

NEWSFLASH BOOKLET

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PROFESSIONAL PRACTICES BOOKLET

Important – This booklet is simply a collection of Newsflash articles relevant to professional practices. The articles are transferred from Newsflash into this booklet so it is best read from the back page forwards to ensure you are reading the latest article on the topic first. Note that the information contained in this booklet is not updated regularly so it is important that you seek professional advice before acting on it.

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Income Splitting

Many professionals are not permitted to go into business with anyone other than similarly qualified colleagues. This makes splitting income with their family difficult. Traditionally this problem was solved by the practitioner's setting up a service entity where the family provided the practice with administration services and equipment for a fee resulting in a profit that could be distributed to the family. This practice was upheld in Phillips case in 1977. The relevant points of this case were:

- 1) The Court found that the fees charged by the service entity were commercially realistic.
- 2) The service entity was set up with the predominant purpose of keeping assets out of the hands of anyone suing the professionals. This is necessary to argue against Part IVA which voids for tax purposes any arrangement with the predominant purpose of minimising tax.
- 3) The service entity took over, all aspects of the practice that were not required to be carried out by a suitably qualified professional and was run by a company whose directors were not professionals in practice or an associate of the professional. This was clearly done in every practical way, such as, a written agreement regarding the provision of services, independent records and issuing of invoices.
- 4) The firm provided accounting and auditing services and had 31 partners and 300 staff.
- 5) None of the partners were directors of the service entity but they were potential beneficiaries of the underlying trust. The partners did not lend the service entity any money.
- 6) Services provided included lending the Professional partnership money, providing clerical staff, office equipment, furniture and share registry services The markup was 50% on wages. Interest on the loan was 10% (commercially realistic in the 70s) and the furniture and equipment was provided at a mark up of 6 to 8% which was considered by the judge to be commercially realistic
- 7) The furniture and equipment that was originally owned by the accounting firm was sold to the service entity at arms length values. Existing staff were terminated and employed by the new service entity.
- 8) The practice didn't try to mark up services where the service company did not value add. For example phone, rent and electricity should only be charged to the practice at the actual cost.

As a result of losing Phillips case the ATO issued IT 276 which states that payments to service trusts that are commercially realistic will not be challenged.

Since then the ATO has issued rulings and guidelines that restrict the mark up permitted to the extent that these arrangements are not worth entering into. I doubt these margins would stand up in court considering they are so low that if an arm's length company charged such low rates, according to the ATO cash economy statistics, they would be likely to be audited to check that income was not being understated. ATO rulings are not law cases such as Phillips case are.

Nevertheless, service entities are best left alone until someone can afford take the ATO on.

What if you are allowed to be in business with your family?

As part of the governments push to import doctors from overseas non doctors are allowed to employ doctors and the Medicare payments are made to their employer. Other professional associations are permitting a small percentage of the owners of the firm to not be professional colleagues. If you are in the position to set up in business in partnership with your family or operate the business as a discretionary trust that can distribute income to your family then you do not need a service entity nor do you need to worry about the ATOs new rulings and guidelines on service entities.

What you do need to worry about is the limitations on the redirection of personal services income to someone other than the person that earns it. The first step is to find a way around the **Alienation of Personal Services Income rules**. We have a complete booklet on this topic with a flow chart. It is available in the free publications section of our web site. Some of the factors that may get you around these rules are:

- 1) Principal and Agent – despite all your income coming from one source ie Medicare or AMP there are a large variety of underlying clients and any retainer is 25% or less of the income. You must also find your own customers and not use your payee's premises
- 2) Less than 80% of your income is from the one source and during the year you earned income from at least two unassociated, to you or each other, sources due to your advertising to the public (APSI 87-20). Refer the above principal and agent test. If you satisfy this you can look beyond your principal to your customers for unrelated clients, but you must have acquired these clients by making offers or

invitations to the public (87-20(1)(b)). For example advertising or word of mouth from other clients but not referrals from your principal.

- 3) In at least 75% of the circumstances of the entity, is the contract to produce a result, supply plant and equipment or tools of trade (if it is normal in your industry to have tools) and liability for the cost of rectifying defective work or liability for damages remains with the sub contractor? APSI 87-18
or
- 4) At all times during the year (or if not, for unusual circumstances) did the business exclusively maintain business premises (not necessarily the same premises all year) and were these premises used almost 100% to produce income for the contract in question? Refer APSI 87-30. Were these premises physically separate from any premises used by an associate or customer or an associates private residence of the entity for private purposes. In the Explanatory Memorandum using a shed in the backyard of the home of the brother of the owner of the business was not considered to be physically separate. The draft ruling implies that a shop with residence above would be considered physically separate.

The next step if one of the 4 concessions above applies to your profession income is to get around the old personal services income rules. These basically state that you cannot divert income from your personal services to other members of your family or a bucket company because that income belongs to you. The exception here is when the income is earned as part of a business entity. This would be the case if your business employed other professionals to contribute to the work that produces the income. IT2639 at paragraph 10 states..... this office will apply a general rule of thumb:

- a. If the practice company or trust has at least as many non-principal practitioners as principal practitioners, then income is considered to be derived from the business structure

Note the ATO has been known to interpret this very narrowly by actually looking at the gross fees generated by the principle compared with those generated by employee professionals. They look at the percentage of actual fees generated rather than doing a head count. Further, no allowance is made for the revenue generated by non professional staff unless it is billed directly to the client.

Partnerships are a great idea - But

Partnerships are a great idea providing you don't need asset protection. Generally a professional will keep all personal assets in their spouses' name so that the assets cannot be touched if they are sued. Note the law will catch these arrangements if they were to defeat creditors. If you bring your spouse into business with you as a partner then his or her assets are exposed as well as yours.

This very fact is part of the reason why the ATO will not object to the splitting of income through a bona fide partnership providing both partners participate in the business even though one may participate far more than the other. You still have to pass the alienation of personal income rules above. The results test is the most likely one to get you through. This carve out for partnerships is documented in an ATO statement outlining the refocus of its income-splitting test case program.

What are the advantages of distributing to your family?

The tax brackets are as follows:

2008/09	2009/10	2010/2011
0 - 6,000 0%	0 - 6,000 0%	0 - 6,000 0%
6,001 - 34,000 15%	6,001 - 35,000 15%	6,001 - 37,000 15%
34,001 - 80,000 30%	35,001 - 80,000 30%	37,001 - 80,000 30%
80,001 - 180,000 40%	80,001 - 180,000 38%	80,001 - 180,000 37%
180,001 + 45%	180,001 + 45%	180,001 + 45%

Splitting income with your spouse means you can double these thresholds. Before entering into an arrangement that effectively shifts income from one partner to the other, crunch the numbers.

The way for a couple to minimise their overall tax is to arrange their affairs so that they are both in the same tax bracket. They do not need to have the same taxable income. Their combined tax bill will not benefit from any income shifting arrangement if they are already in the same tax bracket. Even if one is at the higher end and the other the lower end. The low income tax offset also needs to be taken into account. This means if you need to have gone well into the 31.5% bracket above your low income spouse before any tax arrangement that shifts income to them is worth your while. And then if you have children Centrelink Part B payment needs to be taken into account. The low income tax offset operates as follows:

Year	Offset Amount	Tax Free Income*	Starts to Shade out	Lost at	Tax Rate While Shading
2007/08	750	11,000	30,000	48,750	34%
2008/09	1,200	14,000	30,000	60,000	19% till \$34,000 then 34%
2009/10	1,350	15,000	30,000	63,750	19% till \$35,000 then 34%
2010/11	1,500	16,000	30,000	67,500	19% till \$37,000 then 34%
2012/13	2,100	20,000	30,000	82,500	19% till \$37,000 then 34%

* This only applies if that is all the taxable income you have, otherwise you will start paying tax at \$6,000.

These low income tax offsets also make it much more attractive to distribute income to your children. Minors are subject to penalty rates as high as 66% on passive income. This does not apply if they have earned the income and there are other concessions for income that is not primarily from an income splitting arrangement. But even in an income splitting arrangement providing they do not have any other income to use up their low income tax offset they can use it to offset the higher minor tax rates. Children under 18 can receive the following passive income without paying tax.

Year	Low Income Tax Offset	Free Income Threshold, above this 45%
2007/08	750	1,666.66
2008/09	1,200	2,666.66
2009/10	1,350	3,000.00
2010/11	1,500	3,333.33
2012/13	2,100	4,666.66

Once they reach 18 they are entitled to all the tax free threshold and lower tax rates that your spouse would be entitled to, as discussed above. So if you intend sending your children to university, distributing to your family is a huge tax saving.

Ryan's Case - Superannuation for Employee Spouse

Dr Ryan ran a computer consulting company that employed him and his wife. The court accepted that the company was not set up for tax purposes but that the dominant purpose was for asset protection and because clients generally preferred to consult with companies rather than individuals. Ryan's wife only performed secretarial work for his company. She was paid at commercial rates for the amount of time she spent on company business. This was a relatively small amount but much, much more was contributed to superannuation on her behalf.

The ATO argued that this was simply a scheme to reduce tax and was caught under Part IVA. The court found that the only restriction on the amount of money Dr Ryan could contribute to superannuation for his wife, and claim a full tax deduction was the age base limit. Further the arrangement did not meet the main criteria of a scheme to reduce tax (Part IVA) because if the superannuation contribution had not been made in his wife's name it would have been made in his name, so Dr Ryan's tax situation would remain exactly the same.

I would like to point out that the years the case applied to were before the Alienation of Personal Services Income (APSI) rules were introduced. So the scenario will appear to contradict the law as we now understand it. The APSI rules did not override any existing law. Therefore the circumstances of this case will apply to you if you manage to avoid being caught by the APSI rules. On the other hand if you are caught by the APSI rules you cannot claim a deduction for superannuation contributions for your spouse unless they perform work that the client is directly charged for. Full details of the APSI rules are available in a booklet on the free publications section of our web site.

Buying Equipment to Reduce Tax

If the equipment is going to be depreciated under normal circumstances there is not much benefit in buying it at the year end because the depreciation claimable is apportioned over the year and life of the item so the deduction would be minimal.

It would be different if you leased the equipment, elected to be classed as a small business entity and made 12 months lease payments in advance. You would get a full deduction for those prepayments.

There are concessions for small purchases. If items are **under a threshold** they can be written off immediately:

Non Small Businesses - \$100 GST exclusive if registered.

Small Businesses - \$1,000 (net of GST if claimable) if the item is part of a set the whole set must be under \$1,000.

Wage Earners - \$300 (GST Inclusive) but all items that are identical must be added together for the \$300 test. If an item is part of a set the set must be under \$300.

Rental Properties - \$300 (GST Inclusive) per owner ie \$600 hot water system of a jointly owned rental property can be written off immediately. Identical items or part of a set must be added together.

Some items **purchased in June** will get more than just a few days depreciation if they meet certain criteria.

Non Small Businesses - that buy a piece of equipment for less than \$1,000 they can write 18.75% of the purchase price off in the year of purchase regardless of when it is bought.

Small Business - can write off 15% of any equipment in the year it is purchased if the life expectancy is less than 25 years.

Wage Earners and Rental Property Owners – Can claim 18.75% in the first year, on equipment costing less than \$1,000 regardless of when purchase. The threshold for rental property owners is actually \$1,000 per owner.

Tax Concessions for Charity Auctions and Dinners

Fund raising events should have even greater appeal now that payments for goods, entertainment and/or meals, in excess of their value, can be claimed as a tax deduction.

Previously the rule was, if you received some benefit for a contribution you made to a charity it was not considered a donation so no deduction was available for any portion of the amount even if all you received was a pen. The new concessions are directed at charity auctions and gala dinners where the true value of the benefit received is less than \$100 (GST Inclusive), less than 10% of the amount paid and the amount paid exceeds \$250. Of course the event has to be held by a charity that is registered as tax deductible. The deductible portion of the amount contributed is the difference between that and the market value of the benefit actually received. The organisers of such events are required to provide you with the market value of the benefit on their receipt.

Who or What Should Own Business Premises

Section 152-40 makes the active asset discount available to assets owned by a non business entity providing they were used in the business of their small business CGT affiliate or another connected entity.

Your Small Business CGT affiliate according to section 152-25 is your spouse or child under 18 years or a person who acts in accordance with your directions. Your partner in a business partnership is not your small business CGT affiliate. Section 152-30 describes a connected entity as one where you control 40% or more of the rights either directly or through control of another entity that has that control.

These definitions are also used to define whose assets are added to yours for the \$6 million dollar asset test to qualify for the CGT small business concessions. So on the one hand being a CGT affiliate or connected entity is good as assets owned by these entities and used in your business can qualify for the active asset

discount even though the owner of the asset is not in business. On the other hand to qualify for any of the small business CGT concessions you and your CGT affiliates and connected entities must have less than \$6,000,000 in net assets. Superannuation and personal assets such as homes are not counted, section 152-20 (b). Note your spouse business assets that are not in anyway connected with you do not count.

This is just another one of the many issues that should be taken into account when establishing your business. The trouble is no one really expects to get to the \$6,000,000 threshold so it doesn't get a lot of thought. But the active asset side should always be considered as it is important for asset protection purposes that the assets are owned separately from the business but without losing the small business CGT concessions. Note the CGT concessions do not apply to plant and equipment. In the case of most small businesses the two assets that the CGT concessions are likely to apply to are Goodwill and the premises the business operates from. The Goodwill by definition will always be owned by the same entity as the business so usually it is only the business premises that need to be held in a different entity from the business but still connected with the business so that the active asset concession is available.

So who or what should own the business premises? If you are looking to make the most of the CGT concessions the premises should be owned by you, your CGT affiliate or a connected entity. Owning the building in the name of a child under 18 would result in penalty tax and once they reach 18 they would not be your affiliate so this leaves you, your spouse or an entity you control more than 40% of. A company while qualifying to the CGT concession will not be able to distribute the tax free profits to you without triggering tax at your normal tax bracket and the company will not qualify for the 50% CGT concession. This means the only suitable non human entity to hold the premises in is a trust.

If you want to have flexibility on how the profits are distributed and/or you are concerned that you or your spouse may one day be sued the cost of setting up a discretionary trust is well worth it.

Now the next question is would you be better giving up the CGT discount so that you could hold the premises in your self managed super fund? About 90% of the time, yes. Super funds are only taxed at 10% on capital gains and once they are in the pension stage they are not taxed at all. Careful use of the CGT concessions can reduce the tax to zero as well. Further, having the building in the superannuation fund will exclude it from the \$6,000,000 asset test so that you are more likely to qualify for the CGT concessions on your goodwill. If this has provoked you to change your circumstances, a super fund can buy the business premises from a related entity.

Saving Tax on Your Investment Property – The Book

“Every investment property tax-related question you’ve ever wondered about is answered here and – perhaps more importantly – the ones you didn’t think to ask but should have! For property investors who want to refine their strategy for maximum gain, this resourceful handbook will make a great constant companion.” Eynas Brodie, Editor, Australian Property Investor magazine.

Combining Noel Whittaker’s easy reading style with Julia Hartman’s mind numbing attention to detail was a major challenge which ran way over schedule but it is finished, printed, and in the book stores. You can also purchase it online by going to: www.bantacs.com.au/property.php. The cost is \$29.95 plus \$5.95 postage – tax deductible of course!

Ask BAN TACS

For \$39.95 you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. For your Accountant, we will include ATO references to support our conclusion. Just go to www.bantacs.com.au and look for the Ask Bantacs link under ‘Most Popular’ on the home page.

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Disclaimer: Please note in many cases the legislation referred to above has only just passed through parliament. The full effect is not clear yet but it is already necessary to make you aware of the ramifications despite the limited commentary available. On the other side of the coin by the time you read this information it may be out of date. The information is presented in summary form and intended only to draw your attention to issues you should further discuss with your accountant. Please do not act on this information without further consultation. We disclaim any responsibility for actions taken on the above without further advice as to your particular circumstances.