continue to appear to be more limited. With longer-term yields barely above overnight cash interest rates, it would be unlikely that yields will fall over the next 12 months. Additionally, there does remain a threat that interest rates would respond in the upward direction should burgeoning oil and other commodity prices translate into consumer inflation by more than is currently anticipated. Any upward adjustment in inflation is likely to lead to an underperformance from both fixed interest and listed property investments.

Domestically, pressure on inflation could also arise if the persistently high trade deficit in Australia leads to a downward adjustment in the value of the $A (making imports more expensive). This scenario would become increasingly likely should commodity prices experience a major downward correction.

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

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Australasian Media Sector

The Minister for Communications, Information Technology and the Arts [Senator Helen Coonan] has announced a comprehensive reform package for the Australian media industry.

<u>Key takeaways</u>

In our view, the two key pieces of news from the announcement are:

- *Cross and foreign ownership restriction reforms will proceed* – Senator Coonan confirmed that nothing in the reforms that were proposed in March had slipped, that media reforms were now 'Government policy' and that the enabling legislation would be passed in 2007. Despite the perceived failure to gain consensus across the media operators, and the resulting pessimism that reforms would actually proceed, the Minister has confirmed the Government's intention to progress, with or without consensus support.

- *Reforms will occur in 2007* – In her March discussion paper, the Minister suggested that reforms would either take effect in 2007 or would be linked to the end of the analogue simulcast period in 2010-2012. The announcement today confirmed that ownership reforms will now take effect in 2007. We regard this as the preferred outcome for a sector which has been debating ownership reforms for more than five years.

The rationale for cross-combinations

The principal rationale behind mergers today we regard as somewhat different to five years ago. It is difficult to find disagreement regarding the fragmentation of the media industry and the longer-term erosion of the power and profitability of the traditional media. In terms of advertising, for the year to December 2005, overall media ad spend grew by 7.4%, incl. pay TV and online which grew by 30% and 59% respectively. Traditional media reported growth of 4.8%. And while new media are seen to be adding something to the pie, they are clearly extracting much of their revenue from the traditional players. The challenge for the players therefore, particularly in the more quickly evolving metro markets, will be to position themselves to prosper in the new media environment.

To this end, we continue to view content as key and expect the media companies will be focused on ways to expand their content offerings and similarly package them for the evolving landscape. And logically, the more content you can offer, the more powerful your bargaining chip with the distribution channel.

We regard the following groups as the more likely targets:

Austereo Group Ltd (ASX Code : AEO)

- *Rationale* – Austereo is the dominant radio play in the Australian market and its largest shareholder, Village, has been refocusing its business for some time. Austereo's strengths are in the young demographics. However, there may be an issue with any of the free to air commercial television stations buying Austereo as they are each one of Austereo’s top ten advertisers.

- *Potential acquirers – Fairfax*. We expect Fairfax will be looking for opportunities to further expand its business. Fairfax has publicly discounted metropolitan TV as a target but has been more positive on metropolitan radio. Austereo would provide a channel for Fairfax to reach the youth demographic.

- *Potential acquirers – Macquarie Media*. With a very strong regional radio presence in Australia, we expect Austereo could hold some appeal for Macquarie Media to complete a pan-Australian network.

- *Potential acquirers – Ten.* The complementary demographics of the Ten Network and Austereo could create a potent media combination targeting the 16-39s. Notwithstanding, this could create an issue for Seven and Nine.

Southern Cross Broadcasting Ltd (ASX Code : SBC)

- *Rationale* – Southern Cross has a broad range of quality TV and radio assets that are undergoing cyclical lows [Ten and Nine ratings issues] as well as internal issues [for instance 2UE]. Moreover, we regard the group of assets within the group as somewhat disparate. Southern Cross does not have a major shareholder.

- *Potential acquirers - Rural Press*. We believe that Rural Press could have interest in the SBC suite of assets. RUP has little exposure to QLD where SBC has a strong presence, is a strong manager of businesses and is currently primarily a publisher, albeit in regional and rural areas which are not experiencing the same structural pressures as their metro market peers.

- *Potential acquirers – Macquarie Media*. Macquarie owns regional radio and we believe that there are potentially significant synergies from combining these with the regional TV particularly, and to a lesser extent metro radio assets of Southern Cross.

- *Private equity/ break up* – Given its broad range of assets, we believe that Southern Cross could also be attractive to private equity groups.

John Fairfax Holdings Ltd (ASX Code : FXJ)

- *Rationale* – Fairfax has an open register and is one of the five main metropolitan media players. Moreover, while its newspaper publishing assets in metro markets [est 32% of total] are under increasing structural pressure, we credit Fairfax with its recent expansion and development of its online properties which we expect could appeal [14% of FY 07 profits are forecast to be derived from online]. Moreover, Fairfax creates and owns much of its own content, unlike many of the other companies in the sector.

- Given its size however, it is difficult to point to a trade buyer of the group – more likely there could be some opportunities from a break-up perspective.

- However, we do expect Fairfax will be looking for its own opportunities to grow its business and to that end could be interested in one of the two new digital licences being proposed by the Minister, albeit the format of any associated service remains unclear.

Ten Network Holdings Ltd (ASX Code : TEN)

- *Rationale* – In recent times Bruce Gordon, owner of regional TV station WIN, has increased his stake in Ten to ~12% (or ~ half of this when diluted for the subordinated debentures). Uncertainty regarding Mr Gordon's intentions and similarly CanWest's as Ten's major shareholder, has been reflected in Ten’s media reform related price increase.

By Li Cunxin and Robert McNaught
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