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Are you paying too much tax? The need for Tax Planning

"The art of taxation consists in so plucking the goose as to get the most feathers with the least hissing" – Jean Baptist Colbert.

"The hardest thing in the world to understand is the income tax" – Albert Einstein.

Income tax can be one of the largest cash outlays a business makes and can cause significant cash flow stress. Too many taxpayers do not know what they will be paying until their accountants prepare their tax returns. Often they have not provided for this in their cash flow projections (mainly because they don't do any!) and are left with a short period of time to find the funds.

Taxation planning is a crucial part of planning and running your business and personal finances. Planning should be done early in the year and over the long term (several years). An end of financial year review should also be done to ensure all is going to plan.

Unfortunately most tax planning takes place in May and June each year (if at all) and is reactive in nature. You send your books to your accountant who then tells you that you have made too much money and you need to do a list of things quickly to rectify the situation by 30th June. You go to your banker because you have no funds (you have no idea where the money has gone) to arrange funding. You are then surprised to find out your banker is not amused at having to move mountains in a day or two to make it all happen.

Worst of all is where no planning has been done and you have a large tax bill to pay which will put a lot of stress on your operation. This is normally the case when you have had several low income years and no Pay as You Go tax instalments have been paid along the way. As a result not only do you have to pay this year's tax, but you also have to pay the same amount as a Pay as You Go instalment for next year. This double hit could cripple your business.

"People who complain about paying tax can be divided into two classes – men and women" – author unknown.

Tax planning is not about tax avoidance or arranging your affairs to pay no tax (often to your long term financial detriment). Tax planning is about ensuring the tax you pay is appropriate and can be handled by your operation without resulting in financial stress.

Most people don't like paying tax. Some say that they like paying tax because it means they must be making money! When it comes to tax law, primary producers are given special treatment with extremely generous provisions which are only available to them. Having said that, it still surprises me how many taxpayers are not utilising these provisions to help them get ahead or survive financially.

Tax planning should integrate with your overall plans and goals. When working out how you are going to achieve your goals taxation constraints and opportunities need to be considered. For example if your goal is to pay off your debt within five years, what are the tax consequences? Debt can only be reduced with after tax dollars. Therefore the faster you reduce your debt the more tax you may have to pay. Add Pay as You Go tax instalments to this and you will soon be drawing back much of the debt reductions you have made.

I personally think a lot of primary producers are in new territory now after the recent land grab (particularly in the grazing industry) which resulted in many producers now having significant debt. 15 – 20 years ago a large debt was a million dollars but now many have debts of several million dollars or more. As was the case 15 – 20 years ago producers still want to pay the debt off asap. Back then paying debt off over say ten years didn't result in huge amounts of taxable income being needed and therefore tax rates were acceptable and if tax was managed correctly debt could be reduced (so long as the operations were profitable).

Now if you have a debt of say $10 million to make any inroads into it is going to require significant taxable income having to be declared and taxed. Some may push the deferred profit provisions to their limits, but apart from the danger of this being treated as tax avoidance I think they will end up in a mess.

Instead careful long term planning needs to be done looking at projected cash flows and the need to restructure the operation. Those with significant debt will need to learn to live with it. This is not necessarily a bad thing so long as they are in control. Debt is like fire - a good servant but a bad master. Instead of rushing to reduce debt and getting into a taxation mess, you need to change your focus to managing cash flow and increasing wealth using the balance sheet approach. The following is a simplistic example to illustrate this (the amounts of tax are approximate only):

Jack and John are neighbouring grain growers. Both have $1 million in debt and have had an excellent season making $500,000 taxable income each. Both need $100,000 of taxable income to live on etc.

Jack uses his additional $400,000 to reduce his loan. The tax man puts his hand out for $179,600 (tax on the $400,000) leaving him with with a reduced debt of $779,600. Jack will also have to find funds for the following year's PAYG, probably another $179,600, which may mean he ends up only reducing his debt by $40,800 all up.

John on the other hand puts his $400,000 into a farm management deposit. John doesn't have to pay any tax on the farm management deposit until such time as he withdraws it. John's debt hasn't changed but his "balance sheet" or net position is $600,000 debt. Ie he has a liability of $1 million on one side and an asset of $400,000 on the other. Not only is John instantly wealthier than Jack, he is also in a far better position to fund a bad year down the track. The money Jack has used to pay his tax has gone for good.

Capital Gains Tax planning also needs to be done. You need to examine your position and what opportunities may exist. Are you entitled to the small business CGT concessions? If so should something be done now if succession is being considered? Will these concessions be available in the future? They are after all extremely generous. These should be considered in conjunction with estate planning, retirement planning and succession planning. For example. A land owner who purchased their property in October 1985 (just post CGT) would have enormous unrealised capital gains. If they disposed of the property now by gifting it to a child they may be able to do this tax free if they are entitled to the Small Business CGT provisions. The child would have a cost base of market value at date of gifting. However if they don't and they leave the property to a child via their will, the child will inherit the parent's cost base which would put them in a far worse position should they ever sell the property, especially if the concessions are removed in the mean time. The difference in tax to the child could be millions!

"Day in and day out, your tax accountant can make or lose you more money than any single person in your life, with the possible exception of your kids" – Harvey Mackay.

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