This session will cover

- What is a small business?
  - Business or hobby?
- Taxation of small business
  - Tax rate for small companies
  - Dividend franking for small companies
  - Tax offset for unincorporated businesses
- Depreciation for small businesses
- Personal Services Income
- The sharing economy
- Capital Gains Tax Concessions for small business
- Other taxes (GST, FBT)
What is a small business?

• You are a small business entity if you:
  • carry on a business and
  • have an aggregated turnover of less than $10 million

• There are three ways an entity can satisfy the $10m aggregated turnover test:
  • the entity’s aggregated turnover for the previous income year was less than $10m
  • the entity’s aggregated turnover for the current income year is likely to be less than $10m, calculated as at the first day of the income year, or
  • the entity’s actual aggregated turnover for the current income year was less than $10m calculated as at the end of the income year.

• Carrying on a business – see TR 2017/D7
  • A company should be regarded as carrying on a business under general principles if the company aims to make a profit and has a genuine prospect of making a profit
  • A passive investment company can still qualify as an SBE (eg a company receiving rental from investment properties)

Business or hobby?

• Important in the context of the sharing economy and online selling where many taxpayers dispute that they are in business at all

• If income is from a hobby, it is not taxable, no deductions can be claimed, losses cannot be offset against other income

• If income is from a business, it is taxable, deductions can be claimed and losses may be able to be offset against other income (subject to non-commercial loss rules)
Business or hobby?

• Example:
  • Joan bakes cakes at the weekend. She finds the activity satisfying and relaxing. Her cakes become very popular with her friends, who occasionally ask her to bake a cake for specific occasions such as birthdays. If Joan has time, she often agrees to these requests and charges her friends the cost of materials but doesn't add on any profit.
  • As Joan has no profit making motive and is not baking cakes in a business-like manner – she only accepts an order when she has time for instance – the ATO would accept that Joan has a hobby and wouldn’t expect her to declare the income from her cake-making on her tax return.
  • Eventually, Joan realises that she can make a useful second income from baking cakes. Towards the end of the week, she sets aside several hours a night and bakes up to 30 cakes, which she takes to a local farmers market every Saturday morning and sells, at a mark-up of at least 50% on cost.
  • Although Joan takes as much pleasure from baking cakes as before, she is now baking for profit and by setting aside set, regular times to make cakes, she is organising her activities in a business-like manner. She will now be expected to declare her baking income on her tax return.

### Positive factors

<table>
<thead>
<tr>
<th>Positive factors</th>
<th>More likely to be business</th>
<th>Less likely to be business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large scale operations</td>
<td>Large scale operations</td>
<td>Small scale operations</td>
</tr>
<tr>
<td>Involves employees</td>
<td>Involves employees</td>
<td>One person operation</td>
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<tr>
<td>Frequent acts/transactions</td>
<td>Frequent acts/transactions</td>
<td>Infrequent acts/transactions</td>
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<tr>
<td>Sophisticated transactions</td>
<td>Sophisticated transactions</td>
<td>Basic transactions</td>
</tr>
<tr>
<td>Conducted with a view to profit</td>
<td>Conducted with a view to profit</td>
<td>Conducted on non-profits or for private use</td>
</tr>
<tr>
<td>Profitable</td>
<td>Profitable</td>
<td>Non-profitable</td>
</tr>
<tr>
<td>Conducted over long period</td>
<td>Conducted over long period</td>
<td>Short-term</td>
</tr>
<tr>
<td>Conducted continuously and systematically</td>
<td>Conducted continuously and systematically</td>
<td>Spasmodic</td>
</tr>
<tr>
<td>Conducted in commercial premises</td>
<td>Conducted in commercial premises</td>
<td>At home</td>
</tr>
<tr>
<td>Conducted with knowledge of items typically dealt with commercially</td>
<td>Conducted with knowledge of items typically dealt with commercially</td>
<td>Knowledge of items not typically dealt with commercially</td>
</tr>
<tr>
<td>Conducted with exercise of specialised knowledge</td>
<td>Conducted with exercise of specialised knowledge</td>
<td>Knowledge of items not typically dealt with commercially</td>
</tr>
<tr>
<td>Significant capital investment</td>
<td>Significant capital investment</td>
<td>Little or no capital investment</td>
</tr>
<tr>
<td>Revenue record kept</td>
<td>Revenue record kept</td>
<td>Revenue record not kept or inaccurate</td>
</tr>
<tr>
<td>Full time</td>
<td>Full time</td>
<td>Part-time</td>
</tr>
<tr>
<td>Market research done</td>
<td>Market research done</td>
<td>No market research</td>
</tr>
<tr>
<td>Associated with other commercial activities of taxpayer</td>
<td>Associated with other commercial activities of taxpayer</td>
<td>No other commercial activities of taxpayer</td>
</tr>
<tr>
<td>Existence of business organisation, business books</td>
<td>Existence of business organisation, business books</td>
<td>Conducted personally/providing order</td>
</tr>
<tr>
<td>Marketing</td>
<td>Marketing</td>
<td>No marketing</td>
</tr>
<tr>
<td>Conducted as business</td>
<td>Conducted as business</td>
<td>Conducted personally/providing order</td>
</tr>
<tr>
<td>Existence of a business plan</td>
<td>Existence of a business plan</td>
<td>Little or no business plan</td>
</tr>
</tbody>
</table>
How are small businesses taxed

- Small businesses that trade as companies are taxed at the lower corporate tax rate of 27.5%.
- Unincorporated small businesses are taxed at the relevant rate for the entity and may have access to the tax offset for small unincorporated business.
  - Individuals
  - Trusts
  - Partnerships

Calculating the tax rate for small companies

- Whether a company is a small business entity is no longer relevant to working out the tax rate.
- Lower company tax rate applies if the company is a base rate entity (BRE):
  - Aggregate turnover for the 2019 income year is less than $50 million and
  - No more than 80% of the company’s assessable income is base rate passive income.
- Prior-year turnover is not relevant (unlike small business entity test).
- “Carries on a business test’ is also not relevant.
- Note that BRPE is considered at a company level but aggregate turnover is considered at a group level.
Tax rates for small companies

<table>
<thead>
<tr>
<th>Income year</th>
<th>Aggregated turnover threshold</th>
<th>Lower tax rate</th>
<th>Tax rate for all other companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015-16</td>
<td>$2m</td>
<td>28.5% (SBE)</td>
<td>30%</td>
</tr>
<tr>
<td>2016-17</td>
<td>$10m</td>
<td>27.5% (SBE)</td>
<td>30%</td>
</tr>
<tr>
<td>2017–18</td>
<td>$25m</td>
<td>27.5% (BRE)</td>
<td>30%</td>
</tr>
<tr>
<td>2018–19 to 2019–20</td>
<td>$50m</td>
<td>27.5% (BRE)</td>
<td>30%</td>
</tr>
<tr>
<td>2020–21</td>
<td>$50m</td>
<td>26.0% (BRE)</td>
<td>30%</td>
</tr>
<tr>
<td>2021–22</td>
<td>$50m</td>
<td>25.0% (BRE)</td>
<td>30%</td>
</tr>
</tbody>
</table>

What is base rate passive income (LCR 2018/D7)?

- Dividends, excluding non-portfolio dividends
  - Where a company holds a voting interest of 10% or greater in the company paying the dividend, this will be a non-portfolio dividend (and hence not BRE passive income)
  - Exclusion applies only where non-portfolio dividend is paid direct from company to company (not through an intermediate entity, eg a trust)
- Franking credits attached to portfolio dividends
- Non-share dividends
- Interest (except interest received carrying on a business of providing finance, eg a bank)
- Rent
- Royalties
- Gains on qualifying securities
- Net capital gains
- Trust and partnership distributions to the extent referable to BRE passive income of the trust or partnership
Base rate passive income

- Sharp Pty Ltd undertook a business of making widgets during the year ended 30 June 2019. Turnover from the business was $40 million.
- Sharp Pty Ltd also rented out the surplus space in their factory in Melbourne and received rent of $2 million from the tenants.
- Sharp Pty Ltd also earned interest on surplus cash deposits amounting to $1 million.
- What is Sharp Pty Ltd’s corporate tax rate for 2019?
  - Aggregate turnover is $43 million. This is less than the $50 million turnover threshold for 2019.
  - Base rate entity passive income percentage is 7% ($3m/$43m). This is less than the 80% base rate passive income threshold
- Therefore the company is a base rate entity and will pay company tax at 27.5%

Paying dividends to small company shareholders

- Dividends to small company shareholders are paid with a franking credit to recognise the company tax already paid in respect of the profits the dividends was paid out of
- Franking percentage for 2019 dividends calculated based on the corporate tax rate for imputation purposes
  - If the company would be a BRE in 2018, franking rate in 2019 is 27.5%
  - If the company would not be a BRE in 2018, franking rate in 2019 is 30%
    - Aggregate turnover in 2018 was more than $50m or
    - More than 80% of turnover in 2018 is passive
- If the company is a new one, corporate tax rate for imputation purposes is automatically 27.5%
Example

- Strange Pty Ltd is carrying on a business, and in the 2017-18 income year has an aggregated turnover of $30 million. Their assessable income is $33 million which includes $3 million of base rate entity passive income.
- When franking their distributions for the 2018-19 income year, Strange Pty Ltd assume their aggregated turnover will be the same in 2018-19 as it was in 2017-18.
- Their 2017-18 aggregated turnover was under $50 million and only 10% of their assessable income was base rate entity passive income. This means their corporate tax rate for imputation purposes for the 2018-19 income year is 27.5% and they will frank their 2018-19 distributions based on this rate.
- Strange Pty Ltd wants to distribute $100,000 profit to their shareholders.
- The maximum franking credit they can attach to that distribution is:
  - applicable gross up rate = 72.5% / 27.5% = 2.6364
  - maximum franking credit = $100,000 \times (1 / 2.6364) = $37,930.51.

Poll:
In the 2018 income year, C Co had an aggregate turnover of $48 million and assessable income that was 82% Base Rate Passive Income

In the 2019 income year, C Co had an aggregate turnover of $46 million and assessable income that was 75% Base Rate Passive Income

What is the company’s corporate tax rate and franking percentage for 2019?
- a) Corporate tax rate is 27.5% and franking percentage is 30%
- b) Corporate tax rate is 30% and franking percentage is 30%
- c) Corporate tax rate is 30% and franking percentage is 27.5%
- d) Corporate tax rate is 27.5% and franking percentage is 27.5%
Tax Offset for small unincorporated entity

• For the purpose of determining whether the small business income tax offset is available the definition of a small business entity is amended by changing the aggregated turnover threshold from $10m to $5m
• Only an individual taxpayer can claim the small business income tax offset
• The amount of the offset is equal to 8% of tax payable on “total net small business income” up to a maximum of $1,000
• Total net small business income is the sum of:
  • Net small business income from the taxpayer’s sole trader small business entity
  • The taxpayer’s share of net small business income of an SBE (other than a company) that is included in their assessable income
  • Net small business income is broadly assessable income that relates to the entity carrying on the business less allowable deductions attributable to that income

Tax Offset for small unincorporated entity example

• Adrian is a small business entity. For the 2018-19 income year, Adrian’s taxable income is $100,000, his basic income tax liability is $30,000, and his total net small business income is $50,000.
• To work out the amount of his small business income tax offset for the 2018-19 income year, Adrian first divides his total net small business income by his taxable income ($50,000/$100,000 = 0.5). This shows that half of Adrian’s taxable income relates to his total net small business income.
• Adrian then multiplies the result of the first calculation by his basic income tax liability (0.5 × $30,000 = $15,000). The result of this second calculation shows that $15,000 of Adrian’s basic income tax liability is from his total net small business income.
• Adrian’s potential small business tax offset is equal to 8 per cent of the result of this second calculation (0.08 × $15,000 = $1,200).
• The amount of Adrian’s small business tax offset is therefore $1,000 since the maximum offset he can claim is $1,000.
Small business depreciation

- Small business entities can choose to deduct amounts for most of their depreciating assets under a special depreciation regime (“small business depreciation”).
- The simplified regime for calculating capital allowances on depreciating assets is contained in ITAA97 Subdiv 328-D. Small business entities that choose to use this regime are not subject to the provisions of ITAA97 Div 40.

Small business depreciation

- Any assets (including in-house software) costing less than the small business depreciation threshold amount are written-off immediately in the year they are bought and used or installed ready for use.
- This threshold amount has varied considerably in recent years but is currently $30,000 (effective 2nd April 2019 to 30 June 2020)
  - Previously $25,000 from 29th January 2019 to 2nd April 2019 and $20,000 before 29th January 2019
- Entire cost of the asset must be less than the instant asset write-off threshold, irrespective of any trade-in amount.
- In calculating the deduction, the claim is only related to the taxable purpose proportion in producing assessable income.
- Example: an asset that is newly acquired for $8,000 is to be used 60% for business purposes, the deduction will be $4,800. If it is to be used only for business purposes, the deduction will be $8,000. While only the taxable purpose proportion is deductible, the entire cost of the asset must be less than the threshold for a claim to be made in the first place.
Small business depreciation

- If the cost of an asset (other than a building) is the same as or more than the instant asset write-off threshold, the asset is placed into the small business pool and is depreciated at a rate of 15% for the first year (regardless of when the asset was purchased during the year) and 30% in subsequent years.
- If the adjusted balance of the small business pool is less than the applicable instant asset write-off threshold for the year (currently $30,000) the whole pool balance must be written off.
- A “balancing adjustment event” occurs when the taxpayer disposes of a depreciating asset. If the asset is a low-value asset for which an immediate deduction was obtained, the taxable purpose proportion of the “termination value” (broadly, the disposal proceeds) is included in the taxpayer’s assessable income. If it is a pooled asset, the taxable purpose proportion of the asset’s termination value is subtracted from the pool.

Capital Gains Tax Concessions for Small Businesses

- Basic conditions:
  - A CGT event happens to an asset owned by the taxpayer which would otherwise result in a capital gain.
  - At least one of the following applies:
    - the taxpayer is a “CGT small business entity”, broadly meaning that it has a turnover of less than $2m
    - the “net value” of assets owned by the business and related entities is $6m or less
    - the entity is a partner in a partnership that is a CGT small business entity for the income year and the CGT asset is an interest in an asset of the partnership, or
    - the CGT asset is a passively held asset used in the business of an affiliate, connected entity or partnership in which the taxpayer is a partner that is a CGT small business entity.
  - The CGT asset which is the subject of the CGT event is an “active asset”, meaning an asset used, or held ready for use, in carrying on the business.
The concessions

- **15 Year exemption**: This allows a taxpayer to disregard entirely a capital gain arising from a CGT event happening to a CGT asset if it has owned the asset continuously for at least 15 years prior to the CGT event. If the taxpayer is an individual, the individual must also retire or become permanently incapacitated for the exemption to apply.

- **50% reduction**: The amount of a capital gain is reduced by 50% (in addition to the 50% general discount, where available).

- **Retirement exemption**: This allows a taxpayer to choose to disregard all or part of a capital gain in relation to a CGT asset of the taxpayer’s small business if the capital proceeds from the CGT event are used in connection with retirement. There is a $500,000 limit which applies in the individual’s lifetime.

- **Rollover**: defers the making of a capital gain from a CGT event that happens in relation to an asset where a replacement asset is acquired within two years.

Tax and the sharing economy

- The sharing economy has been the “wild west” of tax compliance.
- Is this income taxable?
  - Yes!
- Widespread under-reporting or non-reporting
- Business or hobby?
  - Usually a business (except Airbnb, which is rental income)
- How does tax law apply to the sharing economy?
  - Same was as any other business income
- How has the ATO responded?
  - Increased compliance and data matching
Personal Services Income rules

• Part 2-42 ITAA 1997
• What is the aim of the PSI rules?
• To treat individuals (whether directly or through entities) who are earning income derived from their personal exertion in the same way that an employed individual would be treated, ie in the hands of the individual deriving it
  • Prevent income splitting
  • Manipulation of tax rates (eg corporate rates)
  • Excessive deductions
• The PSI rules don’t prevent other entities (trusts, companies, etc) being used, they just put the principals back in the tax position they would have been in if employed
• Other small business rules (eg, simplified depreciation) may still apply

Working out if the PSI rules apply
Summary: implications of PSI rules applying

• Sole trader:
  • Restrictions on deductions claimable

• Other entities:
  • Restrictions on deductions claimable
  • Personal Services Income (net of allowable deductions) is attributed back to the individual taxpayer and taxed at normal individual rates
  • No double taxation in the entity

What are the implications where the PSI rules apply to an individual?

• Deductions that can be claimed by individuals are restricted (see TR 2003/10 and Div 85)
• The following cannot be claimed:
  • Deductions an employee could not claim unless they relate to:
    • Gaining work (eg advertising)
    • Insuring against loss of income or earning capacity (eg, sickness, accident and disability insurance)
    • Public liability or professional indemnity insurance
    • Engaging a non-associate to perform principal work
    • Workers compensation premiums
  • Occupation costs for the individual’s or their associate’s residence (rent, mortgage interest, rates, land tax)
  • Salary/wages and superannuation paid to associates unless for performing principal work
    • Salary paid to another medical practitioner may be OK
    • Salary paid to a spouse for admin will not be OK, although will be tax free to the recipient
What are the implications where the rules apply to PSI through an entity?

- If an individual can’t claim a deduction for an expense under Div 85, a personal services entity can’t claim a deduction either (see TR 2003/10 and Div 86)
- The following additional deductions can be claimed:
  - Entity maintenance deductions (bank fees, tax fees, Australian government fees and charges):
  - Car expenses for one car for which there is private use
  - Super contributions up to SG amount for principal work done by associates
  - Salaries promptly paid (to associates for principal work)

Fringe Benefits Tax for small business

- Fringe benefits tax (FBT) is paid by employers on certain benefits they provide to their employees or their employees’ associates (typically family members) in respect of their employees' employment.
- Key exemptions for small business entities:
  - Work-related car parking:
    - The exemption is available in respect of a car parking benefit provided in respect of the employment of an employee.
    - Generally available in relation to the provision of parking facilities on business premises (excluding a commercial car park), where the car was parked for more than four hours on the particular day and was used for travel between home and work
    - an FBT exemption for more than one work-related portable electronic device provided to an employee (eg, a tablet, phone or laptop)
GST for small business

- Entities are required to be registered for GST if they are carrying on an enterprise and have annualised GST turnover of at least $75,000 ($150,000 for non-profit bodies).
- GST registration broadly means that an entity is required to remit GST to the ATO in respect of taxable supplies it makes and is entitled to claim GST credits in respect of GST included in the price of purchases it makes in carrying on that enterprise.
- Taxi drivers and ride-sharing drivers (such as Uber drivers) need to register for and charge GST no matter what their turnover is.
- Small business entities have less GST information to report on their BAS. They only need to report:
  - Total sales
  - GST on sales
  - GST on purchases

GST for small business

- The way an entity accounts for GST depends on whether it operates on a cash basis or an accruals basis.
- The cash basis operates on the basis of when the consideration is actually received or paid.
- The accruals basis generally operates on the basis of when invoices are issued or received.
- The cash basis can only be used by small business entities (and entities that aren’t carrying on a business at all).
- Even then, it is not compulsory. Small business entities can choose to apply the cash basis.
Small Business Tax Compliance - benchmarks

- The small business “benchmarks” (ie industry specific tools) provide a snapshot of what, on average, is happening in particular industries by providing a measure of various business costs in relation to turnover.
- The ATO uses the benchmarks to identify businesses that may be avoiding their tax obligations by tracking performance against other businesses in the same industry.
- If a business is found to be falling outside the benchmarks for a particular industry, especially for a long term, it is more likely to attract ATO audit attention.

Questions?

- You can type them in the “Questions” box now
- Or contact me via:
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