<u>TAX TIME BOMBS</u>
(Do you have one set to explode?)

Like other taxpayers, dentists don't want to pay more tax than they have to. Usual questions to their tax adviser are: Should I be a company or a trust? Can I claim for my car? Should I consider negative gearing? If a favorable response is received to the question of reducing tax then a big smile appears on the face of the dentist while a frown appears on the face of the tax advisor who must now ensure all the technical and legal issues are complied with.

Family (Discretionary) Trust
With over 600,000 trusts operating in Australia it's not surprising that the Australian Taxation Office is working in conjunction with Treasury to modernize the rules on taxing family trusts. The concept of a trust orginated in England in the 16th Century and was used to hide the true ownership of property to avoid taxes and protect the (family) asset. The effect of creating a trust was that the rights to the property were divided between: the trustee (who holds the **legal** title to the property) and the beneficiary (who holds the **equitable** title to the property.)

Commencing in the mid – 1970's, the use of trusts became more popular in Australia for similar reasons in that they protected property, were tax effective and allowed flexibility in distributing income between beneficiaries. When the trust is set up correctly it can be used very effectively by transferring some of the income generated by a dental practice away from the dentist (who is on a high tax rate) to spouse, children, relatives who are on a much lower tax rate. While this sounds simple, it is acceptable to the Tax Office **<u>only</u>** where the distribution of income meets both the rules of the Tax Office **and** the trusts governing rules as contained in the trust deed.

Most trust deeds have rules which provide a definition of income consistent with ordinary concepts but this is often not easily reconciled to taxable income. Two things to note are that if a Trust has an accounting loss it cannot distribute that loss and if it has income that it **does not** distribute to beneficiaries then the profit that remains in the Trust is taxed at highest margin tax rates (46.5%).

Time bomb No. 1 will detonate in the following circumstances; the family trust generates dental service fees, interest and dividends from share investments which combine for a net accounting profit of $100,000. Due to the GFC the shares are revalued and found to have fallen in value by $105,000. Under normal accounting principles the revaluation loss must be deducted from the $100,000 profit to show an accounting <u>loss</u> of $5,000. The loss can't be distributed and no distribution of accounting or taxable income can be made. The trust's tax return does not show the capital loss/revaluation of $105,000 because it's not deductible under taxation rules which means the taxable income remains at $100,000. This is taxable to the trust (because we cannot distribute) at 46.5% and the whole tax liability of $46,500 may have been avoided if the trust deed allows for the shares to remain at <u>cost price</u>.

Most trust deeds require the trustees to pass a resolution on whom to distribute the income to each year. Normally the resolution is required on or before 30th June each year. Most people would say how can you work out how much to pay each beneficiary when the year is not quite over and you do not know how much you have made? For those of you who have a trust you will see your accountant has prepared a minute that either allocates on a percentage method (e.g. 50% to Frank, 15% Lily 35% Ben) or allocates a residual to someone (eg.$40,000 to Frank, $12,000 Lily and balance to Ben). In this way all the income is distributed to beneficiaries and none is left to the trustee where the tax is 46.5%.

For many years the Tax Office has allowed an administrative concession by permitting trustees to allocate the income to beneficiaries by 31st August in each year. (The Tax Office understands there are not enough hours in the day especially at 30th June). However this concession was flawed because the Trust must comply with **<u>BOTH</u>** tax law **<u>and</u>** trust law so if the Trust deed said distribute by 30th June and the trustees did not, then a valid distribution was not made.

Time Bomb No. 2 is set to explode at 30th June 2012 as the Tax Office have withdrawn their administrative concession and unless you can **prove** the trustees have resolved to distribute on or before 30th June 2012 then all the income stays in the Trust and taxed at 46.5%. The Tax Office has already warned one accounting practice after a review of its minutes of meeting where the trust(s) distribution were all held at the accountant's office on 30th June 2010. They could not understand how 352 meetings were all held on the same day at the same place and some of the trustees present at the meeting, were actually overseas at the time!

Subject to the Trust deed, trusts can also distribute to charities, educational institutions and tax exempt bodies. In some cases, due to the different types of income and the difference between accounting income and taxable income, it was possible to distribute the more highly taxable income to the tax exempt body and the less taxable or tax free (such as 50% exempt capital gain) to family members.

The Tax Office has instigated specific anti-avoidance rules and issued PS LA 2010/1 with measures to counter this type of avoidance. **Time Bomb No. 3** will go off instantly if the Tax Office reviews prior years and seeks to impose the general Part IV A Tax Avoidance measures against the trustee or from 2012 finds that the trust has not <u>paid</u> the correct proportionate amount to the tax exempt body within 2 months of the end of the financial year.

Data Matching
This is more of a "slow release" time bomb. The Tax Office collects data from various sources and cross checks it against information it has regarding your tax affairs. If the data does not match, **Time Bomb No. 4** goes off. Some of the data matching activities currently underway are;

a. **Motor Vehicle Data**
   Tax Office will data match more than 2 million ABN holders for sales or purchases of motor vehicles, sourcing the information from transfer of registration data held by Vic Roads and other State vehicle registration bodies. They seek to identify ABN holders who do not declare the sale of vehicles or correctly account for GST on purchases/sales or purchase high value motor vehicles which exceed their affordability levels.

b. **Credit and Debit Cards**
   Tax Office will data match 400,000 ABN holders for sales income paid by credit/debit card from merchant facility data at all four major banks and American Express. They seek to identify non compliance with registration, reporting, lodgement and payment obligations under taxation law.

Benchmarking
Over the past few years the Tax Office has collected data for most industries including dental. The benchmarks are very general but are a guide for how businesses perform against others in their industry. The benchmarks cater for general dentists as well as specialists. **Time Bomb No. 5** goes off when your income or expenses fall outside the benchmark range in <u>any</u> particular year. Usually you will need to give an explanation to the Tax Office or face an audit of your financial affairs. To date we have had 10 dental benchmark reviews resulting in no audit or adjustment to tax payable because the explanation was usually a simple one (e.g. income fell due to birth of child, change from sole practitioner to a trust etc.).

(Sham) Contractors/Employees
Time Bomb No. 6 was deactivated recently with ID2011/87 regarding a doctor operating from a medical clinic on a commission basis. The determination will also apply to dentists and ensures that contract dentists with an ABN will not be considered employees, will not be subject to 9% super guarantee, are not part of a sham agreement and will be viewed as bona fide contractors. Workcover provisions may still apply and needs to be covered by the dental surgery (not the contractor).

Given the increased activity by the Tax Office with the use of data matching, benchmarking and scrutiny of Trust distributions, dentists should seriously consider tax audit insurance. Tax audit insurance covers the cost of your accountant or lawyer (if necessary) to defend you if the Tax Office knocks on your door asking “Please explain”.

MW Partners deals with both simple and complex tax matters for dentists on a daily basis. We specialize in advising and explaining to dentists the risks associated with conducting their business under an ever changing tax regime. If you have difficulty understanding the implications of the above “time bombs” or are concerned there are tax issues which may apply to you **please call Albert Gigl on 03) 8825 5400** for an appointment. As a member of the ADAVB, there is no charge for your first consultation. For your convenience, MW Partners is located on the same floor as the ADAVB at 10 Yarra Street, South Yarra.