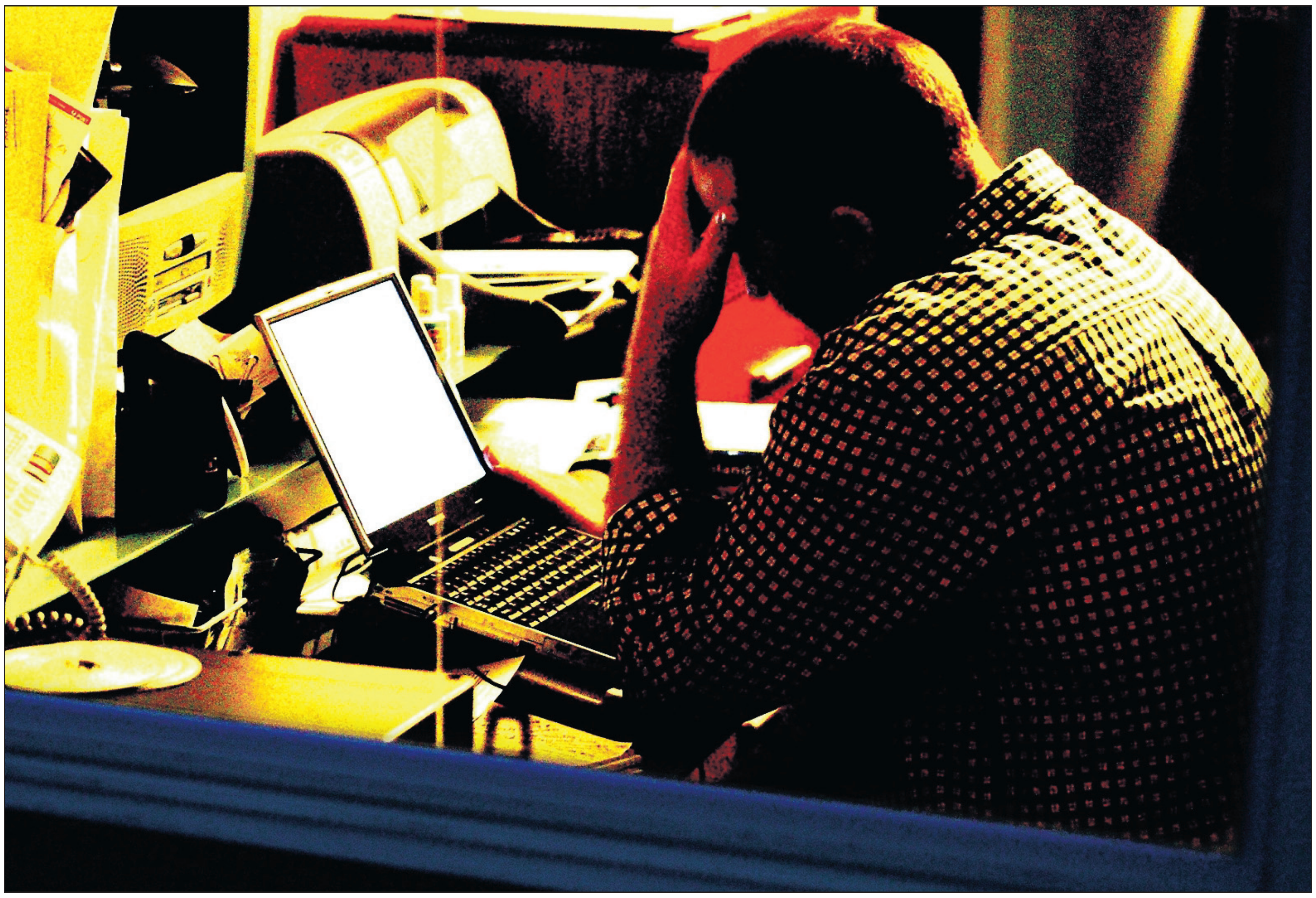
Tax tweak misses the mark

NOEL WHITTAKER

Running a small business just got even harder with the new lower company tax rate.



PRIME Minister Tony Abbott is full of paradoxes. He has repealed the carbon tax, restored the live cattle trade, and taken steps to get the budget back in the black and stop the boats. Unfortunately he has also sacked Philip Ruddock, and knighted Prince Philip – a ridiculous decision which many of us thought was a hoax when we first heard about it.

But his latest effort really gets first prize for getting it wrong. That is to give small business a much-needed boost by cutting their company tax by 1.5 per cent to 28.5 per cent. He promised to consult widely, but judging by the feedback I've been getting, there has been no consultation whatsoever.

In the absence of communication from Canberra, I've done the consultation for him, speaking to several small business owners, as well as accountants who specialise in small business. Every one of them would welcome assistance from government, but a cut in the company tax rate is the last thing on their agenda.

For starters, most small business operators don't work through a company structure: they use a family trust or a partnership. This gives them maximum flexibility for tax purposes, and also allows them to take advantage of the 50 per cent CGT discount when they decide to call it quits. In most cases, these concessions are not available if a company is used.

The big issues for small business are excessive red tape, penalty rates, rising rents and utility costs, and the worst one of all, payroll tax. This is particularly unpopular as it taxes employment, irrespective of company profitability, and the rate increases as employment grows. Given it's a state tax, and the states are all strapped for cash, there is no way it's going to be repealed – especially not by Tony Abbott.

In any event, let's suppose a small business was particularly successful and made a taxable profit of $400,000 a year. At the current tax rate of 30 per cent, the tax would be $120,000. At the proposed rate of 28.5 per cent, the tax would be $114,000 – this is a saving of just $6000 on profits of $400,000.

Then there is the issue of franking credits. Our dividend imputation system is the envy of the world, giving shareholders in a company credit for the tax paid by the company. If a small business works through a company, the net profits can only be taken out by the owners as salary or dividends.

Reducing the rate of company tax would increase the amount available to be distributed to shareholders by way of dividends, but would also reduce the rate of the franking credit they could claim. So they would pay more tax on a dividend, which would wipe out any benefit from a company tax cut.

The net result is no change in their after-tax dividend.

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Above all, a cut to the company tax rate sends the wrong message. For 18 months, the federal government has been highlighting the parlous state of the country's finances, and proposing a wide range of cost-cutting measures to get us back in the black. These have included co-contributions for doctor's visits, and a reduction in the rate of increase in the age pension. How can they possibly change course and single out small business for special treatment?

Noel Whittaker is the author of *Making Money Made Simple*, and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions. Email: noelwhit@gmail.com.

Q I recently heard part of a radio story about a very low interest reverse mortgage issued by the government, which is apparently available to high-income earners. Do you know of this scheme, or where I can access further information?

A There was talk of a government-backed reverse mortgage when the aged care reforms were publicised, but at this stage the only money available is via the Pension Loans Scheme. If you would like to read about this scheme in more detail, have a look at the Department of Human Services website.

Q I have two young children who both have $14,000 in a youth savings account. We add $100 each week to these accounts, and hope to have accumulated a tidy sum by the time they turn 18 to use for their education, or to buy a house. Is this the best strategy in saving for our children's future?

A The problem you face is the punitive children's tax, which cuts in at the top marginal rate when income from the investment exceeds $416 a year. I suggest you talk to your adviser about investment bonds. These are a tax paid investment which means there is nothing to declare on anybody's tax return each year. The cream on the cake is they can be transferred free of CGT any time you choose.

Assess the risks before borrowing to buy shares

JOHN COLLETT

MARGIN loans are back. Banks report that more investors are borrowing to buy shares.

That should be no surprise. Whenever Australian shares do well, high income earners, in particular, borrow to invest in shares.

Borrowing to invest in shares has to be approached with caution. And right now, with the S&P/ASX 200 index at almost 6000 points – the highest it has been in seven years – there are plenty of investors who think the market will continue to trade higher.

There are other factors behind the increase in margin lending besides a strong sharemarket. Interest rates are at historic lows and term deposits pay less than 3 per cent.

The big banks and Telstra pay dividend yields, after franking credits, of between 6 and 7 per cent. Most fixed rate and variable rate margin loans have interest rates of between 7 and 8 per cent.

Borrowing and trading shares incurs costs in addition to the interest costs of the margin loan. That means many investors are likely to be at least slightly cash-flow negative; that is, the investment in the shares is a loss maker.

They are likely to be "negative geared". This is where the costs of investing, such as the interest payments, exceed the income from the investment.

The shortfall can be used by the investor to reduce the income tax they pay. That is of most benefit to higher income earners who are on the highest rates of marginal income tax.

Of course, there is no point in a loss-making investment unless there are the prospects of capital gains down the track when the shares are sold. And the gains need to be decent just to recover the losses made on the investment on the way through.

Borrowing to invest in shares can make sense for high income earners where the gearing is conservative. Financial advisers usually say there needs to be a minimum investment time frame of 10 years. They also usually advise maximising salary sacrificing contributions into superannuation first.

Anyone thinking of taking a margin loan should be conscious of the risks. Just as borrowing to invest amplifies the capital gains, it also amplifies the losses. Many investors with margin loans over shares lost plenty during global financial crises. As the value of their shares plummeted, the lenders, to protect themselves, required investors to sell shares or put in some cash to restore the buffer required by lenders.

One of the cardinal rules of investing is that you do not want to become a forced seller. That will be just at the time share prices are plummeting. A margin call can force an investor to realise losses when the investor may have been happy to hold on and ride out the storm. There were some high-profile disasters involving margin lending after the Australian sharemarket crashed in 2008. These included the collapse of financial planning firm, Storm Financial, where retirees were advised to double-gear into the Australian sharemarket.