

Welcome to the May issue of Pearce Norris Tax News. This issue focuses on:

- Professional practice alert
- Your 2006 tax year end check list
- More superannuation changes!
- ATO data matching hotspots
- Pearce Norris opens Balmain office

We would be pleased to discuss the tax issues set out in this issue of Tax News. Please contact Michelle Pearce or Kathryn Norris on (02) 9555 1309 to discuss how Pearce Norris can assist you and your business.

PROFESSIONAL PRACTICE ALERT

It is common for professionals (like lawyers, accountants, doctors and dentists) to set up a separate entity (e.g., a service trust or company) to provide the business with staff, clerical, administrative and other office services.

There is generally nothing wrong with this type of service arrangement – it is not all about tax and is often also used as a planning strategy to protect your assets.

However, the ATO has some particular views about how your service entity should operate for tax purposes.

If your business has a service entity, the ATO is giving you until 30 April 2007 to make sure it falls within the ATO's recently released operational guidelines.

If your service entity doesn't come within these guidelines, there is an increased risk that the ATO may audit your service entity.

What is the ATO looking for?

The ATO is on the look out for fees and charges levied by your service entity that are:

- disproportionate or excessive;
- calculated using arbitrary or unrealistic fixed mark-ups; and/or
- charged without clear evidence that the service arrangement adds value or performs any necessary functions for your business.

2006 YEAR END CHECKLIST

With 30 June just around the corner, another tax year is rapidly drawing to a close. Now is the time to get your business affairs in order – a bit of planning ahead of time should ensure your business gets its tax obligations right.

Set out below are some tax planning basics to keep in mind, followed by your 2006 tax year end checklist.

Tax planning basics

Ideally, tax planning is something you should be looking at regularly throughout the year. The reality, however, is that most of us tend only to look at it about now. Whilst there is no magic formula for the 'best' tax planning strategies, as a general rule we aim to:

- **cover the basics** - such as including all your assessable income and maximising all the tax deductions to which you are entitled; and
- **look at opportunities to improve your tax situation** – this depends on your particular circumstances but may include things like ensuring any capital gains are offset with any available capital losses or maximising your superannuation contributions for the year.

A WORD TO THE WISE...

Beware of investment products that tend to crop up at this time of year, claiming to wipe out your tax liabilities (usually with large deductions). These products are not always bad but if they look too good to be true, they often turn out to be just that. Always seek advice before you part with your hard earned cash!

Your 2006 Checklist

Set out below is a list of some of the tax-time issues you will need to consider when preparing your 2006 tax return.

1. Maximise your prepaid deductions

It is that time of year when you may be considering increasing your business deductions by prepaying some items of expenditure.

Before you prepay any business expenses, you should be aware that there are some rules that may affect your entitlement to claim a deduction for prepaid business expenses (e.g., you may have to apportion your deduction over more than one tax year).

COMMON PREPAYMENTS

Commonly prepaid business items include rent, lease payments, interest, audit and accounting fees, repairs and maintenance, and business related subscriptions.

2. Value your trading stock at 30 June

You will need to value your closing stock on hand and work-in-progress at June 30.

Above all, resist the temptation to take a stab in the dark about your stock levels or their value.

When you value your trading stock, clearly identify which valuation method you use – cost, replacement, market value (or less if the stock is obsolete).

Trading stock for retailers & manufacturers

Are you a retailer or manufacturer and your gross turnover for the income year ending 30 June 2006 is \$10 million or more?

If so, the ATO requires you to value your trading stock at 30 June using the full absorption cost method.

The application of the full absorption cost method may result in an increase your cost of stock on hand at year-end. This in turn may cause an increase in your taxable income, resulting in more tax payable.

Evidence suggests that many small and medium businesses exceed the \$10 million turnover. If you are retailer or manufacturer affected by this ATO requirement, you will need to seek advice about how best to manage this trading stock valuation issue.

3. Keep an eye on your losses

Has your business received income from more than one activity during the year and one (or more) of these activities made a loss?

You may be able reduce your overall taxable income by offsetting this loss (or losses) against profits from your other business activities during this year.

You should be aware that if you carry on business alone or partnership, there are some special 'commerciality tests' that your business will need to satisfy so you can do this.

NEW BUSINESS ACTIVITIES

If you have started up a new business venture during the year which has made a loss, not uncommon in the early stages of a new venture, you will need to check whether you can claim this loss against your other income.

4. Check your bad debts now

If your business has a debt that has already been brought to account as assessable income and you cannot collect that debt, you want to make sure you don't end up paying tax on income you cannot collect. The way you do this is to claim a deduction for this debt, where such a debt is 'bad' and is written off in your accounts before 30 June.

WHEN IS A DEBT 'BAD'?

You have made an effort to collect it, there is little likelihood that you will ever be successful in collecting it and you have abandoned any debt recovery action.

5. Did you sell any business assets?

Working out the tax implications of selling business assets these days can be a bit of a minefield.

You may find yourself with an assessable or deductible amount arising on the sale, depending on whether the asset was sold for more or less than its final adjustable value.

However, many businesses are also not aware that they may also end up with a capital gain or loss (e.g. the business asset was also used partly for private, non-taxable purposes), as well as a possible GST liability.

DO YOU USE AN ASSET REGISTER?

Things are a lot easier to keep track of if you keep an up-to-date business assets' register that lists all plant, equipment, furniture, fittings, other assets, including all items bought, sold & disposed of during the year.

6. Watch out for GST traps

It is not hard to make a mistake keeping track of and working out your business' GST reporting obligations, payments and refunds. Here are some common traps to avoid:

- Be careful not to understate the total value of goods and services supplied.
- Make sure you are not overstating your entitlement to input tax credits.
- Keep a watchful eye on the timing of supplies or purchases - make sure you report them in the correct period.
- Classify your supplies correctly – be particularly careful if you think a supply is GST free.

7. Review all your loans now

Private company loans to shareholders or anyone linked with or related to a shareholder can be problematic. You may find yourself with an unexpected tax bill if a loan like this is not:

- fully repaid in the same tax year in which it arises; or
- repaid on commercial terms where the loan is for more than a tax year.

A STING IN THE TAIL!

Such a loan could be treated as an unfranked dividend from the private company, which is then fully taxable in the recipient's hands.

On the other hand, if **you have loaned your company money** and it has been treated as an at-call shareholder loan in your company's books, from 1 July 2005 this loan may be treated as an 'equity interest'.

In practical terms, this characterisation of the loan means that if interest is being charged on the loan, it may no longer be a deductible expense for your company.

THERE IS AN ESCAPE...

Provided the company has a turnover of less than \$20 million for the 30 June 2006 income year, these at call loans will continue to be treated as a 'debt interest' for the year.

Low document loans are also still very much on the ATO's radar screen.

Low document loans are still popular, largely because you can get access to finance with little substantiation of your income and assets, in return for paying a higher rate of interest.

Regardless of the pros and cons of these loans, you should be aware that the ATO has recently confirmed that it is now actively and systematically checking the lodgment status of people obtaining finance through these types of loans.

WHAT DO I HAVE TO DO?

If you have a low document loan, make sure you have lodged all your tax returns and that your income and other information in your returns matches what is disclosed in the loan documents.

8. Done any contracting this year?

Are you are trading through a company and/or trust, or working as a “contractor”?

You may need to watch out for what are officially called the ‘alienation of personal services income’ rules (often referred to as the “contractor’s tax”) – the ATO is still targeting this area.

If the rules apply, any ‘personal services income’ may be taxed in your hands as an individual rather than in your company/trust.

This may also affect your tax position by impacting on the types of deductions that can be claimed by you, your company or trust.

9. Employees’ payment summaries

As a general rule, you should give your employees their payment summaries for the year ending 30 June 2006 on or before 14 July 2006.

Do you provide fringe benefits?

Watch out for fringe benefits. If the total grossed-up value of the reportable fringe benefits provided to one of your employees in the FBT year ended 31 March 2006 is more than \$1,000, you will need to show this amount on that employee’s 2006 payment summary.

This disclosure requirement applies to EACH employee who receives reportable fringe benefits that exceed this \$1,000 threshold.

10. Don’t forget about tax rate changes

The general rates of tax that apply to resident individual taxpayers were to change again on 1 July 2006 as follows –

<i>Taxable Income (\$)</i>	<i>%</i>
<i>2006/2007</i>	<i>(marginal rate)</i>
0 - 6000	0
6,001 - 21,600	15
21,601 - 70,000	30
70,001 - 125,000	42
125,001 - above	47

However, the Treasurer has announced significant personal income tax cuts in the 2006-07 Budget. The proposed personal income tax rates are as follows:

<i>Taxable Income (\$)</i>	<i>%</i>
<i>2006/2007</i>	<i>(marginal rate)</i>
0 - 6000	0
6,001 - 25,000	15
25,001 - 75,000	30
75,001 - 150,000	40
150,001 - above	45

MORE SUPERANNUATION CHANGES

It is also time to take stock of some of the key changes that the Government has made to your employer super obligations over the past 12 months.

Superannuation Guarantee (SG)

- If you find yourself in a position where you overlook paying the compulsory quarterly SG contributions for your employees on time, you may now have the option of offsetting this late payment against any SG charge (you will find more details about this in our February 2006 newsletter).
- Do not forget that SG contributions now have to be paid on salary or wages back paid to your former employees.

SG contributions are calculated currently at 9% of the 'ordinary time earnings' of each your employees.

WHAT ARE 'ORDINARY TIME EARNINGS'?

This is simply the earnings for each of your employees:

- for their normal hours of work; and
- must also include any over-award payments, commissions, shift allowances and paid leave

Super Choice

- If you employ people under a State award, you will need to check whether you now have to offer these employees choice of superannuation fund under the Super Choice regime from 1 July 2006.

Special holding accounts

- The special Superannuation Holding Account (SHA), into which employers have been able to make deposits to satisfy their super guarantee obligations, is closing down and will no longer be available for deposits after 30 June 2006.
- If you have been using the SHA, you will need to make alternative payment arrangements with a complying superannuation fund or retirement savings account to meet your super guarantee obligations.

ATO DATA MATCHING HOTSPOTS

Every now and again, we can give you a little insight into some current ATO data matching activities. This is just to show you what the ATO is up to and to alert you to some areas that may affect you or your business.

- If you are a **licensed builder, electrician, plumber or gas fitter** in South Australia, the ATO will be collecting your details from the Office of Consumer and Business Affairs and electronically matching this information with ATO data to identify non-compliance with registration (income tax, GST and PAYG withholding), lodgment and tax payment obligations.
- From the road and traffic authority in each State or Territory, the ATO is collecting details of all individuals or entities who have **purchased or acquired a motor vehicle valued at \$70,000 or more** to identify levels of compliance with lodgment and payment obligations.

The ATO also uses industry information to get an idea of the 'ball park' income figures for your particular type of business.

For example, if you are a taxi driver, the ATO works out a 'national tax vehicle earning rate' (for 30 June 2006, \$1.01 per kilometre). If your earning rate is below this, there is an increased risk of an ATO investigation.

PEARCE NORRIS OPENS BALMAIN OFFICE

Pearce Norris is proud to announce the opening of our new office in Balmain. Please come and visit us at Shop 1, 440 Darling Street, Balmain. Our phone number is 02 9555 1390 and our fax number is 02 9555 8360.

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