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TECHNICAL GUIDE NO 1

TAX EFFECTIVE FINANCING

Often the most important business decisions are in the area of asset purchase, how they are purchased, the refinancing arrangements for the purchases, and the finance arrangements when assets are sold.

The tax effectiveness of the process depends on a number of factors, of which the most important are in the use of the preferred legal entity. There are very stringent rules on the tax deductibility of interest. Suffice to say that whenever an asset acquisition of disposal or loan financing (business or private) is contemplated advice should be obtained to ensure that the maximum tax and minimum cost positions are achieved.

FINANCE HINTS

Here are some basic rules for maximising the tax deductions on interest on borrowings:

1 "Always borrow for business, pay cash for private".

If you have a business capital expenditure to make, eg purchase of an item of equipment, and as well you have some planned private expenditures, eg house renovations, holiday, then the best tax relief is obtained if you take a loan out for the purchase of the equipment rather than use the cash to buy the equipment and have to borrow for the private expenditure. The interest on the business loan is fully tax deductible rather than non deductible in the case of the private loan.

Of course if you do not have any private use for the cash fund then it can be used to purchase the business asset outright.

It is generally not advisable to borrow money at a higher rate of interest after tax than you are earning after tax on the investment.

An extension of this basic rule is to pay off all private debts as quickly as possible and leave the business debts to last, eg paying off private home mortgages as soon as possible before business loans which preferably would be interest only.

2 "Roberts case" finance restructuring

This tax court case involved a partnership in which its partners had contributed a certain amount of equity over a period of years, which was reflected in the partners asset accounts. The partnership agreed to borrow funds from the bank to repay a portion of the partners current accounts. These funds were in turn used to repay private debts or for other private uses. This restructuring resulted in the interest on the new loan being tax deductible.

This type of restructuring is now acceptable for all business structures such as companies, trusts and partnerships (but not joint properties or sole traders or practitioners) as a means of refinancing owners loan accounts with tax deductible external debt. The refinancing is only allowable to the extent of original capital or loan funds provided by the owners and cannot be used to refinance asset valuation increases. In addition the refinancing is not effective in non business dealings, eg property refinancing in joint or single names.

3 Cost of finance.

One of the most difficult issues to resolve when organising finance is to determine which is the most effective and cheapest.

The decision is complicated by allowing for the up front and ongoing borrowing costs such as application, mortgage and loan servicing fees, which can vary substantially between financial institutions. The costs need to be added to the interest costs and spread out over the term of the loan so that the true cost of finance is determined. Sometimes the interest rate charged on the finance is difficult to determine, eg in leases and consumer mortgage, the monthly repayment is often quoted by itself and unless the question concerning what the effective rate of interest is asked, the ability to compare different quotes is almost impossible.

4 "Lease versus borrow".

There is a common misconception that leasing must be a better financing alternative than borrowing because 100% of the monthly lease payments are tax deductible. While this may be true of leases it does not mean that "loan repayments" on say a consumer mortgage are not tax deductible, rather the tax deduction comes in two different forms, ie by an interest portion and a depreciation claim on the asset which together usually add up to the total loan repayment amount.

Accordingly if the term of the finance agreement, amount borrowed, and residual/final payment are the same for both a lease and a borrow alternative the cheaper finance will be the one with the lowest "effective rate of interest". The tax deductions under both alternatives will also be similar over the term of the finance.

5 Financing options.

Variable vs Fixed Term interest rates and Term of Loan.

The decision of whether to choose a variable or fixed interest rate and the term of the overall loan depends on a number of factors including:

(a) likely movement in future rates;
(b) required flexibility to repay loans off before term expires;
(c) satisfaction that interest expense is fixed even if interest rates do fall.

Some of these factors counteract each other, eg if a fixed term interest rate is desired, then the loan could not be repaid before the term expires without a potential early repayment penalty being charged.

Suffice to say that the restructuring of rates and terms depends on the individual requirement of the borrower but that in many cases particularly with large debts over $100,000, a "cocktail mixture" of interest rate types and loan terms can provide a balanced and flexible loan structure.