Year-end Tax Planning Checklist for 2010/11 Year

1. Prepare Trading Accounts up to the end of April or May

The first step to good tax planning is to prepare a set of draft trading accounts in time to take appropriate tax planning action prior to 30 June. These do not have to be 100% correct, just accurate enough to give you a good picture of your expected trading results for the year. Before any planning can be put in place you need to know your potential tax exposure. Get your books brought up to date. If you need a bookkeeper to do this, make arrangements now.

2. Safeguard Brought-Forward Losses

A company is not entitled to offset 'brought forward' losses (including capital losses) of previous years unless it satisfies at least one of the following two tests;

1. a 'continuity of beneficial ownership' test, or
2. a 'same business' test.

These concepts are too complex to explain in this quick checklist. The essential point to note is the obvious implications for year-end tax planning.

A company will lose its entitlement to utilise brought forward tax losses (and current year losses) if it changes its shareholders (more than 50% of ownership) *and* nature of business before the end of the year.

3. Trading stock

If your business has trading stock, then you are required to have an accurate valuation of the stock-on-hand at 30 June 2011. This is best done by a physical count of stock. Note that stock is treated as being on hand even if not on your premises, so long as, at 30 June, you have the right to dispose of it.

Taxpayers can choose each year to value their trading stock using different methods. **Note that a different trading stock method can be selected for each *item* of stock.**

Therefore a taxpayer can choose any combination of the following methods of stock valuation;

- Cost price
- Market value, and
- Replacement price

A fourth special method is available to cater for obsolescence for some trading stock.

The Tax Office has indicated that when using the cost price method to value trading stock, a taxpayer is required to use the full ‘absorption’ method, including an appropriate share of overheads for items like rent, and factory and warehouse administration costs (see Taxation Ruling IT 2350)

4. Personal Taxpayers with Low Incomes or Losses

Individual taxpayers who have a taxable income for the year of $16,000 or less are not able to fully utilise the benefit of the effective tax-free threshold of $16,000 per annum (allowing for the *low income tax offset* $1,500). They also lose the potential benefits of the low income tax rates on taxable incomes up to $35,000 and to a lesser extent up to $80,000 where their taxable incomes are below these levels.

As you can see, enormous tax savings can be made where profits and/or losses are fluctuating each year (particularly primary producers) by utilising the individual tax scales up to the highest marginal rate threshold.

This strategy can still be used where the business is being run through a company structure by careful structuring of the salary, directors fees, superannuation and bonuses to directors.

Example:
An individual taxpayer has a loss of $10,000 in year 1 and a profit of $60,000 in year 2. Tax in year 1 is Nil and year 2 is $8,300 (on taxable income of $50,000). If however, by utilising stock valuation choices and other methods outlined in this article the taxpayer is able to structure the taxable income in both years to $25,000, then the tax payable is only about $3,700 ($1,850 each year) - a tax saving of $4,600!

5. Beware of Tax 'Schemes'

Avoid making last minute rushed decisions into tax minimisation schemes! The Australian Securities and Investment Commission (ASIC) have issued warnings about investors putting their hard-earned money into a variety of schemes promoted as year-end tax saving arrangements. This is only the latest in a run of such warnings issued over recent years about high-risk offers normally promoted at the end of the tax year. Very few of these turn out to be good investments over the medium to long term. An investment decision should never be made on the basis of promised tax benefits. The investment must stand by itself. Treat any tax benefits as a bonus.

For example, one specialist product analyst has estimated that as many as 90% of agricultural investment products offered to investors over the years were not commercially viable. Typically, the promoters charged between 50% and 100% more than the commercial cost to establish a similar agricultural investment!

As a very minimum the investment proposal should be accompanied with a Tax Office ***Product Ruling.*** The Rulings don't pass comment on the commercial viability of a project, but will at least clarify the tax position. Product Rulings can be accessed via the Tax Office site; http://www.ato.gov.au Then search for Product Rulings 2011 or choose earlier years. Note that Product Rulings can be withdrawn if the operation of the business changes in a material way from that described to the ATO.

The ASIC Website for consumers will also be useful. http://www.asic.gov.au

6. Deferring Taxable Income

There is a great incentive to defer taxable income into the next tax year. The advantages sought include a 12 month deferral of tax on that income, and possible "smoothing" of fluctuations (see earlier point). Also, the personal tax rates on income up to about $50,000 can also be reduced by the low income tax offset, so this is an added incentive for deferring of income. There are two broad methods for deferring taxable income;

Defer assessable income
To utilise this strategy of delaying income, you should check the items of income that are likely to be received during the last month of the tax year. Is it possible to delay some of this income into the next tax year? Note; there would be little point in deferral if it pushes you into a higher tax bracket in the later year, resulting in more overall tax being paid.

Accelerate deductions where possible
Rules introduced in 1999/2000 year mean that small businesses under the STS rules (turnover under $2 million) can prepay business expenses and receive a *full* deduction this year. Other businesses are not able to claim prepayments in this tax year. For small businesses under the STS, **prepaying expenses** remains a powerful year-end tax planning strategy.

You can prepay expenses by ensuring that a payment is made for the expense in June, rather than July or August. The tax laws only allow prepayments of expenses up to 12 months in advance. Even so, this is still an excellent way to legally delay payment of tax for a year, particularly for those businesses classified as 'small business'. Some examples of this are:

- Interest can be prepaid on a business or investment loan
- Prepay business rent of premises or lease rentals on business assets
- Repairs to vehicles, equipment and premises can be carried out in June, rather than in July
- Business travel and conference costs
- Other general business expenses such as maintenance, stationery, and insurance
- Make sure super contributions by an employer (or by individual taxpayers where they can claim the personal deduction) are paid in time for the payment to be cleared by 30th June (super cannot be accrued in the same way as other expenses – see below).

7. Structuring Lease Agreements

Note that from the 2003 year onwards this tip only applies to Small Businesses (turnover less than $2 million, or net assets less than $6 million). Taxpayers that meet the definition are entitled to structure leasing deals for items of plant and equipment that have a lump sum payment due at the beginning of the lease. Provided the lease complies with Tax Office Ruling IT 28 the lease payment is tax deductible.

Example: A one year lease agreement can be structured with an upfront payment allowing an immediate tax deduction of over 40% of the cost price of the goods. The residual value is due in 12 months and may be refinanced on further attractive terms. This is particularly useful for year-end tax planning to bring the tax deduction into the current year. Note that Tax Office IT 28 sets out the parameters for lease residuals based on acceptable depreciation rates.

8. Planning to Set up Your Own Superannuation Fund in June? – Consider Deferring the Set-up until July

If you are planning to set up your own superannuation fund in June, consider 'parking' the super contributions in a managed super fund or Retirement Savings Account (RSA) for a few weeks and set up your own fund early in July. Choose a managed super fund that has nil entry and exit fees (most RSA have nil fees – contact your local Bank for details). This could save up to $1,700 or more, in accounting, audit and filing fees for this tax year, and you still get the superannuation tax deduction in this year. The costs saved would include;

- preparing a set of accounts, tax return and regulatory return for this tax year
- audit of the fund for this year
- paying the annual levy
- preparing, distributing member statements

9. Superannuation Contributions on Behalf of Spouse

This is the best tax concession granted to taxpayers in many years! Investment funds can now be sheltered in a low tax (super fund) environment. The payment on behalf of the spouse is treated as an non-concessional contribution even though you may have claimed a tax rebate**. The contribution will NOT be subject to the 15% contributions tax or the super surcharge.** The amount for the receiving spouse is subject to the normal non-concessional contributions caps (ie. $150,000 or $450,000 covering three years). There is no need to show that your spouse has worked either now or in the past (unless over 65). On future withdrawal, benefits will be treated as non-concessional (tax free) although any earnings on the contribution will be treated as a post June 1983 taxable component.

There is also a 'bonus' tax rebate where you have a low-income spouse.

If your spouse has *assessable income* (including reportable fringe benefits and reportable employer superannuation contributions) less than $10,800 in taxable income you are entitled to an 18% tax rebate in respect of any spouse contribution up to a maximum of $3,000. That means the maximum rebate available if you contribute $3,000 or more on behalf of your spouse is $540. The rebate is reduced by $1 for every $1 the '***assessable income'*** of your spouse exceeds $10,800 (ie. rebate reduced to nil at $13,800). Note that this is a *rebate* of tax, not a tax *deduction.* Therefore the partner making the contribution on behalf of their spouse receives the full benefit of the tax concession, even where they are on a lower tax bracket.

Who should take advantage of the spouse super rebate?

- a couple where one spouse has *assessable income* (and reportable fringe benefits) less than $10,800, as they will be entitled to the full rebate
- a couple approaching retirement where one partner has never been in the workforce or has been out of the workforce for some time and has a low level of superannuation
- a couple where the wife ceases working to have children, but wants her superannuation savings built up on a consistent and regular basis throughout the period of child-raising
- Those who have already retired can make their current arrangements more tax efficient by commuting part of the retired spouse's super and contributing the after tax money into the other spouse's fund where the other spouse has little or no super of their own.

10. Superannuation Co-contribution

This is a great incentive offered by the Government to employees who receive less than $61,920 in ***assessable income*** in the 2011 tax year. It can also apply to self employed persons. The Government will make a co-contribution of up to $1,000 to match personal super contributions made by an employee to a superannuation fund. The maximum co-contribution of $1,000 is available to individuals on ***total income**** of $31,920 or less. The amount of co-contribution is reduced pro-rata for every $1 of ***total income*** above $31,920. Phasing out at $61,920.

Those who are in this assessable income range should definitely take advantage of this generous 'gift' from the Government. But you must make your personal contribution to your super fund before 30 June. The Governments co-contribution is calculated and credited after lodgment of your personal tax return. **TRAP**: The income levels refer to ***total*** *income* not ***taxable*** *income. Total income* is gross income (ie. assessable income) before allowable deductions eg. Gross rents received is taken into total income – not the net rental income. *Total Income* is a new concept from 2009/10 year on and now also includes reportable fringe benefits and reportable employer super contributions.

11. Superannuation must be paid before 30 June to claim tax deduction

To claim a tax deduction for superannuation in the current year, the amount must actually be **paid** prior to the year-end. It is also good practice to ensure that the cheque is cleared by 30 June. Superannuation payments cannot be accrued in the same way as other expenses. Many employers mistakenly believe they can accrue superannuation liabilities. This is partly due to the confusion with employer obligations under the **superannuation guarantee scheme**. Even superannuation guarantee payments that can be **legally** payable in late July (see below) must be paid by 30 June to claim the tax deduction in this year.

Sections 82AAA-82AAR govern the deductibility of super and preclude the general deductibility provisions. Therefore general principles of accruals do not apply. This is to ensure that the contribution will have borne tax in the hands of the superannuation fund in the same tax year. A cheque presented in July or a book entry merely crediting an account with the amount of the contribution, or an amount merely set apart as a fund for the purpose of making provision for superannuation benefits, will not be sufficient to attract a deduction: s82AAR (2).

12. Superannuation Guarantee June Qtr must be paid by 28 July

Superannuation paid by an employer for the benefit of eligible employees must have been **paid** by 30 June **if a deduction is to be claimed in that same tax year (see above).** It is also good practice to ensure that the cheque is cleared by 30 June.

The minimum (9%) superannuation contribution for SGS is measured (calculated) on a quarterly basis and for this year must also be paid on a quarterly basis, the deadline for the June 2011 quarter being 28 July 2011. If payment is not made by that date the employer will be liable for the superannuation **guarantee charge**. However if the **payment** is made after 30 June the **tax deduction** will have to be claimed in the following tax year. Therefore timing of your superannuation payments is critical.

13. Bunching of Medical Expenses to Claim the Medical Offset

Note that to qualify for the medical expenses tax offset (or rebate), the medical expenses must actually be paid, not merely incurred. In other words, it is not sufficient that a medical bill is received before year's end, **payment must actually be made**.

'Bunching' of medical expenses may be appropriate where amounts paid for the year will probably exceed the $1,500 minimum level of net medical expenses. Under these circumstances a taxpayer should consider accelerating as much as practicable of medical expenses into the current year. Note that in a family situation, medical expenses should be paid by the spouse deriving income as the rebate is effectively lost if the expenses are paid by a non-income earning spouse.

If towards the end of the current tax year, it appears that there is no chance of reaching the $1,500 threshold, consideration could be given to deferring payment into the following year. Thereby increasing the possibility of being able to claim the rebate in that year.

14. Maximise bad debts claim

To qualify for a tax deduction, bad debts must actually be written off by 30 June. This means that the entries must be made in the books, or other written evidence created *before the close of the year*.

Therefore, just prior to year-end you should review outstanding debtors and take the necessary collection procedure as evidence that the debt was **bad at 30 June**. Directors "minutes of meeting" should clearly identify the debts that are being written-off.

Company bad debt. A company claiming a deduction for a bad debt must be able to satisfy either a continuity of beneficial ownership test or a continuity of business test. These tests are similar to those applying for purposes of the carry forward of company losses (refer earlier tip number 3).

15. Farm management deposits – perfect tax planning

The ***Farm Management Deposits*** scheme system should allow primary producers to plan their taxation affairs to perfection. That is, reduce taxable income when in the top marginal tax bracket (above $180,000). Interest on amounts borrowed to fund the tax deductible deposits should also be tax deductible.

Deposits are fully tax deductible in the year of deposit**. That is, the deposit must be made prior to 30 June to be effective in this tax year**. Amounts are taxable in the year of withdrawal.

The key features of the Farm Management Deposits scheme are as follows;

- deposits will be fully tax deductible in the year of deposit and taxable in the year of withdrawal
- the investment component will be set at 100% on the entire balance ie. interest will be earned on the whole deposit
- eligibility will be restricted to primary producers with a taxable **non-primary** production income of less than $65,000 (excluding capital gains)
- there is an upper limit on holdings in the scheme, of $400,000 per **taxpayer** (companies cannot make deposits. Trusts only for minor beneficiaries. But shareholders and general beneficiaries can make deposits)
- interest on the deposit will be taxable in the financial year it is earned
- the deposits must be made with the one financial institution for a minimum period of 12 months to qualify as a tax deduction
- the deposits must not have a charge or other encumbrances created over them, or to be used in an offset account.

16. Capital gains – 50% discount rules provide tax planning options

There are now three acquisition dates of CGT assets that determine the available tax planning options. These are;

- assets acquired prior to 20 September 1985 (no CGT)
- assets acquired between 20 September 1985 and on 21 September 1999 (choice of indexation or 50% discount rules)
- and, assets acquired after 11:45 am AEST 21 September 1999 (start of *CGT Discount* rules).

The *CGT Discount* rules introduced 21 September 1999 only apply to individuals, trusts and complying superannuation entities (but not for companies). Changes from that date allow these entities a choice to pay CGT on either the indexed (for inflation) capital gain or choose a discount of the nominal capital gain (1/2 discount for individuals and trusts, and 1/3rd discount for superannuation funds). This choice is on an asset-by asset basis (see sec 114-5(2) ITAA 97). Note that the CGT discount option is not available to companies. This causes CGT planning problems for company structures. The CGT rules raise a number of tax planning issues that need to be considered before 30 June. Importantly, the 50% discount on capital gains for individuals and trusts, and 1/3rd discount for superannuation funds, is only available where the assets **are held for more than 12 months.**

Entering into any sale *agreement* within the 12 month period (even where the sale finally takes place after the 12 month period) could result in substantially more capital gains tax, as this would not meet the 12 month holding test (sec 115-40). There are also a number of other new traps relating to the capital gains 50% discount;

- Companies:

The 50% discount is **not** available to companies. Be careful with distribution of capital gains from trusts to companies where the 50% discount applies. As a general rule Company structures would not be used where large capital gains are expected to arise. That is, there would need to be other compelling reasons to acquire new assets in company structures where the asset is expected to generate substantial capital gain.

- Type of assets:

Some assets by their very nature come into existence at the same time that the CGT event takes place. Therefore they would never qualify for the CGT discount, as they will not meet the 12 month holding period. Examples are granting of an option or granting of a lease. The CGT event happens upon granting, renewal or extension. These events are listed in ITAA 1997 item 1 subsection 115-25(3). However not all is lost. Use the capital gains on these types of assets to offset brought forward or current year capital losses (see below). This then allows the discount on other assets sales entitled to the 50% discount, to be maximised.

17. Offsetting capital losses in the most tax efficient way

This is an area that has caught many investors out. Capital losses realised in a tax year can only be offset against capital gains, made in the same year or future years. Capital losses cannot be offset against ordinary income, although they can be carried forward to future years.

Therefore you must ensure where possible, that capital losses are realised before or in the same year as a capital gain. Not in a tax year after the capital gain is made. Otherwise you could be left with a taxable capital gain in this year and a capital loss in a future year that has no other capital gain to be offset against.

If you have a *realised* capital gain in the current year, and are sitting on *unrealised* capital losses, you must give serious consideration to realising the loss to offset the gain in the same year.

Also, realised capital gains are first offset against brought forward or current year capital losses *before* the 50% discount is applied. Therefore, the year in which certain assets are sold has become even more critical. A taxpayer may choose to apply capital losses against capital gains in any order. When deciding which assets to sell before 30 June to maximise the benefit of capital losses, you should aim to apply capital losses in the following order;

1. to capital gains that have received neither indexation of the cost base nor the CGT discount ie. assets owned for less than 12 months, - then;
2. to assets acquired before 21 September 1999 where the capital gain is calculated using indexation of the cost base
3. lastly, to capital gains that are entitled to the CGT discount.

18. Property investment tax tips

- **For the sale or purchase of property the CGT event normally takes place at the time of exchange of contracts, not on settlement. So, for example where an investment property is being sold in June, consider delaying exchange of contracts until July. This allows a further 12 months delay of the tax payable on the capital gain. In the meantime you could offset the tax component against your home loan and reduce your home mortgage interest for 12 months.**

- Consider the use of discretionary trusts for purchase of an investment property where flexibility for distribution of income and capital gains is required. This can save large amounts of tax (but is normally unsuitable while the property is negatively geared).

- Interest paid up to 13 months in advance is deductible in the financial year in which it is ***paid.*** Where exchange has taken place prior to 30 June but settlement will be after 30 June, it is possible to claim the interest deduction in the current year by drawing down the loan (including the 12 month interest prepayment). The funds are held in a cash management trust until the property purchase is settled.

19. Don't purchase property without doing your homework

There are always a number of sales teams offering investment properties to customers attracted to 'free' investment seminars. The seminars set out the attractions of negatively geared investments. After rental income (guaranteed for the first few years of course) and the tax deduction from the negative gearing, the investment can normally be funded with a modest monthly outlay. But be very careful. Sometimes the properties are overvalued. The properties are often interstate, making it difficult for the investor to check on the values. The investor often uses their home as extra security so there is no need for formal valuations. A number of investors have been financially burnt by purchasing properties that are grossly overvalued. To avoid this mistake you must take the time to do your own homework on rental yields and valuations. Don't be seduced by the negative gearing tax loss. Investment choices must never be made on the basis of the tax benefits alone. The tax benefits should just be the 'icing on the cake'.

20. Accrue director's fees and bonuses

Companies with taxable profits for the 2011 tax year should make sure that they advise their Tax Agent of director's fees owing at 30 June (a director's resolution quantifying the amounts will be required).

Director's fees can be taken up as an expense even though the fees are **paid** in the following year. **The fees are not taxable to the director until paid.** The authority for this comes from *Taxation Ruling IT 2534, Paragraph 3;*

"To qualify for a deduction a company must, before the end of the year of income, become **definitely committed** to the payment of a **quantified amount** of director's fees, bonuses or other such payments (eg. by passing a properly authorized resolution)."

Paragraph 4 ."so far as the point in time when the income such as directors fees, bonuses etc. are considered to have been derived for income tax purposes, the law is settled that salary or wages and other similar types of income are derived for income tax purposes at the time the income is **paid or otherwise made available to the employee**. This is so notwithstanding that the services giving rise to the income may have been rendered or performed in a previous year."

Therefore the director's fees or bonuses are not required to be taken up as income to the director until paid or credited to a loan account. Meanwhile the fees/bonuses can be accrued and claimed in the prior year.

Note that this tip would not apply to companies that enter the Simplified Taxation System on the 'cash basis' as they are not able to claim accrued expenses.

21. Don't overlook the $1,500 low income earners tax offset

Many accountants and advisers continue to overlook the $1,500 ($1,350 in 2010 year) low income earners tax offset being equally applicable to children's income. Generally speaking, children under 18 on the last day of the financial year, (subject to some exemptions) are taxed as follows -

Up to $416	Nil
$417 to $1,445	66% of the part over $416
$1,446 & over	45% on the total income

But children are also entitled to the $1,500 low income offset. After allowing for the offset, children will not pay income tax when their income is below $3,333. **This allows a further $2,917 of taxable income to each child, tax-free. Using the same principles, adults can have $16,000 in taxable income without paying tax.** Note. Unfortunately 2011 Federal Budget changes have taken out the low income offset for children from 1 July 2011.

22. Share traders and investors

Before selling shares, share traders and investors must check that the dividend streaming rules don't apply to the share sales. The dividend streaming rules are a danger area for shareholders who;

- expect to receive more than $5,000 in franking credits for the year,
- have sold, or are planning to sell some of the shares on which dividends have been received
- some of the shares have been held less than 45 days (90 days for preference shares), and
- the shares were purchased after the following dates
    - by a **natural person** or a **company** after 30 June 1997
    - by a **trust** after 31 December 1997.

If caught by the dividend streaming rules, the dividend is treated for tax purposes as unfranked (ie. the franking credit is lost).

There are further provisions to be satisfied where a **trust** holds the shares and distributes the dividends and franking credits to beneficiaries. Unless the trust elects to be a family trust, or is a deceased estate, the benefit of the franking credits held by the trust cannot be utilised by the beneficiaries.

To avoid making a family trust election (as this has other disadvantages) consider transferring shares purchased after the above dates to individuals, or to a new trust structure set up for that purpose.

23. Superannuation Excess Contributions Tax

Where a taxpayer has contributed superannuation in excess of the allowable amounts, whether by SG 9% contributions, salary sacrifice or personal contributions, the excess is taxed at a penalty rate. Note that it is the member who is required to pay the excess contributions tax out of personal savings, not the super fund. And the amount of excess contributions tax can vary from 46.5% - and up to 93% in a worst case scenario where both excess concessional and non-concessional contributions have been received. This has caused financial hardship to a large number of superannuation members, even though the mistake was innocently made and often out of their personal control. For example, where an employer pays an employee's super for the quarter ending – say 30 June 2010, and the payment is made in the following July, then the super fund records that payment when received. That is, for the year ended 30 June 2011. The super fund reports to the Tax Office at the end of the year and reports the amounts *received* in that year, regardless of which year the contribution relates to.

Thankfully some relief was provided in the May 2011 Federal Budget. The Budget proposal is that excess contributions tax of up to $10,000 will be able to be withdrawn from the fund and taxed at the marginal rate of the individual taxpayer. The relief will only be available for breaches which occur from the 2011-12 year and will only apply for the first time a cap is breached.

TIP. The lesson is that you should contact your super fund and check the amount of concessional and non-concessional contributions already recorded by the fund to your member's account, before you make any further salary sacrifice or personal contributions.

24. NSW Land Taxes and their effect on Property Ownership

Full details are available on the NSW State Revenue website http://www.osr.nsw.gov.au/taxes/land/- or phone 9685-2133. A brief summary of the NSW Land Tax are as follows;

LAND TAX. Thresholds and rates apply to investment properties (including vacant land) held at 31 December each year as follows;
- Land value (total of all investment properties in NSW land value) of under $387,000 – no tax payable
- Land value over $387,000 (2010 yr $376,000) Land Tax payable = $100 plus 1.6% of the value exceeding $387,000
- Land Value more than $2,366,000 – Land Tax payable = $31,764 plus 2% of the excess over $2,366,000.

There are a couple of tax strategies that may help to counter the NSW Land Tax;

TAX TIP No. 1: Note that the NSW State stamp duties and land taxes do not apply to properties held outside of NSW and overseas. Some investors are now starting to look outside of NSW. But note that other local State taxes may apply, although the Land Tax threshold is available in each State.

TAX TIP No. 2: Note that Land Tax is levied on land held at a specific date each year– 31 December. Keep this date in mind when renting or purchasing an investment property eg. a property first purchased or rented in late December 2010 will be subject to 2011 Year Land Tax - but not if it is first purchased or rented in January 2011.

TAX TIP No. 3: For those earning income from the investment property, note that the Land Tax is tax deductible against the income.

25. Fix Shareholder Debit Loan Accounts

If you have loans to shareholders (or associates of shareholders) in a private company, you should put a number of strategies into position before lodgement of your 20010/11 tax return. If you get caught with a Div. 7A assessment on loan accounts, it can cost over 100% of the loan value in personal income tax and lost franking credits!

Note that recent changes to the rules allow some of these strategies to be put in place at the time of preparing the company's tax return, which can be up to nine months after the year-end. This was a welcomed relief for small companies. But even so, the issue should be looked at as part of the year-end planning procedure.

Division 7A covering private company loans to shareholders, is effective from 4 December 1997. The important point for year-end tax planning is that the critical date for determining the balance of the loan account and the payment of interest, is one day in the year - ***30 June!***

In a nutshell, debit loan account balances with shareholders from 4 December 1997 must be brought back to nil as at 30 June each year, or structured as *'excluded loans'* (see below) to avoid the very nasty punishments set out in Division 7A. Unfortunately many small companies will unwittingly fall foul of the provisions. The consequences can be severe.

Strategies to deal with debit loan accounts

- **Does not apply to loans to <u>employees</u>** (including directors or shareholders) that are subject to the Fringe Benefits Tax rules. If FBT applies to the loan Division 7A does not apply. It is often difficult to distinguish between shareholder loan and an employee loan when an individual is both a shareholder and employee, but it must be done.

- **Quarantine prior 4 December 1997 loans** - Altering the terms or increasing the balance of an existing loan effectively creates **a new loan**. Do not tamper with pre December 1997 loans. **Interest due should be actually PAID before 30 June (not accrued or journalised)**.

- **Any further drawdowns** after 4 December 1997 should be treated as **new** loans. The financial statements must clearly distinguish between pre and post 4 December 1997 loans. All **new** loans should be structured as *excluded* loans.

- **New Shareholder Loans Must be *Excluded* Loans** - Loans made after 4 December 1997 MUST comply with the new requirements ie. written agreement (with stamp duty), benchmark interest rate charged (9.45% for 2009 year) and repayments sufficient to repay the loan over the maximum allowable time. Maximum loan terms are seven years, or 25 years where the loan is secured by a registered mortgage over real property and the value of the property at the time of making the loan is at least 110% of the loan amount.

- **Ensure excluded loan repayments are made prior to 30 June** in respect of any excluded loans that existed as at 30 June 2002. Non-payment of required minimum repayments can have the effect of converting the balance of the excluded loan into a deemed dividend – not just the unpaid installments. Where minimum repayments cannot be made, in full, a further new excluded loan may be appropriate.

- **If the new loan does not comply with the above, consider a further loan from the company of similar amount that DOES comply**. Pay out the non-complying loan. This should not activate the anti-avoidance provision 109R (which catches a *subsequent* re-borrowing).

- **Reduce the <u>new</u> loans to nil.** Alternatively to the above, arrange to have the full amount of the loan repaid in the same tax year eg. by declaring dividends, paying bonuses, transferring assets to the company or arranging with your bank for personal borrowings to repay the loan to the company.

- **Re-classify debit entries as fringe benefits.** Consider whether some of the transactions increasing the loan account from 1 April (beginning of the new FBT year) could be re-classified as fringe benefits.

The new rules also apply to any ***forgiveness of debts*** from 4 December 1997, regardless of when the debts were created.

Tax Strategies for Small Business

Seven years ago the Government introduced a new category of small business under the Simplified Tax System (STS) known as an "STS small business". This has been further modified under the Small Business Tax Concessions from 1 July 2007. A small business as defined is now one with turnover less than $2 million (based on the current or the prior year) or satisfies the $6 million net asset value test. As a result, there are a number of tax planning strategies that now apply only to these "small business entities". These are listed below. Note that the definition of a small business for Capital Gains Tax, GST and FBT purposes is now the same as for income tax purposes.

✓ Prepaying Expenses

Rules introduced from 2004 year mean that only small businesses (as defined – see above) can prepay business expenses for up to 12 months and receive a full deduction this year. Therefore small businesses continue to have the option of taking up a deduction in the current year that would normally fall in the following year. **Refer to tax tip on prepayment of expenses.**

✓ Small Business Capital Gains Tax Concessions

There are four Capital Gains Tax (CGT) concessions for "small business" introduced as part of the Ralph Reforms and effective for CGT events after 21 September 1999. The concessions are now all contained in Div 152 of ITAA 1997, and are as follows;

1. the *15 year total CGT exemption*
2. the *50% reduction* in the capital gain
3. the CGT *retirement exemption*
4. the *roll-over deferral* of CGT

In order to qualify for the concessions a business must meet three basic conditions;

- must be a "small business" as defined ie. Turnover less than $2 million or an alternative test where the net value of the assets of the business and related entities is $6 million or less (but excluding private assets)
- the CGT asset must be an "active asset" (ie. a business asset)
- if the asset is a share or interest in a trust, there must be a **controlling individual just before the CGT event** and the entity or person claiming the concession must be that controlling individual or their spouse.

By utilising CGT strategies, a small business can virtually eliminate CGT on the sale of business assets (including goodwill). **Creating and building up goodwill and business property assets can now create tax-free wealth!**

But There are Traps to be Avoided with the Small Business Capital Gains Tax concessions!

All tax laws are complex when you get down to the details, but the small business CGT concessions are a labyrinth of traps for the unwary! This is one area where you must seek specialist advice ***before*** the sale of any substantial assets takes place. There are a number of restrictions that apply. In particular the controlling individual or shareholder test will catch many out. The consequences could be a financial disaster!

Note – Big Changes to Small Business CGT Concessions
There have been a number of recent changes to these concessions. As well, the definition of a small business for the CGT concessions has changed from 1 July 2007. A business with a turnover of more than $2 million may also be able to access the concessions from 1 July 2007. It is now doubly important to get specialist advice in this area.

Tax **TRAPS** for the 2011 Tax Year

TRAP: Personal Services Income

Rules have applied from 1 July 2000 to stop 'personal services' income (as defined) from being earned through companies and trusts and split with other family members or associates. The type of income likely to be caught will be personal consulting and contracting such as computer, accounting, building and construction contractors where the contractor obtains the work through an agency, or more than 80% of income is from the one source. If these new provisions could apply to your income you should discuss the position with us immediately, as you may need to apply for a *Personal Services Business Determination*. Alternatively contact the Tax Office infoline 1300 139529.

There also seems to be a misunderstanding that the new rules only apply to those businesses that have more than 80% of personal services income from one source, when in fact they also apply where less than 80% comes from one source, but the business fails to pass the 'Results test' or at least one of three further tests (see below).

Personal Services Income Rules - Key Points

- If you earn personal services type income via a trust, company or partnership, and 80% or more comes from the one source, you are caught automatically by the new rules, unless
    1. You pass the 'Results test'. That is, you are being paid to achieve a certain result, or
    2. the Commissioner has made a personal services *business* determination in your favour.
- Effectively the Tax Office is distinguishing between personal services *income* and a personal services *business*.
- You should consider applying for a determination if 80% or more of your personal services income is from one source and you believe you are conducting a personal services *business.*
- Even if you earn less than 80% from any one source **the rules will still apply** unless you can pass one of the following tests (on a self assessment basis);
    a. the results test, or failing this, at least one of the following tests;
    b. the unrelated clients plus advertising to the public test, or
    c. the employment test; or
    d. the business premises test.

If the new rules apply to the personal services income, it is treated as income to the individual and not the company or trust. The only tax deductions allowed against the PSI are those that would have been allowed if the income had been earned as salary and wages, plus basic entity maintenance costs. The balance of deductions are denied and no income splitting is allowed.

Example

New IT Pty Ltd provides computer-programming services through a number of agencies that specialise in that area. Ron does all the work involved in providing those services. Ron's wife handles the bookkeeping and administration and receives a small wage reasonable for time and effort. Ron uses various client's equipment and software to do most of the work, but does do some at home. There were four different sources of income though the year, all through agencies. Even though no single client provided 80% or more of income, he is caught by the new rules, as he was not able to satisfy the 'Results test' or at least one of the self-assessment tests.

Tax Position. New IT's income from providing the services is Ron's **personal services income,** because it is a reward for his personal efforts and skills and he is not paid on a results basis. The net income after allowing for expenses that Ron would have been entitled to as an employee, is taxed in Ron's personal income tax return. The tax planning in the company, including wages and super to his wife, is ignored.

TRAP: Non-Commercial Business Losses

Individuals with losses from business activities deemed to be 'non-commercial' cannot offset those losses against other assessable income. The Tax Office deems business activities making losses to be non-commercial unless the business can satisfy at least one of the following tests;

- The share of assessable income from the activity is $20,000 or more, or
- The business includes more than $500,000 of real property (excluding private residence) or
- The business includes more than $100,000 of other business assets (excluding cars)
- The business has resulted in taxable income in three out of the last five years
- From the 2009/10 year on, taxpayers with "adjusted taxable incomes" more than $250,000 will not be able to offset the non-commercial business loss against income from other sources such as salary or investment income, even if they satisfy the above tests – (but subject to the Commissioners discretion).

"By utilising some of the strategies set out in this report (and the next report) you may be able to make adjustments to your business income to comply with the new rules".

There are some exceptions eg. primary production business, professional arts business and start-up businesses, and the Tax Office do have a discretion to allow a loss if it would be unreasonable not to do so. Note that negative gearing of rental property or share portfolio is not affected by the new rules.

The important point is to be aware of the new rules when putting your year-end tax plan in place. **By utilising some of the strategies set out in this report you may be able to make adjustments to your business income to comply with the new rules.** Overlooking these traps could result in inappropriate selection of tax strategies

Example: A private company shareholder/director structures salaries and bonuses of $170,000 and superannuation of $30,000 for the year, assuming that a loss of $20,000 from a sideline business will be deductible against the salary. If the loss is caught by the new rules the director is up for $9,300 ($20,000 x 46.5%) more tax than planned for.
New Tax Position:
Some months after the end of the year when preparing his tax return the director is shocked to learn that due to the new rules he owes $9,300 in income tax

TRAP: Prepayments

A prepayment is where a payment for goods and services is made in this tax year but the goods or services are supplied in the following tax year. This is a great way of deferring income into the following tax year.

However, changes to the prepayment rules confine the full benefit of prepayments to 'Small Businesses' (see definition page 13) and non-business taxpayers. Other taxpayers cannot claim prepayments in this tax year.

Note that **'non-business'** taxpayers eg. share or property investors, can still prepay expenses up to 12 months in advance and claim the full deduction this tax year. An example is an investor who prepays 12 months loan interest in advance on funds used to purchase an investment portfolio or a rental property.

TRAP: Capital Gains

The 50% discount on capital gains for individuals and trusts, and 1/3rd discount for superannuation funds, is only available where the assets are **held for more than 12 months**. Entering into any sale *agreement* within the 12 month period (even where the sale finally takes place after the 12 month period) could result in substantially more capital gains tax. There are also a number of other new traps relating to the capital gains 50% discount;

- Companies: The 50% discount is **not** available to companies. Be careful with distribution of capital gains from trusts to companies. Also, there would need to be compelling reasons to acquire new assets in company structures where the asset is expected to generate substantial capital gain.
- Type of assets: Some assets by their very nature come into existence at the same time that the CGT event takes place. Therefore they would never qualify for the CGT 50% discount. Examples are granting of an option or granting of a lease. The CGT event happens upon granting, renewal or extension. These are covered in ITAA 1997 item 1 subsection 115-25(3).