
Allied Health Care Professionals: Issues in Tax Planning

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Abstract

A health care professional can provide personal services or conduct a business using various structures, such as a sole trader, partnership, trust or a company. This article examines the tax consequences arising from operating under these structures. The article draws a distinction in the tax treatment of health care professionals whose income is derived principally from the assets of a business or a business structure as opposed to income derived principally from personal efforts and skill. The recent announcement in March 2003 by the Australian Taxation Office to test some income splitting arrangements by personal service businesses in courts may affect some health care professionals. The implications of using service trusts to provide administrative services to health care professional practices are also discussed in this article.

Introduction

Some health care professionals just provide personal services to their clients, for example, a sole general practitioner, whereas others such as radiologists and pathologists often employ technical staff and use a variety of technical equipment. Where health care professionals practice on their own account, they generate personal service income, whereas those who employ staff and use equipment to provide their services generate income from a business structure.

A health care professional can operate a health care business as a sole trader, partnership, company or trust. In choosing the appropriate structure, the health care professional should not only examine the taxation consequences, but also commercial consequences such as personal liability, costs of setting up and costs of operating under the structure, and methods of financing the business. It is important to address the taxation implications before setting up the business, as later changes may attract tax liability. The advantages and disadvantages of the various structures from the tax planning angle are addressed in this article followed by

a discussion of the anti-avoidance rules on alienation of personal service income and the use of administrative trusts and companies.

Sole trader

A health care professional acting as a sole practitioner is taxable on an individual basis, and is likely to be exposed to high marginal rates of tax. As a sole trader, the health care professional should try and maximise the allowable deductions to reduce the tax bill. Employing a spouse in the business would entitle the business to a deduction for a reasonable salary paid to the spouse.¹

Contributions towards superannuation can provide a health care professional with not only a tax deduction,² but also income for retirement. This is a valuable tax concession available to a health care professional. As from 1 July 2002, a sole practitioner is entitled to a tax deduction for superannuation on the first \$5,000 contributed plus 75% of the excess of the total amount contributed over \$5,000, subject to a maximum based

¹ Section 26-35 of the *Income Tax Assessment Act 1997*.

² A tax deduction is available under section 82 AAT of the *Income Tax Assessment Act 1936*.

on the age of the practitioner. The aged based limits for 2002/2003 are as follows:

- Age under 35: \$12,651
- Age between 35 to 49: \$35,138
- Age above 50: \$87,141.

If the sole practitioner has a resident spouse whose assessable income and reportable fringe benefits is below \$10,801, the practitioner can claim a full tax rebate of 18% of the contributions made on behalf of the spouse, subject to a contribution limit of \$3,000 per annum. The rebate is reduced by \$1 for every \$1 the spouse's income exceeds \$10,800, with no rebate available where the spouse's assessable income exceeds \$13,800. Thus the maximum rebate in a year of income is \$540.³ If the practitioner's spouse is working for the practitioner, the practitioner can claim employer contribution deduction subject to the aged based limits stated above.

Other tax advantages of operating as a sole trader health practitioner include a 50% capital gains tax (CGT) discount on any capital gain that the sole practitioner derives. In addition, if the practice is small, the professional can elect to use the Simplified Tax System (STS). To be eligible to use the STS, the professional health care practice must satisfy the following:

- must be carrying on a business as opposed to undertaking a hobby;
- the average turnover of the business must be less than \$1 million; and
- the adjustable values of depreciating assets held by the professional health care practice and their grouped entities at the end of the year must be less than \$3 million.

A number of advantages flow from adopting the STS, as discussed below:

- Cash accounting rather than accruals accounting can be used. A health care professional opting for the STS can account for their income and expenditure on a cash basis. Most business income and deductions can be recognised only when they are received and paid. Trade debtors at the end of the year are not brought to account as income and trade creditors at year end are not allowed as a deduction.
- A simplified depreciation (capital allowances) system is available. Depreciating assets that cost less than \$1000 each can be written off immediately and claimed as a deduction in the year in which the asset is first used by the health care practitioner, or installed ready for use, for a taxable purpose. Other depreciating assets which have an effective life of less than 25 years can be pooled and depreciated at the diminishing value rate of 30%. The pool is treated as a single asset for depreciation purposes. Depreciating assets with an effective life of 25 years or more can be pooled and depreciated at the diminishing value rate of 5%.
- A simplified treatment of trading stock is available. A health care professional is only required to account for changes in the trading stock on hand or undertake a stock count at the end of the year where the difference between the value of opening stock and a reasonable estimate of closing stock exceeds \$5000.

Another advantage of operating as a health care sole practitioner is that profits of the sole practitioner can be offset against commercial losses from other sources. A health care professional may have another business, such as a hobby farm that may be incurring losses. Non-

³ Section 159T of *Income Tax Assessment Act 1936*.

commercial losses cannot be offset against assessable income.⁴ To test whether losses are from a commercial activity, one of the following four tests must be satisfied:

- the loss making business did produce an assessable income of at least \$20,000 in an income year;
- the loss making business made profits in at least 3 out of 5 income years including the current year;
- the loss making business uses real property of least \$500,000; or
- the loss making business uses other assets, other than cars, motorcycles and similar vehicles, worth at least \$100,000, on a continuing basis.

Partnership

Many professional health care practitioners operate under a partnership structure, as this gives them the opportunity to combine professional skills and share their business income with other professionals. There are a number of tax advantages in operating under a partnership structure. The main tax advantage from a partnership structure is that the profits and losses from the partnership business flow to the partners, who are then assessed individually. If the business has incurred a loss, the individual partners can offset that loss against any of their other income. On the other hand, profits from the business can be offset against losses from other businesses that the partners may have, so long as the non-commercial loss provisions discussed above are satisfied.

Similar to a sole trader but unlike a company, the partners in a partnership are also entitled to a 50% CGT discount on capital gains that flow through to the partners. The partnership should be mindful of CGT implications arising from assignment of partnership

interests, as each time a change in partnership occurs, the old partnership comes to an end and a new partnership comes into existence.

A health care professional deriving personal service income may attract the recently enacted Alienation of Personal Service Income legislation⁵ discussed later in this article, if the partnership structure is used to alienate personal service to obtain a tax advantage.

Trust

A discretionary trust is a popular vehicle for conducting business since it can be effectively used to distribute trust income to beneficiaries. The beneficiaries can be family members. The problem of diverting personal service income of a health care professional through a trust is that it may trigger the operation of anti-avoidance tax provisions such as Part 1VA of the *Income Tax Assessment Act 1936* and the recent Alienation of Personal Service Income legislation as discussed below.

Income arises from personal service where it flows predominantly from the skills and services personally rendered. The word 'predominantly' means that although some equipment may be used, it is the skill of the medical practitioner that produces the income. In some large professional practices such as a pathology practice, income is produced by the use of equipment and the staff employed by the practice. In such a case, trust arrangements may be acceptable for income tax purposes.

The trust arrangements were denied in a number of doctors' cases by the High Court of Australia in *FCT v Gulland*,⁶ *Watson v FCT*⁷ and *Pincus v FCT*.⁸ The facts in each of these cases were similar, where a medical practitioner, who had either conducted a medical

⁴ Division 35 of Part 2-5 of *Income Tax Assessment Act 1997*.

⁵ Division 85 of Part 2-42 of *Income Tax Assessment Act 1997*.

⁶ *FCT v Gulland* (1985) ATC 4765.

⁷ *Watson v FCT* (1985) ATC 4765.

⁸ *Pincus v FCT* (1985) ATC 4765.

practice alone or in partnership, established a unit trust, the units held by the trustee of the practitioner's family unit trust. The trustee then acquired the medical practice and employed the medical practitioner on an agreed salary. This gave the trustee the opportunity to distribute the income from the medical practice to the family members of the practitioner. The High Court of Australia held that these arrangements attracted the general anti-avoidance measures in the *Income Tax Assessment Act*.

Although personal service income of a medical practitioner cannot be diverted to family members via a trust arrangement, the transfer of income producing assets to a trust would not attract the anti-avoidance provisions. However, it is necessary to ensure that the income of the practice flows predominantly from income producing assets and not from the rendering of personal services by the 'principal' of the business.⁹ It is also important to ensure that the trustee holds the trust property comprising of the business and its assets absolutely and carries on the business activities for the benefit of the beneficiaries.¹⁰ Such an arrangement was successful in the case of *D.F.C of T v Purcell*,¹¹ where the owner of farming properties created a trust on behalf of himself and his family. Such an arrangement was not successful in *Hollyock v FCT*,¹² where a pharmaceutical chemist created a trust of his business for himself and his wife, since the wife was not a qualified pharmacist and could not lawfully join in carrying on the business.

Company

A health care professional deriving income from personal exertion may have set up a practice company. Income Tax Ruling IT 2503 provides the guidelines on the incorporation of medical practices. According to the tax ruling, the Australian Taxation Office (ATO) accepts the incorporation of professional practices if the

purpose of incorporation is not to divert income from personal services of the professional practitioner to the family members or other persons and the only advantage for income tax purposes is to access greater superannuation benefits.¹³ The practice company may own assets used in the conduct of the professional practice, but it is not acceptable for the company to hold investment property.¹⁴

The income derived by the company must be distributed to the health care professional and cannot be retained in the company. The reason for this is for the company income to flow through to the individual and be taxed at the individual rate, rather than the company rate. Income Tax Ruling IT 2503 states that it is unacceptable for an entity to make little or no attempt to distribute its income to the professional by way of salary or wages or to retain the income in the entity. The recent case of *Egan v FCT*¹⁵ confirms the position stated in the tax ruling and concludes that such a situation implies that the incorporation has been undertaken for the purposes of minimising income tax. This would attract Part IVA of the *Income Tax Assessment Act 1936*. However, in order to apply Part IVA, the Tax Commissioner must prove that the sole or dominant purpose of the taxpayer was to obtain a tax benefit. This may be difficult to prove, and thus the Tax Commissioner may rely on the recent Alienation of Personal Service Income legislation and if this legislation applies, then the income derived by the company will be deemed to have been derived by the individual.

Alienation of Personal Service Income

Alienation of Personal Service Income (PSI) legislation¹⁶ may apply to a professional health care practitioner who derives income through the exercise of his or her professional skills and the income is derived

⁹ See Paragraph 15, Taxation Ruling IT 2330.

¹⁰ See Paragraph 18, Taxation Ruling IT 2330.

¹¹ *D.F.C of T v Purcell* (1920-21) 29 CLR 464.

¹² *Hollyock v FCT* (1971) 125 CLR 647.

¹³ See Paragraph 3, Taxation Ruling IT 2503.

¹⁴ See Paragraph 24 and 25, Taxation Ruling IT 2503.

¹⁵ *Egan v FCT* (2001) ATC 2185.

¹⁶ Part 2-42 *Income Tax Assessment Act 1997*.

through an interposed entity, such as a company, partnership or trust. The purpose of the PSI legislation is to deny individuals the tax advantages of splitting income or to claim deductions which would not otherwise be available if they provided their services in their own right.

The legislation will not apply to a professional health care practitioner who falls within the results test, or carries on a 'Personal Service Business' (PSB).

The result test is satisfied if at least 75% of the professional health care practitioner's income is earned for producing a result and the health care professional provides his or her own tools to produce the results and is liable for rectifying defective work.

A professional health care practitioner will be conducting a PSB if less than 80% of the professional's PSI is received from one source, and services are provided to at least two independent parties, or the health care professional conducts the business through separate business premises. Thus, health care professionals who employ staff and use equipment to generate income are likely to be conducting a PSB and would therefore not be disadvantaged by PSI legislation.

IT 2639 explains the ATO's view of when income is derived from personal exertion, as opposed to being derived from a business. Whether the health professional derives income from rendering personal services is a question of fact and degree to be determined in the circumstances of each case. It is important to determine the extent of the connection between the health care professional's income and the services rendered by the health care professional. The ATO states that the following factors need to be considered in determining whether a taxpayer derives income from personal services, though no one factor is determinative:

- the nature of the taxpayer's activities;
- the extent to which the income depends upon the taxpayer's own skill and judgment;
- the extent of the income producing assets used to derive the income; and
- the number of employees and others engaged.

It is unlikely that a health care professional conducting a PSB would attract the anti-avoidance provisions in the PSI legislation. Until recently, it was commonly thought in the tax profession that such a business would also not attract the general anti-avoidance provisions found in Part 1VA of the *Income Tax Assessment Act 1936*. However, the ATO has recently stated the possibility of the general anti-avoidance provisions applying to a PSB.¹⁷ The ATO is funding a number of test cases in the courts to clarify how the general anti-avoidance rules can apply to personal service businesses.¹⁸ Health care professionals operating a PSB should carefully examine the outcome of these cases.

Administrative companies and trusts

Although income splitting may attract anti-avoidance provisions in the *Income Tax Assessment Act*, a health care professional may benefit from reduction of income tax and obtain protection of assets by setting up a service company or a trust to provide services of non-professional and administrative nature to their practices.¹⁹ The service company or trust would employ non-professional and administrative staff to provide secretarial and clerical services to the medical practice. The medical practitioner can also be employed by the company or the trust, but only for the non-professional and administrative duties, being a proportion of the medical practitioner's time. The time spent by the

¹⁷ See ATO's Fact sheet 'General anti-avoidance rules and how they may apply to a personal service business', released in March 2003.

¹⁸ See ATO Press Release, 14 March 2003 at www.ato.gov.au.

¹⁹ *FCT v Phillip* (1978) ATR 783.

practitioner on administrative duties can be calculated by deducting the following from the total time:²⁰

- chargeable professional duties;
- non-chargeable professional duties (e.g., professional reading, self improvement);
- private matters (e.g., personal matters); and
- social commitments.

Income Tax Ruling IT 2531 provides examples of administrative duties. For a health care professional, administrative duties would include:

- administration of the health care practice;
- selection and recruitment of non-professional staff to operate the health practice;
- clerical duties such as banking, opening mail, filing, copying documents, posting letters;
- personnel duties such as arranging salary payments, superannuation, arranging study and self development of staff, organising leave rosters;
- record keeping for the practice such as general practice book-keeping, maintenance of ledgers, billing records, debtors and creditors controls;
- financial duties such as dealing with banks and financial institutions, preparation of practice accounts;
- management duties such as organising staff meetings, maintenance of office furniture and equipment, and organising ancillary services; and
- maintenance of a professional library including the circulating of reports and updating of reports from professional reference services.

The income of the service company or trust would comprise of a service charge to the professional practice. It is most important that the service charges for

the services provided by the service company or trust are commercially realistic. The Tax Commissioner has recently shown concern at some service trust arrangements and thus it is important that a formal service agreement be drawn up between the professional practice and the service trust.²¹ The agreement should detail the services to be provided and the calculation of the service fees.

The service company or trust can obtain tax deductions not only for providing the administrative services, but can also claim deductions for contributions towards employer sponsored superannuation of the medical practitioner, subject to the limitations under the *ITAA* as discussed above. A service company would not usually have any taxable income as it would charge the medical practice for only the costs incurred, salaries paid and superannuation contributed. If it does have any taxable income, it must distribute the income to the professional practitioner by way of franked dividend. This ensures that the service company is not used by the practitioner for income splitting purposes or to obtain a tax advantage by excessively charging for non-professional services, thereby converting professional income into non-professional income for tax purposes.

Conclusion

A health care professional can obtain tax advantages by using the appropriate structure to conduct the professional business. However, the health care professional should be mindful of the anti-avoidance provisions in the tax legislation. There appears to be a tension in the tax administration of these anti-avoidance provisions. The outcomes of some of the test cases that the ATO is funding to clarify how the general anti-avoidance rules apply to income splitting arrangements in today's environment are likely to impact on health care professionals.

²⁰ See Paragraph 10 of Taxation Ruling IT 2531.

²¹ Speech on 'Tensions In Tax Administration' by Michael Carmody, Commissioner of Taxation, to Institute of Chartered Accountants Melbourne, 14 March 2003, extracted from: www.ato.gov.au.

