

Enterprise

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Tax ruling to take many by surprise

Small businesses face the prospect of heavy retrospective penalties, writes **Mark Fenton-Jones**.

Small businesses are in for a shock, says a tax expert about a ruling by the Australian Taxation Office.

Ruling TR 2010/3, which deals with division 7a of the Income Tax Assessment Act, focuses on the unpaid entitlements of corporate beneficiaries. Critics have said small businesses could face heavy retrospective tax penalties.

Brisbane-based Elliotts Partners said small businesses and corporates could pay more tax than expected due to recent tax law changes surrounding trust distributions.

Elliotts' managing partner Matthew Schlyder said trusts were previously allowed to distribute to a range of beneficiaries, including individuals and companies.

"Businesses have used this allowance as an effective tax deferral strategy," he said. "Distributing to a company means that taxable profit is taxed at 30 per cent instead of a potential 46.5 per cent, and accountants have been advising it as part of their client's taxation plans."

"Often the distribution was done on paper so the cash profit could be left in the trust to fund business working capital. A dividend did not have to be physically paid out of the company until the directors determined," Mr Schlyder said.

However, on December 16 last year the ATO announced a change to such distributions and finalised its view on June 2. "Significantly, the final ruling is retrospective so trustees who have made distributions to companies which are unpaid need to determine the impact it will have on the amount payable to the Tax Office," Mr Schlyder said. He said that, provided certain rules were met, some

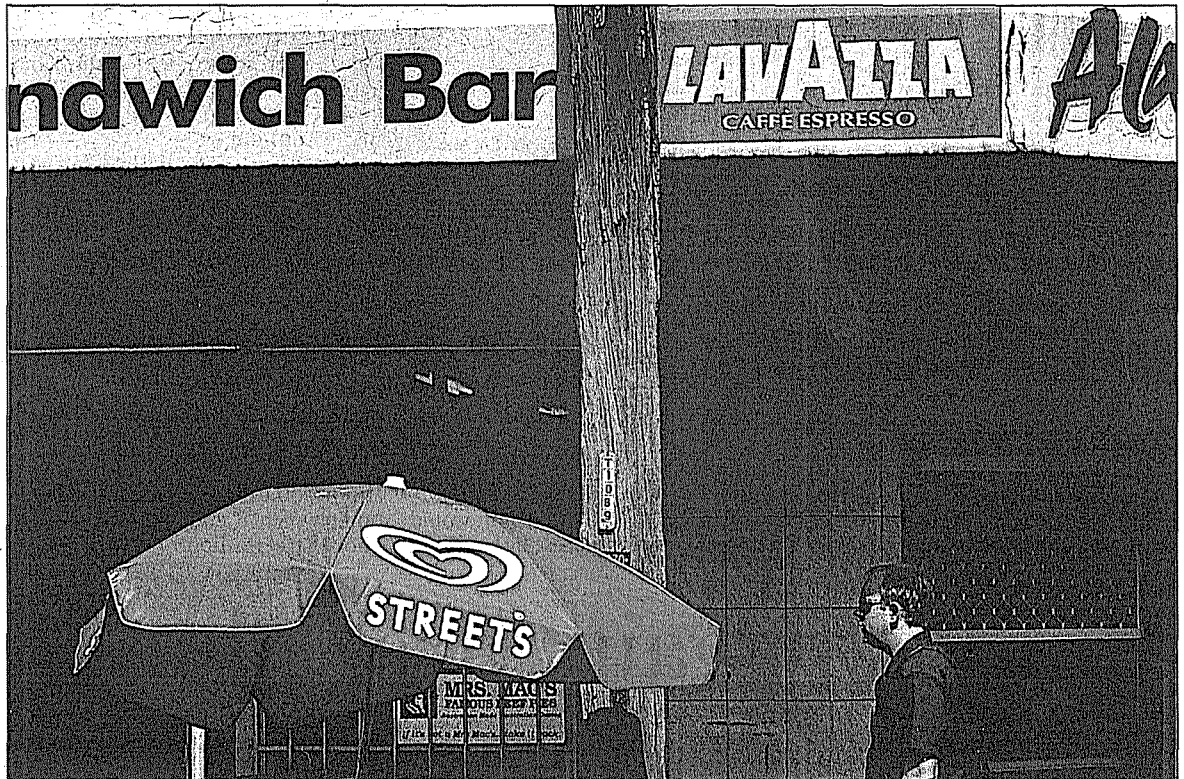
quarantining was available when trusts made distributions to companies before December 16 last year. "If the unpaid amount is determined to be a loan, the amount that is owing may have to be repaid over a period of seven years in most circumstances, with interest at the ATO-determined rate under a documented loan agreement. This can have a significant impact on tax payable so it is vital that trustees consider the implications of these earlier distributions now."

All distributions made after December 16, 2009 would be subject to the new laws. "Loan agreements will need to be entered into with specific terms depending on security offered. The ATO determines the interest rate to be charged on these loans and the minimum repayments due each year," Mr Schlyder said.

He warned that the new laws would have a major impact on the tax payable by a large percentage of small and medium-sized businesses and corporates. "In most cases, business owners will need to complete a new taxation plan in order to structure their affairs so that they legally pay the least amount of tax and retain more income," he said.

"Small business owners are in for a shock," said David Montani, a director at business advisory firm MGI Perth who specialises in tax advice. "They are going to pay extra tax on their profits on top of the 30 per cent corporate rate, even where they haven't paid themselves a dividend out of their businesses."

"Most small business owners wouldn't even be aware of it yet and the tax profession has been scrambling to come to terms with it



New laws could have a big impact on the tax payable by many small and medium sized businesses.

Photo: LOUISE KENNERLEY

UNWELCOME FRUIT

Tax lawyer Graeme Halperin is heavily involved in lobbying for Tax Office ruling 2010/3 to be withdrawn. "It could easily raise more money in the long run than the mining tax," he said.

Mr Halperin provided a hypothetical example of the ruling's potential impact on small business.

Smith Fruit Pty Ltd has Mr and Mrs Smith as directors. Smith Fruit is trustee of the Smith family trust and in that capacity runs a fruit shop in which the two directors work. The Smiths control the trust because they are directors of Smith Fruit. The beneficiaries of the trust are the people who can receive income distributions from it. These include Mr and Mrs Smith, their children and other companies and trusts owned and controlled by the Smiths. Mr and Mrs Smith also own Smith Investments,

which invests in listed company shares for their retirement or is held for other retirement or investment purposes. Smith Investments is a beneficiary of the Smith trust because Mr and Mrs Smith own Smith Investments.

Smith Fruit, as trustee of the family trust, makes a \$100,000 profit in the 2010 financial year and makes a distribution to Smith Investments but doesn't pay the whole \$100,000. Smith Fruit pays \$30,000 and keeps \$70,000 for 10 years, using it to buy fruit packing equipment worth \$50,000 and pay for a new employee.

Mr Halperin said that for the last 12 years it was accepted by everyone, including the Tax Office, that Smith Investments would pay \$30,000 income tax (ie, 30 per cent) on the \$100,000. "The ATO is now saying that in addition to that \$30,000, either the

trust or other beneficiaries must pay income tax on the \$70,000 not paid to Smith Investments," he said.

"That's because the ATO now says the unpaid \$70,000 is a loan by Smith Investments to the Smith family trust under Division 7A. This \$70,000 will be taxed in many cases at 46.5 per cent, so another \$46,500 is payable. As a result, overall income tax on the original \$100,000 is \$76,500 (ie, 76.5 per cent tax)."

If the family trust lends any of the \$70,000 to another family member, such as Mr Jones, the same money will be taxable again at up to 46.5 per cent.

"This can increase the overall income tax rate to 123 per cent."

Mr Halperin said: "This is legally wrong. The money (being the trust profit) belongs to the trust until the trust pays it to the company."

in the last month or so. It's big."

He explained the changes by looking at the different tax treatments of big and small companies. Say, for example, you are paid a \$70 dividend, which means the company has already paid \$30 tax. You will have to pay more tax if your personal marginal

rate of tax is more than 30 per cent. If you are on the top personal tax rate of 46.5 per cent, you will get a tax bill for \$16.50, known as "top-up" tax. The \$30 of company tax already paid plus your \$16.50 contribution to the government's coffers means a total tax take of \$46.50, or 46.5 per cent.

But you only pay the top-up tax when you get paid a dividend. "It's a wonderful system which nobody has any real problem with because it's logical," Mr Montani said.

Similarly with a small business, what do owners do with the remaining 70 per cent of profits?

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Concrete manufacturing facility

Procast Australia Group



Expressions of interest are sought for the purchase of the assets of the Procast Australia Group:

- State of the art pre-stress and precast concrete manufacturing facility including integrated overhead gantry cranes, Filzmoser cut and bend shop, bridge deck pre-stressed plant, precast panel system, concrete batching equipment, and T'roff pre-stressed plant.
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Expressions of Interest are sought by 4.00 pm, Friday, 20 August 2010.

For further information, please contact:

Brendan Nixon on +61 7 3225 4924
or by email on bnixon@333advisory.com
22 Market Street, Brisbane QLD 4000

333 Advisory

Expressions of Interest

Impact (Australasia) Fibre Container Industries Pty Ltd (Administrator Appointed) ("Impact")

Expressions of interest are sought from parties interested in acquiring all or part of Impact's Business. Impact was a leading independent manufacturer and distributor of corrugated paper cardboard products, in Queensland, to the fresh produce wholesale industry, operating from leased premise at Yatala, Queensland.

Key Attributes Include:

- Fully operational corrugated paper cardboard plant
- Existing customer base of over 150 customers
- 10,000sqm Industrial premises (subject to negotiation with landlord)

Expressions of interest are to be submitted in writing before close of business Monday 9 August 2010.

To obtain a Confidentiality Agreement and Information Memorandum please contact Ian Currie on (07) 3220 0994 or by email ian.currie@briferriersq.com.au

BRI Ferrier

Business Reconstruction & Insolvency

Extra funding for skills training

Mark Fenton-Jones

Small to medium-sized businesses will receive \$2.4 million over the next six months for training nationwide.

The federal government will provide grants for more than 300 knowledge and skill development seminars targeted at the sector.

The Department of Innovation, Industry, Science and Research's Enterprise Connect program will administer the funding. Enterprise Connect is itself funded with about \$50 million a year. Its head, Judy Zielke, said more than 360 applications

were received up to March from organisations wanting to run seminars and workshops. Sixty were approved.

Typically, successful applicants are industry associations which often join local government organisations.

Ms Zielke said successful applicants would conduct programs such as workshops on driving performance in growth SMEs, assisting businesses with staff issues, online learning and nanotechnology.

This latest round is the second in the program. The first, in June 2009, had 11 mentors.

Innovation Minister Kim Carr said the courses "will give small to medium-sized businesses access to the latest advances in business management practices to help them improve what they do, become more profitable, and ultimately create more jobs for Australians".

More than 500 businesses have benefited from seminars run under the department's auspices since last year.

The government has also opened a \$20 million "innovation centre" in Victoria and the Mawson Lakes manufacturing centre in South Australia.

Based at Deakin University's Geelong campus, the innovation centre will support regional SMEs to help make them more competitive.

Besides this facility, there will be a mining technology centre in Mackay, funded with \$14 million, and a remote innovation centre in Alice Springs (\$10 million), each over four years.

There are also plans for a "creative industries" centre which will receive \$17 million over four years, and a clean energy facility (\$20 million, four years).

The government seeks expressions of interest for both.

Tax ruling will surprise

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Pay themselves a dividend or reinvest back into the business? Small business owners have a lot less choice, Mr Montani said. They don't have access to many of the funding sources that big businesses do — shareholder capital, derivative instruments and even bank finance — but must rely on reinvesting profits for working capital and so on.

And anyhow, the logic of paying top-up tax only when you were paid a dividend from the business also applied to small business owners. Until now. For the 2010-11 year onwards, the tax law changes will mean most small business owners will be required to pay the top-up tax on profits kept in the business. That is, such owners will get a bill for top-up tax even if they haven't decided to pay themselves a dividend. As for defining "small business", it can range from a corner

deli to an engineering firm employing a hundred or more staff.

The ruling covers hundreds of thousands of Australian small businesses which operate through a trust with profits allocated to a company on which 30 per cent tax is paid. Mr Montani said the long-accepted legal position was that,

although the allocated profit was an entitlement owing by the trust to the company, by its very nature it was not a "loan" made by the company back to the trust. "All of a sudden, the [tax] commissioner says that is exactly what it is."

He said a decades-old established legal position was being tossed out the window in a ruling that seriously lacked legal support. "Rulings are sometimes wrong [but] there's never been one before that is wrong with such a damaging impact on a major sector of the economy," he said.

Treating the profit entitlement as the company having made a loan back to the family trust is the key and critics have argued it triggers a chain reaction of complex tax laws in division 7a of the Tax Act that apply only to private businesses. They say small business owners will be forced to pay themselves a dividend out of the business, thus triggering top-up tax. Owners would have to lend the dividend money straight back into the business. Many small businesses have profits remaining reinvested for years before the owners get to pay themselves a dividend. The reinvested profits allow a small business to grow and employ more people.

Mr Montani said: "Now that's all going to be dealt a serious blow because the business will suffer due to the owners being hit with the top-up tax. This will stunt growth and employment."

An ATO spokesman said the Tax Office was consulting with industry and was likely to have a response in a couple of weeks.



Businesses need to structure affairs to pay the least tax and retain more income.
Matthew Schlyder, Elliotts

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- 307 rental properties currently under management;
- In excess of 30 property listings for sale;
- Solid and longstanding reputation; and
- An attractive strategic acquisition for a larger group/existing operator or new entrant.

Expressions of interest to be submitted by 5pm Monday 9 August 2010. For further details, including an Information Memorandum, contact Lynne Walton or Helen Newman on (07) 3237 5999 or email lynne.walton@bdo.com.au.

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