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TAX PLANNING FOR FINANCIAL PLANNERS

McMasters’ Advisers’ | July 2011

TAX PLANNING FOR FINANCIAL PLANNERS

Tax planning for Financial Planners is one of a series of technical manuals specifically created for financial planners running fee for service practices. These manuals help establish the financial planner as the client's primary advisor, the point of first contact on all business questions and the advisor who facilitates other advice and professional services as needed.

McMasters' Advisors believe businesses are the best investments and that advisors should routinely recommend their clients buy or start businesses, or further develop existing businesses, wherever a client is suited to this, by inclination, personality or training. The extra economic benefits, improved tax planning and, hopefully, the CGT free profit on the ultimate sale of the business mean this is an option clients cannot afford to overlook.

McMasters' Advisers' head office

Clients who are in business have a greater need for the advisor's extra services, and in the new fee for service world it's all about providing extra services. That's where the extra fees come from. A client who is in business has a greater need for a financial planner's skill and experience, including risk insurance planning, income tax planning, debt planning, estate planning, superannuation planning and, of course, investment planning.

The average business client is worth five average non-business clients.

McMasters' Advisors is dedicated to helping advisors develop the skills needed to develop a competent business development advisory capacity as part of their financial planning practices. McMasters' Advisors believes financial planners should be their clients' primary business advisor, with a broad knowledge of all relevant areas, and the capacity and inclination to bring in other specialist advisors including accountants and solicitors where appropriate.

Tax planning for Financial Planners uses the literary device of John, the financial planner, to examine the major financial planning issues connected setting up, running and selling a business in Australia. It works at two levels. The first level is an overview of the technical issues and the second level is a case study in how to set up and run a successful financial planning business.

Tax planning for Financial Planners cross-refers to the other McMasters' Advisors' manuals. Internet links connect these manuals at appropriate points.

I trust you find "The Financial Planner as a Business Advisor an instructive educational experience that improves your understanding of this essential field of expertise for successful financial planners.

Yours faithfully

Terry McMaster
Chairman
McMasters' Advisors


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The Financial
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THE FINANCIAL PLANNER AS A
BUSINESS ADVISER

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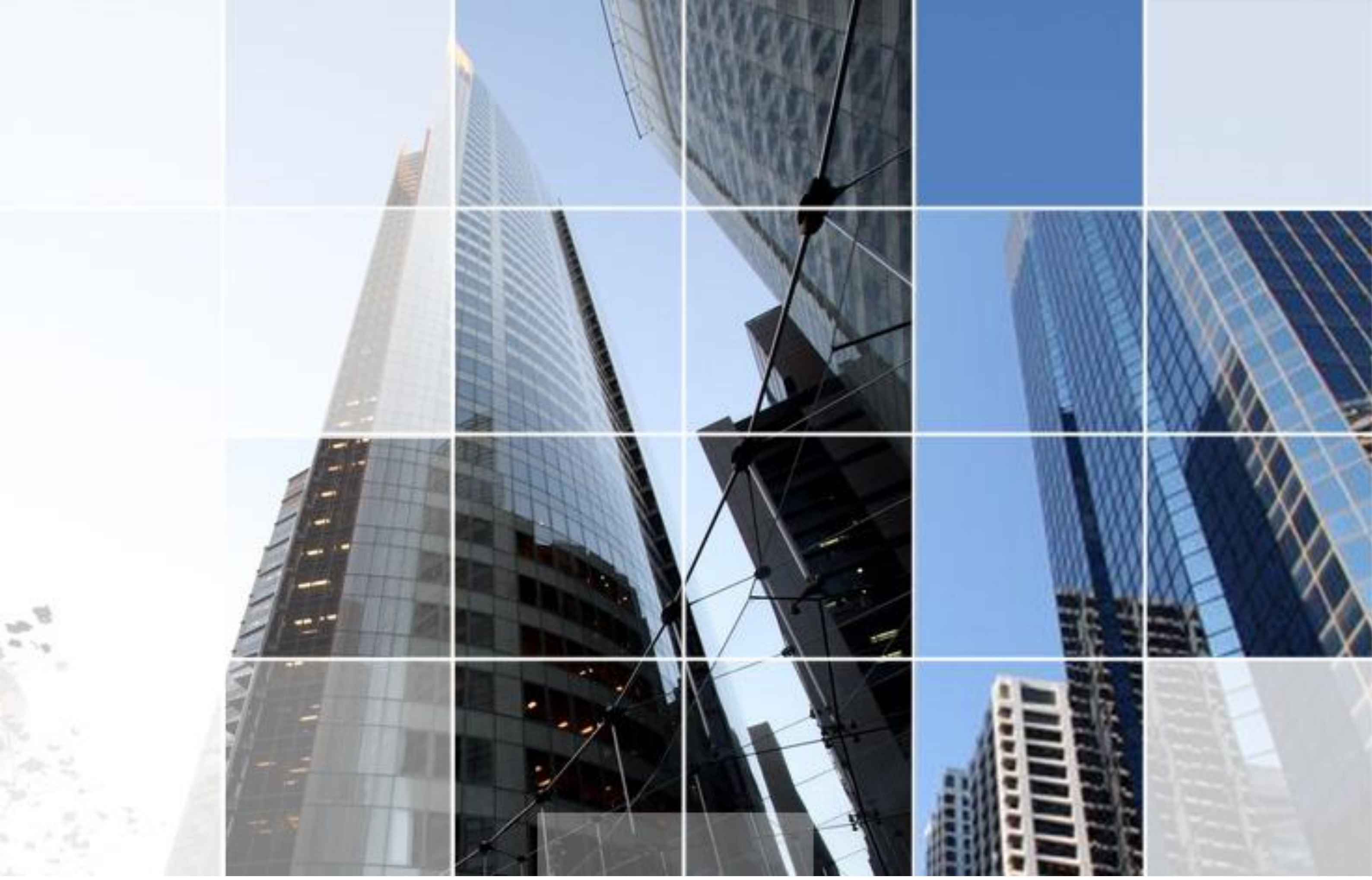


Tax Planning for Financial Planners

Introduction

The purpose of this manual is to show financial planners what can be done to improve the income tax efficiency of their practices, and at the same time show them what they can do to improve their client' income tax efficiency.

Your practice's tax profile

You spend a lot of time and energy in your practice. Making sure you are not paying too much tax and paying the lease amount of tax legally possible is an essential part of running an efficient practice. Making the examples and explanations directly relevant to financial planning practices should make the content more meaningful and relevant.

This manual shows you how to make your practice more tax efficient by eliminating unnecessary income tax expenses.

Your clients' tax profiles

At the same time this manual works as a practical guide to improving your client's tax profiles. Most clients, particularly small business clients, will benefit from following the ideas explained in this manual.

Financial planners as tax advisors

Financial planners advising on taxation is currently a grey area and, in summary, most financial planners are currently not qualified to advise on taxation unless they are solicitors or registered tax agents. The position may change so that financial planners can advise on taxation, within the context of their financial plans, provided they complete further training in taxation.

The proposed position is summarized in the following press release by The Hon Bill Shorten, Minister for Financial Services and Superannuation, on 7 April 2011:

Future Regulation of Financial Planners Providing Tax Advice

The Assistant Treasurer and Minister for Financial Services and Superannuation, the Hon Bill Shorten MP, yesterday met with representatives from the financial planning, tax and accounting bodies, the Treasury, the Tax Financial planners Board (the Board) and the Australian Securities and Investments Commission (ASIC) and agreed to broad principles that will be used to develop regulatory arrangements for financial planners who provide tax advice within the context of providing financial advice.

This meeting was part of ongoing consultation started in 2010 with the release of an options paper by the Assistant Treasurer. A series of meetings have been held since December 2010 to reach agreement on key aspects of a regulatory model.

"I am encouraged by the enthusiasm and constructive engagement of industry in this consultation process. The agreement of the key elements of a practical model will benefit the finance, tax and accounting industries. For consumers, this means they can expect to receive quality financial planning services that include competent advice on related tax issues," Mr Shorten said.

Meeting participants agreed to the following:

- *The current exemption of financial planners from the tax agent services regime will be extended to 30 June 2012 to allow for the regulatory model to be developed and legislation to commence on 1 July 2012.*

- *As far as practicable, financial planners and consumers will interact with ASIC in relation to financial planning services. ASIC and the Board will collaborate closely under the proposed arrangements, with the Board dealing with tax-specific complaints, complex matters referred by ASIC, competencies,* *recognition and investigations. Streamlined arrangements will be implemented as far as possible. For example, there will be one set of tax competencies.*

- *Financial planners would be required to be registered through ASIC with the Board to provide tax advice within the context of providing financial advice. A public register would be created.*

- *The scope of services that can be provided by financial planners is determined according to the type of registration held.*

    1. *A planner can provide general factual tax information (not tax advice).*

    2. *If a planner has an additional form of registration, they can provide tax advice within the context of providing financial advice. The scope of tax advice that will be permissible within this category will depend upon the competencies that are required.*

    3. *Tax agents registered under the Tax Agent Services Act 2009 provide full tax agent services including preparing or lodging returns or representing a taxpayer in their dealings with the ATO.*

- *Financial planners registered to provide tax advice within the context of providing financial advice would also need to abide by tax specific obligations that currently apply to registered tax agents. These obligations would be under a code of conduct that would ensure that services are provided to consumers in accordance with appropriate professional and ethical standards.*

- *Financial planners that wish to obtain this additional form of registration should have sufficient competency to provide reliable tax advice within the context of providing financial advice. To attain these competencies financial planners would be required to have certain tax related qualifications to ensure that quality advice is provided and consumers can rely on this advice. Further consultation would be carried out by the Board and ASIC on the nature of these competencies and the proposed level of the additional qualifications. Without pre-empting the outcome of this process, participants thought that the level of the qualification may be equivalent to that of a Diploma. Tax competencies would be determined by the Board after these consultations.*

A transitional framework would operate from 1 July 2012 that would enable financial planners (existing and new) to be eligible for a simple initial registration for a period of three years. This period can be used to attain competencies to deliver quality tax advice as part of financial planning advice.

The details of the model will be developed in consideration of the Future of Financial Advice *reforms.*

Treasury, in consultation with the Board and ASIC, will now progress the details of the model to be determined by the Government with a view to consultation on exposure draft legislation later in the year.

Our approach

Our approach at present is to take great care to ensure that financial planners are not providing taxation advice unless they are otherwise qualified to do so, that is are registered taxation agents or solicitors.

If the changes floated by Mr Shorten do in fact eventuate we will create further training facilities so advisors can be licensed to advise on taxation. In the meanwhile advisors will not provide taxation advice. However, they can in effect provide taxation advice by involving McMasters' Solicitors, which is a solicitor and a registered tax agent, as the source of any advice on a client's taxation profile.

Further, advisors are encouraged to study this manual and as far as possible ensure the principles are applied to their own business and investment activities, and to ensure the same principles are applied in their clients' financial affairs without providing specific tax advice unless it is tax advice provided by McMasters' Solicitors.

Tax planning for financial planners

Tax planning for financial planners involves:

(i) selecting the correct legal form for the practice. This will usually be a trust based structure with a maximum amount of net income derived through a discretionary trust to be distributed to lower tax rate beneficiaries including investment companies;

(ii) minimizing and even eliminating expensive non-deductible debt connected to home purchases and renovations, through the careful management of practice and investment cash flow;

(iii) deferring tax as far as possible, and using the enhanced cash flow for investment and for debt elimination strategies;

(iv) paying the maximum amount of superannuation possible each year, having regard to age and marital status, using gearing if necessary;

(v) using advanced superannuation planning strategies to minimize tax payable on the superannuation fund's investment income;

(vi) ensuring maximum tax efficiency for two or more cars;

(vii) making sure all possible deductions are claimed, particularly deductions which have a private element and which do not involve extra cash payments;

(viii) investing in your home as a tax free investment;

(ix) investing in your office as a tax free investment;

(x) investing via superannuation wherever possible, using both concessional and non-concessional contributions, as a tax free or near tax free investment;

(xi) structuring debt so that it is connected to the practice and is deductible at the highest possible marginal tax rate; and

(xii) structuring investments so they are not owned by high tax rate persons and are owned by low or no tax persons, such as trusts, companies and self-managed superannuation funds.

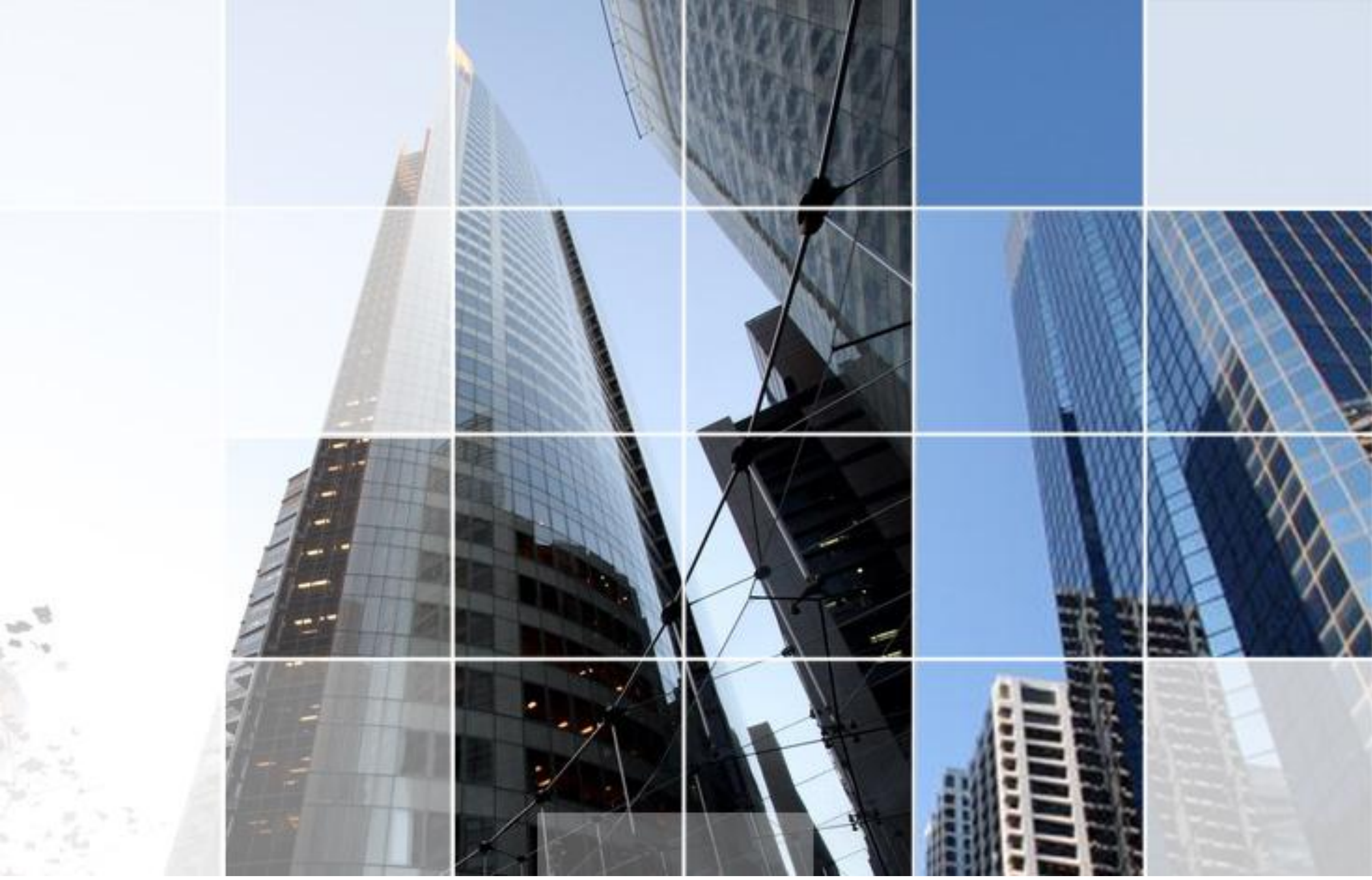
There is no such thing as off the shelf tax advice

This manual explains how and why we use various strategies to improve our advisors' financial planning profiles, which includes the legitimate reduction of income tax on practice income and investment income. These strategies are complex and in most cases their application is simplified to aid understanding and comprehension.

No responsibility is taken for any error or omission contained in this manual and readers are advised to confirm each strategy with us in writing before implementation and on an annual on-going basis.

Commercial purposes

Each structure or strategy we recommend is supported by a number of legitimate commercial purposes other than the reduction of a tax liability. These purposes include administrative efficiency, cost reduction and asset protection. For simplicity, ease of explanation and economy of space these purposes are not explicitly referred to in each part of the manual but they are implied throughout and readers can request further explanation and background as to how these commercial purposes affect their circumstance by contacting McMasters and requesting a specific explanation.



Part 1 Legal Structures

Part 1.1 Introduction, and our usual recommendations

In this section of the guide, we examine the various legal structures financial planners can use to derive income from their practice.

For financial planners who are employees, the range of options available to them to receive that income is limited. The financial planner will basically receive a wage or salary from the employer.

We concentrate on income received by financial planners in private practice. It is this income to which substantial tax planning can be applied. A financial planner in private practice has three broad forms of practice available. These broad forms are:

- to operate as a sole trader (that is, practice in their own name);
- to operate via a practice trust; or
- to operate via a company.

Typically, there are few benefits available to operating a practice via a company. Any benefits that are available to a company are also available to a practice that is operated via a trust. There are various negatives to operating a practice via a company, (particularly the loss of some of the CGT small business concessions) and these are largely avoided if the practice is operated via a trust. And for this reason we rarely recommend practices be owned by companies[1].

There are various benefits available to operating as a sole trader. Once again, those benefits are also available to a practice that is operated via a trust. Once again, there are various potential negatives to operating a practice as a sole trader, most of which are avoided if the practice is operated via a trust.

Because of this, our starting point for a financial planner selecting the appropriate practice structure is typically a practice trust, whether it is a PSI practice trust or a traditional family trust. Such a structure combines the benefits of being a sole trader with the benefits of being a company, while allowing the practice to avoid almost all of the negatives associated with practicing either as a sole trader or as a company.

What do we usually recommend?

We recommend clients use the simplest and lowest cost structures possible, and as few entities as possible.

This means we usually recommend:

(i) solo financial planners deriving personal services income use:

  a. a PSI practice trust, or
  b. a family trust with an arms length reward to the financial planner;

(ii) solo financial planners deriving personal services income consider using a service entity to protect assets and to divert net income to lower tax rate family members and investment companies;

(iii) solo financial planners deriving business income use a family trust to divert net income to lower tax rate family members and investment companies;

(iv) group financial planners deriving personal services income use a hybrid trust with the units owned by family trusts with an arms length reward to the financial planners; and

(v) group financial planners deriving business income use:

  a. a hybrid trust with the units owned by family trusts, or
  b. a partnership of family trusts.

[1] And a significant tax deferral of up to 23 months can be achieved on changing from a practice company to a practice trust

These structures generally achieve optimal business efficiency, avoid unnecessary payroll tax and Workcover premiums on returns to owners, simplify BAS arrangements, minimize bank costs and minimize external accounting fees as well as achieving income tax and capital gains tax optimality.

A table summarising the range of possible practice structures is set out on the next page. This table does not include all possible combinations of structures.

The service entity may be a service trust, a service company or a service partnership of companies or trusts, and each of these options is discussed in the following pages. But in most cases it will be a service trust.

An "arms length family trust" is a normal family trust (ie discretionary trust) where the financial planner receives an arms length reward for actual work completed, made up of salary, trust distributions, superannuation contributions and concessionally taxed fringe benefits such as multiple car fringe benefits.

Table summarizing practice structure options

Type of practice	Type of income	Type of Structure	Service Entity?	Diagram Hypertext link
Solo	Personal services income	PSI Practice Trust	Possibly	
		An arms length family trust	No	
Solo	Business income	Discretionary trust	No	

Group	Personal services income	Hybrid trust with an arms length reward to owners (recommended)	Possibly	
		Associateship of PSI practice trusts or arms length family trusts (not recommended)	No	
		Partnership of PSI practice trusts or arms length family trusts (not recommended)	No	
Group	Business income	Hybrid trust with units owned by family trusts	No	

Part 1.2 Personal services income and business income: the basic idea

A financial planning practice can generate two general types of income. The first is known as personal services income ('PSI'). The second is known as business income.

Which form of income is being generated is a matter of fact. That is to say, there are certain criteria that must be met in order for income to qualify as business income. If these criteria are not met the income will be treated as PSI. The key, then, is to ascertain whether the income is business income. If it isn't, it is PSI income.

PSI income and business income are subject to the same marginal tax rates. The key difference between the two forms of income lies in the way the income can be distributed. PSI income can only be distributed to the individual owner, ie the financial planner. Business income can be distributed to any legitimate owner of the practice. If the practice is owned via some sort of discretionary vehicle, such as a family trust, the income can be divided between two or more eligible beneficiaries of that family trust. In other words, if the practice is a business its income can be legitimately shared with lower tax rate family members under a family trust arrangement.

When two or more people pay tax on a given amount of income, they will pay less tax in combination that an individual would pay if he or she received all the income. That is, if the tax liability is spread between two or more people, less tax is paid. This is because Australia uses a system of taxation known as a progressive system, whereby the amount of tax paid per dollar increases as the number of dollars received increases. Spreading income between related persons usually reduces the total amount of tax paid and the average tax rate.

The ATO has set out its thoughts on when professional practice income is business income and when it is personal service income, and these can be read at Income Tax Ruling IT 2639 Income Tax Ruling IT 2639 dated June 1991. In summary, the ATO accepts as a rule of thumb that:

(i) a practice derives business income if it has more equivalent full time material fee earners who are not owners than owners; and

(ii) a practice derives personal services income if it has fewer equivalent full time material fee earners who are not owners than owners.

The ruling also indicates that a practice may be a business where this rule of thumb is not satisfied, depending on a range of factors including:

(i) the total revenue;
(ii) the total costs;
(iii) the total number of staff, including professional staff and support staff;
(iii) the degree of system and organization; and

(iv) the amount of capital invested in the practice.

Part 1.3 Personal Services Income Trusts

Introduction

PSI Practice Trusts are routinely used by financial planners whose practices are not business for income tax purposes and which derive personal services income.

IT 2639 permits PSI trust to be used.

What is a PSI Practice Trust?

In summary, a PSI Practice Trust is a trust created to run a practice that does not meet the ATO's definition of a business. Basically, a practice will meet the ATO's definition of a business if it has the same number or more non-owner material fee earners than owners.

If this criterion is not met, the practice is a personal services income practice.

In other words, a personal services income practice is a practice where the income is predominantly derived from the personal services of the owner or owners[2].

The question of whether a particular financial planner is deriving personal services income or business income is a question of fact, not law. In each case you have to look at the facts of the practice and apply the law to these facts. In applying the law, common sense tells you to apply the law as it is accepted by the ATO, and hence as a practical matter we regard the ATO's "rule of thumb" as set out in sub-paragraph 10(a) of Income Tax Ruling IT 2639 as the measure to meet.

As a general comment it is better for income to be business income than just personal services income, as tax planning options tend to be better and more numerous. As a general proposition para-planners will be "material fee earners" for the purposes of IT 2639 even though they do not bill clients directly, because they are in fact "material fee earners".

Why do we recommend PSI practice trusts?

We recommend PSI practice trusts because they are simpler, cheaper and more tax efficient than the alternative practice structures. More expansively, practice trusts allow us to obtain better tax planning results for clients by taking advantage of the intrinsic benefits attached to trust based structures, including the timing of tax payments and the ability to withdraw cash from the trust without triggering a tax charge,

[2] See Income Tax Ruling 2639 Income Tax Ruling IT 2639 dated June 1991

and the fringe benefits tax rules connected to the employer and employee relationship between the trust and the financial planner.

A PSI practice trust uses a special trust deed designed by McMasters' Legal that only permits income to be distributed to the relevant financial planner, in line with the ATO's published rulings on the incorporation of professional practices. The PSI practice trust is an integral part of many financial planners' tax planning strategies and allow the financial planner to combine the benefits of running a practice in his or her own name with the benefits of using a practice company.

What are the advantages of a PSI practice trust?

The advantages of a PSI practice trust include:

1. a deferral of tax payments of up to 23 months in the first year of use where the financial planner was previously an employee, as the financial planner changes from the pay as you go withholdings system to the pay as you go instalments system;

2. better debt management, via an enhanced ability to borrow to pay outgoings where the ATO accepts the interest is deductible, such as tax, super contributions, management fees/costs and personal deductible costs. Borrowing for these outgoings 'frees up' the cash flow of the practice. This freed up cash flow can then be used for non-deductible private purposes such as reducing non-deductible home loans and credit cards[3];

3. superior superannuation planning potential, including the ability to superannuate a financial planner receiving significant super benefits from a third party employer such as a public hospital;

4. the ability to provide concessionally taxed fringe benefits, particularly multiple car fringe benefits;

5. reduced substantiation requirements, leading to lighter administration;

6. a better domestic travel tax profile; and

7. easier employment of related persons.

Statutory personal services income rules

The income tax law contains special rules directed at independent contractors that in effect deem their income to be like employment income. These rules do not apply to financial planners unless the financial planner derives all their income from one source[4].

[3] See frequently used diagram 3.4 in Frequently used diagrams
[4] See paragraph 15 of IT Ruling 7 of 2001, which can be downloaded here: ATO Ruling 7 of 2001

Few financial planners derive all their income from one source. Most derive their income from literally hundreds of sources, being the individual clients they see in a year. This is so even if their fees are collected for them by their AFSL

Most financial planners are not covered by the statutory personal services income rules. This is accepted by the ATO. The ATO's views on how the statutory personal services income rules apply to financial planners are set out in a special fact sheet which can be accessed here: ATO fact sheet on PSI for financial planners.

Summary of the advantages of a practice trust

Feature	Individual deriving PSI	Practice company deriving PSI	Practice trust deriving PSI
Cost to set up?	Nil	$900[5]	$500
Cost to run?	Varies	As for individual plus $212 ASIC fee plus costs re more complicated BASs	As for individual plus $212 ASIC fee
Tax collection system?	Pay As You Go Instalments, which means tax is paid later than otherwise	Pay As You Go Withholdings, which means tax is paid sooner than otherwise	Pay As You Go Instalments, which means tax is paid later
BAS simple?	Yes	No, due to PAYG withholding rules	Yes
Can borrow to pay deductible business outgoings?	Yes	Yes, but cannot extract cash from company	Yes
Can borrow to pay tax?	Yes	Yes, but cannot extract cash from company	Yes
Can borrow to pay super contributions?	No	Yes, but cannot extract cash from company	Yes
Tax efficient	Yes	No (deeming rules apply if	Yes. Practice trusts

[5] See www'legaledocs.com.au for a full list of prices of companies, trusts and other legal services

access to cash in entity?		money lent by company to a related person)	are effective for debt conversion strategies
Full deduction for super contributions?	Yes	Yes	Yes
Concessional fringe benefits available[6]?	No	Yes	Yes
Multiple car fringe benefits[7]	No	Yes	Yes
Payroll tax	Not applicable	Yes, if total salaries exceed threshold ($500,000 pa)	No.
Workcover	Not applicable	Yes	No
Compliance with ATO rulings on incorporation of professional practices: the break even rule	Not applicable	Difficult: must estimate salary. May inadvertently breach rule and expose the owner owner to a risk of penalties.	Simple: compliance is automatic as net income is automatically distributed to the owner owner

Part 1.4 Family Trusts and Personal Services Income

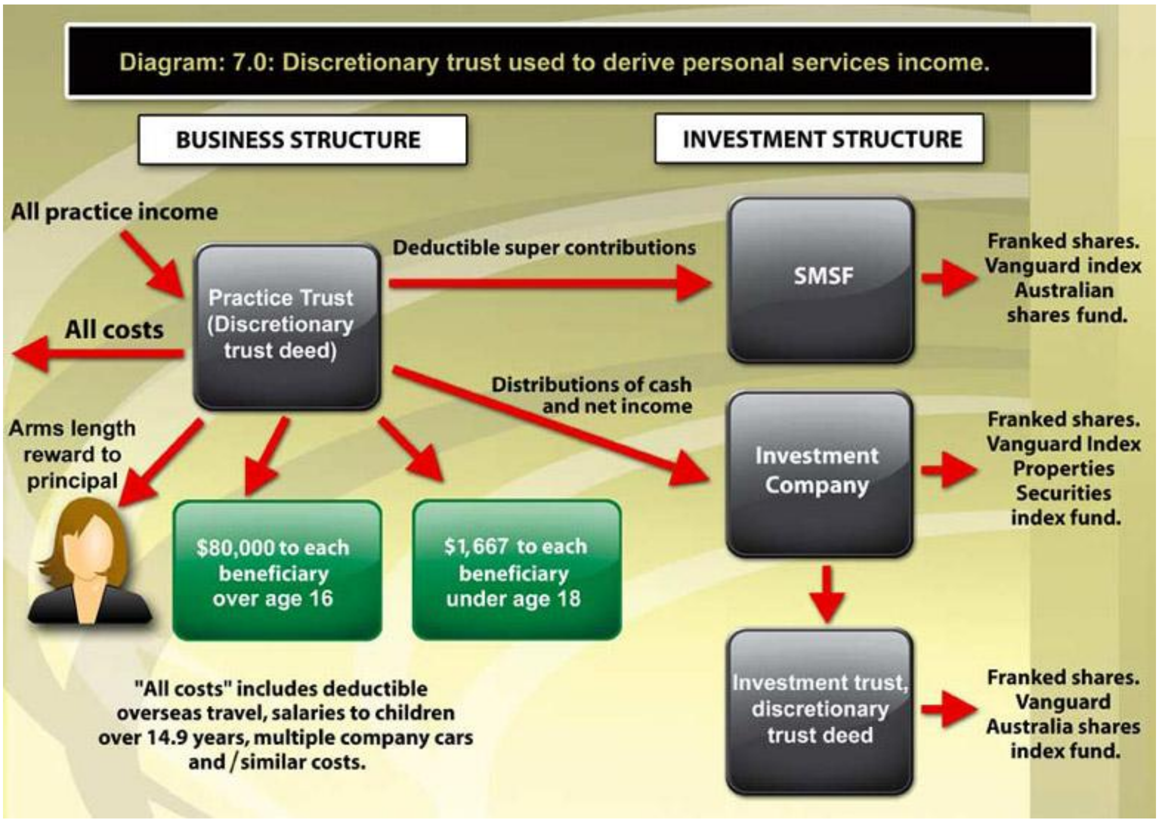
Introduction

In early 2008 a client received advice from a well-known Melbourne tax QC to the effect that the Commissioner of Taxation accepts that professional practices can be run by family trusts (ie discretionary trusts) provided that the financial planner receives a reward commensurate with the contribution made by the financial planner.

The idea is depicted as follows:

[6] Examples include, $300 per employee tax exempt fringe benefits, tax free meal allowances, and similar tax benefits that require an employer/employee relationship to be present

[7] There is no limit on the number of deductible company cars able to be provided as a fringe benefit. This is a useful way to provide financial assistance to low income relatives such as university age children or elderly pensioner parents



The concept of "reward" in this model includes salary, distributions, superannuation contributions and fringe benefits. This advice is well respected, and we are 100% confident in it.

This model is simple, cheap and easy to administer. It confers all the advantages of a personal services income trust, as discussed in the preceding section, plus the possibility of the net income in the trust, less the arms length management fee, being distributed to beneficiaries such as children (cap of about $1700 if under age 18), spouses, parents and possibly an investment company.

The ability to distribute excess net income to low income beneficiaries is a distinct advantage of this structure. This ability dovetails well with the use of tax efficient investment structures. This is because it allows cash to move efficiently from the financial planner's highly taxed hands to the lower taxed hands of relatives and investment companies, where it can be invested tax efficiently. Further, if the practice evolves to become a business, by employing other professional staff, the condition of an arms length reward can be dropped and the taxable income of the financial planner limited to $80,000 per year.

Interaction with service trust rules

The idea of a professional practice discretionary trust with an arms length reward to the financial planner is consistent with the ATO's views on service entities.

In the case of a practice using a service trust, each of the financial planner and the trust end up with an arms length share of the net income, since the service trust's charges are limited to arms length amounts.

In the case of a practice paying an arms length reward to the financial planner, the same result also ensues: each of the financial planner and the trust end up with an arms length share of the net income, since the financial planner must be paid an arms length amount.

This observation gives us increased confidence in the QC's opinion. It also makes it hard for the ATO to apply the anti-tax avoidance rules to the arrangement: if the same result could have been achieved using ATO sanctioned service entity rules, how can it be said the arrangement was entered into for the purpose of securing a tax benefit?

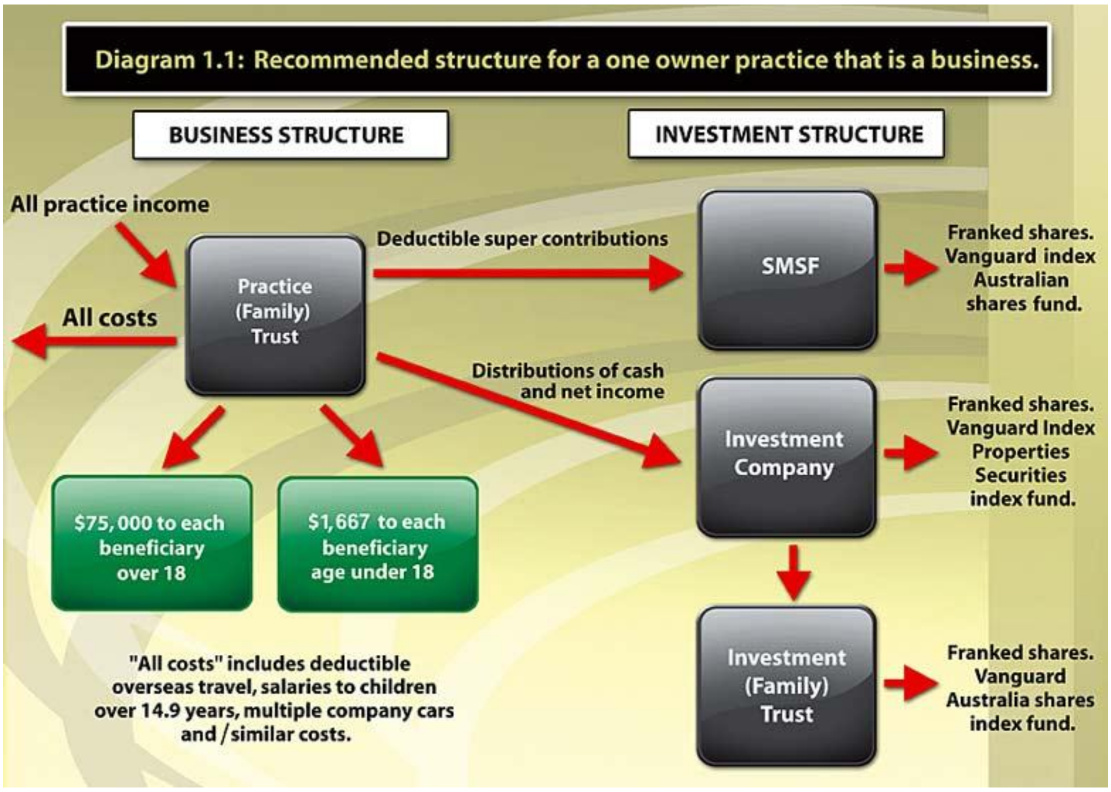
Part 1.5 Business Practice Trusts

Introduction

Business practice trusts are the simplest and easiest way to own a professional practice where the practice is a business for tax purposes. The ATO says that a practice will be a business for income tax purposes where it employs or otherwise engages an equal or greater number of non-owner financial planners than owner financial planners, on an equivalent full time basis[8].

Diagram

Business practice trusts can be depicted as follows:



[8] See Income Tax Ruling 2639 Income Tax Ruling IT 2639 dated June 1991

This structure is extremely simple and cheap to run, avoids payroll tax and Workcover costs on payments to owners and maximizes income tax and capital gains tax efficiency, both on current year practice profits and the long term investment of the after tax amounts of those profits.

Business practice trusts means the top marginal tax rate faced by a financial planner is potentially 30%, and the average tax rate will be somewhere below 30%. This is because the financial planner has the ability to control the amount of taxable income derived by him or her, and in particular to cap this amount at $80,000, which means the financial planner is just below the 41.5% tax rate.

This reduces current year income tax and also improves future year investment performance because:

(i) the financial planner has more money to invest, since he or she is investing after tax income that has only been taxed at 30%, and hence 70% remains available for investing; and

(ii) the after tax rate of return on the investment is greater than otherwise, since the investment company pays less tax than otherwise.

Think of a snowball: if it starts off bigger and rolls faster it will end up a lot bigger, with a double whammy effect at work compounding the growth.

Obviously any amounts distributed to an investment company should be in fact paid to the investment company, or documented and treated as a real loan, to avoid a deemed un-frankable dividend under the private company loan rules.

Significant commercial advantages

The benefits of a practice qualifying as a business are not restricted to superior tax treatment. A practice that engages one or more non-owner financial planners will also enjoy higher levels of profit. Even better, the additional profit is not conditional upon the personal contribution of the owner or owners of the business.

A business practice trust is the simplest way to set up and to run a practice that is a business. The trust requires just one bank account, one tax return, one set of accounts and one BAS each quarter. Business practice trusts are tax efficient, and as a practical matter in most cases mean the practice’s income is taxed efficiently, so that:

1. net income can be legitimately distributed to related persons who face a lower tax rate than the owner’;
2. the top marginal tax rate is as low as 30%, being the current corporate tax rate;
3. the average tax rate is less than 30%, the extent depending on the family tax profile and in particular the age and number of children and other close relatives.

As for PSI practice trusts, the advantages of a business practice trust include:

1 a legitimate 23 month deferral of tax payments in the first year of use where the financial planner was previously an employee;

2 an enhanced ability to borrow to pay outgoings where the ATO accepts the interest is deductible, thereby freeing up cash flow for non-deductible private purposes such as the reduction of non-deductible debts[9];

3 better super planning potential, including the ability to superannuate a planner receiving significant super benefits from an employer;

4 ability to provide concessionally taxed fringe benefits, particularly multiple car fringe benefits;

5 reduced substantiation requirements;

6 better domestic travel tax profile; and

7 easier employment of related persons.

Other advantages of a practice trust

Business practice trusts are simple and cheap to set up and to run each year.

Business practice trusts distribute their reward to owners without paying a salary, which means there is no payroll tax on salary payments and no mandatory work-cover insurance premiums.

A trust with a corporate trustee (that is, which has a company as a trustee) has all the advantages of a company. But it also has relatively few of the limitations often experienced by a company. For example, a practice that is operated via a company has fewer avenues via which it can implement optimal debt management.

Part 1.6 Service Entities

Where a financial planner is operating his or her private practice via a PSI trust, consideration can be given to whether or not a service entity should also be applied.

A "service entity" is usually another trust that provides administrative services to a professional practice. A service trust can be either a discretionary trust a unit trust or a hybrid trust. The service trust of a solo

[9] See frequently used diagram 3.4 in Frequently used diagrams

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practice will normally be a discretionary trust (ie the financial planner's family trust) and the service trust of a partnership or an associateship will normally be a unit trust or a hybrid trust, with the units owned by the financial planners' family trusts in line with their partnership percentages.

The service entity provides the services to the professional practice, whether it is a solo financial planner, a partnership, a practice company or an associateship. These services are provided for a fee, and the fee will include a profit component. The income of the service trust is business income. Therefore, the profit component of the fees paid to the service trust can be distributed with discretion between eligible beneficiaries of the service trust.

Types of service entities

A service entity may comprise:

Type of entity	Where used	Comments
Discretionary trust (ie family trust)	Typically used by one owner practices with related persons facing lower tax rates	Can be used with a corporate beneficiary
Unit trust (with units owned by owner's family trusts (or companies)	Typically used by multi-owner practices where some owners have related persons facing lower tax rates and some do not	Need a unit-holder's agreement to regulate co-owners' relationships
A company	Typically used by one owner practices with no related persons facing lower tax rates	Consider having shares owned by a discretionary trust
A partnership of companies or family trusts	Typically used by multi-owner practices where some owners have related persons facing lower tax rates and some do not	Need a partnership agreement to regulate co-owners'

Part 1.7 Service Companies

A service company is a company beneficially owned and controlled by a financial planner or a group of financial planners for the purpose of providing services to a related professional practice.

Readers should refer specifically to Income Tax Ruling TR 2006/2 dated 20 September 2006 “Income Tax Deductibility or service fees paid to associated entities: Phillips arrangements” and the related guide.

A service company may be used where a PSI practice is owned by a financial planner who does not have any related persons in lower tax brackets to whom net income can be efficiently distributed. The use of a service company to provide arms length services to the practice allows net income to be moved from a 41.5% or a 46.5% tax environment to a 30% tax environment[10]. This saves tax of between 16.5% and 11.5% of the net income distributed to the service company.

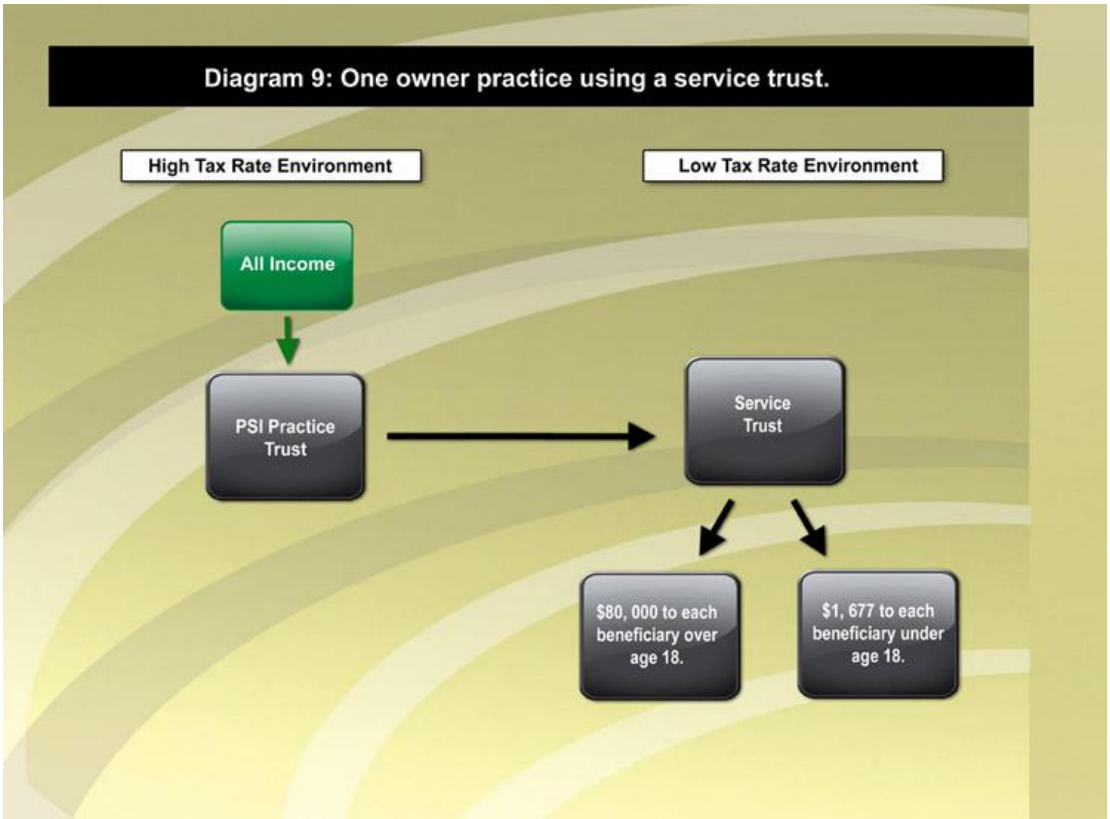
Who should own the shares in the service company?

The shares in the service company should not be owned by the financial planner. This is because they will become valuable over time as assets build up in the company, and this creates asset protection problems.

The shares are ideally owned by a separate family trust controlled by the financial planner or a trusted relative. This creates asset protection advantages, and also allows for future franked dividends paid by the service company to be channeled to a low tax rate beneficiary, thereby reducing the overall level of tax ultimately payable on the service company income (and the investment earnings thereon). Think of that snowball again: there is more to invest, and the after tax earnings are greater, leading to a much bigger snowball later on as earnings compound in a low tax rate environment rather than a high tax rate environment.

Diagram

The arrangement can be depicted as follows:



[10] With the possibility of a refund of all or part of the 30% tax on the ultimate payment of a dividend.

Part 1.8 Investment Companies

Financial planners can set up companies for the purpose of investing monies distributed from discretionary trusts (and hybrid trusts) used to run the practices and the service entities connected to practices.

The investment company pays tax at 30%, compared to 41.5% or even 46.5% tax paid in the financial planner's hands. This means, for example, there is a cash tax saving of between 11.5% and 16.5% of the amount distributed to the company each year.

We recommend investment companies are used by persons facing a high marginal tax rate even after superannuation contributions and distributions to related persons are completed. In summary, despite not receiving the 50% CGT exemption, companies are still usually very efficient investment vehicles because:

(i) the financial planner has 70 cents in the dollar available to invest in the company, compared to just 53.5 cents in the dollar available to invest in his or her own hands;

(ii) eventually a franked dividend will be paid, and this can trigger income tax refunds for excess franking credits; and

(iii) the lower company tax rate translates to a higher after tax rate of return, which means more rapid after tax growth in the value of the investments.

Think of a snowball: if it starts off bigger and rolls faster it will end up a lot bigger, with a double whammy effect at work compounding the growth.

Where should companies not be used to invest?

Companies should not be used to invest in some circumstances including:

(i) where the new investment is expected to generate a significant capital gain in a reasonable short period of time (but more than 12 months), such as a property development (here an investment trust should be used); and

(ii) where the new investment is expected to generate a significant tax loss due to negative gearing, and there is no other investment income available to offset the loss, such a geared residential property investment (here the financial planner should own the property in his or her own name).

You have to pay the cash

The critical practical point is that you have to pay the cash to the investment company. Un-paid trust distributions to investment companies are deemed to be un-frankable dividends, and are penalized under the tax law. Ideally the cash is paid before 30 June in the year the distribution occurs. Second best is as soon as possible afterwards, and the minimum position is by the time the tax return for the relevant year is lodged. This is a very important point with investment companies: you have to pay the cash.

Who should be the shareholder?

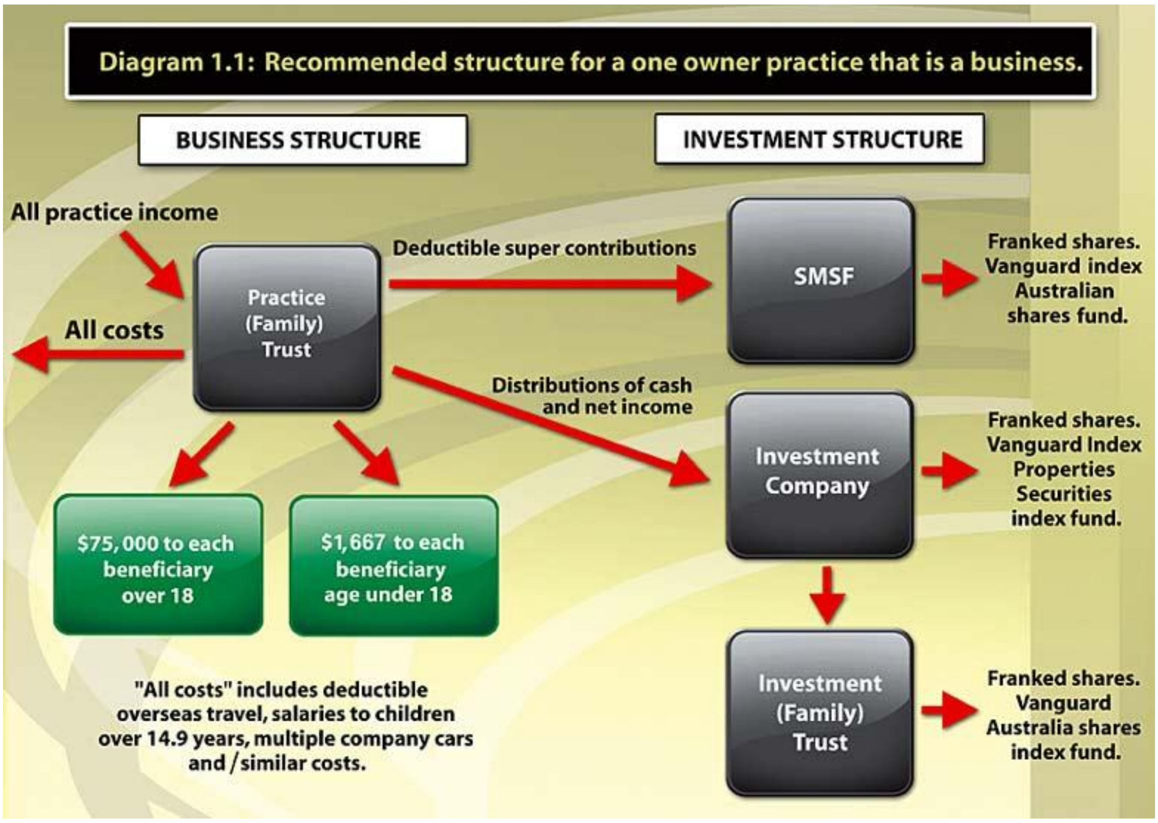
The shares in the investment company should be owned by a separate family trust controlled by the financial planner or a trusted relative. This creates asset protection advantages, and also allows for future franked dividends paid by the investment company to be channeled to a low tax rate beneficiary, thereby reducing the overall level of tax ultimately payable on the service company income (and the investment earnings thereon).

Think of that snowball: there is more to invest, and the after tax earnings are greater, leading to a much bigger snowball later on as earnings compound in a low tax rate environment rather than a high tax rate environment.

Diagram

Investment companies are used in many of our client structures and one application is for a one owner practice that is a business because it has more non-owner fee earners than owner fee earners.

This application is depicted here:



The practice trust:

(i) distributes up to $3,000 net income to beneficiaries under age 18 (just $441 from 1 July 2012) including immediate family members and if appropriate extended family members;

(ii) distributes up to $75,000 to each beneficiary over age 18,

(iii) pays deductible superannuation contributions to the SMSF, and then

(iv) distributes any remaining net income to the investment company.

The investment company then pays 30% tax, invests the after tax amount of the money and pays a fully franked dividends to the shareholder family trust at some time in the future when a low tax rate beneficiaries presents. The beneficiary includes the franked dividend in his or her taxable income and claims a credit for the 30% tax previously paid, generating a refund of excess franking credits. This means the ultimate rate of tax is less than 30%, and may even be nil%.

Part 1.9 Investment Trusts

Investment trusts, particularly family trusts/discretionary trusts are often used to hold investments. Often the investment trust function is combined with a service trust function, but practice trusts should not hold investments due to asset protection issues: the investment would be unnecessarily exposed to a risk of client litigation.

You can read more about family trusts in the Dover Guide to Family Trusts which can be accessed at www.dover.com.au.

The advantages of family trusts as investment vehicles include:

(i) asset protection;
(ii) income tax distribution flexibility;
(iii) capital gains tax exemption (after 12 months);
(iv) capital gains tax distribution flexibility;
(v) can be combined with investment companies to get the best of both worlds.

Part 2 Superannuation: the basic idea

Part 2.1 Introduction

Superannuation has always been important for financial planners.

It is a powerful financial planning tool that integrates tax planning with investment strategies producing very powerful long-term results.

For financial planners the new super rules present a new world of investing where the SMSF becomes a tax free family investment vehicle, and where paying tax is (almost) optional for persons over age 60. And that's a large, and increasing, proportion of the population. This is a revolution in tax jurisprudence. It is the first time we have ever seen Government sanctioned/encouraged tax planning on such a large scale. It is not an exaggeration to say paying tax will be optional for financial planners over age 60.

Take a 60 year old married male financial planner whose spouse does not work and who runs his own practice and that the practice is a business for tax purposes. The practice makes $150,000, and the couple has $3,000,000 in assets, comprising a home worth $1,000,000, an investment property worth $1,000,000 and shares in a SMSF worth $1,000,000.

Assume an average earning rate of 10% per annum on these assets[11].

The couples' total income is $450,000, made up of:

(i) $150,000 per annum of practice profit;
(ii) $100,000 per annum net earnings on the property, comprising, say, ($25,000) net rent plus ($75,000) in un-realized capital gain;
(iii) $100,000 per annum net earnings on the shares in the SMSF; and
(iv) $100,000 per annum un-realized capital gain on home.

The couple face a tax bill of just $28,200, or about 6%, on this income of $450,000. This tax bills is calculated as follows:

Income Component	Amount of Income	Tax on Income
Superannuation contributions	$100,000	$15,000
Un-realized capital gain on home	$100,000	$nil
Owner's taxable income	$37,500	$5,850
Spouse's taxable income	$37,500	$5,850
SMSF income (other than contributions)	$100,000	Nil
Un-realized capital gain on investment property	$75,000	Nil
Total	$450,000	$26,700 or 5.9%

The couple can take as much cash from the SMSF as they need, on top of their taxable income of $37,500 each. This extra cash is not assessable income and does not affect the tax paid on their salary and other assessable income. So cash flow is not an issue. This example is not an extreme example. It's simple, safe and has the Federal Government's blessing.

How can a financial planner best use the new superannuation rules?

Careful planning over the years, even the decades, leading up to age 60 is the key. Financial planners should start super planning as soon as possible. Certainly paying the maximum deductible contributions each year, for both yourself and your spouse, is a good start. Get your super balls rolling as early as you

[11] 10% per annum is a conservative estimate of expected average earnings, and is much less than the historical averages

can and, if you are already over 50, make a big effort to pay the maximum deductible contributions every year.

On 1 July 2007 the deductible contribution limits fell to $50,000 irrespective of the member's age (with transitional rules for those over 50: they can pay $100,000 a year each year for 6 years until 30 June 2012. If cash flow is a problem consider gearing the contributions. This has always been a good strategy but it is now even better because there will now be no tax, or limit, on the amount of the lump sum benefit able to be taken out of the SMSF at age 60, or later, to retire the original debt.

This strategy boils down to tax deductible debt reduction, and is a powerful strategy, particularly for those who have left super planning a little late. For example, a fifty-five year old using a PSI practice trust can borrow to pay a $100,000 deductible employer sponsored super contribution to a SMSF, pick up a $33,000 tax break each year and then pay the benefits out, tax free, at age 60 to retire the original borrowing.

If you are already reasonably wealthy and getting closer to age 60 consider paying un-deducted contributions to the limit of $150,000 per person per annum for you and your spouse each year[12]. That's a total of up to $300,000 per annum, or $3,000,000 in total, plus earnings, from age 50 to age 60. Transferring the future income stream to the SMSF is the economic equivalent of extra deductible contributions above and beyond the $50,000 cap.

Part 2.2 Indirect gearing of non-concessional contributions

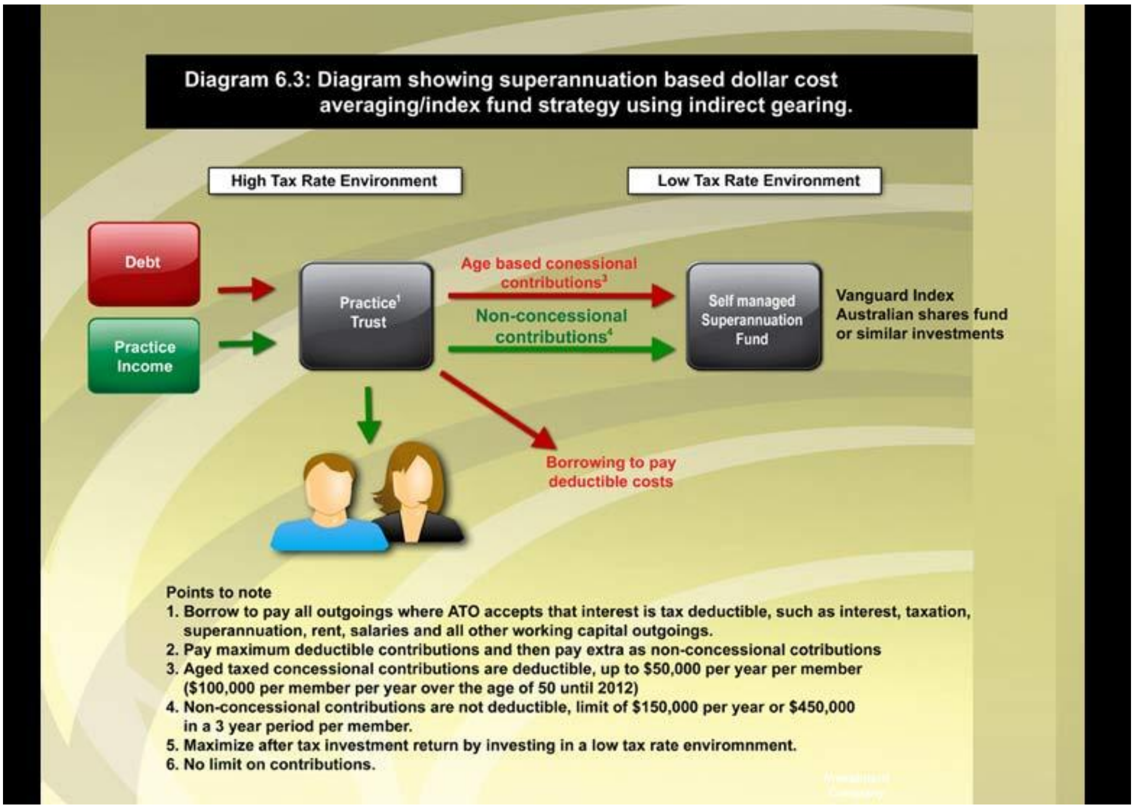
Older clients, particularly those over or close to age 50, and wealthier clients deriving higher than normal taxable income, may choose to use a similar strategy that pays non-concessional (ie non-deductible) contributions to a SMSF on a regular basis.

The problem here is that there is no deduction for interest incurred on amounts borrowed to pay non-concessional contributions. The solution therefore is to not borrow to pay them, and to take care to only use debt free cash flow to pay non-concessional contributions. This means, if necessary, the financial planner should deliberately borrow to pay costs where the ATO accepts that interest is deductible, in order to free up cash flow to pay the non-concessional contributions.

The transfer of the future income stream on the investment of the non-concessional contributions is the economic equivalent of large concessional (ie deductible) contributions over and above the $50,000 per member per year limit ($100,000 if over age 50, until 2012).

[12] Or $450,000 per member in a three year period

Diagram



The idea is shown in the above diagram. The red lines show borrowings and payments using debt, and the green lines show practice cash flow and payments not using debt.

Part 2.3 Summary of superannuation planning techniques

Technique	Comments
Maximum age based contributions paid	$25,000 if under age 50 and $50,000 if over age 50, per year
Superannuate spouse	Employee spouse or director spouse able to be superannuated to age based limits regardless of market value of work done $25,000 if under age 50 and $50,000 if over age 50. Suggest pay salary, appoint as a director and minute the previous year's under-payments
Superannuate parents	As for spouse. Work test must be satisfied if over age 65 Estate planning issues must be considered

Superannuate children	As for spouse, and also consider risk of future divorce
Spouse split contributions	85% of contributions may be split to older spouse to bring forward end of preservation period and the start of the tax free investment period
Borrowing to pay deductible employer super contributions	Interest on employer contributions is deductible. Interest on other contributions is not deductible. Significant cash flow advantages and may create family tax assistance benefits (up to 1 July 2009)
Indirect borrowing to pay other (ie non-employer) super contributions	Interest is effectively deductible. Technique can create powerful tax based investment returns over and above organic investment performance. Suited to older and higher income financial planners
$1,000 Government co-contribution for low income relatives such as 15 year old children	$1,000 contribution will activate a $1,000 co-contribution. Income less than $31,920 pa, subject to transition rules
Transition to retirement pension after age 55 without stopping work	Works best for lower income financial planners with large superannuation benefits and large unrealized capital gains in the SMSF. Tax benefits in SMSF need to be balanced against tax payable on pension income
Transition to retirement pension after age 60 without stopping work	Mandatory at age 60. SMSF becomes tax free and no tax paid on pension income
Superannuation as a debt reduction technique	The closer you are to age 55 the more attractive it is to pay large deductible super contributions rather than pay off debt, particularly tax deductible debt
Retirement at age 55 to access $160,000 tax free lump sum	Need a trigger event, such as a change of office or employment. Financial planner advice required
Salary sacrifice	Prospective substitution of super in place of salary is accepted by the ATO
Controlling shareholder contributions for a spouse	These rules allow a 46.5% tax rate financial planner to superannuate a spouse employed by a controlled company or trust. They cannot be for the benefit of the financial planner/controlling shareholder personally
Re-contribution strategies	Withdraw concessional benefits tax free after age 60 and re-contribute them as non-concessional contributions to minimize or eliminate any death benefits tax

Part 2.4 Borrowing to pay deductible contributions

If cash flow is a problem consider gearing the contributions.

This has always been a good strategy for financial planners but it is now even better because there is no tax, or limit, on the amount of the lump sum benefit able to be taken out of the SMSF at age 60, or later, to retire the original debt.

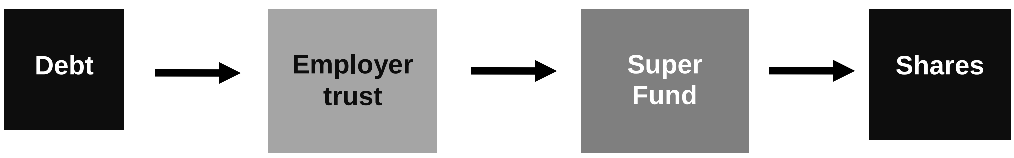
This strategy boils down to tax deductible debt reduction, and is a powerful strategy, particularly for those who have left super planning a little late. For example, a fifty-five year old financial planner using a PSI practice trust can borrow to pay a $100,000 deductible contribution to a SMSF, pick up a $33,000 tax break each year and then pay the benefits out, tax free, at age 60 to retire the original borrowing.

Practice trusts facilitate such strategies because, unlike companies, there is no rule against loan accounts from trustees to beneficiaries. This means a PSI practice trust can borrow to pay a large deductible super contribution of, say $100,000, and then remit an equal amount, ie the $100,000 cash generated by the practice, to the owner without triggering a tax charge.

The strategy does not work for a practice company: the loan to the owner would be treated as an un-frankable dividend in the owner’s hands, which creates an effective total tax charge of more than 60%. And the strategy does not work for an individual owner (ie a financial planner practicing in his or her own name) because interest on amounts borrowed to pay a self-employed person’s super contributions is not deductible (whereas interest on loans for employer contributions is deductible).

The strategy of a PSI practice trust combined with large geared deductible super contributions is routinely reducing tax bills down to 15% or less of taxable income.

Diagrammatically speaking, it looks like this:



Borrowing to pay deductible contributions is first and foremost an investment strategy, and it’s an investment strategy we strongly recommend. This is because economic theory and economic history show that in the long run, on average, the rate of return on each of the major asset classes will be greater than the cost of borrowing.

The ATO View

For completeness, we note that the ATO accepts that a spouse who is an employee can be superannuated up to the deductible contribution limit, ie $50,000 under age 50 and $100,000 over age 50 (until 2012). This is so even where the amount is excessive relative to the market value of the work done by the employee spouse.

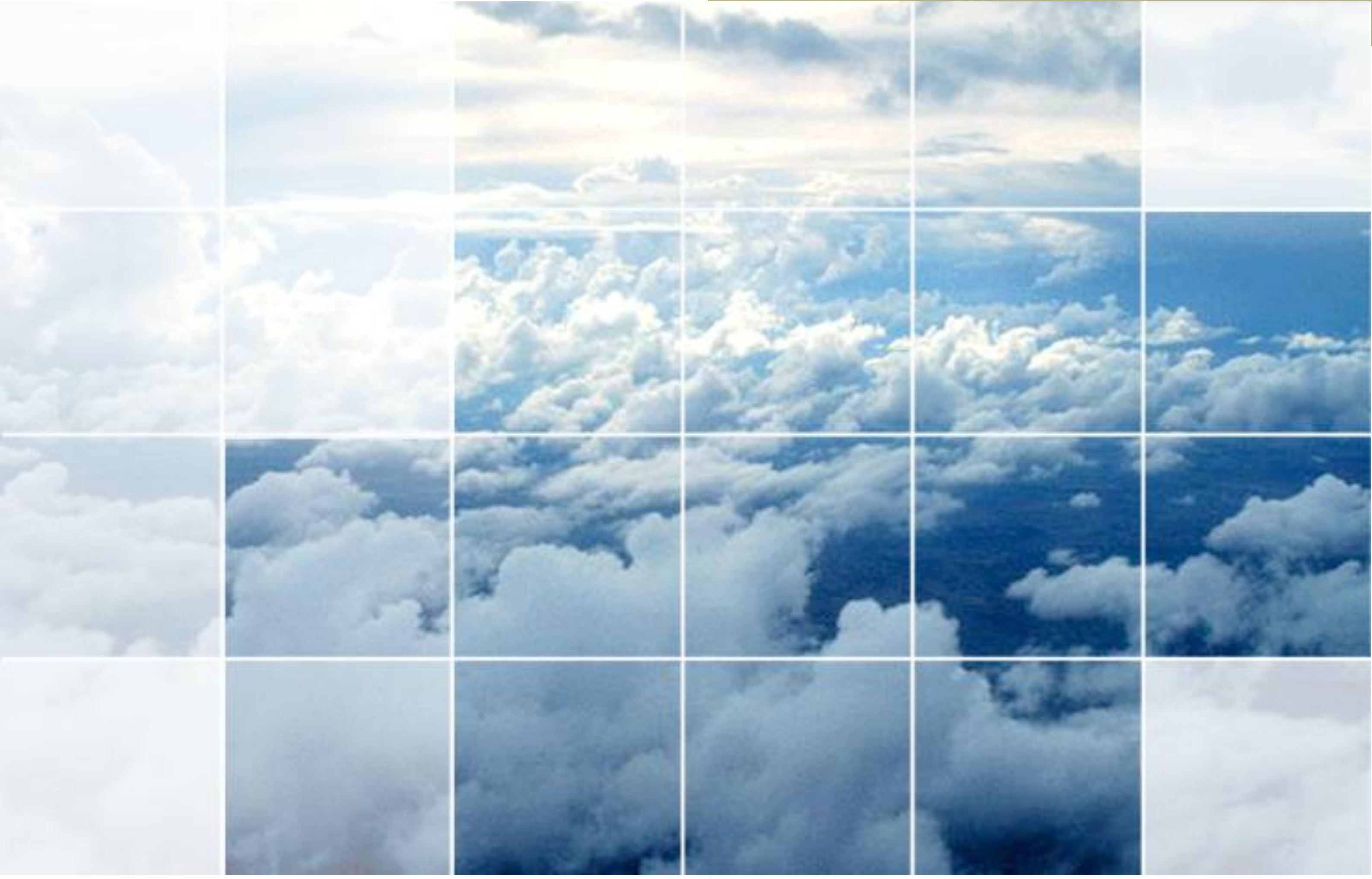
You can read the ATO view in Taxation Determination 2005/29 released 28 September 2005 which can be downloaded here: ATO Determination on spouse contributions .

We usually recommend a three pronged approach, being:

(i) ensure the spouse is a general law employee and actually completes an appropriate amount of real work for the practice, and pay the spouse a market salary for the this work, to help evidence the employment relationship;

(ii) arrange for the spouse to be appointed a director of a company; and

(iii) recording in minutes of directors' meetings the fact that the spouse was under-rewarded in previous years.



Part 3 Cash flow management and non-deductible debt

Part 3.1 Introduction

Often, a client will come to us with a substantial amount of personal debt. Personal debt is debt that has been taken out for a private purpose, and for which the interest is not tax-deductible. In most cases, personal debt arises due to the purchase of the family home. The family home is a private asset and thus the debt is private debt.

This is not to say that people should not borrow to buy their family home. While the personal nature of this debt means that the interest is not deductible, purchasing as much home as the bank's lending agreement is prepared to facilitate is usually a good financial move. A family home has a lot to recommend it: it gives is a place to live and it also provides us with the capital gains tax-free investment asset.

Private debt is very expensive. Private debt should be paid off as quickly as possible. This is because the interest must be repaid using after-tax money. The first thing we do when faced with a substantial private debt is implement one or more strategies designed to quickly repay that debt.

One common presentation involves a client's spouse servicing a large non-deductible debt, such as a home loan (or a planned home extension loan). Here, with careful management of practice trust's cash flow the client can accelerate the re-payment of expensive non-deductible debt. The idea is to borrow to pay all outgoings where the interest on the borrowing is tax deductible, so that the level of deductible (ie cheap) debt increases and to use debt free cash flow for the rapid retirement of expensive non-deductible debt.

Deductible business debt reduces the PSI practice trust's taxable income, and hence the financial planner's taxable income, compared to otherwise. Just as importantly, it increases the amount of debt that the financial planner is liable for, thereby decreasing the financial planner's net assets, while increasing the financial planner's spouse's net assets. This helps on the asset protection front and FINANCIAL PLANNERs are usually particularly interested in making sure the family home is as far beyond the reach of litigious clients as can be.

This process of converting expensive non-deductible loans to cheaper deductible loans is particularly rapid in the two years of a change from a practice company to a practice trust, as the financial planner switches from the PAYGW system to the PAYGI system, and enjoys a tax payment holiday for up to 22 months.

This process is accepted by the ATO and, in particular, the ATO does not regard this strategy is falling within the High Court's decision Hart's case, which involved so called "split loans". This is because there are two separate loans and two separate persons, which was identified by the High Court as being outside the scope of Hart's case. It is important that interest be paid on both loans and that the business loan is in the PSI practice trust's name while the non-deductible home loan is in the financial planner's spouse's name.

It is important that once the non-deductible debt is paid off the deductible debt is paid off too, that the total amount of deductible debt does not become disproportionate to the financial planner's financial profile and that the asset protection emphasis is maintained at all times.

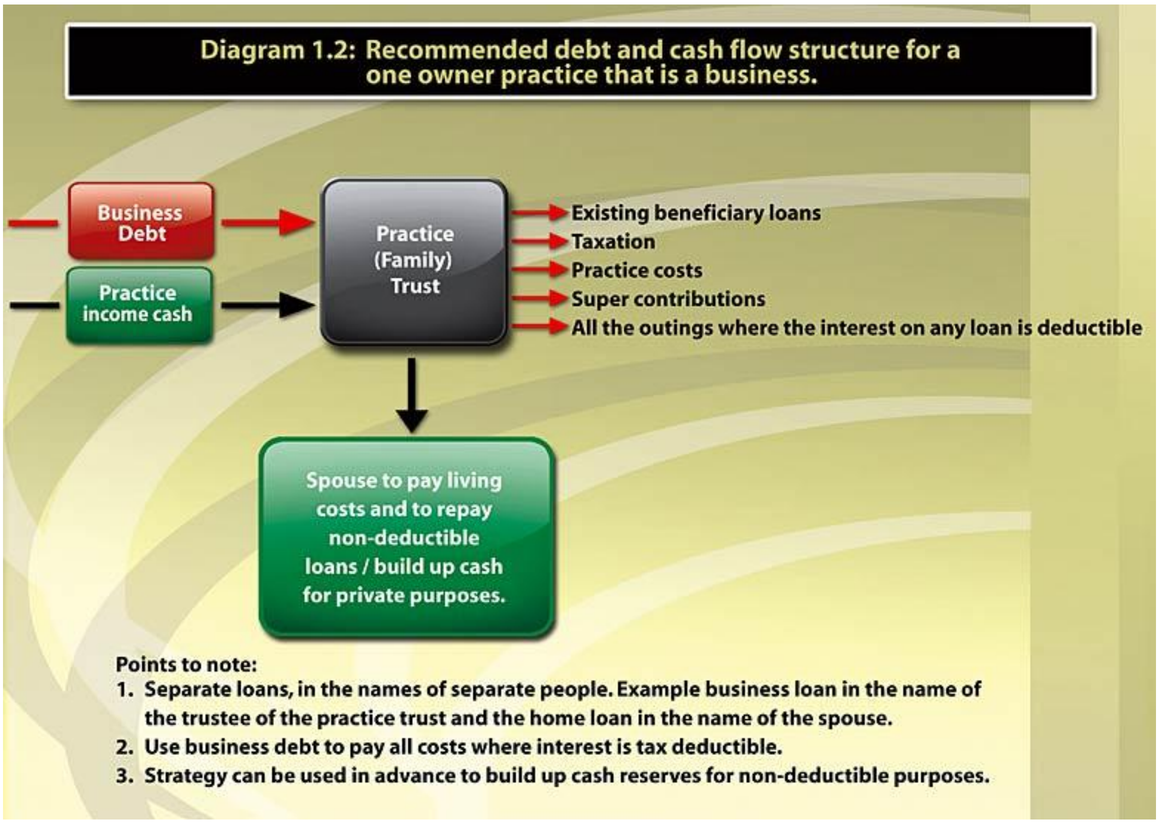
And interest should not be capitalized. That is, paid as and when it is due.

Diagramatically speaking…

A diagram may help illustrate how a practice trust can be used to accelerate the re-payment of non-deductible debts such as a home loan. In this diagram the blue lines show the movement of cash through the practice and the red lines show the movement of debt through the practice.

In summary, the cash from the practice (gross of costs) is being channeled to the owner's spouse to be used for private purposes such as the retirement of expensive non-deductible debt, and debt is used to pay practice costs, including a small salary to the owner's spouse, tax, super contributions and fringe benefits.

Diagram



If, for example, the non-deductible home loan started off at, say, $400,000, and the interest rate is 7% per annum, then at a marginal tax rate of 46.5% including Medicare this strategy will save the owner $13,020 (ie $400,000 times 7% times 46.5%) cash each year for what otherwise would have been the term of the loan. Rough and ready, if the $13,020 cash saving is used to pay back the loan then, ignoring the other scheduled principal repayments, the loan will be paid off completely in about 16 years. Such is the power of compound interest.

Working Capital Loan

Working capital is the collective noun for expenses of a practice.

For the self employed one of the main impediments to repaying their private debt is the need to simultaneously provide the working capital to their practice. That is, the owners are typically using the cash flow generated from the practice to meet the costs of the practice, leaving only the net income of the practice to repay the private debt.

Any business may borrow to finance its working capital requirements. Interest on money borrowed to pay a legitimate expense of the practice will be deductible to the practice. Therefore, we typically suggest that financial planners should arrange for a line of credit loan facility to be made available to their practice. This loan should be entirely separate from all other loans, although it can be secured against residential property if there is sufficient equity in a property to allow this.

When interest on a loan is deductible, the interest paid to the bank represents the effective pre-tax interest rate. This is because the financial planner is able to pay the interest before his or her taxable income is calculated. In the example given above, the annual interest expense of $45,000 is paid before the owner's tax liability is calculated. The owner needs to earn $45,000 to pay the lender. The owner then claims a tax deduction for the $45,000. This deduction is subtracted from the $45,000 that the owner earned in the first place, leaving no net earnings. Accordingly, there is no tax liability either. As a result, the owner needs only to earn $45,000 in order to pay the deductible interest expense of $45,000.

In a line of credit facility, interest is only paid on money that has actually been drawn from within the loan. Money is only drawn from within the loan when there is actually an expense of the practice to be paid. By borrowing to pay the expenses of the practice, the financial planner leaves the revenue of the practice free to be used for some other purpose. In a situation where the owner also has a private debt, the cash can be used to repay that private debt.

Over time, borrowing to meet the working capital requirements of the practice while using the gross cash flows of the practice to retire private debt has the effect of converting non-deductible private debt to deductible practice debt. Provided that every dollar drawn in the working capital loan has been used to pay a legitimate expense of the practice, there is no problem here: the ATO allows the interest as a deduction. Similarly, provided that every dollar used to repay the private loan has been sourced externally (that is, has been sourced from something like client billings), the fact that the private loan has been quickly repaid will not be questioned by the ATO either.

This is an important point: the working capital loan is not being used to repay the private debt. The private debt is being repaid using money derived from client fees. The working capital loan is being used only to pay legitimate expenses of the practice.

For this reason, the process of debt conversion takes time. How long it takes will be a function of the size of the private billings and the size of the debt being converted.

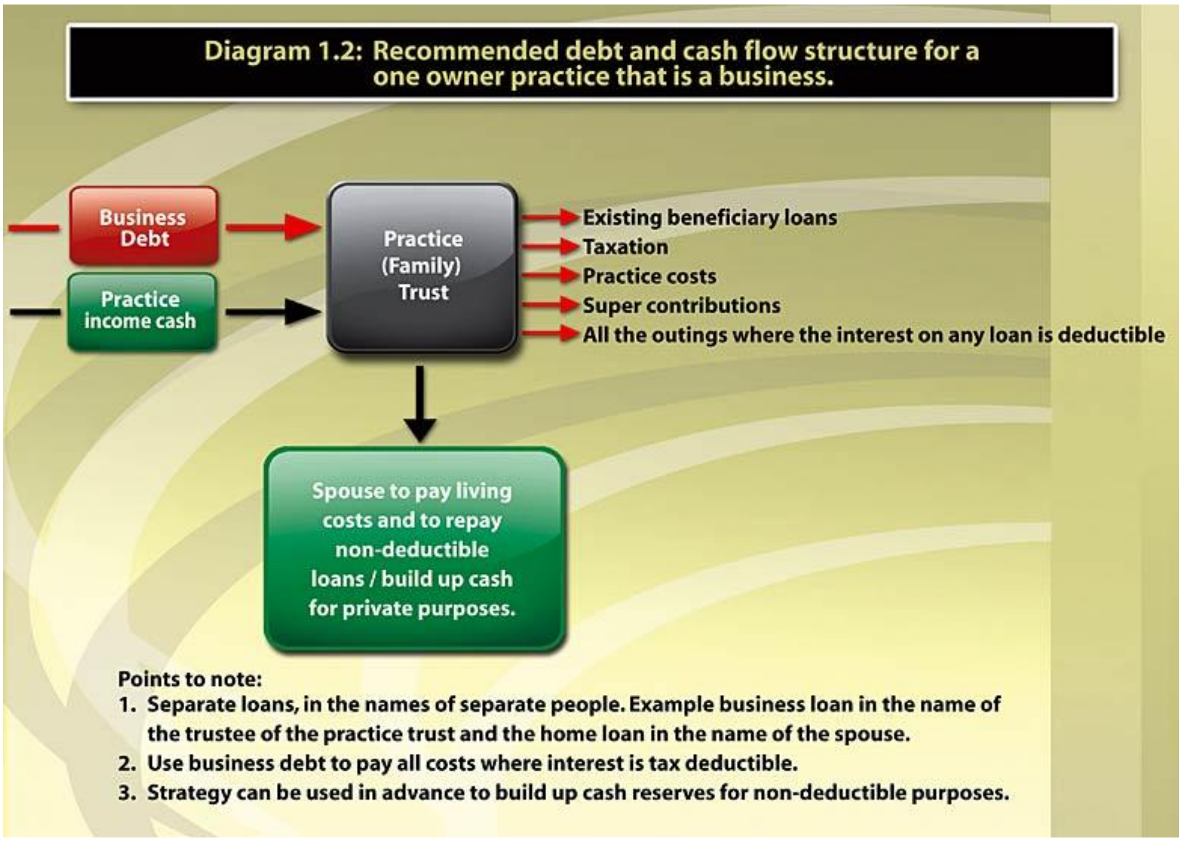


Diagram 1.2: Recommended debt and cash flow structure for a one owner practice that is a business.
Business Debt
Practice income cash
Practice (Family) Trust
Existing beneficiary loans
Taxation
Practice costs
Super contributions
All the outings where the interest on any loan is deductible
Spouse to pay living costs and to repay non-deductible loans / build up cash for private purposes.
Points to note:
1. Separate loans, in the names of separate people. Example business loan in the name of the trustee of the practice trust and the home loan in the name of the spouse.
2. Use business debt to pay all costs where interest is tax deductible.
3. Strategy can be used in advance to build up cash reserves for non-deductible purposes.

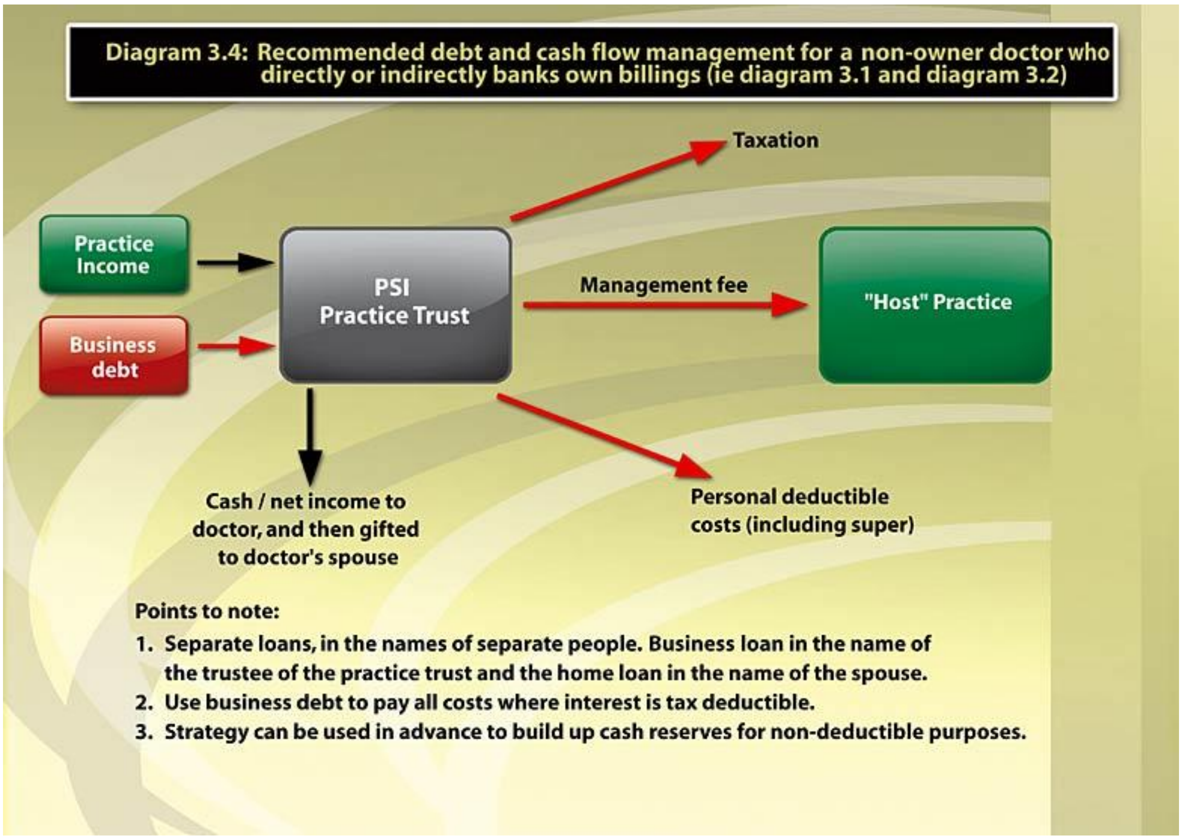


Diagram 3.4: Recommended debt and cash flow management for a non-owner doctor who directly or indirectly banks own billings (ie diagram 3.1 and diagram 3.2)
Taxation
Practice Income
Business debt
PSI Practice Trust
Management fee
"Host" Practice
Cash / net income to doctor, and then gifted to doctor's spouse
Personal deductible costs (including super)
Points to note:
1. Separate loans, in the names of separate people. Business loan in the name of the trustee of the practice trust and the home loan in the name of the spouse.
2. Use business debt to pay all costs where interest is tax deductible.
3. Strategy can be used in advance to build up cash reserves for non-deductible purposes.

Part 3.2 Simple gearing strategies

Simple gearing strategies are discussed in detail in chapter 12 of the Owners' Guide to Financial Planning, under the heading "Debt and the Financial Planning Process" and we refer readers to these materials rather than repeat them here.

Borrowing for investment makes sense for financial planners because on average over time the rate of return on both shares and properties will probably be greater than the cost of borrowing, ie the interest rate.

This means, on raw scores, before tax is considered, borrowing to invest makes sense.

Australia's tax laws, particularly the concessional capital gains tax rules, create tax-based reason for borrowing to acquire investment assets. Only realized capital gains are taxed and, provided the asset is held for more than 12 months, only half the amount is taxed and the other amount is tax-free. However, all if the interest incurred on loans to buy the asset will be deductible in the year it is incurred.

This means if a client borrows to acquire an asset where the bulk of the return comes from unrealized capital gains and only a small percentage derives from income (ie rents and dividends), a significant tax advantage will emerge. This is because the financial planner can offset the loss on the geared investment against his or her other assessable income.

The most common "negatively geared" asset is residential property. In the case of residential property the tax benefits can be enhanced by depreciation on plant and equipment costs and amortization of building construction costs.

For example, if a client borrows say $500,000 to buy a residential property then realistically the financial planner can expect a negatively gearing loss of say $40,000, or 8%, in his or her taxable income computation. This translates to a cash/tax benefit of about $19,000 cash a year, and this usually means owning the asset ends up being a cash flow neutral experience for the financial planner.

Part 3.3 Advanced gearing strategies

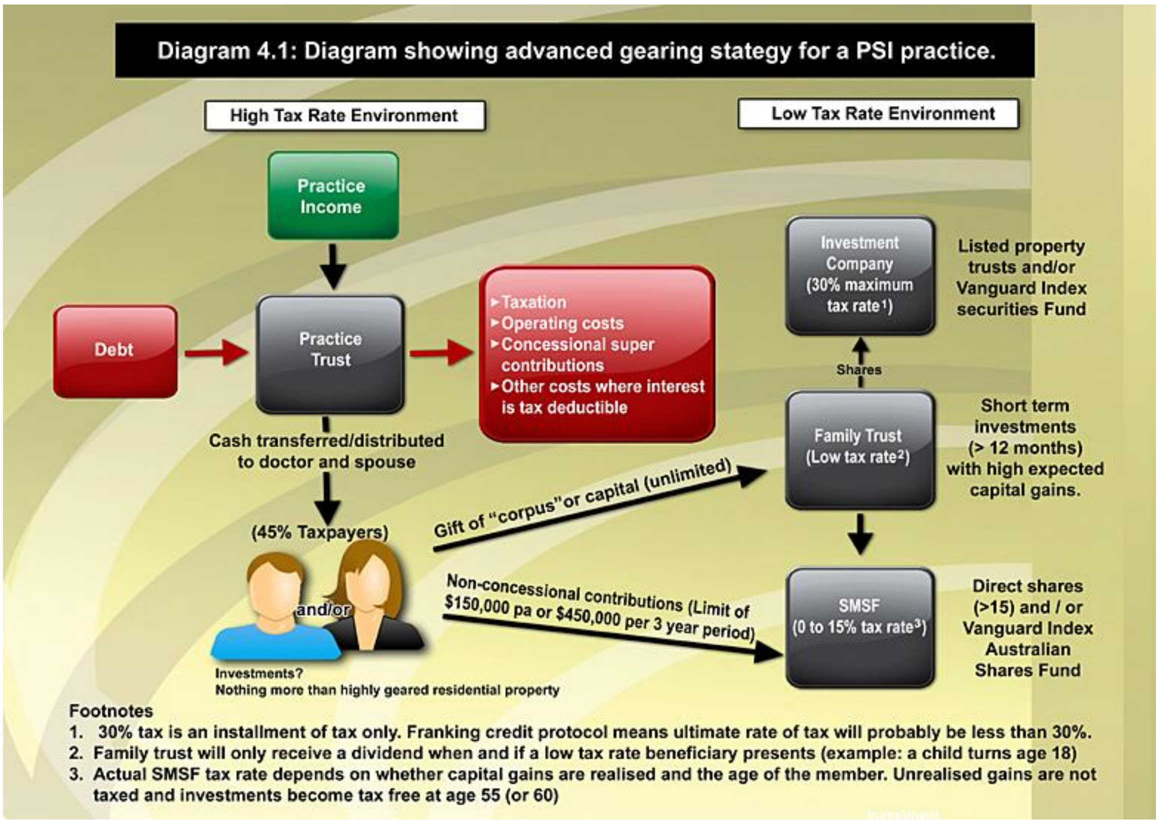
Introduction

Financial planners may implement gearing strategies where the interest is deductible at the high tax rate paid by the client, while the income and capital gains are taxed at a lower rate, if at all, in the hands of related companies, trusts and self managed superannuation funds.

Self-managed superannuation funds are particularly appropriate where the financial planner is age 55 or close to age 55, since the tax free investment period is about to start and the preservation period (ie the time when the benefits cannot be accessed) is about to end. The SMSF strategy is particularly powerful once the client is age 60, since the SMSF can then invest tax free without any tax liability at all and the client can access the benefits (for example, to pay back the loan and un-do the gearing strategy) at any time.

Investment companies and trusts are more appropriate for younger clients. This is because the monies invested can be accessed at any time, compared to the SMSF, although it is likely that more tax will be paid than will be the case using a SMSF.

Diagram



Explanation of diagram

The high tax rate owners arrange the cash flow so that they use debt to pay all costs where the ATO accepts the interest is deductible. These costs include operating costs, employer super contributions, personal deductible costs and taxation (technically an amount borrowed to pay a distribution to a beneficiary, where the beneficiary has lent the money back to the trust).

Borrowing to pay these costs automatically frees up an equal amount of cash in the practice trust. This cash will be sourced from cash flow, not from debt. This cash can be paid out to the owners and invested via:

(i) gifts of capital or corpus to a family trust, which then uses the cash to acquire shares in the investment company, which then acquires investments; and

(ii) non-concessional (ie non-deductible) contributions to a SMSF (or an industry fund) which are then acquires investments.

The choice of an investment company or a SMSF?

Both options can lead to tax free investment returns. The company can achieve tax free investment returns if it pays out franked dividends to the shareholder trust which then distributes the dividend to a beneficiary with no tax liability. The SMSF can achieve tax free returns once it starts to pay a pension to the members, at age 55 or 60.

The character of the underlying investment is important too. For example an investment where the return comprises long term capital gains may end up being tax free in a SMSF even where the financial planners are relatively young, say age 35.

On balance, in general, the younger the client the less likely they are to invest via the SMSF and the more likely they are to invest via the investment company/trust structure. This is because monies invested in the investment company are not preserved and can be accessed early if circumstances change.

For many middle-aged clients, say age between 35 and 50, it may be a bit of a cocktail, a balance between the two options.

Part 3.4 In-house finance company

An in-house finance company can significantly reduce the after tax cost of paying back principal on loans. The technique can be used where the financial planner uses a discretionary trust in his or her practice structure, and that trust is able distribute net income to a related company[13]. This is because the principal is paid back by a company out of after tax income taxed at 30%, which means 70% is available for debt reduction. This is compared to after tax income taxed at 46.5%, which means 53.5% is available for debt reduction. This means 16.5% extra is available for debt reduction.

Further, by consolidating all loans in one entity and providing appropriate security, the effective before tax interest rate is usually lower than otherwise. This is particularly the case where multiple loans, un-secured loans and personal finance contracts (leases, chattel mortgage and hire purchase contracts) were previously used.

Example

Barry Borrower has ten different loan contracts, summarized as follows:

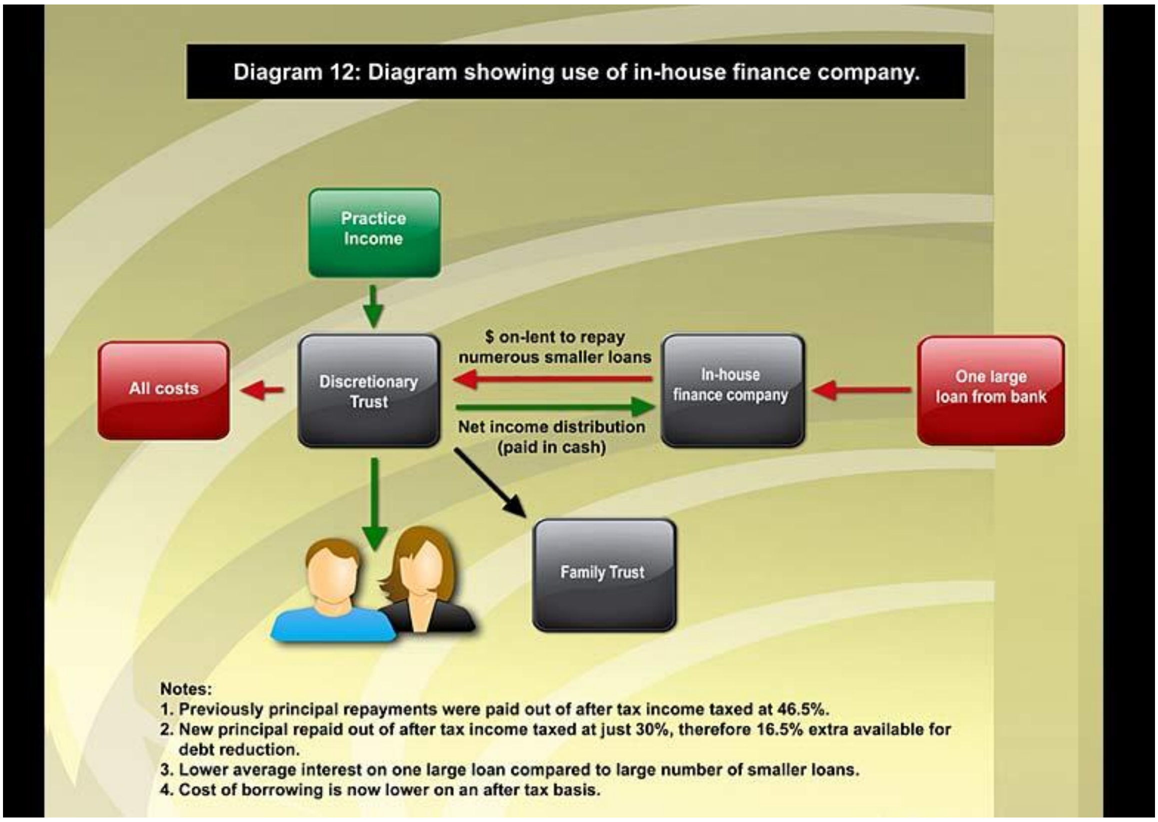
[13] Most modern discretionary trust deeds allow trustees to distribute net income to a related company

	Loan	Borrower	Lender	Amount	Interest rate	Interest cost
1	Surgery overdraft	Service trust	Medfin	$100,000	10%	$10,000
2	Equipment lease	Service trust	Medfin	$60,000	10%	$6,000
3	Car lease 1	Barry Borrower	Experien	$50,000	10%	$5,000
4		Mrs Borrower	Experien	$50,000	10%	$5,000
5	2007 super loan	Practice	NAB	$50,000	10%	$5,000
6	20% loan from broker on hybrid loan/second mortgage	Barry Borrower	Experien	$100,000	12%	$6,000
7	80% working capital loan from Adelaide Bank	Service trust	Bank of Adelaide	$400,000	10%	$40,000
8	Margin lending loan	Mrs Borrower	NAB margin lending	$200,000	12%	$24,000
9	Personal loan for daughter's wedding	Barry Borrower	Aunty Ethel	$20,000	12%	$2,400
10	Credit card	Mrs Borrower	ANZ	$20,000	18%	$3,600
	Total			**$1,050,000**	**10.2%**	**$107,000**

The interest rates are high because there are a large number of small loans. Each small loan also attracts fees and costs, and some of the loans are at very high interest rates.

Barry has to pay the $1,050,000 loan back out of dollars taxed at 46.5%. This means they have to earn $1,962,617 [ie $1,050,000/(1-0.465)] in pre-tax income in order to clear the debt of $1,050,000.

Diagram



Explanation of diagram

We advised the Borrowers to refinance all of the loans using one loan from one bank on our panel of lenders. The loan was at the lowest possible interest rate (ie 9%) and at the lowest possible administration costs.

The borrower was a new company set up to act as a financier for the Borrower group, and it borrowed the $1,050,000 from one bank at 7% and then lent the money to each of the original borrowers at the same interest rate. The non-deductible loans (ie Aunty Ethel and the ANZ credit card) were in effect re-paid using cash, via loan accounts in the Borrower's service trust so they have been replaced by deductible loans.

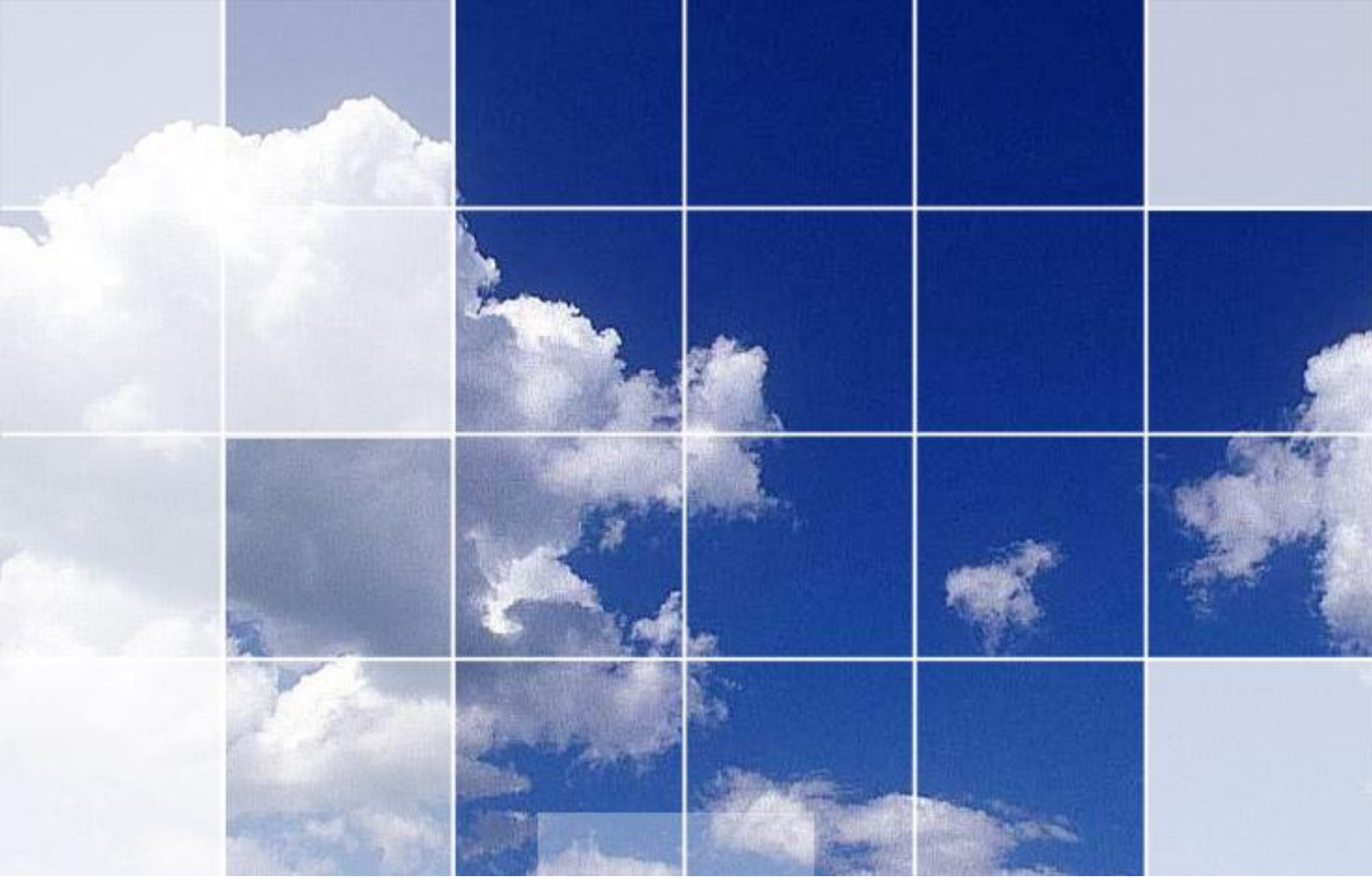
The interest rate is 7%, which means the Borrowers are saving interest, plus a small tax benefit plus lower administration costs.

But the big saving comes when the principal is repaid. The Borrower Company only has to earn $1,500,000 in pre-tax income in order to clear the debt of $1,050,000, compared to $1,962,617 previously. The saving of pre-tax income of $462,617 takes a lot of pressure off theBorrowers, reduces the risk implicit in borrowing and makes sure the loan is tax efficient.

Re-financing through an in-house finance company shortens the period of indebtedness and increases the amount of capital available to the Borrowers when they retire. This is because they will have an extra $323,832 [ie $462,617 times (1-0.30)] available to them compared to what would otherwise have been the case.

In-house finance company and other roles

Existing investment companies can also be used as in-house finance companies. The two roles are complementary and the net cash flow from the investment activity can be used to pay off the third party loan to the bank.



Part 4 Common deductions

In this section of the manual we provide a brief overview of the rules applying to commonly encountered tax deductions.

Part 4.1 Multiple company cars

All financial planners should optimize the tax treatment of their cars.

The Financial Planner Cars

Financial planners who are in private practice can also achieve a level of tax deductibility for the running costs of multiple cars. To do this, the owner must be practicing via a company or trust structure. The company or trust makes a car available to the owner for private use. There is no limit to the number of cars that can be made available for this purpose.

Because the car is being used for private purposes, it constitutes a fringe benefit being paid by the employer (that is, the company or trust) to the employee (that is, the owner). As a result, the company or trust must pay fringe benefits tax. To reduce the fringe benefit tax payable by employer (which is the highest tax bracket 46.5%), the employee should reimburse employer with the portion of car expenses used for private purpose during a FBT year. The amount of fringe benefits tax (reimbursement) varies according to each situation. The amount of tax payable (reimbursement) is a direct function of the purchase price of the car (where more expensive cars give rise to a higher fringe benefits tax payment (reimbursement)) and an inverse function of the distance that the car travels during the fringe benefits tax year (where the further that the car is driven, the less fringe benefits tax (reimbursement) is payable).[14] [15]

Because the company or trust pays fringe benefits tax, the company or trust may also claim a tax deduction for the running costs of the car. Once again, these costs include things like petrol, insurance, registration, mechanical repairs and depreciation.

So, the company or trust simultaneously pays fringe benefits tax on the second and subsequent car while also claiming a deduction for the running costs of that car. Many running costs increase the further a car is driven. Conversely, the further the car drives, the lower the FBT payable.

Putting these two things together, in situations where a car drives 15,000 km a year or more, the deductions available for the costs come to more than offset the FBT payable, and the owner achieves tax deductibility for up to 75% of the running costs of the second or subsequent car.

Luxury cars

In Australia, there is an upper limit on the value of a car for which tax deductibility can be claimed. That limit is known as the luxury car limit and is currently set at just over $57,466 ($75,375 for certain fuel efficient cars). This means of a person pays more than $57,466 for a car, they can only depreciate $57,466 and the excess cannot be depreciated. Similarly, if the purchaser is registered to a GST, they can only claim the first $5,700 of GST paid as an input tax credit.

Used cars

You can depreciate the full purchase price of a car even when that car is bought second-hand. The luxury car limit applies to the actual purchase price paid by the owner or the entity. Therefore, if the owner pays $57,466 for a second-hand car, the full purchase price of $57,466 can be depreciated over the working life of that car.

In practice, this often means that a client who buys a late-model second-hand European car gets to fully depreciate the entire price of the car that would have cost considerably more than $57,466 had it been bought brand-new.

[14] The fringe benefits tax year runs from the first of April to the 31st of March.

[15] The inverse relationship between the distance the car drives and the amount of fringe benefits tax payable is a deliberate tool of government policy. It exists to encourage greater use of cars, which in turn will lead to increased support to the Australian automotive manufacturing industry.

Part 4.2 Overseas and Extended Domestic Travel

Where an employee is required to travel for work purposes the employer can pay a tax-free travel allowance to cover the travel costs. Where a financial planner is using a practice trust, the practice trust is an employer for these purposes. This means that the practice trust can make a tax-free payment to the financial planner whenever the financial planner needs to travel interstate or overseas for work purposes.

The idea is that the employer reimburses the employee for costs incurred due to the travel. The ATO has published what they refer to as reasonable amounts of costs related to travelling for work purposes. Provided that the amount paid to the employee is within that reasonable amount, the financial planner does not need to substantiate the costs associated with the travel. The financial planner merely needs to be able to prove that they were in a particular place for a particular purpose.

The practice can then pay them what is commonly known as an unsubstantiated travel allowance. As that name suggests, the amount of the allowance does not need to be substantiated by documents such as receipts for accommodation. Provided that the financial planner can prove that he or she travelled and that the travel was work-related, the allowance can be paid.

The reasonable amount payable as an unsubstantiated travel allowance is defined by the ATO each year. The amount payable varies according to the salary level of the employee. In the case of financial planners, the salary equivalent will almost always be greater than $155,000 (the top bracket for the purposes of the allowances).

For domestic travel, the following table shows the amount of unsubstantiated travel allowance payable for each of the major cities in Australia:

Table 3: Employee's annual salary - $155,001 and above

Place	Accomm.	Food and drink $ B'fast $25 Lunch $36 Dinner $56.40	Incidentals $22.05	Total
Adelaide	195	117.40	22.05	334.45
Brisbane	216	117.40	22.05	355.45
Canberra	195	117.40	22.05	334.45
Darwin	195	117.40	22.05	334.45

Hobart	195	117.40	22.05	334.45
Melbourne	265	117.40	22.05	404.45
Perth	213	117.40	22.05	352.45
Sydney	265	117.40	22.05	404.45

The table reflects the fact that a night in Melbourne or Sydney tends to be more expensive than a night in other cities – although anyone who has tried to obtain a room in Perth or Brisbane recently might disagree.

For international travel, most countries of the world are divided into one of six cost groups. The amount of unsubstantiated travel allowance that is payable then becomes a function of the particular country's cost group.

The table of allowances is as follows:

Cost Group	**Salary $87,200 and below**			**Salary $87,201 to $155,000**			**Salary $155,001 and above**		
	Meals	**Incidentals**	**Total**	**Meals**	**Incidentals**	**Total**	**Meals**	**Incidentals**	**Total**
1	$65	$25	$90	$90	$25	$115	$115	$30	$145
2	$80	$30	$110	$110	$35	$145	$140	$40	$180
3	$105	$35	$140	$130	$40	$170	$160	$45	$205
4	$130	$35	$165	$160	$45	$205	$190	$50	$240
5	$170	$40	$210	$210	$50	$260	$250	$60	$310
6	$205	$45	$250	$260	$50	$310	$300	$60	$360

Cost group 1 that includes countries such as Uganda. Interestingly, the United States of America is in cost group 5, whereas the United Kingdom is in cost group 6, as our countries such as Russia and New Caledonia.

Once again, the financial planner does not need to substantiate the amount of money that they have spent in a particular city to claim the unsubstantiated travel allowance. They need only to be able to prove that they were for a work purpose.

These are the limits for payments that do not require substantiation. If an employee incurs actual expenses that exceed these limits, then the employee can be reimbursed for the full amount of the expenses paid. Once again, whether or not to practice can claim a tax deduction for these expenses is a function of whether or not the employee needed to be in that place at that time for a purpose related to their practice.

Costs such as the airfares are also deductible provided, once again, that the primary purpose of the trip was work related. Airfares must be substantiated and the amount that can be claimed is limited to the actual airfare paid.

Part 4.3 Employment of relatives

A financial planner in private practice is able to employ people to do work for that practice. The employee can be a person related to the financial planner, such as a spouse, parent or child who has reached employment age.

The financial planner can only pay arm's-length wages or salary to any employee. That is, the amount of wages or salary that can be paid to family members is limited to the amount that would be reasonable to pay for the work done to some person unrelated to the financial planner.

It is important that the work is actually done. Common examples of work actually being performed by family members includes things like: providing part-time receptionist services outside of school hours and on school holidays; cleaning services; and administrative services such as bookkeeping.

The amount that can be paid as a deductible super contribution is not a function of the wages or salary paid to an employee. All employers are obliged to pay a superannuation contribution equal to 9% of wages or salaries paid to employees. However, this 9% is the lower limit on how much can be contributed. The upper limit is a function of the age of the employee. Employees aged under 50 can receive a deductible superannuation contribution of up to $25,000. Employees aged between 50 and 74 can receive a deductible contribution of up to $50,000.

Therefore, it is effective for an employee who is being paid a salary of, say, $10,000 per year, to also receive a deductible contribution of up to $100,000. This assumes that the employee is aged between 50 and 74 and that they are actually doing the work for which they are being paid a salary.

There is no problem in employing children to work in the practice provided the above rules are satisfied. The salary will be deductible to the employer/financial planner and the salary payments will be assessable to the employee/child. Provided the child does not have a taxable income above $6,000 no tax will be paid by the child.

Example

For example, Dr Dianne employs her 15 year-old daughter, Fastidious, as a part time receptionist and office assistant over the school holidays, and pays her the going rate for receptionists, which totals $5,000 for the year.

The payment of $5,000 is deductible to Dr Dianne, and generates a tax benefit of $2,325 cash each year, but there is no tax charge in Fastidious's hands, which means the family tax bill has fallen by $2,325 overall.

Part 4.4 Ownership of a related business

In recent times, we have seen examples where a financial planner's spouse or other related person starts a small business. This small business creates a potential tax planning opportunity for the financial planner.

The question of where (as in, within which entity) the business should be located is basically a function of its profitability. If there is a risk that the business will have low profitability, or even losses, then it often makes sense for the business to be owned by the financial planner in his or her own name. Losses concerned with the business can be offset against the financial planner's other taxable income before his or her ultimate tax liability is calculated.

This strategy is particularly useful for financial planners who are employees and for whom the range of tax planning options is otherwise limited.

As the owner of the business, the financial planner can employ the spouse and pay the spouse an arm's length salary for work provided to that business. In addition, the financial planner can pay deductible superannuation contributions on behalf of the spouse (as his or her employee) up to the spouse's age based deductible limit.

If the spouse receives a salary of, say, $50,000 pa and a deductible superannuation contribution of $50,000 pa, then sales need to exceed the cost of goods sold by at least $100,000 pa before a tax liability is created for the financial planner.

Profits of this level are typically not expected within the first few years for most small businesses – and will represent a nice problem if they do. If the profits do reach this level, then the profitable business can be transferred into something like a family trust.

While such a transfer comprises a capital gains tax event, there are a series of exemptions available that will allow the amount of capital gains tax paid to effectively be reduced to zero.

Part 4.5 List of commonly encountered deductions

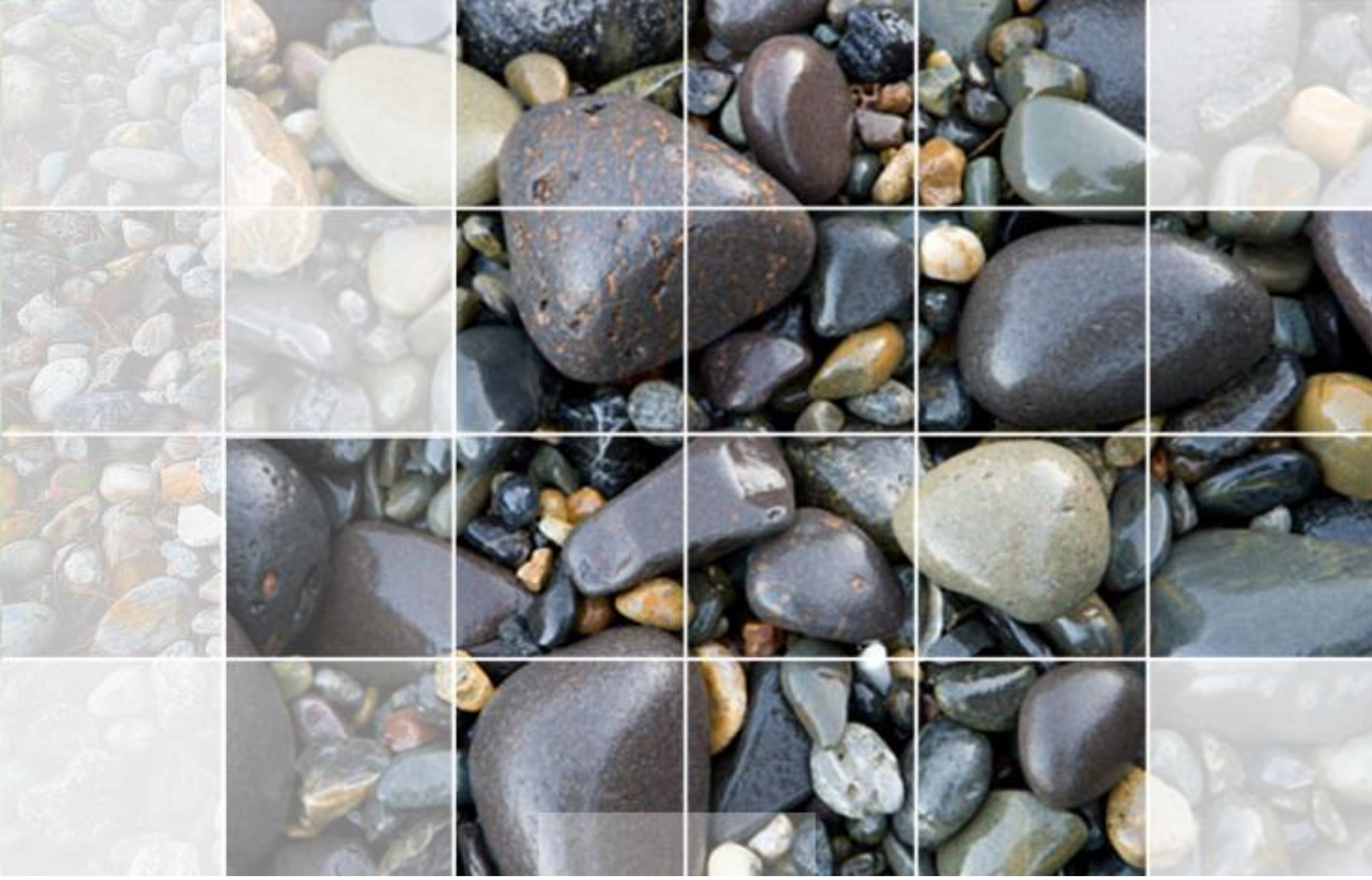
Deductible Item	Comments
Borrowing and mortgage discharge costs	These are deductible to the extent they relate to the financial planner's professional or investment income. The deduction is spread over the period of the loan, or the actual loan period (eg if the loan is repaid early), or five years, whichever is shorter, beginning with the year in which they were incurred. The amount deductible each year is calculated by dividing the un-deducted expenditure by the number of days remaining in the loan period and multiplying the result by the number of days in the loan period that are in the income year.
Laundry costs $150 per person unsubstantiated	Should be claimed by every owner or dentist. $150 can be claimed without substantiation but more can be claimed with log-book or diary records.
Non slip shoes and other protective clothing items	The ATO has released rulings confirming that nurses can claim non-slip shoes. Financial planners work in the same physical environment and on there is no reason why they cannot claim these costs as well. Taxation Rulings TR 95/15, TR 97/12)
Occupation specific clothing	Should not be common items, and include white coats and protective clothing.
Dry Cleaning Costs (substantiated)	Keep tax invoices for the laundry of clothes soiled by your work environment. 100% of these costs are deductible.
Newspapers & magazines	Newspapers and magazines bought for the waiting room or which are related to financial planning matters are deductible costs. Suggest buy them using your business credit card when filling up on petrol
Overtime meal allowance (@ $22.60 per day 2007)	The allowance is effectively a tax-free benefit if paid by an employer subject to an award. If not paid under an award the meal costs must be deductible (we suggest you use your dedicated business credit card to

	record all these costs).
Equipment costing less than $300	Deductible under common sense "de minimis" tax rules that ignore small immaterial amounts.
Vaccination costs	Deductible where the purpose is to inoculate against the risk of a work place disease or illness
Percentage of home telephone costs (up to 80%)	Home telephone calls are deductible on a reasonable estimates of business use relative to private use. A four-week diary will assist in substantiating the reasonable estimate (Practice Statement PS LA 2001/6).
% of home internet costs (up to 80%)	Home internet costs are partly deductible based on reasonable estimates of business use relative to private use
Mobile phone costs	ATO accepts mobile phone costs are 100% deductible provided private use is minor and incidental
Telephone costs at a holiday home	A taxpayer was allowed a deduction for 80% of the telephone rental on a telephone installed in her investment/holiday home on the basis that it was essential for the purposes of her job that she be contactable at all times (*Case* R118 84 ATC 773).
All relevant business and professional memberships	100% deductible
Home office running costs	100% deductible. Includes depreciation. Not wise to claim a % of home loan interest or rates as this will prejudice the home's status as a CGT free exempt principal residence
Home office plant depreciation claim	100% deductible. Includes depreciation on art, desks, tables & chairs used for business/professional purposes

Home office % if home rented	An estimate of the rent connected to the home office is deductible, normally on a percentage of floor space basis
Deductible interest on loans	Interest is deductible if incurred in connection with assessable income or as part of an assessable income producing business
Interest and other fees on business credit card or part thereof	Interest is deductible if incurred in connection with assessable income or as part of an assessable income producing business. It is recommended that you use a special credit card for professional purposes and that you do not use this credit card for other purposes. This ensures all interest is deductible and there is no need to apportion interest between deductible purposes and other purposes.
Interest paid to ATO	ATO interest is deductible
Interest on employer super contributions	Interest is deductible
First car costs	Deductible under the statutory fringe benefits tax method
Second car costs	Deductible under the statutory fringe benefits tax method
Third car costs	As for second car costs
Parking costs	Deductible if connected to business travel
Salary to children age 15 plus working in practice	Deductible to employer and tax free to employee provided less than $6,000 a year
Low dollar value FBT free fringe benefits	Must not be regular or expected. Less than twice a year and not in return for a specific action or task.

Income continuance insurance premiums	Deductible
Life insurance paid as super contributions	Deductible
Self-education costs including higher qualification costs	Deductible. The tax cases show a broad range of courses are deductible for financial planners provided there is a financial or business element. Financial planner courses will be deductible provided the knowledge is intended to be used in the existing practice and not used in a new practice.
Overseas travel	Very deductible provided business and professional purposes can be substantiated. Paper proves purpose, and purpose determines deductibility. Therefore paper trail critical, before, during and after the travel is critical: The ATO's view is where the main purpose of the trip is professional, the costs will be deductible notwithstanding an incidental private purpose. If, however, the professional purpose merely incidental to the private purpose, apportionment of the expenses is necessary and only the expenses directly attributable to the income-earning purpose will be deductible. Where both purposes are equal, 50% of the expenses incurred for both purposes (ie other than those directly attributable to income-earning purposes) will be deductible (*Taxation Ruling* TR 98/9).
Secretarial services (includes management fees paid by employee financial planners Wells Case)	Can allow a deduction for amounts paid to a related person by an employee owner for assisting that person in the production of their assessable salary and wages. For example, a fee paid to a spouse, calculated on an arms length basis, could be deductible to the employee (example professorial position: sub-contracted research or administration)

Relocation or similar costs incurred by an employer entity	Can be deductible
Brief case	Deductible
Professional indemnity insurance premiums	These are 100% deductible. Further, United Medical Protection Limited support payments are deductible under ITAA97 s 25-105 if they are not otherwise deductible (eg if the taxpayer has retired or left the profession).



Part 5 Income

Part 5.1 Deferring income

We are often asked whether financial planners can defer taxable income from one tax year to then next by not tax invoicing clients or otherwise ensuring amounts are not received until the start of the next year.

If the tax rates fall in the second year this might mean there is a smaller amount of tax paid when the income is finally included in taxable income. And it would mean tax is paid later, creating a timing advantage equal to the interest rate on the deferred tax.

A financial planner is probably on a cash basis of computing taxable income, which means amounts received, rather than amounts earned, are included in assessable income. But special rules may apply to include the income in the first year and to render the deferral ineffective.

Part 5.2 Pre-paying deductible costs

Financial planners can claim a deduction for deductible costs paid in advance before 30 June each year. For example, a planner with practice and investment loans of $1,000,000 at 7% interest can pre-pay say $70,000 before 30 June and claim a deduction for the $70,000 in the current tax year. At a marginal tax rate of 46.5% this means cash flow will improve by $41,850, with a further lagged effect on later instalments of tax.

The improved cash flow can be used to reduce non-deductible debt.

It is better if cash is used to pay the interest, or at least a separate and distinct loan. The same loan should not be used to pre-pay the interest, as this may technically not be a pre-payment.

Pre-paying deductible costs creates a timing advantage, and may create an absolute advantage by deferring taxable income to a later year if tax rates are falling. It can also be a very useful circuit breaker, creating time to get better tax planning strategies in place for later years.

Part 6 Minimizing tax on investments

Part 6.1 Introduction

Part 6 deals with using legal structures to minimize tax on investment earnings.

As always, we highlight two key issues, being the importance of choosing:

(i) the right assets to invest in; and

(ii) the right legal structure to hold those investments.

Minimizing tax on investment earnings maximizes the after tax return on the underlying investments. It sounds simple and obvious, but it's an area that is often misunderstood and where expensive mistakes can happen. Most people have little control over the underlying performance of their investments, but they can control the tax rate on those investments, so it makes sense to get it right at the beginning by choosing structures and assets that minimize the tax payable on investment earnings.

The basic principles

If an investment generating 10% per annum is owned by an investor with a marginal tax rate of 46.5%, and all the return from the investment is taxable, then the after tax rate of return will be 53.5% (ie 100% minus 46.5%) of 10%, or 5.35%. If inflation is 3%, the real (ie after inflation) after tax rate of return will be 2.35%.

That's not much. In fact the behavioral economists might even say it's not enough to encourage investors to defer consumption and to take on the risk of the investment under-performing. Why invest in risky low-returning assets when you can buy a new car and go overseas for a month now?

How to avoid investment returns being destroyed by tax and inflation

You cannot do much about inflation, although staying in growth assets and avoiding non-growth assets is one way to overcome inflation. But you can do something about tax. Tax planning for investments boils down to three simple rules:

(i) select investments where the return is either tax-free or concessionally taxed;

(ii) choose tax efficient legal structures, or combinations of legal structures, ie legal structures that are taxed at a rate less than the top marginal individual tax rates, ie, use companies, trusts and SMSFS to hold your investments;

(iii) use concessional (ie deductible) super contributions and non-concessional (ie un-deducted) super contributions to minimize tax on taxable income.

Investments where the return is either tax-free or concessionally taxed

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An investment where the return is either tax-free or concessionally taxed will have a relatively higher after tax return than an alternative investment. Which investments are tax-free? Tax-free investments are not common, but include:

(i) the home, where the CGT principal place of residence exemptions apply. This includes a home that is no longer used as a home but is leased to a tenant, for a period of up to 6 years. Most residential properties have performed quite well over the last fifteen years, and in many cases have out-performed the share market (although generalizations are dangerous: the comparison ultimately depends on which property and which share);

(ii) a business, where the CGT small business exemptions apply. This is most small and medium sized businesses and most includes financial planning practices. Developing, and then selling, a business that has goodwill is one of the most common tracks to becoming wealthy;

(iii) business premises, where the CGT small business exemptions apply. This is most financial planning offices and also small offices, shops and factories used in small and medium sized businesses.

So, if you are interested in minimizing tax and maximizing after tax returns on your investments, it makes sense to first invest in your home, your practice or business and your business premises. By eliminating income tax on the capital gain you will increase the after tax rate of return and become wealthier faster than otherwise.

Which investments are concessionally taxed?

Most so-called "growth assets" are concessionally taxed. Growth assets are essentially shares and real estate[16]. These assets are concessionally taxed because:

(i) a large part of the return is in the form of a capital gain, ie an increase in value over time. And capital gains are only taxed if realized, ie if the underlying asset is sold. Unrealized capital gains are not taxed; and

(ii) the Australian tax system provides tax incentives, in the form of exemptions, to encourage people to invest in properties and shares. Briefly, where an asset is held for more than 12 months a capital gain on its disposal will be:

  (a) 50% exempt from tax if derived by an individual or a trust (but not a company); and

  (b) 33.3% exempt from tax if derived by a super[17] fund.

So, if you are interested in minimizing tax and maximizing after tax returns on your investments it makes sense to invest in shares and real estate, and to not realize the capital gains on the shares and real estate unless you have to.

Long-term investors typically pay much less tax than short-term investors. This means long-term investors usually make more money than short-term investors. In one way the un-paid tax, the latent tax liability connected to the un-realized and therefore un-taxed capital gain, can be seen as an interest free loan from the government that you can use to build further wealth[18].

Part 6.2 Tax efficient investment structures

The second variable in the tax efficient investing equation concerns legal structures. Companies, trusts and SMSFs all have a role to play. This role has two functions:

(i) allowing income from other investments, including the practice, to be diverted to a lower tax rate entity, via trust distributions and/or deductible contributions, and taxed at a lower tax rate than otherwise;

(ii) owning investments so the income generated is taxed at a lower tax rate than otherwise would have been the case.

[16] Ultimately there are only four types of basic assets, being businesses, shares in companies, real estate and cash deposits. All other types of assets are really just derivatives of these four basic assets
[17] Hence an affective tax rate of 10%, ie 15% less 33.33% on these capital gains
[18] With full credit to Warren Buffet for this thought

How are the different legal structures taxed?[19]

Individual's pay tax at a range of tax rates depending on their income level. The rates for the year ending 30 June 2012 are:

Taxable Income	Tax Rate %
0 - 6,000	0 %
6,001 - 37,000	15 %
37,001 - 80,000	30 %
80,001 - 180,000	37 %
180,001 +	45 %
Plus Medicare 1.5%	

Companies pay tax at 30%. However, this is just round one of a multi-round game. This is because the ultimate rate of tax will not be known until the company's after tax profits are paid out as franked dividends to an individual shareholder. If the individual's tax rate is more than 30%, extra tax will be paid, which means the ultimate rate of tax will be more than 30%. If the individual's tax rate is less than 30%, there will be a part or full refund of franking credits, which means the ultimate tax rate ise less than 30%. Companies create income distribution flexibility over a number of income years.

Trust income is normally not taxed. A trust's net income is instead attributed to its beneficiaries (unit-holders) and these persons are taxed on the net income depending on their own tax profile. Sometimes net income passes through a series of trusts until derived by an in individual or a company, in whose hands it is ultimately taxed.

Discretionary trusts, or family trusts, allow the trustee to allocate net income amongst the beneficiaries, usually family members or trusts and companies controlled by family members, who will pay the least amount of tax on it. Trusts create income distribution flexibility amongst related persons within a particular income year.

We often set up investment companies for clients where the shares are owned by a discretionary trust. This allows the client to get the best of both worlds, that is, multi-dimensional distribution flexibility, over time and between beneficiaries due to:

[19] The following paragraphs are simplistic. One could write a book on this topic, and many have.

(i) the income distribution flexibility amongst related persons within a particular year, created by the discretionary trust; and

(ii) the income distribution flexibility over a number of income years created by the company, and the dividend franking protocols.

Super funds have a more complex tax profile and it is best summarized in table form:

Income	Tax rate in accumulation mode (ie under age 60)	Tax rate in pension mode (ie over age 55 or 60)
Contributions	15%	15%
Dividends	15%, less franking credits	Nil %, less franking credits
Interest	15%	Nil%
Rents	15%	Nil%
Realized capital gains < 12 months	15%	Nil%
Realized capital gains > 12 months	10%	Nil%
Un-realized capital gains	Nil%	Nil%

In an ideal world…

In an ideal world each client has four investment structures. These are:

(i) one or more individuals, including a spouse or children over the age of 18, who pay tax under the progressive tax rates set out above;

(ii) a self-managed super fund;

(iii) a discretionary trust; and

(iv) a company, with the shares owned by the discretionary trust.

New investments are allocated to one of the four structures depending on their expected characteristics including expected:

(i) income yield;

(ii) capital gain; and

(iii) holding period,

to minimize or even eliminate tax on income and tax on capital gains.

Part 6.3 Inter-face with practice structure

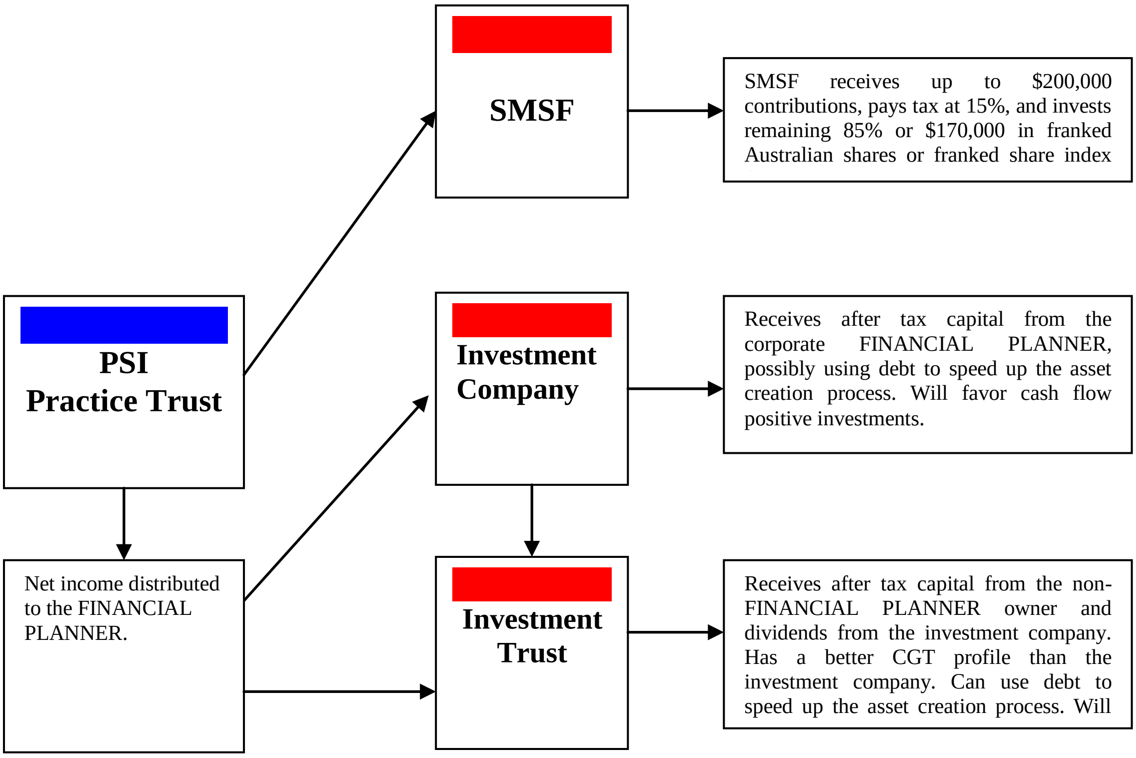
Nothing exists in a vacuum. In most cases we also have to determine the best practice structure for the client and then integrate the best practice structure with the best investment structure. In most cases non-owners owners in private practice will be best served by a PSI practice trust.

The integration results in money flowing from the practice structure to the investment structure, and then being used to acquire new investments. This flow can occur in one of two ways, being:

(i) a deductible super contribution paid from a practice trust to a self-managed super fund, with the fund then paying tax at 15% and investing the remaining 85%; or

(ii) a payment to a self-managed super fund, an investment company or an investment trust out of income previously taxed at the individual's marginal tax rate, ie a tax rate up to 46.5% including Medicare Levy (but possibly as low as 30% or even 20% depending on the clients' marginal tax rates).

Diagramatically speaking, things look like this:



By following the three rules for tax efficient investing a financial planner can seriously reduce his or her total tax bill be and have increase the amount of wealth able to be invested. This increase in wealth creates a compounding effect that gets stronger over time. A snow-ball is a good analogy because:

(i) the tax efficient practice structure means the snow ball is bigger at the start; and

(ii) the tax efficient investment structure means the snow ball rolls faster over time, collecting more snow as it goes,

so the snow ball is much bigger at the end, due to the double whammy effect of more being invested in the beginning and more being reinvested along the way.

Also bear in mind that the investment/reinvestment process is dynamic. Dividends and rents are constantly being received, taxed and reinvested, and excess cash from the practice is constantly being transferred to the super fund and the investment company/trust and invested in new investments. Ideally at least some of this process will be automated, using dollar cost averaging principles and index funds to implement a systematic, stable, diversified and cash flow positive investment strategy, at the same time as significant tax-free capital gains are notched up.

Expected capital gain

Individuals and trusts enjoy a 50% exemption from capital gains tax on capital gains on assets held for more than 12 months. For SMSFs the exemption is 33% for assets held for more than 12 months. Companies do not enjoy this concession. This means John and Betty are likely to own the asset in either their family trust or their SMSF in order to get the benefit of the CGT exemptions when the asset is ultimately sold.

The less likely the capital gain, or the more remote in time it is, the more likely it will be that the asset will be owned in a company. Some specific comments on the investment company are warranted. The shares in this company will be owned by a discretionary trust, and this trust will probably not do much for a few years until the first franked dividend is paid from the investment company, at which time it will start to distribute franked distributions to low tax rate family members, for example, children once they turn age 18, ideally timed to trigger a refund of franking credits due to the family member's marginal tax rate being less than 30%.

The purpose of the investment company is to buy and hold new investments, particularly investments that are cash flow positive and expected to be held for the long term. This excludes most residential property, which is rarely cash flow positive.

One downside of an investment company is that it does not enjoy the benefit of the 50% discount on capital gains on assets held for more than 12 months. For many advisors this is reason enough not to use a company for investment purposes. But we believe this view is actually a little shallow and ignores the other advantages of an investment company. Whether or not these other advantages more than compensate for this CGT disadvantage depends on a number of variables, the relative values of which will only become known as time passes. But we expect that in most case involving long-term investments, ie investments held for ten years or longer, these other advantages will more than compensate for the absence of the 50% CGT exemption. These other advantages include:

(i) tax being no more than 30%, and possibly less than 30% once dividends are paid out to the shareholder trust and then distributed to the ultimate beneficiaries (probably timed to achieve a refund of franking credits which means less equivalent pre-tax income is needed to acquire an asset of a given value, in after tax dollars). This means the same amount of pre-tax income buys a lot more investment, and seriously speeds up the asset acquisition strategy;

(ii) higher after tax rates of return, since the tax on earnings is no more than 30%, and possibly less (see (iv below,) which is less than 48%. That is, there is less tax payable on investment earnings in the company, which means after tax rates of return are higher, which in turn means debt reduction and asset acquisitions can occur at a faster pace;

(iii) income tax flexibility achieved by having the shares in the investment company owned by a family trust, with an ability to distribute future franked dividends to family members who will receive a refund of franking credits;

(iv) asset protection advantages achieved by having the shares in the investment company owned by a family trust; and

(v) the investment company's future taxable income can be reduced by deductible fringe benefits, particularly car fringe benefits and deductible super contributions.

If there is a particular project where a significant capital gain is expected within the short to medium term then we should consider whether it should be owned directly by the family trust or the SMSF.

Holding period

The longer the holding period the more likely it is that the asset will be held in the company rather than the family trust, because the long term nature of the investment means the CGT advantages of the family trust are less important.

And the longer the holding period the more likely it is that the asset will be held in the super fund. Capital gains will be tax-free once the member is age 60. So there is a lot of sense in investing through the SMSF if the return is expected to comprise of long-term capital gains.

Of course, there is no CGT advantage of holding an asset in a trust if it is bought and sold within 12 months.

What other issues impact the choice of structure?

There is a range of other issues impacting the choice of structure and these issues will differ in significance from client to client. These include the client's age, the client's income level, the client's family profile, the client's (material) living standards, and the client's attitude to borrowing.

Your age

Most owners are aged between 35 and 70. From 1 July 2007 on each client can contribute $50,000 a year to a super fund, and for married couples this means $100,000 a year can be contributed to a super fund. If over age 50 these amounts are doubled. Investment earnings in the fund before age 60 are taxed very concessionally, at tax rates between 0% and 15%. Once a owner is aged 60 super benefits can be withdrawn tax-free and the investment earnings in the fund become tax-free.

This means there is a powerful tax incentive to invest through a self-managed super fund, and this incentive gets stronger and stronger as age 60 gets closer, to become virtually irresistible from age 55 on. Therefore we usually recommend that owners at all ages pay the maximum possible amount of deductible contributions to their fund each year, using debt to do this if necessary. And we often recommend owners pay un-deducted contributions to their fund to build up the amount of wealth in this tax-free box as quickly as possible.

Part 6.4 Table summarizing investment issues

Entity	Investment	Comments
Individual	Family home	CGT-Free on disposal. Asset protection may be an issue. Should be held in spouse's name if spouse is not in a litigation exposed occupation
	Negatively geared residential property	Tax benefit of gearing loss may justify holding in an individual's name to get tax benefit at 46.5%. Personal super contributions may be available to reduce effective tax rate on capital gain on sale. Cannot reduce taxable income with concessional fringe benefits. Can hold lifestyle assets (eg beach house). Can implement advanced gearing strategies.
Family Trust	Long-term assets such as commercial properties and shares, whether owned directly or indirectly through actively managed public trusts or index funds.	Income can be distributed between all adult beneficiaries or to an investment company to be taxed at no more than 30%. Can also make deductible super contributions for employees including the directors of the trustee company. In some cases investments are held in a private company with the shares owned by the family trust (see box below). Very efficient for capital gains: 50% exemption, plus ability to superannuate directors creates a potential effective top tax rate of 7.5% on realized capital gains (subject

		to limits). Debt works well in a trust, but watch for quarantined net losses. Can reduce taxable income via concessional fringe benefits and hold lifestyle assets (eg beach house). Can implement advanced gearing strategies.
Investment company	As for family trust, but with less expectation of a capital gain: no 50% CGT exemption for a company. Therefore do not use if a large early capital gain is expected.	Often the link between the practice structure and the investment structure Taxed at 30% on income and capital gains, but the ultimate rate of tax may be less than this due to refunds of franking credits on dividends paid in later years, and the ability to superannuate directors thereby achieving an effective tax rate of 15% (subject to limits). 30% tax means 70% of earnings available for reinvestment: the snow-ball is bigger. Suits long-term investments (10 plus years) with higher income and smaller capital gains. Debt works well in a trust, but watch for net losses. Can reduce taxable income via concessional fringe benefits and hold lifestyle assets (eg beach house). Can implement advanced gearing strategies but care needed with loan accounts.
Self-Managed Superannuation	Non-debt financed, regular investments such as franked	Earnings taxed at no more than 15% or 10% on capital gains on assets held for more than

Fund	Australian shares and/or commercial property, whether owned directly or indirectly through actively managed public trusts or index funds.	12 months. No tax on income and capital gains realized after a pension starts (ie age 60, and possibly age 55). Pension income paid to members is tax-free after age 60 and concessionally taxed between age 55 and 60 (15% rebate). Tax benefits become more persuasive as members approach age 60. Tax benefits become overwhelming at 55 plus. SMSF cannot borrow (without restrictions and conditions), provide fringe benefits or hold lifestyle assets. Works well with geared deductible and non-deductible contribution strategies.

The client's taxable income

As a general proposition, the higher the client's taxable income the more likely the client is to invest through super or an investment company. This is because doing so minimizes the amount of tax payable on their practice income and therefore maximizes the amount available for investing.

The client's family profile

Clients using discretionary trusts for investments who have dependant adult relatives, such as a spouse, parents (without an old age pension), children or nieces can distribute up to $25,000 to each relative and the tax will be less than15% of the amount distributed (assuming the relative has no other taxable income).

The client's preferred material living standards

Some people spend more than others. Tax planning increases the amount able to be spent. But we confess we are usually happier to see the benefits of our work reinvested in permanent wealth, with possible exceptions for education and family holidays. Some clients just survive on $400,000 a year, whereas others accumulate wealth on less than $100,000 a year, and seem just as happy, if not happier, than everyone else.

The higher a client's material living standards the less cash is available for investing, no matter what structure is chosen, and it is more likely that a tax inefficient structure will be used, because of the need to access cash for consumption, and the high marginal tax rates faced by individuals[20].

The client's attitude to borrowing

As indicated above, subject to some commonsense cautions, we are generally in favor of borrowing to acquire investment assets, and doing so usually increases the net return on the investment and hence the client's wealth level. Most investors who have borrowed money to buy assets over the last 20 years have done well. Our common sense cautions include:

(i) observing prudent debt to equity ratio, both on an overall level and an individual asset level (what is prudent will differ from client to client, but we get uneasy where total debt is 60% or more of total assets, except where the level of assets is low);

(ii) ensuring "representative" assets are acquired, that is, assets which will behave pretty much in line with the general movement in prices for that asset class, and which are less riskier than otherwise (which is one of the reasons we like index funds[21]); and

(iii) flow positive investments).

[20] Not to mention GST on consumable goods and services
[21] See Dollar Notes dated 12 October 2005 dealing with index funds, which can be downloaded from www.mcmasters.com.au