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Selling or buying a business? Think about earn-outs

Mary sells her business with a promise by the purchaser to pay her 50% of the following year's profit, that is, an earn-out.

Earn-outs enable a vendor to maximise the sale price of a business, with the 'price' delivered once a certain contingency, say, a profit target, is met.

A purchaser may intend to employ the vendor in the business after acquisition, so an earn-out may also be a de facto bonus mechanism.

Times change

Before October 2007, where a vendor received part of their

sales proceeds as an earn-out, these proceeds equalled the market value of the earn-out when the earn-out right was created. The purchaser simply included the amount paid under the earn-out in their cost base of the assets acquired.

However, the ATO changed their views substantially on earn-out arrangements when they released their draft Taxation Ruling TR 2007/D10, particularly where an earn-out arrangement spanned multiple payments.

Now the purchaser is seen to have, at the time of contract, agreed to acquire assets and has, in return, given property, being the earn-out right. The purchaser must value the

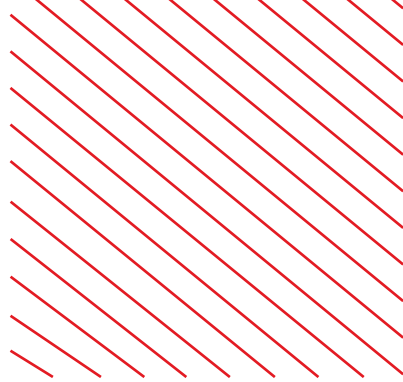
property to determine the cost of the assets they have acquired.

Tom acquires the goodwill of a business for 50% of next year's profits.

At the time of contract he considers that the market value of the earn-out right is \$225,000.

This will be the cost base of the goodwill.

Contact Frost Crane & Co with any queries on the sale or purchase of a business.



A valuable sacrifice: Salary sacrificing super contributions

Salary sacrifice is an arrangement between you and your employer where you agree to forego part of your future salary or wages (e.g. that which is yet to be earned) in return for benefits of a similar value:

- super
- car fringe benefits, and
- expense payment fringe benefits, such as
 - school fees
 - child care costs, and
 - loan repayments.

Employers are not obliged to offer salary sacrifice arrangements. You should ask your employer if they do so and what you will need to do to assist. An employer may charge an administration fee to implement salary sacrifice arrangements.

“The sacrificed component of your total salary package is not assessable income for taxation purposes, not included as income on your payment summary, and is not subject to PAYG withholding tax.”

Benefits of salary sacrificing super contributions include

- Salary sacrificed contributions made to a complying super fund are not considered a fringe benefit for tax purposes. Your employer:
 - will not be liable to pay fringe benefits tax (FBT) on them, and
 - won't need to include them as a reportable fringe benefit amount on your payment summary.
- If you are under 75, your employer can usually claim a tax deduction on salary sacrificed contributions made on your behalf.
- The sacrificed component of your total salary package is not assessable income for taxation purposes, not included as income on your payment summary, and is not subject to PAYG withholding tax.

- Super contributions through a salary sacrifice agreement are taxed at only 15% (maximum).

Salary sacrifice limits

Depending on the terms of your employment, there may be no limit to the amount you can salary sacrifice.

However, salary sacrificed contributions form part of the super fund's concessional contributions taxed at the low rate. There is a cap on the amount of concessional contributions for each person for each income year.

Concessional contributions also include:

- your employer's contributions under the super guarantee, and
- any additional contributions your employer makes on your behalf.

To avoid paying a higher rate of tax on your super contributions, ensure that your salary sacrificed

amount and any other concessional contributions to your super fund do not exceed the cap amount.

It may be possible for you to make salary sacrifice super contributions for your spouse, however the tax implications are less favourable for both you and your employer. Contributions such as these are a fringe benefit. Your employer is liable to pay FBT on the amount, and your payment summary includes the amount as a reportable fringe benefit.

An effective arrangement

By making super contributions under an effective salary sacrifice arrangement, there are benefits for both you and your employer.

The key is good communication between you and your employer, clearly documenting the agreed arrangement, and thorough record-keeping by both parties.



Spotlight on John Mackay

"I was born in Kempsey on the mid north coast of NSW. My heart is still very much in the country," says John Mackay, who joined Frost Crane in 2007.

John came to Sydney in 1969, finished high school, and went to work with Johnston's Transport, which at that time was Sydney's largest privately owned transport company with more than a hundred trucks. He remained there for 20 years, progressing through the company as a driver, forklift driver, storeman, loading supervisor, freestore manager, accounts clerk, paymaster, financial accountant, and then management accountant. "The focus of my management accountant role was the development and maintenance of costing models, which helped to maintain the position of the company as a leader in its field."

John went on to buy a small farm near Tamworth and worked for 10

years with a smaller local, family-owned transport company, in a "much more hands-on role." He was responsible for administration, financial and management accounting, as well as operations when required, and was instrumental in winning and implementing a major logistics tender in Queensland.

"Grass roots experience has given me a great appreciation of issues from operational, practical, management, and financial viewpoints," he says. "I enjoy helping clients grow and improve their businesses, arranging their financial affairs in a way that suits their needs and aspirations."

2009 has seen John's family grow with the birth of two grandchildren, Susannah and Hamish. "The whole family shares my love of the country," he says.

"Grass roots experience has given me a great appreciation of issues from operational, practical, management, and financial viewpoints."

Super & retirement: Related but not synonymous

When will you access your super? Whatever your situation, it is imperative to talk to a professional to fully understand the range of options at your disposal, the opportunities for gain, and the ramifications of your decisions.

Some facts

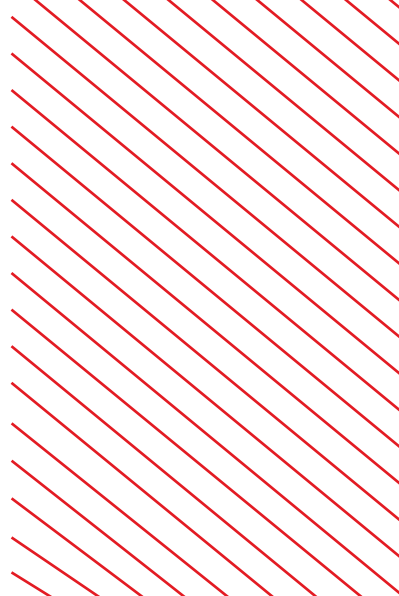
- You can access your super when you reach preservation age and retire, or when you turn 65, even if you haven't retired.
- You may also be eligible to access some super under transition to retirement rules, in severe financial hardship, or on compassionate grounds. If you need access to your super before you reach preservation age or retirement, your super fund will advise terms and conditions and it will make the final decision about releasing benefits.
- Even after you have retired and received your preserved super, you can still return to work.
- Preservation age is not the same as your pension age, which is when you may become eligible for government pension benefits, depending on your income or assets.

- Your preservation age depends on your date of birth, on a sliding scale (consult the ATO or Commonwealth Super Scheme websites to check your preservation age).

Someone born prior to 1 July 1960 has a preservation age of 55. However if you were born since 1 July 1964 your preservation age is 60 which could significantly impact your working future.

Generally, super benefits are either preserved benefits or restricted non-preserved benefits, for which there are requirements before release of funds, or unrestricted non-preserved benefits, which are readily accessible.

Since 1 July 1999, all super payments and all earnings are preserved. Your annual super fund statement will list your totals in preserved and non-preserved categories.



“You can borrow personally, giving personal guarantees. In this case, the loan is not subject to any superannuation borrowing restrictions and the interest on this loan is the normal interest rate.”

SMSF borrowing

While regulated super fund trustees are now enjoying the right to borrow, we all know that trustees cannot borrow as easily as individuals might borrow.

One of the important requirements to meet is to ensure the loan is a limited recourse loan: where the lender rights against default by the super fund trustee on the borrowing (or on its sum and total charges) are limited to rights relating to the asset being acquired.

As a result, lenders bear more risk than usual. To help defray the extra risk, they may charge higher than normal interest rates. In other words, trustees pay a risk premium on borrowings, typically an interest rate that is 1–3% higher than the going rate.

Bank practice usually requires related parties to give personal guarantees for borrowings and SMSF borrowings are no exception. Many banks have been asking members of SMSFs to give personal guarantees and the ATO has flagged related party guarantees as a cause for concern.

A high-value solution

You can borrow personally, giving personal guarantees. In this case, the loan is not subject to any superannuation borrowing restrictions and the interest on this loan is the normal interest rate.

You can then on-lend the money to your SMSF. The interest on this loan is the normal interest rate plus the risk premium. Because you control

the loan, you can choose not to require related party guarantees. If related parties lend to their SMSF, the interest rate must be at the ‘commercial rate of interest.’

Complying with these requirements provides an important arbitrage opportunity. You can borrow at, say, 9% and on lend to the SMSF at, say, 10.5%. By using related party lending, the risk premium stays within the family group. It is this risk premium that adds tremendous value.

This is a beneficial arrangement. Compliance is often looked upon as a cost and not a source of profit; in this case, you could see significant returns simply by following the requirements.

Case study

Trustees of an SMSF with \$1million cash resolve to buy business real estate worth \$2million and seek to borrow the balance of the money to acquire the asset. The fund’s investment strategy and governing rules expressly allow for such an arrangement. Either the fund borrows directly from a bank or borrows from its individual trustees.

In the first instance, the fund will pay an effective interest rate of 10.90%, and the trustees will be required to give personal guarantees. However, in the second instance, the fund borrows from its trustees. The fund pays an effective interest rate of 10.90%. The trustees will borrow from the bank and will personally pay only 9.26% interest. The difference, 1.64% on the amount borrowed, represents real profit for the trustees while the fund benefits from the acquisition of the asset.