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Tax planning to avoid surprises...

Planning and managing your tax payments is critical to your business says David Espiner of Business Advice Ltd

If there are only two certainties in life – death and taxes - careful planning can reduce, but alas not eliminate, the impact of both these inevitabilities.

Managing and planning your tax affairs is essential for sustainable cash flow. This article deals mainly with income tax, but all taxes (direct & indirect) must be considered. Tax and payment dates should be budgeted, just like any other business expense.

Because commercial businesses aim to make profits, the drivers are sales and costs, with often little or no thought given to tax payments. This problem is aggravated by the fact that tax is paid in arrears – something that increases the need for tax planning.

Increased compliance obligations, penalties, interest and the frequency of tax payments, make it highly unlikely that you could continue the practice of ignoring tax until your accountant prepares your financial statements.

How should I budget for tax payments?

For most business owners January to April is fraught with cash flow problems, brought about by shutdowns, holiday pay, PAYE, GST, provisional and terminal tax payments. All businesses must hold on to their money to pay for these. But this is only the tip of the iceberg. To plan properly for tax, it is important to know:

- How to calculate your **taxable** (as opposed to **accounting**) profit.
- How this taxable profit will be distributed – wages, shareholder salaries, interest, directors fees etc - as this determines the tax type and rate.
- How to calculate your **total tax liability**.
- The due dates for each type of tax (they vary).
- How to ensure that cash is available when required - it is good practice to keep tax payments in a separate bank account.

Simple as it sounds, this can be quite complicated. It is a specialised area and important enough to get good advice on – in advance.

Why regular tax budgeting and payments benefit you

Regular tax budgeting and monitoring protects you from having to pay interest charges and penalties. For instance, in some circumstances you may become liable for "Use of Money Interest" (UOMI), which is charged on **all** (not just income tax) unpaid / under paid taxes.

The current rates of interest are 13.08% paid to the IRD on underpayments and 5.71% earned by the taxpayer on overpayments. Why hold tax money on deposit at 5% while paying the IRD 13% – a cost of 8%?

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So how do you minimise your interest charges? Listed below are the more common ways to minimise your interest. Each should be considered against the cost of achieving these savings, as well as any implications or restrictions they might put on the business.

- Estimate your tax liability for the upcoming year and pay 1/3 of it on each provisional tax payment date – even if it is more than what you are required to pay. It is important to keep reviewing this estimate against actual results during the year.

OR

- Calculate your tax liability each month and pay this tax monthly – check for profit fluctuations over the year – especially increases in the later part. This will help smooth cash flows.

AND

- Have your business advisor review these estimates and calculations, as there will be many tax related adjustments required – which in turn allows a better tax estimate.

OR

- Have your business advisor prepare management accounts for you and also manage your tax affairs – while this cost might be the same as any interest savings, at least you are receiving something of value. Your advisor also sees your business's performance (more regularly or when needed) and can therefore give more effective advice.
- Do all the above regularly, for maximum benefit.

When cash is tight many people hold off paying their taxes in order to pay other creditors.

While this can be necessary, it is important to understand the cost of doing so – how many of your creditors charge you interest and penalties on your outstanding account from day one?

For example, You have a GST payment of \$1,854.32 payable on the 31st August, but cash flow problems force you to delay payment until the 18th November.

The total interest and penalties incurred will be approximately \$185 dollars, which is not much money but translates into 46% p.a! Your credit card charges are probably less than half of that.

Other tax points to consider

- Penalties will only be waived in very limited circumstances, interest in even fewer cases.
- Penalties are charged in addition to interest.
- Penalties are not deductible for tax purposes (interest is), which further increases the annual interest charge.
- First year self-employed individuals may qualify for a 6.7% early payment discount if they pay their income tax early.
- The same budgeting procedures should be applied to all taxes and ACC levies.
- Consider using the "Tax Pooling" scheme whereby taxpayers with underpaid tax can utilise overpayments by other taxpayers. Ask your business advisor.

BOX 1

So how much should I put aside for tax payments?

The answer depends on profit, margins and tax rates. The following rough guide to estimating how much of your income should be put aside to meet your income tax and GST obligations should help you –

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Monthly Sales (GST incl)	112,500
GST	<u>12,500</u>
	100,000

Net Profit on margin of 35.00% 35,000

Tax payable

	Tax Rate	Income Tax	GST Payable	Total Tax	% of Sales GST Incl	Provision Rounded
Individual up to \$60k	24.45%	8,558	12,500	21,058	18.72%	20.00%
Company / Trust	33.00%	11,550	12,500	24,050	21.38%	22.00%
Individual over \$60k	39.00%	13,650	12,500	26,150	23.24%	25.00%

The main variables in the table are sales and net profit margin. This company should put aside about 22% of all sales invoiced to provide for tax. Remember that this calculation uses invoiced sales - not paid sales. This calculation cannot be used instead of detailed profit and cash flow forecasts.

I recommend that every business should prepare detailed forecasts as a normal part of their planning procedures and should review these regularly (ideally with their business advisor) to ensure they are still accurate. As I said earlier, the savings easily offset the costs.

BOX 2

New Business Owners

While there is no tax payable in the first year in business, it does not mean the year's trading is tax free. Year one's tax payments will be due in year two, which means that in year two you pay tax for two years, but on one year's cash flow. Usually the extra cash from the first year is put into extra stock, equipment, debt reduction or worst of all – private expenditure. This cash has to be extracted in the second year, to pay tax. The cash flow problems brought about by this, which could take years to recover from, or could sink you, could be avoided by planning with our advisor and regular monitoring.

For instance:

Details	Period	Tax Payable	Tax / Profit	Surplus cash
Business start date 1-Apr-04	8 Apr 04 to 7 Apr 05	0	0.00%	50,000
Profit each year 50,000	8 Apr 05 to 7 Apr 06	24,600	49.20%	25,400
Tax rate (individual) 24.00%	8 Apr 06 to 7 Apr 07	12,000	24.00%	38,000
	Average for period	12,200	24.40%	37,800

While the average tax liability over the three years is \$12,200, it is the timing of the payments (cash flow) that differs.

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Not only new businesses are affected – significant year-on-year profit growth brings the same problem.

BOX 3

David Espiner is the Director of Business Advice Ltd, Chartered Accountants and Business Advisers. If you are interested in a more complete guide to tax planning call Business Advice Ltd at 09 430 2301 or david@bizvice.co.nz or their associates Aidmax Ltd 0800 692 384
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