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Best year-end tax strategies for SME owners

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Sydney tax consultant Robert Richards would echo the sentiments of much of the tax professional in regard to end-of-year tax planning for 2010-11 when he says: "Super is almost the only game in town".

His main tip is to maximise contributions while taking extreme care not to overshoot the annual caps – excess contributions could cost you dearly.

And Richards is always wary about end-of-year tax shelters. "Everyone I know who has gone into one has lost money, plus had a fight with the Tax Office."

When checking your last-minute tax opportunities, don't overlook that a measure in the Federal Budget means 2010-11 is the final financial year that discretionary trusts can tax-effectively split income with children. This is a key consideration for many SME owners.

As usual, shareholders and their associates should ensure they don't run foul of Division 7A provisions of the tax act regarding "loans" from their private companies. Hefty deemed dividends plus penalties and interest on unpaid tax may otherwise apply.

Here are 10 of our best end-of-year tax strategies for SME owners:

1. Maximise super contributions

This is the second last tax year before the standard cap for concessional contributions by members over 50 is halved from $50,000 to the indexed $25,000 cap that already applies to other fund members. (As later discussed, members over 50 with low super savings will not have their concessional caps halved.)

And tax and superannuation specialists emphasise that members under 50 should also maximise concessional contributions where appropriate because of the low annual caps and the highly-favourable tax treatment of super.

Concessional contributions mainly comprise superannuation guarantee and salary-sacrificed contributions as well as tax-deductible contributions by the self-employed and eligible investors.

Like Richards, Paul Banister, director taxation services for accountants and business advisers Grant Thornton in Brisbane, stresses that fund members should make the most of both the concessional and non-concessional (after-tax or personal) contribution caps.

"You use it all, you lose it," Banister says, referring to the limited amounts that members can contribute each year.

2. Don't make excess super contributions

You could pay a shockingly high price for overshooting your caps by just a few dollars or cents.

SmartCompany knows of horror cases where inadvertently exceeding the concessional caps by a little more than $10 has triggered a chain of events leading to assessments for excess contributions tax of almost $70,000.

Typically in such cases, fund members nearing retirement were trying to pour large amounts into super as both concessional and non-concessional contributions.

"Make sure you don't slip up in some way and go over the limit," Banister stresses. He says one of the problems with having such a low concessional contribution cap is that it is easy to exceed.

And Richards suggest that while SME owners should consider a strategy to maximise their contributions as 2010-11 draws to a close, he warns that rushed contributions could lead to accidentally exceeding the caps.

A budget measure allowing members who exceed their concessional contribution caps for the first time by up to $10,000 to request a refund of the excess does not apply to contributions made before the next financial year.

3. Split super contributions with your spouse

Members are allowed to split most of their concessional contributions – salary-sacrificed, compulsory and deductible contributions with spouses. This means they can direct these contributions to their spouses' super accounts.

The strategy is more significant since the budget confirmed that members over 50 will continue to have a $50,000 concessional contributions cap after July 2012 provided their fund balances are under $500,000. (From that date, the cap is halved to $25,000 for other members over 50.)

Different rewarding twists are applicable to the contribution-splitting strategy.

For instance, a spouse whose super savings are under $500,000 could direct much of his or her contributions to the spouse who already has $500,000 or more in super. This will help the partner with the lower balance to remain under the $500,000 threshold longer and potentially increase the family's ability to save much more in super after July 2012, depending upon the circumstances.

Alternatively, if both partners are below the $500,000 threshold, a percentage of contributions could be directed to the spouse with the lower balance. And hopefully, both partners will remain under the threshold for longer than otherwise.

Significantly, the contribution cap of the member making the contributions applies – even when most of the contributions are directed to a spouse's super account.

Banister agrees that the contribution-splitting strategy may particularly appeal to small business owners as an end-of-year strategy if they make large concessional contributions shortly before June 30.

4. Identify potential deemed dividends

SME owners should treat this as an annual end-of-year tax ritual.

- Under Division 7A of the tax act, loans to private company shareholders or their associates are automatically deemed as dividends – unless formal loan agreements are in place, and interest and capital payments meet minimum legal requirements. (Deemed dividends cannot be franked.)
- The measure is designed to stop profits of private companies being distributed to shareholders as tax-free "loans".
- Banister believes the tax commissioner is stepping up his enforcement of Division 7A.

What should a private company do regarding a loan granted to shareholders or their associates during 2010-11 in order not to be caught with a deemed dividend? Banister suggests that by the time the 2011 tax return is due, the private company should do one of the following:

- Ensure the money is repaid. (In this case no documentation or interest payments are required to avoid being caught in the Division 7A net.)
- Declare a dividend and treat the amount as income. (In this case, the dividend may be franked if applicable.)
- Enter into a complying loan agreement.

What should a private company do regarding a loan to shareholders or their associates from past financial years that are undocumented and sufficient repayments have not been made?

Banister says the company should make sure that a complying agreement is in place, and bring interest and capital repayments up to date. And then the shareholder who received the money from the company should "go cap in hand" asking the tax commissioner to exercise his discretion to provide relief from Division 7A.

Sue Prestney, a principal of accountants and business consultants MGI Melbourne, reminds SME owners that the commissioner last year issued a ruling stipulating that unpaid distributions (unpaid present entitlements) from trusts to associated private companies will be treated as loans.

Prestney says this is the first financial year where trusts have to deal with this issue otherwise, in accordance with ruling, the amounts are caught by the Division 7A deemed dividend rules.

"Trusts really need to look at this issue," she emphasises. "Previously, an unpaid present entitlement wasn't treated as a loan – so it didn't fall within Division 7A."

Prestney says a way for trusts to deal with this issue is to have a sub-trust arrangement whereby the funds representing the unpaid present entitlement are held by the trust for the sole benefit of the company. Alternatively, but not preferably, a complying loan agreement could be entered into under the terms of Division 7A, providing for minimum interest and capital repayments. (The ruling applies to unpaid distributions from trusts to private companies from December 16, 2009.)

5. Check your private use of private company assets

Be aware of the possible consequences when using private company assets for private purposes – you could be caught with a big tax bill plus penalties.

Deemed dividends now arise under Division 7A for the personal use of private company assets by their shareholders or associates for free or for less than market value.

Banister says that a difficulty with the private use of company assets is calculating the market value of this usage. "For example, it's going to be hard to find a benchmark for the use of a Ferrari or private yacht that is owned by the family company. You have to pay for the usage as you go.

"There may be a credit loan account that is owing to the individuals using it and they might charge against that loan [for private use of company assets]."

6. Split income within your family

Often, this tax-cutting strategy typically involves holding non-super investments either jointly with a lower-earning spouse or in the name of that spouse.

Another popular method is for a discretionary trust to direct investment income and capital to lower-earning family members.

Significantly for income-splitting strategies, the Federal budget announced that children under 18 will no longer be eligible from July 2011 for the low income tax offset on their so-called unearned income (such as dividends, interest and rent). This means that unearned income paid to children – perhaps through family trusts – will be subject to the full penalty rates applying to minors.

Under existing law, the offset enables children to receive the first $3,333 in unearned income without paying tax. But from July, children can receive only $416 without paying tax.

Banister emphasises that a family trust still has time this financial year to make a distribution to minors who are likely to receive the low income tax offset.

7. Don't bother timing the purchase of your next work vehicle

As announced in the budget, small businesses can claim an immediate $5,000 tax write-off for vehicles bought from July 2012. There is the possibility that this may convince some businesses to postpone buying their next utility or car.

Indeed, the Government also proposes from July 2012 an immediate tax write-off of all assets valved under $5,000 – up from $1,000 at present. Again, this may encourage some businesses to delay some purchases if practical.

Banister says some motor traders are concerned that the budget measure to provide small businesses with an immediate $5,000 write-off for their vehicles will persuade many to postpone the purchase of their purchases for 13 months. But he is unconvinced.

"If you are a small business that needs to upgrade your vehicle now, this would surely override the minor tax benefit by deferring the purchase," Banister says.

8. Always consider eligibility for small business tax concessions

Banister suggests that small business owners keep a close watch on their eligibility for the raft of small business income tax and capital gains tax concessions. And, where appropriate, take action to remain eligible for the concessions.

The prime test for eligibility is having a turnover of under $2 million for the current tax year. However, if your business does not fall within this threshold, business owners may still be eligible for highly valuable small business CGT concessions if net assets included in the test do not exceed $6 million.

Banister says a business that is close to exceeding the under $2 million turnover threshold for any of the small business concessions may consider deferring income until the following year. This may allow the business to qualify for the small business tax concessions for another financial year.

And Banister believes a smart approach to the small business CGT concessions is for small business owners to always keep a watch on how they measure up against the $6 million net asset threshold.

The CGT concessions, for instance, can potentially provide a means to significantly reduce or even wipe-out multi-million capital gains on the sale of small businesses.

Assets counting towards the $6 million threshold include the value of the small business owner's business assets as well as their personal investment assets – along with those of their associates. Significantly, some exemptions apply.

"I think the way to approach small business CGT is to, on an ongoing basis, think about how your circumstances compare with the $6 million threshold," says Banister. "That means people should be constantly reviewing whether they should be doing things like paying off their private mortgages, doing home improvements, paying off private loans or putting money into super [these do not count towards the threshold]."

Banister says this strategy will help place the business owner in the best possible position when the time eventually arises for measurement against the threshold.

9. Don't forget the basics

Among the basic end-of-year tax strategies is to defer income until the next tax year and to accelerate deductions into this tax year where possible.

Techniques to defer income include delaying the issuing of invoices, postponing the sale of assets (if justifiable for non-tax reasons), and not pursuing unpaid bills until after June 30. Private companies could consider waiting until the new tax year before paying dividends.

And ways to accelerate deductions include prepaying interest, undertaking last-minute repairs and maintenance to business or investment properties. And small businesses can claim immediate deductions for certain prepaid expenses.

Interestingly, the flood levy for 2011-12 – generally applying to individuals earning more than $50,000 – may encourage a few owners of unincorporated small businesses or trusts to maximise their income this financial year when less tax is paid by the shareholders or beneficiaries. And some might simultaneously consider deferring deductions until next financial year because of their increased value with the flood levy.

However, Prestney does not think that a strategy of bringing forward income because of the flood levy will be tax effective. She believes most SMEs would probably have to borrow the money to pay the extra tax this financial year. "That's going to be more expensive than paying the flood levy. The numbers don't stack up."

10. Write-off bad debts

Check through your list of debts and check whether any should be written-off.

Under the accruals method of reporting income, bad debts are generally deductible. However, bad debts must be written-off in the same income year in which the deduction is claimed.