

# NEWSFLASH BOOKLET

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## BUYING A BUSINESS

**Important** – This booklet is simply a collection of Newsflash articles relevant to buying a business. The articles are transferred from Newsflash into this booklet so it is best read from the back page forwards to ensure you are reading the latest article on the topic first. Note that the information contained in this booklet is not updated regularly so it is important that you seek professional advice before acting on it.

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# Introduction

Eighty percent of businesses fail within the first 5 years. Of course the first year is the most difficult but if you have enough cash you maybe able to get past your mistakes. This is not necessarily a good thing. In my experience it is quiet often better for a business to have minimal excess funds available to it. Spare cash can quiet often only delay the inevitable. Is the inevitable failure? No! The inevitable is push coming to shove and the business owner deciding to toughen up.

Usually this means getting serious about making money. In the service industry in particular people tend to start out trying to help everyone out until they realise that at some time during the working day they must make enough to pay the rent. The tyre kickers have to go and you **are** entitled to remuneration for your time. My favourite way of explaining this is to ask clients how benevolent they would feel towards someone, who was not destitute, yet walked into their home and stole the food off the table, from their children. This puts them in the right state of mind for me to explain that it is their right to choose to spend their time either providing for their family or spending time with their family any customer who prevents them from doing either is simply stealing from their children.

This is not over dramatic. Eighty percent will fail! And it will be their choice to fail, either from lack of planning or lack of self discipline. As for the planning here are some ideas you should try to adapt to your particular circumstances. Please ask us for help if you need it.

**Recommendation:** read the KPI booklet to learn a few tools for managing your business.

## Working out how much capital you need

This is not just the purchase price of the business but in many cases the funds needed to pay for stock and wages while you wait for your accounts to be paid. In manufacturing there is a far greater time lag. I have seen many a client walk away from a business idea when they realised how much money they needed to keep the doors open while they were waiting to be paid.

The CD enclosed has a very simple cash flow analysis just to give you an idea. It is in Excel. I strongly recommend that you take this as a base and put in all the information relevant to your circumstances, then do some what if analysis. For example see what will happen if only half your debtors' pay within your terms and the other half take an extra 14 days.

## Breakeven point

This is the level of sales or gross income that your business must achieve before it can even start to make a profit. It can be calculated over any time period preferably monthly, weekly or daily. Assuming you are measuring the monthly breakeven point of your business you will need to know your fixed monthly overheads. These are the expenses that would be the same whether you opened the doors to trade or not. Your variable overheads are those expenses that increase as your sale increase. Using your phone bill as an example the line rental is a fixed overhead but the amount of calls you make in many businesses is a factor of the amount of sales you make. Many expenses are variable in the long term but fixed in the short term so the period of time you are analysing can effect your definition of variable or fixed expenses. In the short term the only variable cost you may have is the cost price of the product you are selling Your breakeven point is calculated by working out how much gross profit is left after the variable expenses are met and then working out how much gross profit it will take to cover the fixed costs. The following three examples all say the same thing it just depends which one works for you:

- 1) If for every dollar of sales a business makes it spends 50% on variable costs (in the short term this could mean 100% markup of goods purchased for resale or working back the other way a 50% gross margin) and this businesses fixed costs are \$5,000 per week, it will need to sell \$10,000 to breakeven.
- 2) Sales less variable costs as a percentage of sales (gross margin) tells us that half of every dollar received goes towards fixed costs so the business needs to sell twice its fixed overheads to breakeven. Or if the variable costs are only 40% of sales then 60% of sales goes on fixed costs.. So every dollar sold contributes 60 cents to fixed overheads. If you divide you fixed overheads by 60 and multiply the by 100 you find out how much you need to sell to breakeven.

- 3) For the number crunchers that is your fixed costs for the period divided by the percentage of each dollar sold that contributes to your variable costs (gross margin) multiplied by 100 gives you the sales required to breakeven.

$$\frac{\text{Fixed Costs}}{\text{Gross Margin}} \times 100$$

Now consider how many days in that particular period it would normally take you to meet your breakeven point. Are you cutting this too fine? For ideas on how to improve your breakeven point refer to Chapter 5 of *Driving Small Business*. More Key Performance indicators are available in our Newsflash Booklet of that name; see *free publications* on our web site.

## Business plan

A business plan covers the cash issues in a business but also the reasons you purchased the business and the plans you had for it, so when things get out of hand you can regroup.

Basically a business plan is documenting all those thoughts that go through your mind when you are considering a business and a few extra thoughts that you should have. Don't be overwhelmed by the task just put your thoughts down on paper and add the break even point, a cash flow analysis, and a profit estimation. Examples of these last two items are on the enclosed CD and Graham Long can help you with the industry averages. Breakeven points are discussed above. The following is a list of topics that will get you started on the rest:

Introduction	Business objectives
Description of Products or Services	Marketing Plan
Business Structure	Succession Plan
Loans – <i>Term, Collateral and financial information from the previous owners</i>	

## Evaluating a business

The first issue is can you believe the financial reports you are given? At least construct your own set of accounts from the facts you are confident of and the averages for your industry. These averages may be available from your professional association. Graham Long also has access to this information for hundreds of industries. The averages together with the figures supplied by the seller should give you a contrast from which to draw some conclusions about the business' profitability.

Most of the industry averages information you receive will be presented as a percentage of sales so it is very important that you get the expected sales as accurate as possible. This isn't as hard as you think if you have the dedication. You only have to spend a lot of time watching the business to work this out. Hopefully, seller will allow you enough hands on involvement in the business but if not, stalk the business. You may feel strange staking out the place but what does this matter when making such a life style altering decision? I persuaded one client, who was determined to buy a business to sit and watch it for a day. That was all it took to change his mind.

You need to work with figures you feel confident with. Then work out your break even point, the amount of working capital you will need to carry the business and do some what if analysis on the profit forecast. When working out the capital you will need to carry the business also do some what if analysis on bad debts and slow payers.

A CD with two very simplified excel spread sheets is enclosed in the folder. These can be used as a basis to analyse the profit and the working capital required. The trick when developing these is to put your assumptions into cells that are linked to the other figures. This allows you to do what if analysis. For example, in the cash flow look what happens when you change the 30 day accounts from 75% of sales to 60% with the other 15% moving to 90 days. The profitability flow chart is based on a motel look what happens if the occupancy rate changes from 75% to 60%, which Graham will tell you is the industry average. Then what happens if the occupancy rate is really only 60% and interest rates go up 1%. Not too bad, is it, so that is not really your problem occupancy is the main issue. If you can take the time to build an interactive spreadsheet with figures you have confidence in you will really start to understand what you are getting yourself into.

## Recommended reading

### **“The E Myth Revisited” by Michael Gerber**

This is available in most major bookstores and is one of the best business books ever written about creating the systems necessary to run a business.

### **"Driving Small Business" by Des Knight and Noel Whittaker**

This book is now out of print but worth while hunting down. It combines both important advice on how to analyse your key performance indicators and offers moral support for the ups and downs of being in business.

## Insurances

You are probably aware of the normal insurances that you will need such as Public Liability, Professional Indemnity, Stock, Equipment, Vehicles etc. One form of insurance that you will have difficulty getting when you first start out in business is income insurance. An effective way to overcome this is to insure your business expenses instead. This way the insurance company pays most of the business expenses if you are sick so the business should be in a position to get by without your earning capacity. I found an interesting statistic when reading up on business expenses insurance. The highest cause for claims was Accidents at 39% the second highest was Mental Disorder at 21%, I feel this is indicative of the stress you will be putting yourself under by taking on a business that is not up to scratch. Business expenses insurance can also cover you for the amount that the costs of hiring a locum exceed the fees he or she generates.

If you have a business partner that is not your spouse you should also consider looking at a buy sell partnership agreement. This policy will allow the surviving partners to buy out the heirs of the deceased rather than be forced to sell the business or try and raise the money themselves. You can also buy loan guarantor insurance to cover a business partner's share of the debt in the event of their death.

Life insurance should be purchased through your superannuation policy so it is effectively tax deductible. As long as it is payable to your dependants it will not be taxed if your family make a claim.

*Tony Townsend is the man to see for a free full needs analysis. Phone 5443 3209*

## Finance

Generally a bank will only lend you 60% of the valuation on business premises but they will lend you 80% on residential premises. The interest rate is also lower when residential premises are the security. If you do put your house up as security and it already has a mortgage make sure this is kept separate from the business loan. If you have non deductible debt such as your original home loan, make the loan for the business interest only, if the bank will allow.

Banks are very unlikely to lend for a business that is just starting up. This is one of the reasons why well established businesses cost so much. They are the only kind that can give you the track record to obtain finance. Otherwise consider methods of finance, such as personal loans, before you give up employment.

How you present your application makes a great deal of difference as to whether you are successful. At a bare minimum the bank will need the previous years trading figures of the business you are considering buying and a 12 month cash flow analysis from the point you take over.

BAN TACS have brokers that can help you find the best finance for you without having to go from bank to bank.

### **Vendor Finance:**

This is where you take over the business under an arrangement to pay the balance of the price over a period of time. Even if you do not require finance it is worth asking the vendors, just to gauge their confidence in the business.

# Business structures

There are four main structures used to operate a small business:

1. Sole Trader

2. Trust

3. Company

4. Partnership

The type of business structure you choose will affect your taxation position and your personal legal liability.

Sole traders and partnerships have always provided a cheap and simple means of being in business. But the collapse of HIH and the volatility of the public liability arena have caused concern for these sorts of businesses. If you operate your business as a sole trader or partnership it is simply you who operates that business, so if something goes wrong it is you personally who will be sued or held liable. Partners are also joint and severally liable for each other. This is why we are all careful to cover ourselves with public liability insurance no matter how simple a business because someone could simply trip over you, sue you and you could lose your house. The trouble is that if your public liability insurer goes broke you could still lose your house. Accordingly, the protection of a corporate veil is becoming more and more attractive. By setting up a company you become merely an employee who is not normally liable for his or her actions while working. Note some professions will still be liable for faulty work and you are still responsible for your actions if you act improperly i.e. trade while insolvent, misappropriate funds, operate the company vehicle while drunk etc. But if you behave properly you can structure your affairs so that in most cases it is your employer namely, the company that is liable so only the company's assets are up for grabs. But there are many disadvantages in owning a company, i.e.:

- 1) Cost around \$1,200 to set up with additional running costs compared with a sole trader of about \$400 per year.
- 2) Wages paid to family members must be justified by hours worked.
- 3) Passive income can only be distributed by dividends (assuming Alienation of Personal Services Income provisions do not apply). Dividends can only be received by shareholders so flexibility of distribution of income is not available and the same amount must be paid on each share in that class. Changing shareholders will normally create a capital gains tax problem. On the other hand ownership rights are very well defined and enforceable.
- 4) Does not qualify for the Capital Gains Tax 50% discount. The active asset discount and rollover relief are quarantined within the company. The retirement CGT exemption is available if the requirements of a controlling individual can be met.
- 5) Most creditors will require Directors guarantees so only protection is from people suing the business and some sub contractors who do not have Directors guarantees. Some protection from the ATO if you have been up front with them right from the start.
- 6) Subject to company law rules as well as normal business and tax law.

*Points 3, 4, & 6 can be minimized by putting a discretionary trust under the company*

## **There are two disadvantages of a trust rather than a company:**

- 1) Difficulty in carrying losses forward so make sure you don't make a loss.
- 2) Any profits retained by the trust will be taxed at the maximum tax bracket. So another entity such as a company or superannuation fund may be needed to store retained profits in. This has another advantage in that anyone suing the trading trust cannot touch the assets in another trust or superannuation fund.

A discretionary trust has far more flexibility as to who it can distribute income to as long as it is not Personal Services Income but the ownership of the underlying assets is not as clearly defined. A unit trust has clearly defined ownership but has many of the problems associated with companies. If two families are going into business together, and clearly defined ownership of assets is important, consider a partnership of discretionary trusts, one for each family. The partnership agreement would define exactly what percentage of the business each trust owned and what each trust's entitlement to profits is. The individual trusts are then free to distribute that profit amongst family members as suits them personally on a year by year basis. This also allows each family trust to choose a different approach to the capital gains tax concessions available to it.

A trust is not a legal entity in its own right so cannot enter into contracts etc. Accordingly, it needs a legal entity to act on its behalf. This is where the company comes in. It holds no assets and is not the trading entity it is just the figure head but if someone sues the trading entity namely the trust they can get at only the trusts assets but they can't go any further unless the directors have acted illegally. Ideally the assets of the business should be held in a superannuation fund or an entity other than the trading trust so those assets will be safe too.

# When do you become an employer?

A key case in this area is *Hollis v Vabu Pty. Limited* where the high court decided that a bicycle courier was an employee of the courier company. Note this case was not in regard to the superannuation guarantee.

The contrast between this and another *Vabu* case gives you an idea of how unclear the area of employee or contractor is and how little this relies on outward appearances such as an ABN. The ATO has announced that it will rule on bicycle couriers to the full extent based on *Hollis*' case (2001 ATC 4508). In other words all bicycle couriers are now considered employees of their courier company. Accordingly, the ATO ruled that as at 1st July, 2002 all bicycle couriers with an ABN for that purpose only are to cancel their ABN and GST registration if applicable and Courier companies must treat their bicycle couriers as employees including deducting PAYG withholding from their payments, paying FBT on any benefits they receive and paying the 9% superannuation surcharge. Yet the very same courier company won the right not to include its Courier drivers who supplied a purpose built car as employees for the superannuation guarantee levy. Further in the *Hollis* case the judge said that it does not matter if the courier supplies a bicycle or a car they are still employees.

In view of the above please take the following as the best guideline we can give you but nothing is black and white. Please note that the alienation of personal services income rules (80/20 rule) do not apply to make contractors employees. These rules are only intended to control how contractors deal with the payments they receive.

## ***For PAYG Withholding Purposes***

Whether a person is an employee (and therefore the Payer is required to withhold PAYG) is an issue of common law. Therefore it is not specified in legislation but by various cases over the years. The ATO has outlined its opinion in TR 2000/14. This topic is full of fine lines for example the difference between an employee and an independent contract is whether the contract is a contract of service or a contract for services. Probably the strongest indicator is the control test. Years ago this used to be called the servant master relationship. The control test looks at how much the payer has a right to direct how, where and when the work is performed. This is where the question of, is the contractor employed to perform a specific task or to provide services as directed by the payer, comes from. If a contractor is paid on an hourly rate it strongly suggest that the payer has control over their efforts and so should be withholding PAYG Instalments. Having said that, you should now be aware of some direct contradictions of this situation. Solicitors and accountants may charge on an hourly rate but be contractors because they have so many other clients. A salesperson who only receives commission, so is remunerated purely on a results basis is usually still considered to be an employee. Other tests include: does the contractor have the right to employ someone else to perform the work and does the contractor assume any risks that could result in he or she making a profit or loss on the job (payment for a result) rather than a guaranteed income. The more tools and materials the contractor provides the less likely the payer will have to withhold PAYG. The more payers the contractor has the less likely that PAYG Withholding Instalments need to be deducted. If the contractor is a partnership, company or a trust the payer does not have to withhold PAYG unless the set up is purely a sham, refer TR 1999/13 paragraphs 7 to 9. The provision by a contractor of an ABN will not automatically relieve the payer of the responsibility to deduct PAYG Withholding (TR 2000/14 Para 17). When the contract includes the payment of sick leave and/or annual leave the payee is most likely to be considered an employee. The higher the proportion of the gross income which the worker is required to expend in deriving that income, and the more substantial the assets which the worker brings to his or her tasks, the more likely it is that the contract is for services.

Simply writing in a contract that the payee is not an employee but a contractor will not automatically make that the case for tax law purposes. This clause is only effective if the contract has the elements of a sub contract relationship. The claim that it is not a contract of employment can only be used to clarify any ambiguity.

It helps to support the argument that the worker is a contractor if the relationship came into existence because of an advertisement by the contractor of his or her services to the public or if it was in response to a tender notice.

An oldie but a goodie in support of an independent contractor is the *Worldbook Case*:

“Undertaking the production of a given result has been considered to be a mark, if not the mark, of an independent contractor.”

A major factor in this case was the contractor's right to employ others to do the work and the fact that payment was only by way of commission for actual sales made. Payment was not related to the amount of work done but to the result it produced. Though as you can see from TR 1999/13 paying commission alone is not sufficient argument that the payee is a contractor.

### ***For Superannuation Guarantee Purposes***

Common law employees as discussed above are caught by the guarantee but contracts with individuals that are principally for their labour are also caught. The most significant case here is Vabu's case, discussed above. The court found that a courier company was not required to pay superannuation under the guarantee where the courier drivers provided their own vehicle that was designed to carry parcels. SGD93/6 gives the ATO's opinion of when a courier driver is considered to be acting independently of its company and therefore the courier company is not liable for the guarantee. The more the arrangement becomes a payment for more than just the personal services of the worker the less likely the payer is to be liable for superannuation. For example a payment to the owner driver of a semi trailer is not subject to the superannuation guarantee because the majority of the payment would be for the provision of the truck.

The right to control is also a major determining factor. For example, family day care providers in their own home are not entitled to have superannuation contributions made for them because they have so much independence in their daily tasks (SGD94/4) yet family day care has a large amount of rules and guidelines this is not considered to be control. The right to refuse a child was also considered relevant. If a contractor is operating as a company, trust or partnership there is no requirement for the superannuation guarantee levy. If the payee is a sole trader and less than 50% of the payment received is for the sole trader's own labour there is no requirement to pay superannuation. Examples of this would be supplying and installing an air conditioner where the charge for the air conditioner was more than the installation charge. Of course if a sole trader provides you with the services of one of his or her employees you are not required to make a superannuation contribution for that employee the sole trader is.

If you are found to have not met the requirements of the Superannuation Guarantee you will be fined, required to pay the omitted superannuation and not receive a tax deduction for it. Therefore we recommend you err in favour of caution.

### ***For Workers' Compensation Purposes***

In Queensland from 1<sup>st</sup> July, 2003 a Payer does not have to cover its subcontractors for Workers' Compensation if they have an ATO Personal Services Business determination or they satisfy the results test used in the APSI legislation (80/20 Rule). The results tests states that all the following conditions must be met:

- The contract is to produce a result, supply plant and equipment or tools of trade (if it is
- normal in your industry to have tools) and liability for the cost of rectifying defective
- work or liability for damages remains with the sub contractor. APSI 87-65(5)&(6).

Further, a Payer who has a contract of service with a company or a trust is not required to cover the company or trust's employees for workers compensation, it is up to that company or trust to cover its' employees. Directors of companies or trustees of trusts do not have to cover themselves with workers compensation. More information can be found on the Queensland Workers Compensation Board' web site at [www.workcoverqld.com.au](http://www.workcoverqld.com.au).

**Note:** If you have not covered a worker that is injured and you should have, you will be liable for 150% of the costs associated with the injury.

## **Breaking up the purchase price**

Generally the seller will get the most tax concessions for the portion of the price that represents the Goodwill and/or Building so they will want this to be the biggest slice of the agreed price. On the other hand the purchaser will not get any tax breaks for the Goodwill or the actual price paid for the building until they sell the business. The seller will have the same tax consequences for stock, plant and equipment yet the buyer will benefit from a deduction for the stock before he or she qualifies for a full deduction for plant and equipment. This all leads to a very messy negotiation of the price breakdown for the contract. Make sure this issue is addressed early in the piece.

# GST

## ***Basic Mechanics of GST***

All businesses with a turnover greater than \$50,000 must register for GST unless they are “Input Taxed” i.e. domestic rental properties. Even exempt businesses need to register in order to claim back their input credits. All businesses that are not exempt and are registered for GST must charge GST to all customers even if the customers are exempt from GST. The only exemptions from charging GST are on exempt goods not exempt customers, with the exception of disabled vehicles and the parts for these vehicles. All businesses registered for GST can claim an input credit for GST paid on inputs to their business though apportionment may be necessary.

## ***Definition***

**Input Taxed** – GST is paid on all expenses unless they are an exempt expense such as food. But no credit can be claimed for the GST paid. No GST is charged on sales or income. Examples domestic rental properties.

**GST Free** – GST is not charged to customers but an input credit can be claimed on inputs where GST has been paid. Must register for GST and perform basically the same paperwork tasks as normal businesses. Examples medical services, childcare and exports.

## ***GST On the Purchase of a Business***

The purchase of a business can be GST free if the following requirements are met.

- 1) The transfer of the business has some value
- 2) Both the buyer and seller are registered for GST
- 3) All things necessary to continue the operation of the business are transferred.
- 4) The seller carries on the business until the day of transfer.

GSTR 2002/5 goes into the detail of these requirements. In particular point 3 above is a problem (GSTR 2002/5 paras 58 to 70). For example to meet the requirements of transferring all that is necessary to run the business the lease on the business premises (if necessary for the continued operation of the business) must also be transferred. This requirement cannot be satisfied if the seller is behind in the rent and without a lease or does not pay rent (paying outgoings only does not meet the requirement of paying rent).

If the purchase of the business is subject to GST make sure the contract satisfies the tax invoice test so you can claim the GST input credit back. Also make sure you are registered for GST on or before the date of the contract.

Whether the contract includes GST or is GST free is neither here nor there if you are registered for GST and if you receive a tax invoice, though it may cause an initial cash flow problem. If you end up paying GST you will be able to claim it back anyway. It is really for the seller to beware.

## **Who should pay black hole expenditure**

Examples of Black Hole Expenditure are the set up cost for a trust or company or a feasibility study before starting a business. These costs can be written off over 5 years by the entity or person who incurred the expenses. The 5 years is in equal instalments so even if the expenses were incurred in June and the business started to trade before the end of the financial year you would be able to claim a full 20% in that financial year. The 5 year period does not start until the business starts to operate.

It is important to note that the deduction is only available to the entity or person who incurred the expense. The person setting up a company or trust is entitled to claim the deduction in their personal tax return if they are connected to the business ie will receive income from it. Having the new entity reimburse you for the costs of setting up the entity will eliminate the tax deduction completely. The new entity will not be entitled to a tax deduction because it did not incur the expenditure and the reimbursement would be taxable income to you so cancelling out the benefit of the tax deduction.

# Check list before paying invoices

Please go over the following check list for before making each payment.

Is the Invoice for more than \$55 GST inclusive or \$50 excluding GST?

Yes ↓

No → Pay without question. No need to withhold tax and can claim input credit.

Has the Supplier Provided an Invoice?

Yes ↓

No → Withhold 48.5% of the total Invoice price to remit to ATO Ask Supplier for TFN

Does the Invoice have an ABN?

Yes ↓

No → Withhold 48.5% of the total Invoice price to remit to ATO Ask Supplier for TFN

Does the Invoice include the words "Tax Invoice," the date, name of the supplier, the Tax inclusive price and a brief description of the goods supplied?

Yes ↓

No → No input credit can be claimed so this supply should be at least 1/11th cheaper than a correctly invoiced supply.

Is the Invoice for more than \$1,000?

Yes ↓

No → Bingo! Pay full amount of invoice & claim input credit.

Does the Invoice include in addition to the above - the quantity of the goods or the extent of the services supplied, your name and address or name and ABN?

Yes ↓

No → No input credit can be claimed so this supply should be at least 1/11th cheaper than a correctly invoiced supply.

Bingo! Pay full amount of invoice and Claim input tax credit.

## Saving Tax on Your Investment Property – The Book

*"Every investment property tax-related question you've ever wondered about is answered here and – perhaps more importantly – the ones you didn't think to ask but should have! For property investors who want to refine their strategy for maximum gain, this resourceful handbook will make a great constant companion."* Eynas Brodie, Editor, Australian Property Investor magazine.

Combining Noel Whittaker's easy reading style with Julia Hartman's mind numbing attention to detail was a major challenge which ran way over schedule but it is finished, printed, and in the book stores. You can also purchase it online by going to: [www.bantacs.com.au/property.php](http://www.bantacs.com.au/property.php). The cost is \$29.95 plus \$5.95 postage – tax deductible of course!

## Ask BAN TACS

For \$39.95 you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. For your Accountant, we will include ATO references to support our conclusion. Just go to [www.bantacs.com.au](http://www.bantacs.com.au) and look for the Ask Bantacs link under 'Most Popular' on the home page.

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**Disclaimer:** Please note in many cases the legislation referred to above has only just passed through parliament. The full effect is not clear yet but it is already necessary to make you aware of the ramifications despite the limited commentary available. On the other side of the coin by the time you read this information it may be out of date. The information is presented in summary form and intended only to draw your attention to issues you should further discuss with your accountant. Please do not act on this information without further consultation. We disclaim any responsibility for actions taken on the above without further advice as to your particular circumstances.