"MADA NEWS"   JUNE 2007 EDITION

Suite 16, 828 High Street
Kew Victoria 3101
Phone 03 9819 7308

45-47 Addison Street
Elwood Victoria 3184
Phone 03 9531 666

INTRODUCTION

Welcome to our June 2007 edition of MADA News; we hope one or more of the articles make interesting reading for you!

A belated congrats to Michael Waycott and the Dawnbusters who at first attempt, managed to crack the Oxfam Walk in March comfortably within 21 hours (great effort guys)!! We appreciate our clients that sponsored and supported Michael through this event.

We also appreciate the support and attendance of our clients at our Division of General Practice presentations and wish to extend a genuine welcome to our new clients. We look forward to working with you all closely to achieve your financial goals.

Finally on the cusp of a new financial year, we would like to welcome on board several new staff members.

In our Elwood office we would like to welcome Gabrielle Waters, a Chartered Accountant and a whiz at superannuation funds and Debra Tarrant, a Chartered Accountant with a similar background to Caroline Poon in tax consulting and compliance.

Kew welcomes on board David Abdo, an accountant who has already impressed clients with his easy, outgoing manner and efficient service and Sophie Trask, our new receptionist there.

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.

The topics covered in this June newsletter cover amongst other things; superannuation (of course!). The whole new superannuation regime is very confusing to a non superannuation expert. Specific advice with regard to your personal situation should always be sought. Please do not hesitate to contact us to discuss your circumstances so we can give you tailored advice rather than advice we like to call "One size fits all".

We also explore two much overlooked choices regarding the main residence capital gains tax exemption.

We give a concise explanation regarding family trusts and finish up looking at rental property deductions for 2007.

Topics covered

1. Contributions To Superannuation – New Limits From 1 July 2007
2. Transition to Retirement Allocated Pension ('TRAP'): Tax Planning Opportunity
3. Paying Out Death Benefits From a Self Managed Superannuation Fund – Be Careful!
4. Main Residence Issues - Exemptions From CGT
   - Choice of main residence – "6 year rule"
   - Dwellings acquired from deceased estates
5. Family Trusts: Advantages and Disadvantages
6. Rental Property Deductions for 2007 and What Can be Claimed

Contributions To Superannuation –New Limits From 1 July 2007

The Government has set limits, which apply from 1 July 2007, on the amount of contributions that a person can make over their working life.

<u>Concessionally taxed contributions.</u>

These are usually referred to as deductible contributions or taxable contributions made to superannuation funds. The superannuation fund pays 15% tax on these

contributions. These are generally those contributions made for an individual by an employer to a superannuation fund.

From 1 July 2007 there is a superannuation contributions cap of $50,000 per year from all sources. Practitioners receiving income from various sources should note that this $50,000 cap applies in total, not per employer. This amount will be indexed in subsequent years.

There is also a transitional arrangement in place for the period 1 July 2007 until 30 June 2012. The cap is $100,000 per year for people aged 50 or over on the last day of the financial year during this transitional period. For example, say a person turns 50 on 1 May 2011. Then, for the financial years ended 30 June 2011 and 2012 the cap of $100,000 applies. This cap will not be indexed.

Any contributions in excess of $50,000 (or the transitional $100,000 if applicable) are subject to excess concessional contributions tax of 31.5% (bringing total tax on the contributions to 46.5%).

So please ensure that your concessionally taxed contributions (deductible contributions) do not exceed the relevant cap. It will be of no consequence to employers as they will receive a deduction for contributions, regardless on whether contributions exceed the cap or not. The onus is on the employee. If you are going to be taxed at 46.5%, it's best this is outside the superannuation environment where you basically can't pull any money out until you are 55 and most tax effectively at 60.

<u>This is particularly pertinent to our clients who are specialists and may receive salary or wages from a number of public hospitals and (say) their private practice and also have life via super contributions. Pay offices must be notified accordingly so you don't get caught out!</u>

<u>Non-concessional contributions</u>

These contributions were previously referred to as "undeducted contributions" or after tax contributions. The superannuation fund does not pay tax on these contributions.

From 1 July 2007 a non-concessional contributions cap of $150,000 per year applies. This amount will not be indexed but will be fixed at three times the concessional contributions cap of $50,000.

Any contributions above $150,000 will be taxed at the highest marginal tax rate plus the Medicare levy – i.e. 46.5%.

Warning: Any excess concessional contributions are included in the cap for non-concessional contributions. Should the non-concessional cap of $150,000 also

be exceeded, the amount of the excessive concessional contributions will be subject to additional tax at both 31.5% and 46%; i.e. the same amount will be effectively taxed twice!

Note that there is a cap of $450,000 per person for non-concessional contributions over a three year period (provided you are under 65 at the time you make the $450,000 contribution).

Transition to Retirement Allocated Pension ('TRAP'): Tax Planning Opportunity

The acronym suggests this type of pension is a trap, but nothing could be further from the truth. In fact it provides some sensational taxation savings as part of the new super legislation, and is available from 1 July 2007 (for those members of super funds that qualify). The good news is, the allocated pension which is part of the TRAP strategy is tax free in the recipient hands! Some basic information re who is eligible to draw a TRAP and the tax planning opportunities this offers are detailed below-:

As you are aware, as part of the Government's new superannuation legislation, pensions paid from superannuation funds, whether they are self managed, via a wrap account, industry or retail fund are tax free in the member's hands from 1 July 2007, if the recipient is aged 60 or over (after meeting the conditions of release.

It is worth noting here some conditions of release:

- Retirement after preservation age (55 to 60 depending on date of birth) working less than 10 hours per week
- Termination of employment after 60
- Attaining the age of 65
- Death

Members of regulated and approved superannuation funds are able to draw a tax free TRAP from their respective super funds (say Self Managed Super Funds) from 1 July 2007 if the member is aged 60 or over. The maximum TRAP a member is able to withdraw from the super fund is capped at 10% of the member's balance per annum. Again, the TRAP is tax free in the member's hands and does not need to be added in as exempt or excluded income to the member's individual tax return.

Once a TRAP is drawn from the super fund, the assets for that member of the super fund are frozen, which means the earnings on those assets within the super fund (taxed at 15% while the fund is in accumulation phase) are taxed at zero. This alone, will mean substantial tax savings within the super fund depending on the level of assets. Our ball park figure to clients starting a TRAP is

a member's balance of at least $500,000 in order to make the TRAP viable but of course each client's circumstances is unique and should be dealt with on its own merits. We actually prefer a balance of $1,000,000 for the member so that terrific tax savings may be achieved.

As the recipient of the TRAP is still working, the individual has the option of re contributing the amount of the TRAP up to the new superannuation deductible limit (less than 50, $50,000 per person and 50 or over $100,000 up to the year ended 30 June 2012). An illustration may help here:

From 1 July 2007 the member starts a TRAP so that the monies held at 30 June 2007 go into pension phase and a pension is drawn by the member:

Say Members Super Balance is	$1,000,000
TRAP drawn (to max of 10%)	$100,000 (not taxable)
Tax deductible: Re-contribution to super fund	$100,000
Tax Rate: 46.5%	($46,500)
Super Fund: Taxable super contribution	$100,000
Tax Rate: 15%	$15,000
Net Tax Savings on re-contribution	**$31,500** ($46,500 - $15,000)

This generates significant tax savings with funds being recontributed to the super fund and balances within the fund continually growing. Significant tax savings will also be achieved on assets frozen within the super fund (say $1,000,000) after the fund moves to pension phase as the tax on the earnings from those assets is taxed at nil.

The above strategy is applicable to many of our clients and to date we have roughly 25 clients starting a TRAP after 1 July 2007. An important point to note is that the re-contribution strategy is a very tax effective strategy but may not suit all circumstances, as some members may decide to extinguish some debt that is left on the house (non-deductible) for example or debt created to contribute large super contributions or to pay off investment debt.

Finally, please remember the new superannuation deductions limits per annum are per **member** from 1 July 2007 not per employer (up to 30 June 2007). The new limits are:

Age <50	$50,000
Age>50	$100,000*

*Note that the $100,000 once you are over 50 applies up to the year ended 30 June 2012. Accordingly if you turned 50 on 28 June 2011 you would get two years at $100,000 as you turned 50 in the year ended 30 June 2011.

Paying Out Death Benefits From a Self Managed Superannuation Fund – Be Careful!

There are a number of issues that can arise when paying out a death benefit from a self managed superannuation fund ("SMSF"), which, if not addressed correctly, can result in the benefits not being paid to the intended beneficiaries and /or costly litigation.

It is firstly important that the right persons are appointed as trustees of the SMSF, as it is those trustees who will be responsible for making the decision who the death benefits are to be paid to.

There are also a number of steps that can be taken to ensure that the member's intentions are carried out:

- Adjustment clauses in wills:

  The member's will should include an adjustment or equalization clause in their will to deal with the possibility of unequal payments of superannuation death benefits.

- Binding death benefit nominations:

  The trust deed of the SMSF should permit the member to make a binding death benefit nomination. This enables the member to clearly nominate the beneficiaries who are to receive the death benefits. The trustees are then bound to pay the benefits in accordance with that nomination. However it should be noted that a binding nomination doesn't allow the trustees any flexibility at the time of death to change the beneficiaries or form that the benefit will take if circumstances have altered.

  It is also advisable for anyone making a binding nomination to include as part of their financial enduring power of attorney, an express authorization for their attorney to confirm their binding nomination. A binding nomination would lapse after three years if no such confirmation occurs.

- Successive trustees

  As long as the trust deed allows, a legal personal representative may be appointed to represent the deceased member. Their appointment runs from the time of a member's death until the death benefit commences to be paid.

This would help to ensure that the deceased member's intentions are carried out.

"Katz Case"

The consequences of not having the appropriate steps in place when paying out a death benefit from a SMSF, and the importance of having the right persons acting as trustee, were demonstrated by the decision in *Katz v Grossman [2005] NSW 934*. This case involved a contest between a brother (Daniel Katz) and a sister (Linda Gossman) over the death benefit (approximately $1m) paid upon the death of their father (Ervin Katz).

The superannuation fund was established in 1965 by Ervin Katz as the sole member. The deed was amended from time to time up until 1995. The 1995 deed provided *that where a member has died the trustees must pay the benefits to or for the benefit of such of the dependants of the deceased member as they consider appropriate or where there are no dependants, then to the member's legal personal representative*.

Ervin's wife Evelin died in 1988. Evelin had previously become a member of the superannuation fund and had been appointed as an additional trustee. At this time Ervin appointed his daughter Linda an additional trustee. Ervin and Linda resolved that Evelin's death benefits would be paid to Ervin.

Ervin died in 1988 at which time Linda became a member of the fund. Linda appointed her husband Peter as an additional trustee. Linda and Peter refused to allow Ervin's non-binding nomination that his benefits be shared equally between his daughter and his son. Rather they resolved to pay the entire amount to themselves!

Daniel Katz challenged the appointment of Linda and Peter as trustees of the fund and also the appointment of Linda as a fund member on the basis that these appointments were defective. The court decided that the trustee appointments of Linda and Peter were valid, whilst Linda had not been validly admitted as a member of the fund. In the end Daniel did not receive any of his father's $1m superannuation benefits from the fund. Ervin's intentions of providing equally for his daughter and son were not fulfilled.

Clearly there would have not been a problem if Ervin had made Daniel also a trustee and member of his superannuation fund. And there are no happy family social gatherings between the siblings!

Main Residence Issues – Exemptions From CGT

Choice of main residence – “6 year rule”

If renting out your home at any stage, it is important to consider the capital gains tax (“CGT”) issues which may affect this decision.

There is an exemption from CGT where a dwelling is considered the taxpayer’s main residence. There is a rule, often referred to as “the 6 year rule” which enables you to be absent from your home for up to six years, if the home is used for income producing purpose (i.e. rented out) without losing this main residence exemption. The circumstances where this might be relevant are:

- buying a new home to move into and renting out the existing home; or
- being posted interstate and buying a new home (interstate), while renting out the existing home.

Firstly you must have actually lived in the home before the 6 year rule will apply. Assuming you have lived in the home, you may, in these circumstances, choose to continue to treat the existing home as your main residence. The home can be rented out for up to six years at a time and continue to receive the main residence exemption. During this time no other property can be considered the main residence. Couples are only entitled to one main residence exemption between them.

If you move back into the home and then move out and rent it again, another six year exemption period starts. If you vacate your property for more than six years in a row, any subsequent sale will be exempt from CGT for that six year period. Any resulting capital gain or loss will be apportioned accordingly.

If the home is not used for any income producing purpose while you are away then it can be treated as the main residence indefinitely.

Planning Issue:

From a planning perspective it is important to remember that there is a choice as to whether or not to apply the six year rule to the existing home. It may be more advantageous to treat the new home as the main residence from the time of moving into it. Generally speaking, the main residence exemption should be maximized for the property that is likely to generate the largest capital gain when sold. Relevant factors will be the cost base of the properties and the respective market values.

Another factor to consider is the length of time that each property is likely to be held. If the intention is to sell the original property (i.e. the one being rented out)

in the short term, and the new property (i.e. the one being lived in) in the longer term, it would make sense to consider applying the 6 year rule to the original property. From a cash flow viewpoint it may also be better to delay the payment of any CGT as long as possible.

Timing of choice to apply six year rule:

There is no requirement to make a choice as to whether or not to apply the six year rule to any property you have moved out of until it is actually sold. The choice is made when the tax return is lodged for the income year in which the property is sold. The treatment of the sale of the property in the tax return is evidence of the choice made.

[Note that this discussion only applies to properties purchased after 19 September 2005.]

Dwellings acquired from deceased estates

The CGT main residence exemption may also apply to the sale of a dwelling that has passed to a person from a deceased estate, either as a beneficiary of the estate or as a trustee.

<u>Full CGT exemption</u>

For a full CGT exemption to apply certain conditions must be satisfied. The conditions vary depending upon whether the dwelling was a pre or post CGT asset: i.e. purchased by the deceased on or before 19 September 1985 or after that date.

Pre-CGT dwelling

If the dwelling is disposed of within two years of the death of the deceased then the sale will be exempt from CGT. If, however it is sold *more* than two years after the death of the deceased, it may still be exempt from CGT. It will still be exempt as long as the property has been the main residence of the beneficiary, the deceased's spouse, or an individual having the right of occupancy under the will, from the time of the deceased's death until the time the property is sold.

[*Note: The dwelling did not have to be the main residence of the deceased.]*

Post-CGT dwelling

For the disposal of a post CGT dwelling to be exempt from CGT, the conditions are a little more stringent. The following conditions must be met:

- the dwelling was the deceased's main residence just before death;

- the dwelling was not being rented out just before death;

AND either of the following conditions are satisfied

- the dwelling is sold within two years of the date of death of the deceased;

Or

- the dwelling has been the main residence of the beneficiary, the deceased's spouse, or an individual having the right of occupancy under the will, from the time of the deceased's death until the time the property is sold.

  Note: If a person dies whilst absent from the property and the choice is made to enable the "6 year rule" (refer above), the dwelling is treated as the main residence before the person dies. The sale would therefore be exempt from CGT.

Partial CGT exemption

Only a partial exemption is available if these conditions are not satisfied. In this case the amount of the capital gain is worked or loss is apportioned by determining the number of non-main residence days as compared to the total ownership days that are relevant for main residence purposes.

There are other specific rules regarding the main residence exemption as it applies to deceased estates for the following circumstances:

- where a person dies while building, renovating, or repairing their main residence before construction is completed;
- a person inherits a property which the deceased had acquired as a beneficiary under another person's will;
- where a legal or personal representative acquires an ownership interest in a dwelling under the terms of a will for occupation by an individual.

The main residence rules for dwellings acquired from deceased estates are complex and advice specific to the particular case should always be obtained.

Family Trusts: Advantages and Disadvantages

There is much confusion re family trusts and the separation between legal and beneficial ownership and trustee and beneficiary. Trust law is a complex and complicated issue and can be quite confusing to many clients. We have tried to explain as best we can in this short article.

What is a Family Trust?

A Family Trust is also referred to as a discretionary trust. The word “trust” is a technical legal term, which refers to a relationship, based on confidence, under which property is held by, and formally vested in, one party, on behalf of other parties who are entitled to the benefits of that ownership. A discretionary trust is generally established for the benefit of a family and its members. It allows the Trustees the discretion to as to how to distribute the income and capital of the trust for the benefit of the family members.

A trust is composed of four parties:

1. The “settlor”. This is the individual who legally creates the trust by executing the trust deed and by injecting the initial assets (money or property) into the trust. This person is often the accountant e.g. Caroline Poon.

2. The “trustee”. This person administers the trust in accordance with the trust deed and the law. This includes the management of the money or property in the trust. The trustee can be an individual or a corporate trustee e.g. Jasmin Waycott as trustee for the Jasmin Waycott Trust or Jasmin Waycott Pty Ltd as trustee for the Jasmin Waycott Trust.

3. The “beneficiaries”. These are the people who are entitled to receive the income and capital from the trust. A person can be a beneficiary for income only, or capital, or both.

4. The “appointor”. This person has the power to appoint and remove the trustees and a can nominate a successor.

Note it is only the trust i.e. the Jasmin Waycott Trust that needs to prepare accounts and lodge a tax return.

Advantages of a family trust:

There are many advantages to setting up a family trust. These include the following:

- Enables those setting up the trust to make provision for the family, in particular very young children or children with disabilities;

- Can give children the benefits of family wealth without losing control over key assets;

- Creates a legal framework for the family assets which will last for a long time ;

- Protects assets against actual and potential creditors;
- Enables wealth to pass from generation to generation;
- Can create a tax effective structure for the distribution of wealth;
- Allows administrative, investment and record keeping functions to be centralized and handled more efficiently;
- The trustee has decision making power at their discretion;
- Provides flexibility in terms of income distribution (at the discretion of the trustee);
- Confidentiality – There is no capacity to search any public record;

Disadvantages of a family trust

Offsetting the benefits outlined above are the following disadvantages which should be considered when setting up a family trust. These include:

- Costs of setting up and maintaining the family trust - There will be preliminary expenses involved in setting up the trust including professional fees such as legal, accountancy, taxation and investment advice. There will also be legal fees for documentation and stamp duty. Ongoing expenses will be in the nature of administrative costs for bookkeeping, tax returns, and separate bank accounts. There will also be costs when the trust is eventually wound up;
- The trust must run in accordance with the rules of the trust deed, and the Common Law of trusts;
- The trustee is responsible for the liabilities of the trust. This is because the trust has no separate legal status;
- Onerous trustee duties apply;
- Risk that a trustee will not act in the best interests of the beneficiaries through incompetence or dishonesty;
- The political climate (including taxation) may change to negate some of the reasons that the trust was set up in the first place;

- Changed circumstances of the beneficiaries. There is no ability to return assets once they are given to the trust despite changed circumstances such as impoverishment, deaths of beneficiaries, divorce.

Whilst the setting up of a family trust may achieve certain objectives it is important to keep in mind the various disadvantages that my also arise.

Trusts are particularly relevant to our client base. A trust may be formed for a number of reasons; investment purposes e.g. shares and/or property for asset protection purposes or for trading purposes e.g. a practice trust or for administrative/business purposes e.g. a service trust.

Rental Property Deductions and What Can Claim Be Claimed

On 7 June 2007 the Tax Office released a document entitled "Rental Property deductions for 2007". In this document the Tax Office advises that there are two categories of rental property expenses that can be claimed as follows:

- Expenses paid and deductible outright in the current year such as council rates, repairs, insurance and loan interest; and

- Expenses where a deduction can claimed over a number of years such as borrowing costs and the costs of depreciating assets.

The Tax Office also advised that renovation costs and costs to repair damage, defects or deterioration existing on purchase cannot be claimed as an immediate deduction. These costs are likely to be considered capital expenditure and will be claimed either as depreciation over the effective life of the asset or as a capital works deduction over 40 years.

Some common mistakes made by rental owners include the following:

- incorrectly claiming the cost of structural improvements as repairs when they are capital works deductions;

- overstating deduction claims for the interest on loans taken out to purchase, renovate or maintain a rental property, where the loan was taken out for both income-producing and private purposes;

- incorrectly claiming the full cost of an inspection visit when it is combined with a private visit (you can only deduct a portion of the travel cost and potentially none if the property inspection was merely incidental to the private purpose for the trip);

- claiming deductions for properties only available for rent part of the year;

- incorrectly claiming the cost of land as a capital works deduction;

- incorrectly claiming deductions for depreciating assets that are actually capital works deductions. The Tax Office's booklet contains a comprehensive listing of property items and sets out whether they are depreciating assets or assets eligible for a capital works deduction.

The Tax Office document "Rental property deductions for 2007" is available at http://www.ato.gov.au/print.asp?doc=/content/85365.htm

As many of our clients own rental properties (or are in the process of purchasing, etc), we thought this article prudent for 30 June 2007. Care must be taken in claiming expenses, etc as rental property deductions are on the Commissioner's "hit list" year in and year out.

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 preparing the articles, specific advice should be obtained before proceeding with any suggestion or recommendation made

By Caroline Poon and Michael Waycott, Directors, Medical and Dental Accounting Pty Ltd. Note Caroline Poon is also an Authorised Representative of Hillross Financial Services Limited (AFS Licence No. 232705).