MEDICAL AND DENTAL ACCOUNTING

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INTRODUCTION

Welcome to our December edition of MADA News.

Our second series of seminars to the various Divisions of GPs have commenced and we are extremely pleased with the positive feedback we have received to date. We have also enjoyed conducting seminars for specialist doctor groups in relation to business and superannuation matters. Thank you to all attendees.

We would also like to take this opportunity to wish all our valued clients a Merry Xmas and a happy, healthy and successful New Year. Enjoy the festive season!

Note our offices will close on Friday 22 December 2006 and will reopen on Monday 8 January 2007.

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. Alienation of personal services income
2. Making super contributions rather than paying off your mortgage – what are the risk factors with this strategy
3. Re contributing for estate planning benefits
4. Superannuation strategy opportunities up to 30 June 2007 – consider bringing your eligible termination payment (ETP) forward
5. Conditions for a lease to be an ordinary lease for tax purposes
6. Bankruptcy – is my superannuation protected?

Alienation of personal services income

The ATO is currently looking to identify a suitable test case involving the retention or splitting of profits by a professional practitioner.

There are some practitioners touting the use of a practice trust for non principal doctors where income is split to lower taxed beneficiaries on the basis that a material fee earner (as per Tax Ruling IT2639) is employed so that the income derived is business income not personal exertion income. The material fee earner just happens to be the spouse who is a practice nurse. IT2639 specifically excludes nurses from its definition of “practitioners” so using such a scheme smacks of Part IVA, the general anti avoidance provision.

In some alarming situations and in light of the Tax Office’s recent release of the Final Ruling on Service Trusts, we are aware of some advisors still implementing a structure that allows a ‘double dip’ on service trust profits. An example of a double dip is as follows:

An owner of a medical practice has an associateship structure and a practice service trust between all owner Associate GPs (i.e. all owner GPs collect individual patient fees). Each owner Associate GP pays a share of costs plus mark-up (commercially acceptable) to the practice service trust. The double dip occurs where each owner Associate GP pays a service fee (plus mark-up) to their own family trusts that includes the service fee payment to the practice service trust in order to push further profits in to the family trust and accordingly have more profits to distribute to lower taxed beneficiaries.

The problem here is that the family trust not only receives its share of profit from the practice service trust but also makes a profit on the service fee it has charged back to the owner Associate GP. The Tax Office see this as a blatant breach of Part IVA as more income is likely to be switched from the highly taxed hands of the GP to the lower taxed hands of beneficiaries within the family trust.

The above scenario’s dominant purpose is clearly tax avoidance and accordingly subject to Part 1VA, the general anti avoidance provisions of the Tax Act. If your accountant is advising you to do this you should seek a second opinion from either a qualified accountant experienced either dealing with the medical profession or with sound tax knowledge.

We are also aware that these same advisors are suggesting to non principle GPs, engaged as Associates, where they collect 100% of patient fees and pay back the management fee of say 40%, to run this through a Practice Trust. The idea here is for profits generated within the Practice Trust to be recognised as income from personal exertion (income that must be taxed in this situation; the GPs hands) to be split amongst family members that are likely to have a lower marginal tax rate than the GP. Again, tread carefully if you are advised to enter into such a scam.

In another instance, we have advised four sole traders “not to go there” when an advisor has suggested they run their solo practices through a practice trust, say it is business income so that their family trusts can split income to lower taxed family members.

Beware...there are two test cases regarding the alienation of personal services income i.e. splitting income to lower taxed beneficiaries, before the Courts at the moment.

Making super contributions rather than paying off your mortgage – what are the risk factors with this strategy

Following on from our article in our last newsletter and the tons of press in relation to this strategy, should you go ahead and borrow to make superannuation contributions rather than paying off your mortgage?

You get a tax deduction at 46.5% (if you are on the top marginal rate i.e. taxable income over $150,000) on the funds you contribute to super rather than paying off the principal on your loans. You draw the funds from super at 60 tax free to pay off your loans. Some commentators are even advocating this whether you are 20, 30, 40, 50 or 60!

In the first instance (10 years to pay off loan) you are nearly $80,000 better off but in the second instance (20 years to pay off loan) you are worse off by over $24,000.

In the past paying off the mortgage has been hard to beat from both a numbers and emotional point of view. However, the proposal to remove tax on super for people aged 60+ has changed the playing field making super a very real alternative. If it were simply a numbers game, clearly in Scenario 1 it would be recommended. We would recommend that your mortgage were restructured and converted to an interest only loan and that the balance were contributed to superannuation. Then when you reached age 60 we would recommend you withdraw a lump sum (which would be received tax free) and pay off your mortgage.

However, things are never as simple as they seem. There are a number of important variables beyond the math that must also be considered and these are the reasons that we recommend you do not implement such a strategy.

Interest/earning rate assumptions

The best results for such a strategy are for individuals on a marginal tax rate of 41.5% or more. If you were to contribute increased amounts to superannuation and fall below this marginal tax rate, the results are not as good. A critical assumption for success is that the mortgage interest rate & super fund earnings rate are the same.

If the actual mortgage rate was greater than the superannuation fund earning rate, then paying off the principal and interest mortgage will result in a better result long term than an interest only mortgage.

Accessibility

Should you stop work, such as due to sickness or injury, over the course of the loan term, you may have difficulty meeting the mortgage repayments and be also denied access to your super. Your life style options may change, you could get divorced. Regardless of whether the calculations show the super option as superior, this will be cold comfort if the funds cannot be accessed and you are forced to sell your home.

Investment risk

It must also be recognised that paying off the home mortgage effectively involves no investment risk, whereas contribution to superannuation via salary sacrifice or otherwise does. Furthermore, paying off the mortgage also helps reduce debt, which in turn may offer some protection to you from adverse interest rate movements.

Legislative risk

There is also legislative risk; will the government change its mind before you turn 60 and/or retire?

Peace of mind

Most importantly can you have peace of mind with this strategy. Will you be able to pass the sleep test?

Re-contribution strategy for estate planning benefits

For many years the re-contribution strategy has been a strategy employed prior to commencing superannuation sourced income streams with the aim of improving the tax treatment of pension payments.

We revisit the benefits of the re-contribution strategy in a Post budget environment.

KEY FINDINGS

The re-contribution strategy will continue to play a very important role in estate planning.

With lump sum superannuation death benefits paid to non-dependants still subject to taxation, this strategy should be considered where there is a likelihood that non-dependants eg adult children will benefit from the proceeds.

It is equally important to consider the mechanics of the re-contribution strategy and how some of the other superannuation reforms may have impacted on the ability for people to undertake such a strategy and the extent to which it can be employed.

Tax effective pension income

The re-contribution strategy effectively transforms ETP components that do not count towards the Undeducted Purchase Price (UPP) of an income stream (i.e. Pre and Post 83 components) into Undeducted component (which does count towards the UPP). As the UPP is used to determine the amount of tax-free deductible amount paid from an income stream, the benefit of such a swap is a more tax efficient income stream.

As part of the 2006 Federal Budget proposals, pension income paid to people aged 60 or over will be tax free from 1 July 2007. As a result, it would appear that the benefit of having a larger UPP has largely become redundant thus reducing the need to perform a re-contribution strategy where the primary purpose is to improve the tax efficiency of pension payments.

Bearing in mind however, that clients receiving an income stream prior to age 60 will continue to benefit from having an UPP.

Minimise lump sum tax – Estate Planning

Another often overlooked benefit of the re-contribution strategy is the potential to reduce lump sum tax payable in the event of death.

Whilst superannuation death benefits paid to tax dependants as a lump sum are tax free, from 1 July 2007, where superannuation proceeds are paid to a tax non-dependant beneficiary (eg an adult child), the death benefit may be subject to lump sum tax.

How are death benefits to non-dependants taxed?

Current rules
Under current rules, superannuation death benefits paid to non-dependants are taxed as follows:

Pre July 1983 component: 5% added to assessable income and taxed at MTR
Post June 1983 component: 16.5%
Undeducted: Nil

Budget changes and ETP components

The complex current scenario of multiple ETP Components is due to be simplified from 1 July 2007. Effectively, all of the existing ETP components will be grouped together to form 2 new components. The 2 new components will be made up as follows:

ETP Components	**Made up of**
Taxable component	Post June 1983 component
Exempt component	Pre July 1983 component* Undeducted component Invalidity component CGT Exempt component

* The Pre July 1983 portion of the Exempt component will be crystallised based on account balances and existing components as at 30 June 2007.

Under these proposed changes, superannuation death benefits paid to tax non-dependants will be taxed as follows:

- Taxable Component: 16.5%
- Exempt Component: NIL

As such, any re-contribution strategy undertaken prior to 1 July 2007 will ensure a larger exempt component is created and therefore reduce the potential to pay significant amounts of lump sum tax in the event of death.

Case Study

Michael (age 60) currently has $600,000 in his superannuation fund ($200,000 Pre July 1983 component, $400,000 Post June 1983 component). He has 2 children, Lachlan (age 34) and Jasmin (age 30).

In the event of his death, Lachlan and Jasmin will receive the proceeds from his superannuation fund. They are non-dependants for tax purposes.

How much tax will Lachlan and Jasmin pay?

Under the current rules, if we assume Lachlan and Jasmin are on a marginal tax rate of 41.5%, the combined tax that they would pay upon receiving the superannuation proceeds is as follows:

Component	**Tax**	**Total**
Pre July 1993	$4,150	**$70,150**
Post June 1983	$66,000	

If we assume that Michael were to pass away on or after 1 July 2007, then the tax payable by Lachlan and Jasmin will be as follows:

Component	Tax	Total
Exempt Component	NIL	**$66,000**
Taxable Component	$66,000	

The tax savings occurs as a result of the Pre July 1983 component forming part of the Exempt component from 1 July 2007.

Would a re-contribution strategy have helped?

If we are able to increase the size of the ETP components that will count towards the Exempt component prior to 1 July 2007, we will be able to further reduce the tax payable by Lachlan and Jasmin in the event of Michael' death.

Let's assume that Michael cashes out $400,000 and re-contributes this back into his superannuation fund as an undeducted contribution. His ETP components (assuming no growth) would now be as follows:

Pre July 1983 component: $200,000
Post June 1983 component: $ NIL
Undeducted component: $400,000
$600,000

At 1 July 2007, when the Exempt component is calculated, Michael's benefits will be broken down as follows:

Exempt Component: $600,000
Taxable Component: $ NIL
$600,000

Should his children receive these proceeds following Michael' death, the benefits (ignoring growth) would now be received completely tax-free. Any growth on Michael' superannuation benefits would count towards the Taxable component and as such, subject to tax at 16.5%.

In this situation the re-contribution strategy has saved Lachlan and Jasmin $66,000 in lump sum tax.

Other Considerations

The re-contribution strategy is a two-step strategy. The first step involves the cashing in of superannuation benefits whilst the second step requires that these monies be contributed back into the superannuation system.

Cashing in superannuation benefits

It must be remembered that a re-contribution strategy will generally require a "retirement" condition of release to be satisfied in order for clients to be able to cash in their superannuation benefits as a lump sum.

Also important to remember is that despite the introduction of Transition to Retirement as a condition of release, this condition will not allow superannuation benefits to be taken in the form of cash.

In our example above, we have assumed that Michael has already met a condition of release eg retirement.

Contributing back into the superannuation system

Contribution rules
Despite the raft of superannuation reforms announced in the 2006 Federal Budget, one area that will remain unchanged is the requirement for people aged 65 or over to satisfy a work test in order to make contributions into a superannuation fund.

This test requires that a client has already completed 40 hours of gainful employment over a consecutive 30-day period within the financial year the contribution is made. Failure to satisfy this test will result in a clients' inability to contribute funds back into superannuation.

Further, contributions can only be made up to age 75.

Clients who are under age 65 will be able to make superannuation contributions without the need to satisfy any form of work test. As Michael is under age 65, he is not required to satisfy any form of work test.

Contribution limits
Between Budget night and 1 July 2007, people who meet the contribution rules (above) will be able to contribute up to $1 million of Undeducted contributions into superannuation.

However, effective from 1 July 2007, individuals will be limited to $150,000 per annum of Undeducted contributions, with people under age 65 able to utilise special averaging provisions allowing them to make 3 years worth of Undeducted contributions in one period (i.e. $450,000).

As Michael undertook a re-contribution strategy prior to 1 July 2007, he is well within his allowable $1 million limit. If he were to conduct the same strategy on or after 1 July 2007, he would still be able to utilise the $450,000 averaging provisions as he is under age 65.

Superannuation strategy opportunities up to 30 June 2007 – consider bringing your eligible termination payment (ETP) forward

If you are likely to receive an eligible termination payment (ETP) from your employer after 1 July 2007, there may be some advantage in bringing your payment forward into this financial year i.e. 30 June 2007. After 1 July 2007, you will not be able to roll over your employer ETP into your super fund, but will have to take it as a lump sum and pay tax.

If you wait until after 1 July 2007, assuming the Budget proposals are adopted, you will no longer have the option of rolling it over. You will be forced to receive it as a cash payment and will be liable for the appropriate amount of lump sum tax, which could reach up to 46.5%.

If however, you had an existing contract as at Budget night (9 May 2006) stating your entitlement to an employer ETP, you will receive a transitional tax treatment up until 1 July 2012. Transitional rules will allow you to still roll over your ETP into super and will limit tax on amounts between $140,000 and $1,000,000 to a maximum of 30%.

In some cases, there is a strong argument to rollover an employer ETP and delay accessing your super until you are at least 60, which was a key part of the Government's intention. However, if you choose to retire ahead of your 60th birthday during this current year, you will still be able to enjoy some tax concessions, notably you can draw down a lump sum up to $135,590 from your post-June 1983 component tax-free.

Conditions for a lease to be an ordinary lease for tax purposes

There is no general definition of a 'lease' for tax purposes. As a general principal, for tax purposes, leases are considered to be ordinary commercial leases unless they are, in substance, consideration for the sale of the asset purported to be leased (i.e. finance leases).

Lease agreements in respect of the following types of arrangements are generally treated by the Commissioner as a contract for the sale of the asset for tax purposes i.e. they are not leases for tax purposes:

- Where there is an obligation, right or option that property in the asset passes from the lessor to the lessee on the expiration of the lease or at an earlier point in time;
- Where such an obligation, right or option is held by an associate of the lessee;

- Where provision is made for the disposal of the leased goods at the end of the lease except by way of public auction, there is a presumption that the lessee has a right to purchase the asset;
- Where, at the end of the lease, the lessee is permitted to retain the use of the asset;
- Where, at the end of the lease, the residual value of the goods which was used to calculate the lease payments is disproportionate to the reasonable commercial value of the asset at that time (based on the table below reproduced from IT28);
- Where the lease payments made at the beginning of the lease are high and the lease payments at the end of the lease are lower than commercial rates (or of a nominal amount);
- Where an asset is leased for a comparatively short period of time in return for high lease payments and there is an option to renew the lease at nominal rates for the remaining useful life of the asset.

When this is the case, some of the lease payments may have a capital component to the extent that the expected sale price is less than the actual market value.

Finance companies don’t care as the problem lies with the lessee, not the lessor if the lease is not a genuine lease and a deduction or part deduction is denied.

The Commissioner’s views of the minimum residual values which can be used to calculate the lease payments, based on the effective life of the asset, are as follows:

	Effective life					
Term of lease	**5 years**	**6.66 years**	**8 years**	**10 years**	**13.3 years**	**20 years**
1st year	60%	63.75%	65.63%	67.5%	68.5%	70%
2nd year	45%	52.5%	56.25%	60%	62.5%	65%
3rd year	30%	41.25%	46.88%	52.5%	55%	60%
4th year	15%	30%	37.5%	46.88%	50%	55%
5th year	nil	18.75%	28.13%	37.5%	45%	50%

Make sure that your accountant reviews lease contracts to ensure that your lease is an ordinary commercial lease for tax purposes and thus a full deduction for lease payments may be claimed for tax purposes.

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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Bankruptcy – is my superannuation protected?

Individuals wishing to protect their assets from the risk of bankruptcy proceedings have long protected those assets through the use of a discretionary (family) trust or through the use of superannuation.

In this issue we focus on the impact of bankruptcy on your superannuation.

When a person becomes bankrupt, ownership of their property passes to the trustee of the bankrupt estate. The trustee will then divide those assets among the bankrupt's creditors.

All property that is acquired or devolves to the bankrupt after the commencement of the bankruptcy and prior to its discharge will pass to the trustee.

The balance of a person's superannuation up to their pension reasonable benefit limit (RBL), currently $1,356,291, is protected from their creditors in the event of bankruptcy. If a person has a transitional RBL higher than the $1,356,291 then their protection is afforded at that higher level. Anything above that can be accessed by the trustee in bankruptcy.

To complicate this matter there have been recent changes to legislation that change this position somewhat.

Firstly, as you may already know the superannuation simplification initiatives announced by the Federal Treasurer in the May budget will see the elimination of RBLs. Thus the question arises, if there is no such things as RBLs, is my superannuation still protected from bankruptcy at all? While we are yet to see the proposed changes to the Bankruptcy Act that will address this issue, it is understood that individuals will not be worse off than they are now. Therefore we do expect a similar amount of protection to be provided, but the final position is still to be confirmed.

The second change is the closing of the loophole that previously allowed individuals to transfer large amounts of assets to superannuation to protect them from looming bankruptcy. This issue arose from the High Court decision in *Cook v Benson* which cast doubt on a trustee's ability to recover superannuation contributions using the existing clawback provisions in the Bankruptcy Act.

In July of this year Attorney General Philip Ruddock announced that superannuation contributions made prior to bankruptcy with the intention to defeat creditors will be recoverable by the bankruptcy trustees, even if the amount is within the RBL limit.

In determining whether contributions to superannuation were made to defeat creditors, courts will be able to take into account the person's history of contributions and whether the contributions in question are "out of character".

Thus we believe that superannuation, genuinely accumulated for the purpose of wealth accumulation to fund retirement will continue to be protected to its existing level, despite the recent changes.

We will update you on the RBL in future editions.

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The information contained in this article is 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.