In Brief

Commentary by Professionals for Professionals

Part 3

This four part series provides no-nonsense commentary upon topical issues for professional services firms and the professionals that practice within them.

The series will provide a perspective upon:

- Allocation of Profit
  - A pathway to Greater Certainty
- Structuring a practice
  - Navigating the Maze
- Structuring for equity participants
  - Preserving the Return
- Partner compliance obligations
  - Keeping partners focussed.

Our comments are drawn from the personal experiences of the members of our Professional Services Industry Focus Group either as advisors to the Professional Practices or equity participants in those practices. The comments reflect the reality of the issues facing practices and the equity participants – not mere theory.

Structuring for Equity Participants

Preserving the Return

In Part 2 we highlighted a number of structuring options for professional practices. Selecting the right model depends on a number of factors including practitioner's personal preference, however most traditional operating structures allow practitioners to introduce a discretionary trust to receive distributions. Those distributions may originate from a service trust, operating entity or a finance structure that stands alongside the operating entity. Indeed, Tax Office guidelines on profit allocation acknowledge the practice of streaming practice profits to a family trust. The existence of a discretionary trust within the personal structure employed by a practitioner is a threshold element of a structure that would preserve the return.

In terms of preservation, that in essence encompasses:

- Protection of the wealth created through deployment of the profits allocated to a practitioner;
- Tax efficiency; and
- Efficient transfer of wealth on the occasion of death.

Each of these elements are relevant to ensuring that the hard earned return is available to fund the practitioners own objectives and aspirations. These would typically include the desire for provisioning an acceptable retirement lifestyle, and possessing accessible wealth intended as financial support for the practitioner's surviving family.

A plan to preserve returns therefore needs to take into account both short and long term objectives. Whilst it may not be desirable to dwell on what the future holds, it is important to consider the family's future needs, when designing a structure to receive and invest profits from a professional practice.

Tax efficiency is the entry point of any strategy, but does not deliver the desired outcome alone. Rather, an effective plan considers tax efficiency as a supporting rather than central role. In short, a strategy first needs to make commercial and practical sense. The role of tax efficiency is to make a strong plan better, by building upon a solid foundation of wealth creation and preservation.

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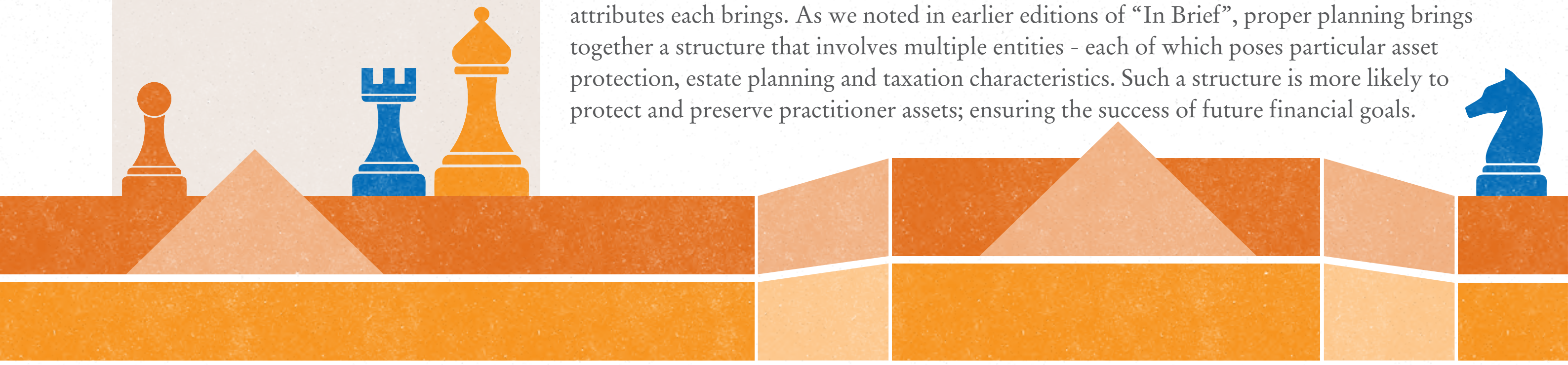
In designing a personal structure to receive and deploy practice profits, the following require consideration:

- A discretionary trust can be the centrepiece of a personal structure to:
  - receive distributions (pre and post-tax) from a variety of entities underlying a professional practice structure and develop a strategy for onward distribution having regard to the specific tax profile of the beneficiary group
  - manage franking credits turning a tax liability into an asset able to be crystallised with a changing tax profile for the beneficiary group over time (e.g. on retirement)
  - hold appreciating assets without exposure to practice operating risk whilst facilitating access to CGT concessions on future disposal
  - provide access to accumulated funds by way of loan to individuals and other entities including superannuation funds
  - operate as an efficient estate planning vehicle avoiding the erosion of wealth by way of tax on death as the trust continues without the need to dispose/transfer assets for the benefit of the immediate family.

- A company appointed as a beneficiary of a discretionary trust allows:
  - management of franked income without incurrence of top-up tax (i.e. excess of the top marginal rate over the company rate);
  - access to efficient use of franking credits through development of distribution strategies that facilitate the refund of credits (hence, the treatment of the credits as an asset rather than a liability);
  - management of trust distributions within the terms of the Tax Office requirements regarding Unpaid Present Entitlements. An integrity measure which provides a foundation for acceptable tax management;
  - access to profits taxed at 30% by way of loan within the terms of the private company loan rules. An integrity measure that supports a legitimate deferral of tax.

- A Superannuation Fund that:
  - receives concessional and non-concessional contributions. Concessional (i.e. deductible) contributions are relevant to facilitating the efficient use of franking credits by individual family members;
  - builds wealth in a 15% tax environment;
  - preserves the wealth created;
  - allows wealth to be accessed at concessional even nil tax rate to fund the required lifestyle in retirement
  - borrows to repay debt in after tax terms. That is, repays debt using income taxed at 15% or less fuelling wealth creation;
  - operates as an estate planning vehicle to provide for the immediate family on death.

Each of these attributes can be employed in a well-designed strategy. The effectiveness of the plan relies on how these various entities interact, making best use of the specific attributes each brings. As we noted in earlier editions of "In Brief", proper planning brings together a structure that involves multiple entities - each of which poses particular asset protection, estate planning and taxation characteristics. Such a structure is more likely to protect and preserve practitioner assets; ensuring the success of future financial goals.



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