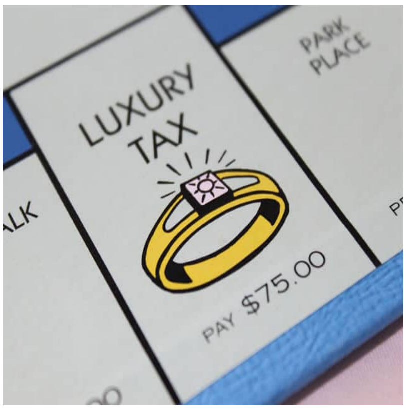

Profit versus Tax

Description

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Is your Accountant Encouraging Bad Business Decisions????

(albeit inadvertently)

Stop for a sec think about this… In a bid to reduce your taxes, do you forgo profit?

1. Do you buy up extra “unnecessary” items in the Financial Year End Sales to gain the Tax Deduction
2. Do you keep your prices down because your accountant said “If you don’t watch out you will make a profit this year” or “If you earn $200 more next year you will go up a tax threshold and have to pay GST, VAT, more tax etc.”

This behaviour is quite common in the US, UK and Australia. We have a culture of avoiding paying taxes *AT ALL COSTS*. But this mindset can lead to business failures. Don’t get me wrong, I strongly believe everyone should pay their fair share of tax – exactly what is owed- not a penny extra or one cent too little.

This post examines the “benefits” of actively reducing income and profit to reduce taxes paid, and the flow-on reduction in returns and rewards that arises as a result.
What I am concerned about is a mindset where decreasing profit is undertaken for the sole purpose of reducing or avoiding tax, the overall focus isn’t about the method of money distribution, but decreasing the total.

Let’s start by having a look at what profit really is:

> **Profit is the payback you receive for taking the risk:**
> It is a financial benefit that is realized when the amount of revenue gained from an activity exceeds the expenses, costs, and taxes needed to undertake the activity.

It may help to remember there are two sorts of profits; short-term or long-term:

- **Trading Profit** : arises from the day-to day activities of the business as it goes about selling goods and services (after expenses of course). This is the “bottom line” referred to for annual business planning.
- **Capital Gains** : arises from finally selling the business. This is the ultimate “bottom line” we get when we eventually step away forever.

Just as in the corporate world, the process of making a profit is the same for solopreneurs;

- **When you work in big business** each day and receive a salary job. You could then invest your savings in shares

on the stock-market. You would as a result of your investment receive dividends (a share of the trading profits) for risks you take of investing in those companies. Plus the shares you purchased would also hopefully increase in value over time as the company grew enabling you to eventually sell your shares for a profit (your long term capital gains)..
- **When you work in your own business** you should also get fairly paid for any time you spend working on the business.Â Just the same as any big-business salary. AND you should also get a return for the investment you contribute to your own businesses in just the same way as you would if you put your savings into shares on the stock exchange PLUS if your business has grown then when you come to cash-out a good capital gain as well.

Side Note: *For this post I am lumping any "earnings" in return for labour that an owner receives from their business the single phrase "salary" – be it as Superannuation, a fancy car, holiday perks, or cash. This article isn't about how you categorise the money you take, there are often good tax reasons for splitting it up between profit and salary at the end of the day, the key is you make at least enough provide yourself with reasonable returns and rewards, and preferably more.*

By making profits we are also able to building something more; a saleable business with its own intrinsic value. It is profitability that potential buyers will be looking for when it comes time to sell your business, not little tax you have managed to pay. If you plan to sell your business in the near future, then increasing profitability, and reducing any extra "unnecessary" expenses will also enable you to increase your asking price.

Now, without getting complicated and tax-ey, as far as I know global corporate tax systems all have tax rates of less than 50%, and none have tax rates that are 100% or more. What that means is for every $1 dollar of profit you make (all of your income less all of your expenses) even at the highest tax rate, you still end up with 50c to either reinvest in your business or take out as a dividend.

This also is Fifty Cents more than the Zero Cents you have when you avoid making any profit in the first place.

So why would anyone avoid making profit if it is the only way you can get repaid for all the risks you have taken?

Side Note: *Actively avoiding profit is different to running a washed-up business – in the first instance there is the capacity to sell more and/or raise the prices to improve profit; in the latter instance there are insufficient customers/clients to sell to and therefore the problem is actually one of insufficient revenue to cover costs. Avoiding profit requires a conscious decision; the activity of purchasing "extra and luxury" expenses that add very little value to the business, or choosing to stifle revenue streams to ensure profit is forced down.*

Minimising tax v Maximising profit

Small and Micro-Businesses in particular seem to struggle with this, having had some fear or paranoia about "paying tax" instilled into them by their family, their accountant some other non-financial advisor, so they work hard to hide, shuffle and reduce their profits as the main method of reducing their tax.

Does Your Profit Management Look Like This?

A while ago came across a bright young jeweler starting out, Simone loves her work but for three years has ensured she earned less than the Australian GST threshold so she could "*avoid paying the GST*" by billing less than $75K Revenue each year.

Once she took into account the costs of materials, insurances, and other day to day running expenses she was consistently making losses which she had funded by hocking up her credit cards. So, as her business debts increased the borrowing costs increased as well.

Worse still, as her business floundered Simone was forced to take less and less home for herself, only living on a salary of about $15,000 a year.Â She was deliberately keeping her salary below the lowest tax threshold of $18K to reduce the amount of tax she had to pay personally. Unfortunately this also meant she was living below the poverty line.

When she came to me she was stressed to the eyeballs, eeking out a living and barely coping day to day, she had lots of back orders, but no money to buy the materials to fulfill them.

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Simone wholeheartedly believed if she did fill the orders a fate worse than death would befall her – she would "have to pay GST"; in her she would somehow have failed is she "made a profit" and had to pay income tax…

She had big dreams of growth, great ideas to pursue and was hoping to save up for her up-coming wedding.

Of course, given her mindset, reaching any of her dreams, even simply buying a new piece of equipment was impossible – there was simply no money available.

The solutions are easy:

1. **Starting by explaining she was already PAYING GST**, it couldn't be avoided – every single time she purchased anything for her business this tax is present – entering the GST system actually give her a benefit, she was now able to claim a credit for the GST on all her purchases, effectively making her business 10% cheaper to run. With a better understanding of the system she might have been concerned about "charging" GST once she hit the threshold… Many people believe going over the GST threshold will lead to a price hike, this is also not true – by entering into the GST her business became 10% cheaper to run, she could maintain the same prices, still pay 10% to the government and make exactly the same profit margin. Avoiding Revenue to avoid tax turned out to be unnecessary.
2. **Her next fear was of doing the "paperwork",** again although she didn't realise it, she was doing that anyway – with a small amount of training she was empowered to do accounts monthly instead of her annual "shoe-box shuffle". Overall she reckoned the time spent was actually much the same, but by learning how to do the basic bookkeeping herself she also became a much better business manager as she now had greater transparency around the decisions she is making.

3. **Her final fear was that paying taxes would make her worse off**, as already discussed, profit taxes are marginal, i.e. a PORTION of the total profit goes to the taxman, which means SHE GOT TO KEEP THE OTHER PORTION. And, as the proportion that goes to the taxman is always less than half of the total, in her case she got to keep two-thirds of all her profit to either re-invest in new equipment etc, or take out as a dividend. Once she got her head around this she freed herself up to profit.

So, what it all boiled down to was misinformation

When she let go of her per-conceptions of how the tax system actually worked, she was able to also let go of her preconception that making a profit was somehow going to work out badly….

She went on to change her business model to one where she limited her production to the number or hours she wanted to work, instead of the number of hours that capped her revenue to $75K.

Now she takes deposits upfront, uses that to purchase materials, pays herself a competitive salary, AND still makes a tidy profit – she is now a much happier person, and a much more successful business owner.

Making Profit ALWAYS WINS over Avoiding Tax – Always!

Sometimes it may make sense to forgo profit to be able to take money out of the business as a bigger salary, or larger super contribution – how you organise your personal returns is best left up to you and your tax adviser.Â W**hen decreasing profit is undertaken for the sole purpose of reducing or avoiding tax;**
that is simply bad business.

It is always unsustainable over the long-term because making a profit enables us to reinvest, buy new assets, renew our equipment, to borrow and replay loans. Without profit our business is really just a way of providing ourselves with a salary, instead of having a job. There are rarely, if ever “benefitsâ?• to actively reducing income and profit to avoid taxes. Without profit a business is unable to grow, and without growth a new business is usually unsustainable.

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Date Created
20 February 2022
Author
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