

TAX

Big tax change for small business

Small business owners are in for a shock. They are going to pay extra tax on their profits on top of the 30% corporate rate even where they haven't paid themselves a dividend out of their businesses. While everyone's attention was focussed on that other profits based tax, this change in small business tax policy has been disturbingly overlooked. 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 in the last month or so. **It's big.**

So, who's behind this new tax hit on small business? It basically comes down to **Assistant Treasurer Nick Sherry** and the Tax Office. Going straight to the top, I queried Senator Sherry in person when he visited Perth recently and I also have a letter from him on this change in tax policy. No disrespect to Senator Sherry, but I'm not sure he fully grasps what he's given the green light to or the bullying tactics behind the change and why such tactics have been used.

How business profits are currently taxed

Let's start with some perspective. Imagine that you own shares in a large, listed company. The company runs a business and pays 30% company tax on its profits each year. What does the company do with the remaining 70% of profits? Basically, it either keeps it or pays it to you as a dividend. Listed companies generally do both – paying a dividend satisfies your expectations as a shareholder while retaining some profits is necessary to fund working capital, acquire new equipment, paying off external debt or inevitably all three and more. Profit kept back for these purposes is often referred to as being “reinvested” back into the company's business to facilitate business growth and, more importantly, allow businesses to employ more people.

Similarly with a small business, what does the owner do with the remaining 70% of profits – pay him or herself a dividend or reinvest back into the business? Small business owners actually have a lot less freedom of choice in the matter. They don't have access to many of the funding sources that big businesses do – shareholder capital, derivative instruments and even bank finance. Small businesses have to rely on reinvesting their own profits to fund growing needs for working capital and so on. Anyway, the logic of paying top-up tax only when you actually get paid a dividend out of the business also applies to the owners of a small business. Until now.

What's going to change?

For the 2010/11 year onwards, tax law will be applied differently such that most small business owners will be required to pay the top-up tax on profits kept back in the business. That is, you will get a bill for the top-up tax even though you haven't decided to pay yourself a dividend. And as for what is a "small business" caught up in all this, that can range from a corner deli to an engineering firm employing a hundred or more staff.

I know what you must be wondering. When did all this happen? Where was the government announcement, the amending legislation, the fiery debate in Parliament and the avalanche of talk-back radio calls? Here's how it happened.

How the change is being implemented

The tax laws are enforced by the Commissioner of Taxation. One of the many things he does as part of that job is to issue what are called Taxation Rulings. Taxation Rulings are not law, like a court decision, but merely the Commissioner's opinion – right or wrong – on a particular tax law. Rulings are a double-edged sword. The Commissioner is bound by these Rulings when enforcing the law, which is great if a Ruling is favourable to taxpayers, not so great when unfavourable. And then things get strained when the Commissioner decides to enforce the law based on a Ruling that is just plain wrong. That isn't new by the way; there have been court decisions over the years that have shown some Rulings to be wrong.

But here's where the Rulings system has now taken, shall we say, a Stalinist turn. The Commissioner issued a new Taxation Ruling last month, TR 2010/3. The Ruling covers the everyday, common garden situation for hundreds of thousands of small businesses across Australia of operating a business through a trust with profit allocated to a company on which 30% tax is paid.

The long accepted legal position is that although the allocated profit is an entitlement owing by the trust to the company, by its very nature, it is not a "loan" made by the company back to the trust. However, all of a sudden, the Commissioner now says – in a Ruling – that is exactly what it is. Just like that, a decades-old established legal position is tossed out the window in a Ruling that is seriously lacking in legal support. As I said, Rulings are sometimes wrong. It's just that there's never been one before that is wrong with such a damaging impact on a major sector of the economy.

Treating (wrongly) the profit entitlement as the company having made a loan back to the family trust is the key to everything. It's the release of a linchpin that triggers a chain reaction of complex tax laws in Division 7A of the Tax Act that apply only to private businesses. Cutting a long story short, the practical effect is this. The small business owner will be forced to pay themselves a dividend out of the business, thus triggering the top-up tax. As we've discussed, a small business can't just pay out this money, it needs it. So the owners will have to lend the dividend money straight back into the business. In the wash up, nothing really happens except that the business has to fork out for the top-up tax. In a perverse twist, the Commissioner has cooked up a "round-robin" tax scheme with two exceptions: it creates a tax bill out of thin air and operates in broad daylight.

Again cutting a long story short, this enforced "round-robin" of payment and re-lending of dividend money will happen over a seven year period for each year's profit. That's a separate, seven-year round-robin cycle created for every year's profit. The additional compliance costs and administrative burden make a mockery of all the efforts to reduce red tape for small business, let alone the extra tax bill itself. Big business and their owners are not affected.

Why the iron fist approach?

In recent years, the Commissioner has fought some cases all the way up the High Court on other issues, different from this one, relating to the taxation of trusts. Although he lost every time, the Commissioner just kept going, appealing this case and that case, starting a new case with another taxpayer, up and down the court system for years desperately trying to get the result he wanted. The reason the Commissioner kept losing was simply that he was wrong. The courts weren't fooled and sent him packing.

It is thought the Commissioner was fed up and decided that instead of losing another court case due to the small matter of being wrong, he would simply bypass the courts altogether. So, he issued a Ruling saying these entitlements are loans and will now enforce the law on that basis. Even though I think the Commissioner's position is wrong, I would abide by the umpire's decision from a test case. But apparently that's not the way it's going to happen this time.

There are thousands of small businesses that have reinvested their profits after paying the company tax rate that will now be hit with top-up tax, even though they have no capacity to pay a dividend. Don't get me wrong – they would pay it one day anyway, just like when you get paid your dividend from a big company. But now it's being forcibly brought forward by dictatorial decree. The Commissioner has basically put a gun to the small business owner's head and said "Comply or I'll hit you with ruinous penalties". This isn't the head of a government department going rogue, because he's doing this with Nick Sherry's blessing.

You might think this is easily fixed by taking the Commissioner to court to settle the matter. But who's going to do that on behalf of all small businesses? Even when you know you are in the right, it's a pretty daunting prospect taking on a multi-billion dollar organisation.

In a nutshell

Many small businesses have profits remaining reinvested for years, decades even, before the owners get to pay themselves a dividend. But in the meantime, those reinvested profits serve a vital function in permitting a small business to grow and employ more people. But 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 in the biggest employing sector in the economy.

So what are small business owners going to do? Well, what would you do if someone put a gun to your head? That's right, exactly as you're told. Small business owners and their accountants need to start planning for this.



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