

Introduction to

Tax Effective Investment Structures

Contents

1. Purpose of this Report.....	2
2. Considerations when structuring Investments.....	3
3. Without information, What strategies do people generally use?	4
4. Available vehicles for structuring an investment.....	5
5. What is a trust?.....	6
6. Types of trusts available.....	7
7. Conclusion.....	8

1. Purpose of this Report

This report is prepared as an introduction to understanding structures used in tax planning and the considerations required when structuring investments.

Taxation, retirement, litigation and family succession are factors relevant to most considerations

When planning for the future it is important that asset investments (made with hard earned dollars) are protected and that the appropriate legal and taxation structures are put into place.

The report is designed to create awareness of the possibilities. More details are sometimes made available at seminars we hold and other we participate in including those held at meetings of the networking group Sydney Property club. Also e-newsletters of Property Tax Specialists have a lot of items dedicated to tax issues relating mainly to investments in property assets.

2. Considerations when structuring Investments

When structuring investments, whether property, shares or business, considerations should be given to the following matters:

Asset Protection

One of the major considerations which wealthy people have when planning an investment, is how to limit the risk associated with their trading business/professional, from reaching their home and other investments, in the event of disputes, litigation or other unforeseen downturns.

Income Tax

Given an individual or family's circumstances, goals and desired lifestyle, the objective is to select structures, which will maximise the investment returns – after tax.

Retirement Planning

Appropriate structures help produce the results which will contribute towards maintaining the desired lifestyle after retiring.

Family succession

Most people seek to pass their wealth onto their children. Appropriate structuring should ensure that assets are transferred to the younger generations without excessive leakage of tax, stamp duty or other costs.

Negative-gearing

By its very definition, 'negative' implies loss. Generally this loss is offset against capital gain in the value of the asset. It becomes a timing issue – trading losses now in favour of perceived capital gains on sale. Where there are economic benefits, negative gearing is possible in suitable structures, without the effect of quarantining losses.

Refinancing

Because interest on loans taken out to finance income generating investments is tax deductible, the objective with re-financing is to use cash to pay for private assets, such as home, and finance income generating investment assets

Costs

Consideration has to be given to the costs of setting up and maintaining the structures. Benefits of structuring, sometimes intangible, have to exceed benefits. Depending on circumstances benefits may be long term while setup and administration outlays are shorter.

3. Without information, What strategies do people generally use?

Without information, people generally acquired investments in their own name.

Real Estate

Real estate investments are acquired and held by

- the primary income earner in his own name or
- jointly held between spouses, family members or
- severally held by friends or associates

Shares

Same as Real Estate.

Businesses

There is more creativity in structuring trading businesses. Most advice revolves around limiting liability from failure of the business so - the structures have revolved around:

- companies
- discretionary trusts

First Home - principle place of residence

Young couples and first home buyers in general have to consider what options are available to them to financially assist them in acquiring their first property, or upgrading to a better one.

If it is accepted that many professionals (with families) move out of their first home within 3-7 years and before repaying the mortgage, consideration should be given to the benefits of acquiring that first home in a trust, and retaining it as an investment while they move to another

With real estate, once people are sold on a strategy with negatively geared property held in a primary income earner's name, little consideration is given to the time when the property stops being negative and starts becoming positive producing taxable income.

Some recommendations advocate the acquisition of another property with larger loan secured by both properties, without addressing the issue about of when both properties are producing positive net taxable income.

4. Available vehicles for structuring an investment

Some of the structures to be utilised in holding an investment include:

Individuals

Holding an investment in an individual's name does not provide the following:

- protection of assets from creditors/disputation/litigation etc
- flexibility with distribution of income

Partnerships

Partnerships are in a similar situation to individuals. It does however allow some sharing of income (not distribution with flexibility)

Owning property as tenants in common provides a separate interest in the asset for each partner. This may offer better security against creditors for at least the partner who is not exposed to a business risk.

Companies

A company has liability limited to the amount of capital subscribed as shares. While better than individual and partnerships, in offering some asset protection, shareholders are exposed if personally sued, when the shares are owned in their individual names..

Companies are not suitable for holding appreciating assets like property and shares. Generally, this is because the 50% discount on capital gains from assets held for over 12 months is not available. When the gains are distributed as dividends they will be assessed at the individual's marginal tax rate – unsuitable where this is above 30% franking credit rate.

Trusts

In their various forms (see below) and to various degrees, Trusts offer more flexibility and better asset protection.

Bankruptcy laws allow clawback of assets if transferred when an entity is already insolvent or has indications of trouble.

Structuring is best done as early as possible.

Superannuation Funds

Because the government's aim is to ensure benefits flow to beneficiaries, thus reducing welfare payments, Superannuation funds regulations are very strict. Notwithstanding this with careful considerations there are opportunities available.

5. What is a trust?

While I am not a lawyer the following fictitious story is shared to illustrate the point.

Consider the days of Robin Hood, King Richard and that evil brother King John.

In those days, King Richard was away crusading in the Mid East somewhere. While preparing to go on his huge adventure, he would ask his knight, lords, earls etc. those guys who owned land (which he granted – as King), if they wanted to accompany him.

If they refused, they risked him taking back the land. If they accepted, they may die either in battle or on the journey. Having died the land is available to be taken back by the king.

So those lovable people who gave us bookkeeping, the monks, came up with the idea of having control of the land but not direct ownership. Result is protection.

Consider these lines (& interpretation) between King Richard and his brother John as he is about to leave:

King Richard to brother John “I appoint you trustee”	I appoint you legal owner - trustee
“I entrust the estate and lands of England in your care”	Set up the trust assets - corpus
“You are to manage and look after them for the benefit of the people and the family”	Identified the beneficiaries Identified the responsibilities of the trustee – usually specified in the trust deed

Individuals are referred to as natural persons in law. As such they are entities. They can sue and be sued.

Companies are referred to as legal entities as they are defined in the Corporations Act. They can sue and be sued.

By contrast a trust is only a relationship between the legal owner (trustee) and beneficial owners (beneficiaries). So a trust is not an entity in its own right – even though ATO makes references to it as such. All liability is taken on by the trustee.

Title to all trust assets is held in the name of the trustee.

6. Types of trusts available

The four basic trust structures are:

Non-fixed (discretionary investment or family) trusts

Flexibility in distribution - can provide a wide class of beneficiaries. The trustee may distribute income and capital to the listed beneficiaries **at its discretion**. That means to any beneficiary, with any proportion.

Suitable for close families or group of friends

Fixed (unit) trusts

The entitlements of beneficiaries are fixed and the trustee does not have any discretion in relation to the distribution of income and capital.

Suitable for parties who are dealing at arm's length where it is desired that each party's share is clearly identified.

Class trusts

The most significant area of use of class trusts is where two or more families wish to invest in a single asset. These are basically discretionary trust where the trustee is limited to distribute a fixed portion to at least one group – as specified in the deed. Then to any beneficiary within that group.

Suitable for say 2 families to acquire a large asset.

Hybrid trusts

A hybrid trust exists where different entitlements to either income or capital are allocated to different beneficiaries.

Generally this is a discretionary trust where the trustee has been given the power to issue units as well. It is a hybrid between discretionary and unit type trusts.

The most flexible of the structures

Unlike companies, trusts cannot retain income. Income must be distributed in the year in which it is earned. Like companies it can not pass on losses. They are quarantined. Careful planning is required depending on the type of asset involved and circumstances of the individuals and their goals. Careful consideration and professional advice is recommended, particularly for the inexperienced.

7. Conclusion

There is no doubt that the Australian Taxation System is complex. But the more you realise how complex it is, the easier it gets.

By learning more and understanding better, the structures available, their benefits, limitations and costs they can be tailored to suit an individual or family's circumstances and ambitions on the road to maximising their overall position.

Seek professional advice wherever practical. Simply being aware could save much heartache and disappointment. It also enables you to quickly generate alternatives to initial thinking, maximising your opportunities.

I wish all readers abundant happiness, health, wealth and wisdom.

To discuss any matter relating to structuring your rental investments, Protecting your assets or arranging your affairs for minimum tax., contact Property Tax Specialists principle adviser Shukri Barbara on 02 94118133 or email: shukri@propertytaxspecialists.com.au

Disclaimer

The comments in this introduction are intended to be for general information only. Before taking any action on any comments, professional advice on the individual's particular circumstances must be obtained.

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