

**BUSINESS
INFORMATION >**

**IN THIS
ISSUE >**

The Small Business Hit List: Is the Tax Office targeting your business?

Last month, the Tax Office released a raft of new benchmarks for small business. Under the gentle guise of 'helping small business with their tax compliance', the benchmarks are, in reality, one of the key indicators used to identify who is likely to come under Tax Office scrutiny.

The industries benchmarked are high on the 'likely offenders' list for the cash economy and the Tax Office make it clear that "businesses reporting outside of these benchmarks are likely to attract attention."

The small business benchmarks provide an indication of likely costs relative to turnover for different industries. Up to five ratios are used:

Cost of goods sold to turnover	$(\text{Cost of goods sold} \div \text{turnover}) \times 100 = \text{cost of goods ratio (\%)}$
Labour to turnover	$(\text{Labour costs} \div \text{turnover}) \times 100 = \text{labour/turnover ratio (\%)}$
Rent to turnover	$(\text{Rent} \div \text{turnover}) \times 100 = \text{rent/turnover ratio (\%)}$
GST-free sales to turnover	$(\text{GST-free sales} \div \text{turnover}) \times 100 = \text{GST free sales/turnover ratio (\%)}$
Motor vehicle expenses to turnover	$(\text{Motor vehicle expenses} \div \text{turnover}) \times 100 = \text{motor vehicle expense/turnover ratio (\%)}$

So, for a pub with sales between \$250,000 and \$750,000, the expected cost of goods sold to turnover ratio is 36%-50%. In this same example, the expected labour to sales ratio is 15% - 23%. If the pub falls outside of this benchmark, the Tax Office will take a closer look at their records and determine if an audit is required.

The danger is that if your business falls outside of the benchmark for legitimate reasons, you still need to ensure that you can justify the reasons for the variations. This will be a common problem where businesses do not neatly fit into an industry definition.

See over the page for the Tax Office small business hit list.

If you want to know more about reducing your tax risks, contact us today.

> The Small Business Hit List: Is the Tax Office targeting your business?	1
> The Small Business Hit List	2
> Crackdown on the 'hobby businesses' of the rich	3
> Investment Allowance traps	3
> How much is my business worth?	4
> Business scruples	5
> An idea to save you thousands	6

Quote of the Month

"There is nothing so useless as doing efficiently that which should not be done at all".

Peter Drucker

Our Mission

To help **grow** and realise the **profit** improvement potential, business **value** and **lifestyle** choices of our clients through **innovative** application of **wealth** creation strategies.

Compliance Corner

The Tax Office small business benchmark hit list

Accommodation and food services		
Chicken shops	Coffee shops	Fish and chips shops
Kebab shops	Pubs, taverns & bars	Restaurants
Sandwich shops	Takeaway pizza shops	Takeaway food services
Sushi takeaways		
Administrative and support services		
Building and other industrial cleaning services		Pest control services
Construction		
Air conditioning, refrigeration and heating services		Bricklaying
Blocklaying	Concreting services	Electrical services
Fence construction	Painting services	Plumbing services
Plasterboard installers	Plastering and ceiling services	Roof guttering installation
Roof painting and repair	Roofing services - includes roof tiling and metal roofing services	
Tiling - floor and wall	Tiling and carpeting services	
Timber floor sanding	Timber floor installation	
Manufacturing		
Cake shops and patisseries		Bakeries and hot bread shops
Plasterboard installers	Plastering and ceiling services	Roof guttering installation
Rental, hiring and real estate services		
Video and other electronic media rental and hiring		
Retail trade		
Clothing retailing	Computer retailing	Floor covering retail
Florists	Fresh fish and seafood retailing	Fresh poultry retailing
Fruit and vegetable retailing	Furniture retail	Grocery retailers and general stores
Houseware retailing	Liquor retailing	Meat retailing and butchers
Newsagents	Tyre retail	
Transport, postal and warehousing		
Courier services	Delivery services	Furniture removalists
Road freight transport services	Taxi drivers and operators	Towing services
Other services		
Barber and men's hairdressing	Beauty services	Hairdressers
Laundry and dry-cleaning services		Nail salons

Crackdown on the 'hobby businesses' of the rich

A lot of successful businesses have meagre origins evolving out of the home or a personal interest. For many, these businesses are able to survive because the owners already have alternative forms of income; full time jobs, or other unrelated businesses. Even the great champagne house Veuve Clicquot evolved out of a passion for and a belief in the potential of champagne (the family were successful textile manufacturers). Prior to their success however, there were many years of experimentation and losses not helped by an uncertain political and economic environment.

Until recently, taxpayers were able to offset losses incurred in the hobby business against their other tax liabilities if certain tests were passed.

Last month, the Government moved to prevent individuals with an adjusted taxable income above \$250,000 from offsetting tax losses incurred in the hobby business (non-commercial losses), unless they can prove to the Tax Office that the business is a genuine commercial activity.

The change was announced in the 2009/2010 Federal Budget as part of the Government's integrity measures. Legislation was introduced into Parliament last month to effect the changes which apply from 1 July 2009.

In a recent statement, the Government labelled the change a crackdown on a "\$700 million hobby farm tax loophole" but the changes can apply to any type of business that fits the characteristics. The examples in the explanatory memoranda to the amending legislation explore party planners, vineyards, and a business which bred and sold cattle.

Under the non-commercial losses rules, you can generally apply losses against other income if you pass one of four tests:

- assessable income test — the assessable income generated from the activity must be at least \$20,000;
- profits tests — the activity must have produced a profit in three of the last five income years;
- real property test — the reduced cost base value of real property or interests in real property used on a continuing basis to carry out the activity is at least \$500,000; and
- other assets test — the reduced cost base of any other assets used on a continuing basis to carry on the activity is at least \$100,000.

Genuine business activities are typically those that have an expectation of becoming commercially viable in the near future. For those seeking the Commissioner's discretion in order to deduct the losses, they will need to detail the business itself, the nature of the losses and the reason for failing the tests, and provide objective and independent evidence that even though the business is producing losses now, the business will pass one of the four tests within a period of time that is considered commercially viable for the industry concerned.

While there is no doubt that the Clicquot champagne house would pass the non-commercial losses tests, even they may have struggled in the first few years to prove that they were a commercial operation rather than just simply a passion. As with many tax issues, the devil is in the detail.

If you are uncertain of your position, want to start up a business, or simply want to review your options, talk to us today.

Investment Allowance traps

The Investment Allowance (or tax break) was part of the Government's stimulus package designed to ensure that business investment remained consistent, despite the dwindling economy.

Unfortunately, a lot of time passed between when the Government first announced the tax break and the rules being enacted by Parliament. As a result, there was little guidance on exactly how the Investment Allowance would apply in real life despite being heavily utilised and promoted. Since the release of the enacting legislation, the ATO have clarified many of the points of concern to business.

Where the asset is used for personal as well as business use

To qualify for the Investment Allowance, an asset needs to be for the "principal purpose of carrying on a business." There has been a lot of confusion around what "the principal purpose of carrying on a business" really means, particularly for assets like cars where the asset might be used for personal as well as business use.

The Tax Commissioner has since concluded that where a taxpayer is expected to use an asset for more than 50% of the time for the purpose of carrying on a business, this will meet the eligibility criteria for the Investment Allowance.

Hire purchase agreements

To qualify for the Investment Allowance the "investment commitment time" must occur after 12.01am, 13 December 2008 and before 1 January 2010.

Also, in order for a non-small business entity to qualify for the 30% Investment Allowance, the investment commitment time must have occurred before 1 July 2009.

When it comes to hire purchase agreements, the Tax Commissioner has stated that the "investment commitment time" is the time at which the hire purchase agreement was entered into. It is not when the deposit was paid or order placed. So, be careful you have the right dates in place if you are claiming the investment Allowance.

Demonstrator vehicles

Generally, the Investment Allowance only applies to new cars. The exception is where the car has been used as a demonstrator vehicle held for "testing and trialling". But be careful, just because the dealer calls it a demonstrator vehicle doesn't mean the tax office will accept their definition. To qualify you need to prove that the car was only held for a reasonable period of testing and trialling. As a general rule, the ATO have stated that a demonstrator vehicle will be considered 'new' where it has been used for demonstration purposes for a period up to three months.

For assistance on how to use the Investment Allowance in your business, contact us today.

Business Development

How much is my business worth?

For many small business owners, their business is their largest asset and for many, one that is expected to help fund their retirement. We take a look at what your business is really worth and what sets a high value business apart.

Irrespective of whether you are contemplating retirement or have many years ahead of you in business, every business owner is curious about just how much their business is worth.

For every business that sells for an attractive price, there are many that struggle to sell, let alone fetch an attractive price. With the average age of business owners increasing and fewer new entrants looking to buy existing businesses, the sale price of many businesses is likely to come under pressure.

When you come to sell a business the first question is – what are you selling? In most cases, this is fixtures and fittings, plant and equipment, stock on hand, and the goodwill of the business. Generally, a buyer won't want to purchase your liabilities or your business structure, nor will they want to collect your outstanding debtors. Most business sales become a sale of business assets.

These assets are relatively easy to value with the exception of the goodwill. The value of plant and equipment, and trading stock, can generally be agreed. The tension is usually around the value of the goodwill. This is because goodwill is made up of many intangible assets – things that you can't readily quantify. This can include the value of:

- the business name
- the customer list
- the income stream generated by the business
- your location and lease on premises
- your brand value
- franchise or distribution rights
- your operating systems
- advertising
- supply agreements

And the list goes on. We can all agree that there is value in these assets but the question is, how much? Goodwill is basically the value of the future free cash flow of the business. Based on how your business is structured, it is the value of the profits the business can generate in the future. This is what a buyer is prepared to pay for. If a buyer has a reasonable certainty of profits and free cash flow in the future, then this is worth something. By comparison, a start up business will have a higher level of risk and no certainty that profits can be generated. In fact, a new business may need to trade for a number of years at a loss before it can establish itself and generate profits. Goodwill is what you are prepared to pay to avoid the risk and 'time to establish' factor.

What influences business value and what will people pay for?

1. A history of profits, profits, and more profits
2. Returns on capital invested better than 30%
3. Strong growth and growth prospects
4. Brand name and value
5. A business not dependent on the owners
6. A strong customer list
7. Monopoly income – exclusive territories
8. A sustainable competitive advantage
9. Good systems and procedures

It is possible to get a price that is widely different from the norm. Unique businesses, unique circumstances, and unique opportunities can always produce 'an out of the box' price. If you can build something special, then you may achieve a price beyond normal expectations. At the end of the day, the market will set the price. If you are planning to sell your business, be aware of who your buyers might be. There could be someone out there who is prepared to pay a big premium to own your business. And, even if you are not thinking about selling your business, the reality is that one day you will be. If you build your business with this in mind, then you should be looking to do those things that will grow your business value from year to year.

Where possible, the sale of your business should be mapped and planned three to five years in advance of the business sale. The majority of purchasers, when they assess the value of a business will look for established trends. This means seeing business performance reflected in the financial statements over a number of years. Most buyers and their advisers will want to review the financial performance of the business for at least the past three years. So, if you are making changes to enhance the business value then ideally these changes will show themselves over a sustained period. Where you can only show improved performance over one year or in the forward budgets, then there will always be a level skepticism that this is an aberration, or that the improvement has been artificially created in some way. Irrespective of the conclusion, a higher level of discount to the result will generally be applied.

If you want to find out more about how to prepare your business for sale, or would like to know how much your business is worth, talk to us today.

Business scruples

Welcome to the first edition of business scruples. It's an Agony Aunt column for business professionals; a little tough love but always with your best interests at heart!

Dear Business Scruples,

The costs of running my business have gone up (despite what they keep telling me on the news) but I have held off increasing my prices. It just doesn't seem right when the economy is in a slump to pump up prices. I don't want any existing sales to dry up.

What's the best approach to keep customers on my side during the economic downturns? Should I be doing more and adding a bit of a discount to keep people happy?

*Yours,
Fiscally Anxious*

Dear Fiscally Anxious,

If someone suggested a strategy to you where the outcome saw you absorb additional costs, reduce your profit margin, slow your cash flow and limit your ability to reinvest in your business, you would think they were insane wouldn't you?

You're in business to make a profit right? After all, profit is what enables us to reinvest and grow the business, employ more people, and build an asset that is something more than just another form of employment (with longer hours and often less direct benefits).

So, if you want to sacrifice yourself for the public good, then do it for a real charity (and then claim the tax deduction). If your customers don't know about the sacrifice you're making on your prices to keep them happy then you are not building loyalty anyway. History shows that martyrdom is not a survival strategy.

Not doing anything about your prices and maintaining them at 2008/2009 levels, or reducing prices directly or indirectly through discounting, is a decision like everything else and one that comes at a cost. So, let's forget about whether it is socially right or wrong to put your prices up and look at the business case for a decision either way. As Plato said, "a good decision is based on knowledge not numbers." Let's not fixate on what the number is so much as what the number needs to be.

Understanding your market

Everyone thinks their market is price sensitive but how do you know whether it really is? Most of us are just a bit afraid of the reaction we might receive. STOP BEING PARANOID.

Judging by the recent inflation figures that saw Australia record one of the lowest inflation rates in a decade, it seems that you're not the only one concerned about keeping prices in check (unless you're an oil company). Everyone is holding their collective fiscal breath until the recession is no longer in range. It's a bit like those movies where the good guys are hiding from the bad guy in a dark room and trying not to make a sound in case they are discovered. But, as American writer Irene Peter said, "Anyone who thinks there's safety in numbers hasn't looked at the stock market pages."

If you are dominated by competitors who have a market share the size of New Zealand and you have no differentiator, then you will be pressured on price. Whereas, if you are not dominated by your competitors or you are able to differentiate in other ways, you can take the focus away from price. Value conscious and price conscious are not automatically the same things.

If you have a more personalised product and interaction with your market, then it is a question of whether or not a marginal increase is going to make any difference to your customers. A price increase or a discount is a small consideration compared to the broader decision of whether to buy what you offer now, later, or never. No one likes to pay more but if your costs have increased then a price increase is merely a reflection of what is happening in the broader market.

The cost of discounting

Any fool can sell at a discount. You can't be a success if you only focus on sales volume without identifying the cost of your discounting strategy. Eighty three year old Hugh Hefner is also popular with the ladies but you need to ask yourself what the cost of that popularity actually is.

Discounting creates a leverage impact on profits. Essentially, by discounting you are giving away some or all of your profits. The key is to understand the impact and just how far you can go. For example, a business with a 30% gross profit margin that offers a 25% discount (certainly nothing unusual about that in today's market) needs a 500% increase in sales volume just to maintain the same position – and, in almost all cases, that's just not going to happen.

Business scruples, *continued*

The result generally is that the business trades below its break-even point and generates a loss. You can only do that for a limited amount of time (and yes, some of your larger competitors might be engaging in a discounting war with you in an attempt to bury you once and for all).

Many businesses don't understand the impact of pricing on their business and instead measure success by sales activity rather than by their gross profit. It's such a feel good measure to fixate on.

Understanding your cost structure

Do you know what your real cost of doing business is? Your break-even point is the level of sales activity where your business is neither making a profit or a loss. You calculate your break-even point by dividing your fixed expenses by your gross profit margin. This figure represents the level of sales income you need to break-even. With this piece of information you will know, at any time, whether or not you are profitable (providing your fixed expenses and profit margin have remained constant).

Not only will your break-even point assist you to monitor business performance, it's critical when deciding whether or not to offer a discount. If your break-even point is well below your current operating level then you have a good buffer in your profits to manage growth, invest in further capital opportunities, and to protect yourself against any sudden downturns in operating performance. And before you say "I know that" ask yourself how many people actually put this theory into practice. Even some of the largest businesses have been caught out on this one and tie up valuable resources in unprofitable projects and products.

Putting up your prices during the down times is not an act of social betrayal. If your prices have increased you should flow these through unless you are comfortable making less for the same amount of effort, or you are in an industry that is so price sensitive that you have no choice but to follow the crowd like spawning salmon.

An idea to save you thousands

The Reserve Bank of Australia has removed almost all of the mystery about what is going to happen with interest rates. Rates have bottomed out and are likely to start going up. Announcements from the RBA Board state that the "stronger-than-expected economic data and the general improvement in sentiment both in Australia and abroad have reduced the likelihood that a further reduction will be required."

Most banks have already factored in the likelihood of a rate increase so it's possible you are already paying more for your cash.

Typically, we take on debt at different times and it is often linked to a major purchasing decision or event. As a result, it is not uncommon to be carrying multiple debt commitments. If you take a moment to have a look at your various debts you are likely to

find that they are quite different from each other. Interest rates, the life of the loan, whether you are repaying the principal of the loan or only the interest costs, the ability to accelerate repayments – all of these may be different and the difference may not be to your advantage.

We've mentioned this before but it is something few of us actually get around to doing anything about: If you have not had a banking review done for some time, now is the time to do it. It might save you thousands.

Contact us today and we'll help put you in touch with specialists who can work with you to reduce the cost of your cash while we ensure that any change takes into account your business and taxation needs.

BHT PARTNERS

Suite 11, Midway Arcade
974 Main Road, Eltham
PO Box 588, Eltham

Tel: (03) 9431 3000

Fax: (03) 9431 1618

Email: bhtpl@bhtpartners.com.au

Web: www.bhtpartners.com.au

Brian Taylor

Director of Business Development Services
Email: btaylor@bhtpartners.com.au

Jim Tyrrell

Director of Accounting & Compliance Services
Email: jtyrrell@bhtpartners.com.au

Melinda McAllister

Director of Audit & Assurance Services
Email: mmcallister@bhtpartners.com.au

Disclaimer

While every effort has been made to provide valuable, useful information in this publication, BHT Partners accepts no responsibility or any form of liability from reliance upon or use of its contents. Any suggestions should be considered within your own particular circumstances, as they are intended as general information only. Additional information and advice may be obtained from BHT Partners Pty Ltd.



Liability limited by a scheme approved under Professional Standards Legislation.