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Save tax or protect your assets? Both? Read on...

Many dentists are often recommended not to own assets in their personal name in case they are sued. If you are successfully sued and you don't own anything, you have nothing to lose!

However, if you don't have the ability to stream taxable income to other individuals such as your spouse (and consequently have to declare all practice income in your personal name), it can often be tax-inefficient not to own investments in your personal name – particularly when you have borrowed to acquire them – as you won't enjoy the negative gearing benefits. This begs the question, what's more valuable; asset protection or tax benefits?

WHICH RISK WORRIES YOU MORE?

There are two things that can go wrong in life that can result in a dramatic loss of wealth. Firstly, you might be sued by someone, i.e., an action by a patient – we call this external asset protection. Secondly, you might be party to a relationship break-down (marital or de facto) – we call this internal asset protection. You need to decide which risk concerns you the most because often you cannot protect yourself from both. For example, putting 100% of your assets in your spouse's name might provide external asset protection but could cause some headaches should you go through a nasty separation. Protecting against one risk might expose you to other risks so you really need to understand which risk concerns you the most.

I am not aware of any dentists suffering a personal loss, i.e., loss over and above what the professional indemnity insurer has met as a result of an action by a patient in say the last decade (more on this later). However, the divorce rate in Australia is over 40%. Therefore, one could argue (based on probabilities alone) that internal asset protection is perhaps a greater risk than external.

TAX SAVINGS FORGONE

If you are a commission based dentist or operate your own practice and earn more than 50% of the practice's income, i.e., from the patients you see, you'll have to weigh up tax benefits and asset protection – you can't have both. However, if you operate a practice that employs a dentist (or multiple dentists) who works as many hours as you do, *then your practice income will typically be classified as 'business income' and you should be able to structure your affairs so that you enjoy tax savings and asset protection, i.e., you can have your cake and eat it too* (often through a company and trust structure).

Consider a situation where a dentist, John, wants to invest in a

\$700,000 investment property. He will utilise the equity in his family home to borrow the total cost (including stamp duty) of the purchase – say \$740,000. The property's taxable loss in its first year, i.e., rental less expenses including interest on the loans is expected to be \$36,500. If the property was owned by John personally and he is on the highest marginal tax rate, then he would save approximately \$17,000 in tax, i.e., negative gearing benefit.

A discretionary (family) trust often provides good asset protection. If John's property was owned in a family trust then the tax loss of \$36,500 would be trapped inside the trust and carried forward. Therefore, the dentist could offset the trust's loss against his income. The trust could carry forward losses and these would eventually offset any profit that the trust makes. This means you don't lose the tax breaks – you just don't get the benefit now.

The difference between owning the investment property in personal name versus in a family trust is just under \$250,000 over a 20 year period (in today's dollar). Put differently, putting the investment property in a trust and achieving some asset protection will cost the dentist \$250,000 (reduction in net worth). Asset protection comes at a significant cost! Is the price worth paying?

WHAT ARE THE 'EXTERNAL ASSET PROTECTION' RISKS?

What is the risk of you being sued by a patient and suffering a personal loss – either because your MDO doesn't pay out or the cost of settling that claim exceeds the MDO limit? Firstly, dental professional indemnity insurance provides very deep cover in that the limit on any single claim is very high – often in the order of \$10 to \$20 million. There isn't any history in Australia of plaintiffs being awarded damages even close to this amount. Dentists also aren't subject to the same risk that other medical practitioners are (which reduces the risk of a very high claim). For example, a doctor that practices obstetrics is arguably exposed to much higher risks as problems can occur during the birth of a child that can have severe consequences – probably why PI insurance premiums are five times higher than premiums for dentists.

There are a few things in Australia that help limit the amount of medical liability legal actions. Firstly, the Statute of Limitations for medical liability claims is limited to two years (this was changed a few years ago as a result of Tort Reforms). Secondly, lawyers are not allowed to work on commission-basis in relation to medical liability actions, i.e., the fee cannot be a percentage of the damages.

Generally, for a claim to fall outside of a professional indemnity policy, the dentist needs to have acted egregiously – essentially with criminal negligence. For example, if you purposely harm a client the insurer won't pay out – of course! However, anything less than criminal negligence will generally be covered by professional indemnity. Again, these policies provide very robust and deep cover.

A review of medical liability claims* highlights that approximately only 3% of claims exceed \$250,000. The average claim in 2008 was \$80,000. Remember, this is for medical claims – dental are likely to be lower. This evidence suggests that the maximum liability coverage referred to above is more than adequate.

One major non-financial consideration is the emotional toll and reputational damage that a claim could bring. Whilst there might be a very high likelihood that you won't suffer financial loss, having all assets in your personal name might make you feel more stressed about the outcome of the litigation process (because you have more to lose). This consideration cannot be underestimated. A legal action can be protracted and time consuming.

Whilst it's dangerous to make generalisations, based on the above factors it is reasonable to assess an average dentist's external asset protection risk as low.

A WORD ON 'INTERNAL' ASSET PROTECTION

Practically, the only effective way of protecting your assets from a relationship breakdown is through proactive measures (when the relationship begins) rather than retrospectively. The reason for this is that the Family Court has very wide sweeping powers and can look through most structures, e.g., trusts and make determinations that it feels are the fairest (much wider powers than a trustee in bankruptcy). They can unwind transactions that it feels were undertaken with the dominant reason of protecting assets from a separation agreement.

The proactive steps you can take include the use of pre-nuptial and/or cohabitation agreements and using trusts that are independently managed. However, this is a complex area and advice should be sought at the outset of any relationship (should you seek protection).

AND THE SOLUTION IS...

Typically, a good solution for a dentist is to utilise a variety of structures to hold their wealth (assuming they don't operate a practice that is classified by the ATO as deriving business income as you can benefit from asset protection and tax efficiency). For example, we might recommend an investment property owned in the dentist's personal name with some gearing, direct shares or managed funds in a discretionary trusts and superannuation in a low-cost industry fund such as Health Super (or an SMSF where the dentist wants to invest in direct property). This diversification of ownership structures often helps balance out tax benefits. In addition, it also manages overall financial and compliance risk, cash flow, estate planning, retirement planning and so on.

Of course, financial advice is never 'one size fits all' and I have made some broad sweeping generalisations. The purpose of this editorial is not to give you advice but to challenge the traditional way of thinking that: "dentists shouldn't own assets in their personal name because of asset protection". What I am suggesting is that perhaps the risk isn't as high as many might think and that maybe it is acceptable for a dentist to own some (not all) assets in their personal name. It's food for thought.



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*I couldn't find any data for dental claims.