

## End of Financial Year Newsletter



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The end of the tax year is fast approaching and time is running out to do year end tax planning.

If you need to see us about any area of tax or business planning that is time critical, we are here to help.

In this quarter's newsletter, we are focussing heavily on a case study, which is all about succession planning and how one event could change the fortunes of so many people.

Another area we want clients to think about is capital expenditure and taking advantage of the competitive interest rates at present. Far too many clients are

either paying well above market interest rates or have the wrong banking product in place. If you want to make a legitimate tax claim on the interest expense of a finance product, you need to ensure the tax paying entity gets the right product, right interest rate and independent advice.

We hope you enjoy the newsletter content and urge you to call us if there is any area that is time critical Pre 30th June.

# Last minute Superannuation contributions

The 2012 Concessional Contribution limits are (tax deductible)

Person under age 50	\$25,000
Person over aged 50	\$50,000

## Non Concessional Contributions

Up to \$450,000 in 1 year by taking up 3 years of contributions up in the 1st year ... but generally a maximum of \$150,000 per annum

The tax rate of a super fund is 15% in accumulation phase (pre retirement ) and tax free once you reach the retirement age limit and are in pension phase.

## Health Insurance

From 1/7/2012 the private health insurance rebate and medicare levy surcharge will be income tested against three new income thresholds.

Higher income earners will receive less private health insurance rebate, or if they do not have private hospital cover the medicare levy surcharge may increase.

This will be determined by the ATO when you lodge your income tax return.

**Tier 1:** 20% Health Insurance rebate for singles whose income is between \$84,001 and \$97,000 or couples whose combined income is between \$168,001, and \$194,000. The Medicare levy surcharge will remain at 1% for persons who fall within tier 1 and do not have private health insurance.

**Tier 2:** The rebate will be reduced to 10% for singles between \$97,001 and \$130,000 or couples \$194,001, and \$260,000, The Medicare levy surcharge will be increased to 1.25%.

**Tier 3:** The rebate will be removed for singles above \$130,000 or couples above \$260,000; in addition the Medicare levy will increase to 1.5% for this group of taxpayers.

## Motor Vehicles

The FBT rate that applies, where the cents per kilometre method of tax calculation is applied, changed from 1/4/2012 and is as follows:

0-2500cc	48c per km
Over 2500cc	57c per km
Motorcycles	14c per km

# Reviewing capital expenditure requirements

A popular business planning tool is to do a Pre June 30 review of capital expenditure requirements in the business.

Whether it be replacing vehicles, purchasing new machinery or equipment or even considering an office refurbishment, consider whether it is more effective to make the purchases pre 1 July 2012, or more tax effective if delayed until the next financial year.

Generally speaking, if you are having a very profitable year, this year it may be better to consider bringing these expenditure items forward.

Using a Finance Broker that is not owned by one of the major banks, and is independent of the products they recommend is a vital planning tool, and in our experience the savings in interest in this area is the real broker's bread and butter.

The car dealers or the local bank are often 2-3% above the market on vehicle and equipment rates.

As an example, in the first few days of June, and being mindful that rates change every day, the rate for a client wanting to purchase a new truck for \$90,000 with no deposit was just under 7%, this compared to the dealer rate of 9.8%. Over the 4 years of the lease the difference was a staggering \$11,000 in payments.

If you don't have a broker, or want to discuss your own capital expenditure calculations call our office we can help.

# Tax rate changes

From July 1 2012, personal tax rates are to be adjusted delivering tax cuts to low and middle income earners.

The tax rates are:

2011/12		2012/13	
0-6000	nil	0-18200	nil
6001-37000	15	18201-37000	19
37001-80000	30	37001-80000	32.5
80001-180000	37	80001-180000	37
180001 +	45	180001+	45

The greatest saving is for the low income earner on \$18,200 that now pays 15% tax on \$12,200 of that income, where from July 1 2012 the tax payable will be nil.



# A Case Study – D&J Plastics Operations

Doug and James each own 50% of the Company with approximately 30 employees.

Successful plastic injection moulding business manufacturing containers for the food industry.

Doug is a mechanical engineer and a leading expert in the revolutionary Injecta plastic moulding process.

James is in charge of sales and has an extensive network in the food industry and is a marketing guru of the food packaging industry.

## D&J Plastics Financial Structure

- Annual orders from the food industry \$25 million
- Injection moulding plant has been purchased under a financial lease. Lease commitments are approximately \$2 million per annum.
- Plastic pellets are purchased from a Japanese supplier. Purchases are approximately \$1 million per month.
- Bank overdraft of \$5 million to fund working capital requirements. Bank overdraft is secured by joint and several personal guarantees.

## Doug's Circumstances

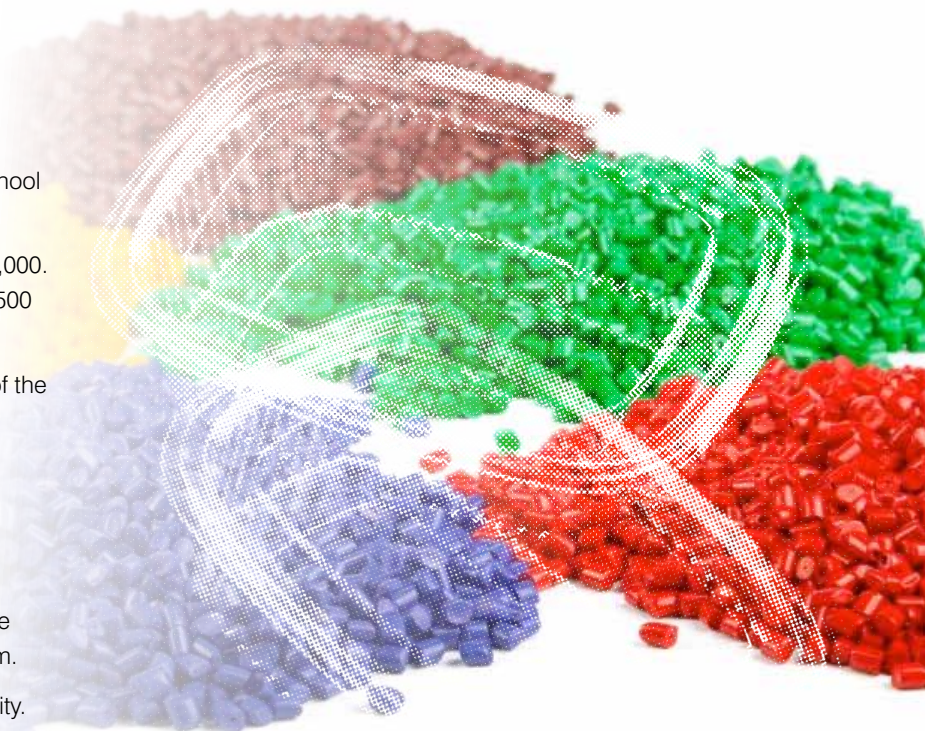
- Age 45 years.
- Married to Rose.
- Two teenage children at private schools. School fees are \$25,000 per annum.
- House worth \$1.5 million. Mortgage is \$500,000. Mortgage repayments of approximately \$2,500 per month.
- Personal guarantee to the Bank in respect of the Company's overdraft.

## James' Circumstances

- Age 50 years.
- Married to Bridget.
- Two children of primary school age at private schools. School fees are \$20,000 per annum.
- One child from a former marriage at university.
- Home worth \$1.5 million, mortgage of \$1 million.
- Personal guarantee to the Bank in respect of the Company's overdraft.

## Tragedy Strikes

- Doug works late one evening rectifying faults on the injection moulding plant.
- Drives home, but falls asleep while driving.
- Vehicle leaves the road and overturns.
- Doug is killed instantly.
- Funeral is held celebrating his life, but grieving the tragic death of a family man killed in the prime of life.





# What are the economic consequences for the survivors?

## What Happens to D&J Plastics?

James tries to run both the production and the marketing side of the business. He cannot cope with the increased burden, but cannot afford to pay for additional support.

The food industry clients get nervous, and place orders with other suppliers.

The Japanese raw material supplier sees the Company as an unacceptable risk, and will therefore only operate on a COD basis. This creates additional cash strains.

Sales collapse, but costs remain the same. The high fixed cost elements being wages, rentals and machinery lease payments continue.

The woes gather momentum. Support staff members lose confidence and leave.

Doug's widow, Rose, enters the business and interferes in the running of the business. James and Rose have a different view on the future of the business. James feels that he is working long days only to be sabotaged by the deceased's family. Often the death of a partner can mean the involvement of the deceased's family in the business. They often know nothing about the business, and present obstacles to any initiatives taken by the surviving partners to bring things back on track.

The drop in sales causes a breach in bank covenants. Generally, banks require the maintenance of certain financial ratios to continue lending. If the ratios move to unacceptable levels, the Bank will try and limit its exposure by foreclosing in the hope that its security is still sufficient to cover the capital sum borrowed.

## Death of D&J Plastics

Cash flow crises mean that the company defaults on its lease payments and the Bank also triggers the foreclosure.

The Company is placed in liquidation and the bank appointed liquidator sells the assets on a fire sale basis.

Liabilities exceed assets, and the shares in the Company become worthless.

## A succession plan for D&J Plastics

Had the business looked at a succession plan, the following key questions would have been considered.

On the death or permanent disability of one of the partners how would D&J Plastics ensure:

- Protection of the company's profits.
- Protection of the Company from creditors.
- It could transfer the shares in the Company to the survivor.
- Protecting the family home and maintenance of the family's lifestyle e.g. the payment of the school fees of the shareholders.

## Solution 1 : Protecting the Company's Profits

The future profits of D&J Plastics depend upon the continued presence of both Doug and James. The death of either shareholder will compromise future profits.

The profit flow will be compromised on the death of either shareholder for a period until a replacement employee can be found, and the replacement can undertake the duties of the deceased with the same confidence and credibility.

The potential loss is therefore:

- Cost of locating and hiring a replacement.
- Loss of profits in the interim period.
- Overhead costs until normal income flows resume.

This risk can be protected by a key person insurance policy which will cover D&J Plastics for loss of profits caused by the death of either Doug or James. This means that on the death of James or Doug, the key person policy claim proceeds provide cash to enable the company to continue operations in the crucial period following Doug's death until normal profit patterns return.





### Key Person Revenue Tax Treatment

The premiums payable will be deductible to D&J Plastics, as the insurance cover relates to the protection of the future revenue of the Company.

It is important to document the purpose of this insurance to secure the tax deduction. The documentation reflecting this purpose would be the Statement of Advice, any board papers, and minutes/resolutions of the board of directors.

The claim proceeds will be assessable to the company, but the additional costs such as staff hire costs and the overheads such as lease rentals will be deductible. Therefore, there should be no additional tax burden to the company.

### Solution 2: Protection from Creditors

The existence of the bank overdraft and compliance with associated covenants presents the risk that the Bank will trigger foreclosure procedures in the time of any stress. There is also the ancillary threat that any default by the Company will trigger the Bank to claim under the guarantees given by each shareholder.

The ideal situation is therefore to eliminate the debt within the Company in times of stress. This can be achieved by a policy on the life of Doug and James owned by the Company which will yield an amount on claim equal to the maximum overdraft facility offered by the Bank. This will enable the Company on the death of either shareholder to use the claim proceeds to repay the Bank, and enable the Company to be debt free.

This type of policy is often referred to as key person capital.

### Key Person Capital Treatment

The premiums on the policy under Solution 2 will not be deductible for tax purposes. The bank debt is part of the financial structure of the company and any expenditure associated with the repayment of the bank debt will also be regarded as part of the structure of the company. Structural expenditure of this type is regarded as capital expenditure for tax purposes, and is therefore not deductible.

It is important to document the purpose of this insurance in board minutes, etc., to reduce the risk of the ATO querying or contesting the purpose of the insurance.

In the event of a claim, the proceeds will be treated as being on capital account. It is necessary to consider whether or not capital gains tax is applicable.

The proceeds of a life policy paid on the death of the life insured are exempt from capital gains tax if paid to the original beneficial owner of the policy. D&J Plastics is the owner of this policy, and therefore the claim proceeds paid on Doug's death should be exempt from capital gains tax.

### Solution 3: Transfer Of the Deceased's Shares to the Survivor

This solution enables the family of the Deceased Shareholder to exit the partnership, and to receive value for the Deceased's interest. This solution also enables the Survivor to acquire the Deceased's shares and to operate the Company in the future without any interference from the Deceased's family.

Doug and James should enter an agreement drafted by their solicitor which provides that the survivor is bound to purchase the shares of the deceased shareholder. (Buy/Sell Agreement).

The purchase price of the shares would be the market value of the company excluding bank debt less any amounts due under the Solution 3 life insurance policy.

Doug purchases a life insurance policy on his life equal to the value of his shares in the Company as calculated above. James also purchases a policy on his life equal to the value of his shares in the company.

### What Happens On Doug's Death?

James purchases Doug's shares for a market value amount from the Executor of Doug's Estate. The purchase consideration should be nominal if the market value of the business approximates the amount payable to Doug's estate under the life insurance policy.





Doug's estate receives the claim proceeds of the Solution 3 insurance policy on Doug's death. The claim proceeds should approximate the value of Doug's shares. The claim proceeds are then distributed to Doug's heirs in accordance with the terms of his will.

Doug's family makes a clean exit from the business, and receives full value for the shares.

### **Buy/Sell Tax Treatment**

The premiums paid by Doug and James to provide the cover required by the Buy/Sell arrangement would not be deductible for tax purposes. This expenditure is regarded as capital expenditure.

Doug and James would have to consider how they will fund the premiums. This funding could be provided via additional salary from D&J Plastics or a dividend.

The claim proceeds paid to Doug's estate on his death should be exempt from capital gains tax. Doug is the original beneficial owner of the policy. The proceeds of a life insurance policy paid to the estate of the original beneficial owner of the policy are exempt from capital gains tax.

Doug's estate may be subject to capital gains tax on the transfer of Doug's shares to James. The capital gain is the difference between the value of the shares and the cost of the shares. It is important to note that this capital gains tax liability is not due to the Buy/Sell arrangement. It will apply whenever Doug's shares are sold.

50% of the any capital gain will be exempt from capital gains tax. Doug's tax adviser needs to consider whether or not any additional CGT exemptions are applicable. There are, for example, a number of small business exemptions which could shelter the gain wholly or partially from capital gains tax.

James would acquire Doug's shares at a cost base equal to the market value of the shares on Doug's death. This is important as this cost base will be used to determine James' capital gains tax liability when he eventually disposes of the shares.

### **Solution 4: Protection of the Family Home & Lifestyle**

Doug has a mortgage of \$500,000 and a commitment for school fees and other domestic costs.

This exposure should be covered by a policy on Doug's life to yield a sum on his death equal to the mortgage debt plus a lump sum to fund school fees and other expenses. Therefore, on his death, the home mortgage can be discharged using the claim proceeds. The balance of the claim proceeds can be used as a sinking fund to finance future school fees.

Doug should consider holding this policy via superannuation. The premiums can be financed via tax deductible contributions from the Company. Doug can take a salary sacrifice equal to the contributions required to fund the premiums. This will ensure that the Company is not out of pocket as a result of the contributions. This arrangement is tax effective for Doug as he is financing the cost of cover from pre tax dollars.

James owns his own home, but has a spouse and two children of primary school age and a child from his first marriage at university. He should consider holding a life insurance policy to provide funding for the living expenses of these individuals in the event of his death. James should also consider holding this policy via superannuation.



## Solution 5: Tax Treatment

Doug can make a binding nomination in favour of Rose. This will ensure that the death benefit flows intact to Rose on Doug's death. Rose can then use the claim proceeds in any way she considers appropriate.

Death benefits paid by a superannuation fund to a surviving spouse of the deceased member are tax free.

This approach enables the death benefit to bypass Doug's estate, and to flow directly to Rose. This reduces the risk of the benefit being eroded by the claims of creditors or other heirs.

James should consider a binding nomination directing a specified portion of the amount insured to be paid to Bridget on his death. This will ensure that the benefit flows directly to her, and in the event of James' death, Bridget can use this sum to fund the living expenses of herself and her two children.

James could, via a binding nomination, direct a portion of the amount insured to be paid to the child at university in the event of his death. An alternative would be to nominate James' estate as beneficiary of this portion, and specify in his will that this sum be used to create a testamentary trust in favour of his child at university.



## On a light hearted Note ...

An old farmer is working in the paddock when a driver pulls up. The driver, a young man in a Brioni suit, Gucci shoes, Ray Ban sunglasses and YSL tie, leaned out the window and asked the old man, 'If I tell you exactly how many cows and calves you have in your herd, will you give me a calf?'

Billy looks at the young man, who obviously is a yuppie, then looks at his peacefully grazing herd and calmly answers, 'Sure, why not?'

The yuppie parks his car, whips out his Dell notebook computer, connects it to his Cingula RAZR V3 cell phone, and surfs to a NASA page on the Internet, where he calls up a GPS satellite to get an exact fix on his location which he then feeds to another NASA satellite that scans the area in an ultra-high-resolution photo.

The yuppie then opens the digital photo in Adobe Photoshop and exports it to an image processing facility in Hamburg, Germany.....

Within seconds, he receives an email on his Palm Pilot that the image has been processed and the data stored. He then accesses an MS-SQL database through an ODBC connected Excel spreadsheet with email on his Blackberry and, after a few minutes, receives a response.

Finally, he prints out a full-colour, 150-page report on his hi-tech, miniaturized HP LaserJet printer, turns to Billy and says, 'You have exactly 1,586 cows and calves.'

'That's right. Well, you'll be helping yourself to one of me calves, then, since you won it fair 'n' square.' says Billy.

He watches the smartly dressed yuppie select one of the animals and looks on with amusement as the man gingerly picks it up & stuffs it into the boot of his car.

As the yuppie is carefully brushing the dust & hair off his suit, Billy says, 'Hey, if I can tell you exactly what work you do & where you come from, will you give me back my calf?'

The yuppie thinks about it for a second, wondering what this wrinkled up dirt encrusted uneducated old man could possibly know? He grins and then says, 'Okay, old fella, why not? I'm a believer in fair play.'

'You're a politician & you work in Canberra.' says the old timer.

'Wow! That's correct,' says the yuppie, 'but tell me how on earth did you guess that?'

'No guessing required.' answered Billy 'You showed up here even though nobody called you; you want to get paid for an answer I already knew, to a question I never asked. You used millions of dollars worth of equipment trying to show me how much smarter than me you are; and you don't know a thing about how working people make a living - or about cows, for that matter. This is a herd of sheep.

Now give me back my dog.'