Accounting and taxation aspects of financing management rights

Financing costs are a significant expense in the operations of a management rights business so it is important they are structured correctly to maximise the potential taxation benefits.

Here are a few tips to help ensure you optimise those taxation benefits.

Good and bad debt!

When looking at the various loan options on offer for a purchase of a management rights business most people would assume that the loan with the cheapest interest rate and fees is the best loan. That is a reasonable presumption and would be true if you were taking out a normal home loan to buy your residence and tax deductibility of interest was not an issue.

However once you are borrowing to buy a business asset or investment, the tax deductibility of the interest on that loan becomes an important factor. Any loan upon which the interest is not tax deductible (such as a home loan, credit card or personal loan) is what we call "bad debt" as the interest on those loans is not tax deductible. Conversely loans upon which the interest is tax deductible are "good debt".

For instance, a non-tax deductible loan with a 5 per cent interest rate will actually cost you more than a tax deductible loan at 7 per cent - sounds strange, but it is all to do with the tax deductibility of the interest! One of the key tax planning strategies in any business is to eliminate any "bad debt" and only have "good debt".

Structure of borrowings

When purchasing a management rights business there are two assets acquired, the managers unit and the business.

The managers unit is generally treated as the manager's principal place of residence, which means the interest on any loans to acquire this unit will not be tax deductible (just like a normal home mortgage).

The management rights business is as the name says 'a business' and therefore the interest on any loans to acquire this asset will be tax deductible.

A lender will want to take security over both assets in financing the

purchase of the business. The subtlety and what determines the tax deductibility of interest on a loan is how the loans are structured. Take at a look at the following two scenarios It is not uncommon for a lender to propose two loans:

- A home loan over the manager's unit (usually the lowest rate loan); and
- A second loan over the business

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Scenario 1 below looks attractive on the surface as most of the borrowings are against the unit, and the home loan will have the lowest interest rate.

However from a taxation perspective this is the worst possible scenario as the interest on the home loan will not be tax deductible.

The only interest that will be tax deductible will be on the business loan, but this loan represents less than half the borrowings for the business.

Contrast this with scenario 2 where all the borrowings are against the business with the unit merely being used as part security for the business borrowings. The way this has been structured from a

Scenario 1	Unit	M/Rights	Total
Cost	500,000	1,000,000	1,500,000
Home loan	(400,000)	0	(400,000)
Business loan 1	0	(350,000)	(350,000)
Nett equity	100,000	650,000	750,000

Scenario 2	Unit	M/Rights	Total
Cost	500,000	1,000,000	1,500,000
Home loan	0	0	0
Business loan 1	0	(350,000)	(350,000)
Business loan 2	0	(400,000)	(400,000)
Nett equity	500,000	250,000	750,000

taxation perspective is that the purchaser has used their cash equity to purchase the unit with the balance of funds applied towards the business. The bank borrowings are therefore specifically applied towards completing the business purchase with both assets used as security. This is the most tax effective way to structure your borrowings.

This process is made easier if there are different entities purchasing the manager's unit and management rights business, which is fairly common particularly in medium – large buildings.

In this case all borrowings should be in the name of the entity purchasing the management rights business.

	Bank 1	Bank 2
Business profit	200,000	200,000
Less interest on loans ($700,000 @ 6 per cent)	(42,000)	(42,000)
Taxable Income	158,000	158,000
Less tax @ 30per cent	(47,400)	(47,400)
Less principal repayments	(35,000)	(70,000)
Nett income to managers	$75,600	$40,600

Principal repayments on loans – how much?

There are two components in any loan repayment, interest and principal repayments. Most financiers will generally require some level of principal repayments on a loan, though the amount can vary substantially. The first thing to keep in mind is that it is only the interest on a loan that is tax deductible.

Any amounts you pay off the principal of a loan are not tax deductible, which means this amount is coming out of the after tax profits of the business.

If the principal repayments are too high, it can severely curtail the cash flow of the business and leave the manager with limited funds.

Let's take the following example to explain the issue:

- Business profit of $200,000, multiple of five times, so purchase price of $1,000,000
- Managers cash equity towards purchase of $300,000
- Two bank loans of $350,000 each; total $700,000
- Interest rates are 6 per cent
- Business is in a company, flat tax rate of 30 per cent
- Bank 1 will allow interest only on the first loan but P&I over 10 years on the 2nd loan
- Bank 2 requires P&I on both loans over 10 years

As you can see the differences in principal repayments between the two loan options makes a significant difference to the manager's net income.

Debt reduction is important in any loan structure and should be encouraged; however it has to be at a manageable level. You need to carefully consider the loan payment amounts in assessing any finance proposal, don't just look at the interest rate. ■

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