

Tax Busting Property Structures

At some point, property investors ask themselves 'how should I own my investment property(s)?' Many turn to their accountant for some advice and guidance. I'm going to suggest that the decision about the ownership structure of individual properties must be made at a property portfolio level. The reason for this is that it often works out best for clients to have a combination of different ownership structures rather than holding property in the one structure. Strategic ownership structuring will see you balance out the pros and cons of different structures at a portfolio level.

Let's have a look at some common structures.

In the highest income earner's name

Probably the most common ownership structure is to hold an investment property in the highest income earner's name. The main reason people make this decision is to maximise the negative gearing taxation benefits as the property's income loss can be offset against the highest income earner's salary thereby reducing tax payable.

Pros	Cons
<ul style="list-style-type: none"> Maximises tax benefits in first few years of ownership (while the property is negatively geared) which makes property more affordable 	<ul style="list-style-type: none"> Will probably be tax inefficient once the property produces a taxable profit Will be Capital Gains Tax inefficient if the property is ever sold No asset protection Asset passes to estate on death so it need to be covered in the owner's will

Tenants in common

There are two ways to own a property with another party being joint tenants and tenants-in-common (TIC). There is no discernable ownership percentage (split) when two or more people own property as joint tenants. Should one of the joint tenants die, the ownership of the property will pass to the remaining joint tenant(s). However, owning a property as TIC allows the owners to stipulate an ownership share. This can provide good tax planning opportunities.

For example, married couple Keith and Anna want to invest in a property together. Keith is the sole income earner for the family (earning \$160k p.a.) and Anna is a stay-at-home mum. They want to invest in a property worth \$500k and have \$150k of cash savings to contribute. They have worked out that the total cost of the purchase will be \$530k (including stamp duty) so they'll need to borrow \$380k in total (\$530k - \$150k). I would suggest that Keith and Anna consider buying the property as TIC. I would allocate 100% of the cash savings to Anna and allow her to borrow enough money to reduce her income position to neutral. Then Keith can own the balance and gear his share 100%. Based on the

above numbers, I believe that Anna should own 40% of the property and Keith should hold the remaining 60%.

	Keith @ 60%	Anna @ 40%
Share of rental income after expenses except interest (say \$12,500 p.a.)	\$7,500	\$5,000
Loan amount	\$318,000 ¹	\$62,000 ²
Interest expense at 7%	\$22,260	\$4,340
Net taxable income/(loss)	<u>(\$14,760)</u>	<u>\$660</u>
Tax benefit/(expense)	<u>\$5,830</u>	<u>Nil</u>

¹ Being 60% of \$530k

² Being 40% of \$530k less \$150k cash

As the above table demonstrates, the tax benefit from this structure is \$5,830 in the first year (which is about \$200 more than if Keith owned 100% of the property). However, over the long term (30 years), this structure delivers approximately \$260,000 of after-tax income in today's dollars whereas if Keith owned the property 100%, the after-tax income would be just under \$170,000. That's a huge \$90,000 difference in after-tax income.

Pros	Cons
<ul style="list-style-type: none"> Allows tax planning opportunities should husband and wife have or accumulate cash savings and/or uneven income Good for estate planning as percentage share of ownership is included in the deceased's estate 	<ul style="list-style-type: none"> May be Capital Gains Tax inefficient if the property is ever sold No asset protection

Discretionary trust

A discretionary trust is often referred to as a family trust. In a discretionary trust it is the trustee's responsibility to distribute the Trust's income at the end of each financial year (in accordance with the trust deed). This is advantageous from a taxation perspective as we (trustee) have the flexibility to distribute income to people based on the best tax outcomes. This may be particularly useful where Capital Gains are involved (e.g. should the trust sell a property).

The biggest downside to using a discretionary trust is that it cannot distribute a loss. Therefore, any negative gearing tax losses that are made by the trust are trapped inside the trust and carried forward to offset future profit.

Returning to the above example, if Keith held the property in a discretionary trust over 30 years, it would produce approximately \$262,000 of after-tax income in today's dollars (assuming any future profit is distributed to Anna and their two children, grandchildren or any non/low income family members). This compares favourably to the after-tax cash flow if the property is held in Keith's personal name - \$170,000.

However, from a cash flow perspective, a trust is a long term vehicle. Over the first 10 years, owning the property in Keith's sole name is better (from a cash flow perspective) by about \$30,000. Over 20 years the cash flow is even between the two structures and anything longer than 20 years a discretionary trust is superior.

If you are self employed, you might be able to benefit from investing through a discretionary trust without losing any short term income tax benefits but it depends on your business income structure. Anyone that is earning a reasonable amount of taxable income from being self employed should seek specialist structuring advice to ensure business and investing structures work together efficiently.

Pros	Cons
<ul style="list-style-type: none"> ▪ Excellent tax planning for distribution of income and capital gains ▪ Good for estate planning as trust can continue after death and distribute to beneficiaries ▪ Good asset protection 	<ul style="list-style-type: none"> ▪ Cash flow burden in earlier years of property ownership is higher due to not immediately enjoying the negative gearing benefits

The major benefit of a SMSF is the tax rates. Whilst in accumulation phase (i.e. pre-retirement) a SMSF pays a flat 15% income tax and 10% capital gains tax rate. In pension phase (i.e. post-retirement), a SMSF pays no tax. Of course, super legislation is changing all the time and these tax rates (benefits) might change in the future too. However, it's very likely that super will always be concessional taxed.

Pros	Cons
<ul style="list-style-type: none"> ▪ Superior taxation arrangements ▪ Good for estate planning as trustee of your SMSF will pay super funds in accordance with the deed ▪ The best asset protection 	<ul style="list-style-type: none"> ▪ Wealth is trapped inside super until your preservation age which for most people is 60 (soon to be 67 years) which doesn't allow for the flexibility to retire early

Other trusts and companies

A company is rarely a good vehicle to hold property for the long term. The reason for this is that income losses are trapped inside the company and carried forward (like a trust), companies don't benefit from the 50% CGT concession (which applies to individuals and trusts) and companies do not provide much flexibility with how income is distributed.

There are two additional types of trusts in addition to discretionary trusts being hybrid discretionary trusts (HDT) and unit trusts. For a variety of reasons (beyond the scope of this article), it is rare that these types of trusts would be useful to property investors.

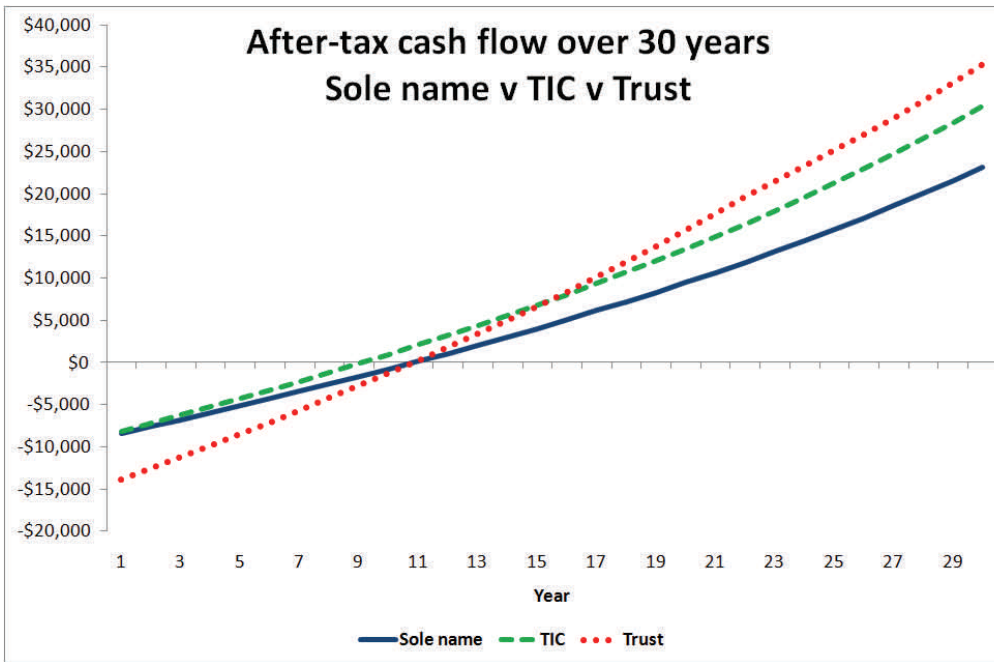
Portfolio mix – balance pros and cons

Rarely would it be appropriate for an investor to hold all their property in one ownership structure. Often, the best solution is to use a combination of ownership structures. This allows

the investor to balance the pros and cons of each ownership structure at a portfolio level. It also manages legislative risk – i.e. the risk that laws change and adversely affect certain structures.

Tax is only one consideration

Whilst it's great to develop a plan to minimise tax, there are other things we need to consider when determining our investment property ownership structures. Items such as estate planning, asset protection, retirement planning and so on are very important and difficult to put a dollar value on. It is therefore important that you are not too 'tax focused' when making these very important ownership decisions.



Self managed super fund (SMSF)

Due to changes in law made in September 2007, investing in property through a SMSF is now more attainable as SMSF's are now able to borrow (under certain arrangements). This means you can benefit from effectivly gearing using your super. It is also very tax effective as most of us can contribute up to \$25,000 a year into super and claim a tax deduction (the \$25,000 includes your employer's compulsory 9% contributions). Therefore, deciding to contribute more money into your SMSF to assist funding a property investment (and the associated loan) will reduce your personal income tax expense.

Planning is the answer

The simple solution to the ownership question is 'do some planning'! If you sit down and develop a property investment strategy from the start you can determine which properties will be held in what ownership structures from the beginning. You should financially model different scenarios to determine the best outcomes. Certain property types or investment strategies might suit certain structures (depending on the income and capital gains they are expected to generate) and this must be explored. Thinking about these things from the beginning will allow you to tax effectively develop a good, holistic solution and can quite possibly (as demonstrated in the above example) result in tens of thousands in additional after-tax income.

This article was written by Stuart Wemyss for Wealth Creator magazine (May 2010 issue).

Through mentoring, coaching and independent advice (on both shares and property—no bias) **ProSolution Wealth Advisory** proactively keeps its clients on the right track to building wealth making sure that they only make good-quality financial decisions and maximise opportunities. Contact [Jery Mourelatos](#) for a confidential discussion to explore how we might be able to assist you (including a copy of our Client Value Proposition).

Using your super as a deposit to buy an investment property

On 24 July ProSolution is hosting a seminar that will show you how to make the most of your super using the new borrowing rules. These rules allow you to use your super as a deposit to buy an investment property. If you and your spouse have more than \$130,000 to \$150,000 (combined) in super, you must come and learn how to super-charge your retirement strategy. [Click here](#) for a detailed list of what we will be covering.

Calling All Share-Market Investors with More Than \$500,000 Invested (including super)

We recently welcomed a new financial planning client aboard that approached us after being very dissatisfied with the quality and independence of the advice they received from their existing financial planner. At the time, they had approximately \$650,000 invested with their advisor (all in super). They were paying their advisor a fee of 1% of the funds under advice (\$650k) in financial

planning fees - so \$6,500 per annum. This is the 'industry standard' fee level (for investments > \$250k).

Many financial planners believe that charging clients a flat 1% fee is a satisfactory 'fee-for-service' solution (in response to the incoming laws that will prohibit commissions). It's not. Whilst it is marginally better than accepting commissions (because the total cost of advice is more transparent), it does not avoid the conflict of interest created by a percentage-based fee and it's not necessarily representative of the work involved in advising a client. It's really just a commission under a different name.

Consider the situation where you receive a sizable inheritance. A financial planner charging you 1% might be tempted to suggest you invest the inheritance rather than repaying your home loan (because the more you invest the more their fees will be). However, its possible that repaying your home loan is actually a superior option. Herein lies the conflict of interest. The advisory outcome should never influence the advisor's remuneration. A fixed and transparent advisory fee resolves this.

Also, consider the amount of work involved in advising someone with \$500,000 versus someone with \$1,000,000 invested. Does the latter require twice as much work as the former? Possibly. However, the amount invested is only one component of the cost of producing the advice. Using a fixed fee advisor allows you to benefit from the *economies of scale* in that as your investments grow (and your fee remains materially the same), your percentage advisory fee actually falls over time. Not only will you received independent advice, it will actually cost you less.

Returning to the example of our new client, not only were we able to deliver better-quality and independent advice, we have nearly halved their financial planning fees.

If you are paying your financial planner 1% (or know someone that is) and they are not particularly happy, please contact us as we may be able to develop a better all-round solution (in terms of both quality and cost).

Current Interest Rates

Basic variable (LVR < 65%)	6.45%
Offset (\$700k—\$1.1m)	0.80% disc off Std Var.
Offset (> \$1.5 million)	0.90% disc off Std Var.
2 years fixed	6.89%
3 years fixed	7.15%
5 years fixed	7.74%

Rates current as at 28/6/10 and are subject to change without notice. Standard lenders terms and conditions apply.

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