WMC accounting

YOUR Knowledge

The pitfalls of accessing your company profits

One of the benefits of operating a business through a private company is the ability to access a flat 30% tax rate on profits. However, shareholders often forget that the 30% corporate tax rate is only intended to apply while the profits are being used in the company's business or investment activities. The Government and ATO's expectation is that top-up tax (if any applies) should be paid by shareholders at their marginal tax rates once they have access to these profits.

Even though accessing company profits is an issue affecting all shareholders of private companies, the tax rules can be extraordinarily complex and can lead to some very harsh tax outcomes.

Take the example of a private company with one shareholder and makes a profit of $100,000 in the 2013 income year. The company pays tax of $30,000, leaving $70,000 of after-tax profits. Let's say the shareholder takes $70,000 from the company bank account during the 2013 income year to do some renovations on their home.

One option to access these profits is for the company to pay a fully franked dividend of $70,000 to the shareholder. Assuming the shareholder is on the top marginal tax rate of 46.5%, top-up tax of $16,500 will need to be paid by the shareholder after they have claimed the benefit of the franking credits attached to the dividend (i.e., representing the tax already paid by the company on its profits). This means that the $100,000 profit originally made by the company has been reduced to $53,500 by the time all the tax has been paid by the company and shareholder.

Another way of accessing the funds is to simply treat the arrangement as a loan from the company to the shareholder. However, unless a complying loan agreement is put in place by the earlier of the time the company lodges its 2013 tax return and the due date for lodging that return, the tax rules treat the shareholder as having received a $70,000 unfranked dividend. Assuming a marginal tax rate of 46.5%, an additional $32,550 in tax will be paid by the shareholder. The end result is that the $100,000 profit originally made by the company has been reduced to $37,450 by the time all the tax has been paid by the company and shareholder. This is an effective tax rate of 62.5% - ouch!

A common method of managing loans from the company and deferring the top-up tax liability is for the shareholder and company to enter into a complying loan agreement with a 7 year loan term and with the interest rate linked to the ATO's benchmark rates each year. While this might defer paying some additional tax in the short-term, it may not lead to the best outcome over the term of the loan.
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Time to start thinking about tax time…

The countdown to the end of the financial year is on and that means you should start to focus on your end of financial year position and any tax planning that is appropriate for you. Don't leave it till the last minute. No decision, or rushed decisions, can lead to the wrong outcome. Here is the starting point of the process:

1. **Get your health & hygiene tax list together**

   There are lots of little things that need to be attended to that can add up to tens of thousands of dollars in tax savings. Writing off bad debts, maximising stock valuation outcomes, declaration of bonuses and director fees, prepayments, income deferrals, trustee resolutions to appoint income, maximising depreciation charges, superannuation payments.

2. **Where are the bigger tax planning opportunities**

   Beyond these health and hygiene opportunities there may be larger tax planning opportunities that should be considered. This could include being eligible to claim R&D tax concessions, taking advantage of the loss carry back rules to get a refund of company tax paid in the last year, and export market development grant eligibility. All of these opportunities are time sensitive and time limited. The things you do between now and June 30 could make a significant difference in the benefit obtained.

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The pitfalls of accessing your company profits *continued*
This is because interest will accrue on the loan each year. For every dollar of interest that accrues on the loan, 30% needs to be paid to the ATO in tax by the company. Then, when the shareholder wants to access those funds again there can be further top-up tax of up to 16.5% when dividends are paid.

In some cases, using a loan agreement between the company and the shareholder may still be the best option from a tax perspective. If so, the loan needs to be managed carefully on a year to year basis to ensure that minimum annual repayments are being met. Also, shareholders should look to make repayments as early as possible each year to minimise the interest that accrues on the loan. Every dollar of interest saved can represent a cash saving of up to 46.5c to the shareholders when the funds eventually come back to them.

These scenarios only cover a fraction of the tax issues that can be triggered when shareholders want to access company profits. The general rule is, if something belongs to a company (including cash, boats, holiday homes etc.,) and is used by a shareholder (or a family member or other related entity), then there might be some tax to pay unless the situation is managed very carefully.

Given the complexity of the tax system and the significant tax liabilities that can be triggered when a shareholder or other related party accesses company profits or assets, it is important to seek advice and explore the alternatives available. In some cases shareholders may actually be better off triggering an up-front tax liability by declaring franked dividends and then borrowing funds from a bank to fund the top-up tax rather than trying to access company profits in the form of a loan.

Let us know if you would like to explore better ways of dealing with this common problem!

Did you know?

- The 2009/2010 Budget estimates were closest to the actual Budget figures than any future year.
- The worst year for budget forecasts was the 2010/2011 Budget that predicted the deficit for 2011/2012 to be -$13 billion. Turned out this forecast was over $30 billion off at -$43.4 billion.
- The budget deficit for the current financial year is expected to be $19.4 billion (or 1.3% of GDP, that is 1.3% of the economy). The deficit for the new financial year is expected to be $18 billion.

Quote of the month

"It is hard to imagine a more stupid or more dangerous way of making decisions than by putting those decisions in the hands of people who pay no price for being wrong."
Thomas Sowell

Time to start thinking about tax time *continued*

3. **Are you creating permanent benefits or simply a timing advantage**?
   Consider whether your decisions are creating a permanent benefit or simply deferring the tax liability to a later date. Both can be valuable however permanent benefits will always be more valuable. This is relevant if you have to create a hierarchy of the options. You may not be able to do everything possible.

4. **Are there cash flow implications?**
   An essential consideration. Some of the options will require you to spend money, bring forward expenditure or defer income. These will all have cash flow impacts and you need to ensure that creating the best tax outcome does not cause a short-term cash flow problem. Calculate the funding impact of your choices and if you need funding support from your bank, then talk to them early. You need to map out how much you need, how long you'll need it for, and what is being covered.

5. **Are there any risks?**
   Keep in mind that there could be some risks with the decisions being taken. These could include tax risks, funding risks and business risks. Tax benefits always need to stack up on the risk to reward matrix. Quantify the benefit and assess any risks.

You should take advice on your tax planning. Spend some time with your accountant and map out a plan that works for you.

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