

Amazing observations: Developing a property ownership strategy

As I tried to communicate in my latest book (*The Property Puzzle*), developing an astute financial strategy requires you to model and measure the financial consequences of various structures. Doing so allows you to look into the future to see how different strategies/structures perform, which is very valuable as direct property investments are made for the long term. You don't want to wait 10 years before realising that the ownership of your property is all wrong! Time is one thing you'll never get back.

We develop financial strategies all day long. Sometimes you can correctly predict the outcomes of the financial analysis you are about to undertake for a client. However, sometimes, we are amazed by what we learn and time and time again; it proves how valuable and necessary this type of analysis can be. This newsletter looks at a couple of interesting examples. It will be a real eye opener for all investors.

Don't enjoy the tax benefits all at once!

When undertaking an analysis for a client recently we compared the benefit of owning some or all property in personal names versus holding some in a discretionary trust. An investment property will generally produce a taxable loss in the first 5 to 10 years (as rental income doesn't cover all expenses including interest). Most investors like to offset this loss against other income (salary) to save tax. One of the downsides of using a discretionary trust is that a property's taxable loss is trapped inside the trust and carried forward each year to offset future taxable profit (so tax benefits are still enjoyed, but just at a later stage) – instead of reducing your income in the year the loss is made. What we need to keep in mind is that each additional property you own may provide smaller marginal tax benefits. Let's look at this a bit closer by way of example.

Assume a property produces a \$20,000 loss in the first year. If someone earning a salary of \$100,000 acquires this property (subtracting this loss means their taxable income will reduce to \$80,000) his tax payable will reduce from \$26,950 to \$19,050 saving \$7,900 in tax.

Buying another property would reduce his taxable income to \$60,000 (with another \$20k loss). His tax payable would therefore reduce further from \$19,050 to \$12,600 saving \$6,450 in tax – which is 18% less than what the first property produced.

One of the benefits of using a discretionary trust is that you can potentially save tax in the future, when your property starts producing a taxable profit. The reason for this is that you will have complete discretion over how the property's income is distributed (i.e. can distribute to a non-working spouse or children). There comes a time when saving tax in the future is more valuable than saving tax now (because each incremental property might save less immediate tax).

The scenario we were looking at involved an investor earning \$130,000 per year. His wife wasn't employed (looking after children). We compared buying 3 properties in his own name versus 2 in his own name and one in a discretionary trust. In the table below, I set out the comparison of the aggregate after tax cash flows over 10, 20 and 30 years (it is the net present value which means the cash flows have been discounted back into today's dollars to exclude inflation). As you can see, over 10 years we are slightly worse off by having one property in a trust. Over 20 years we are about break even and over 30 years we are much better off – more than \$280k in today's dollars.

Period	Two in personal name and 1 in trust	All 3 in personal name	Difference
10 Years	\$527,598	\$582,520	(\$54,923)
20 years	\$1,644,589	\$1,628,431	\$16,158
30 Years	\$3,525,685	\$3,241,258	\$284,427

Of course, we cannot be totally "tax focused" when developing these strategies, so we must take into account other benefits like better asset protection and estate planning offered by a trust. Another benefit is the ability to minimise Capital Gains Tax should you sell a property owned by a trust (as the capital gain can be shared amongst a number of people).

The lesson we learnt from this example is that sometimes it is more effective to 'park' tax benefits in a trust and use them later.

This simple example reminded us that a combination of various ownership structures (e.g. personal name, trust, super fund and so on) within a person's portfolio often produces a far superior outcome as opposed to one ownership structure for everything – which, unfortunately, we see regularly. Using different

ownership structures also spreads regulatory risk (i.e. risk of laws adversely changing).

The hidden consequences

When investing in property, most people immediately jump to the conclusion that the highest income earner should own the property to maximise tax benefits (negative gearing). Sometimes we fall into this trap too. We were assisting a client (married couple) where one partner earned significantly more than the other. They owned existing investment properties and we were assessing the ownership structure for the next investment property purchase.

Initially we (financially) modelled the highest income earner owning 100% of the next investment property. You would think that this would be superior from a cash flow viewpoint, as he would receive the highest tax benefits (due to his high income). We then compared this to a different scenario, which involved the wife owning 100% of the next investment property. You would think that this would be inferior from a cash flow viewpoint because she would receive less of a tax benefit. We found that each option was almost identical from a cash flow perspective in the earlier years. Over the long term, the wife owning the property was far superior. This puzzled us. After some analysis and digging deeper, we identified the cause. In the first scenario (100% owned by highest income earner), the additional land tax attributed to the new investment property was fully offsetting the additional income tax benefits he would receive. Because he already owned investment properties in his personal name, he had already 'used up' the land tax free threshold, so each additional investment property that he owned attracted a reasonable amount of land tax. This 'extra' expense was eating up all the tax savings. However, if his wife owned the property she wouldn't pay any land tax (initially). She would still receive some tax benefits (albeit less than the husband). However, she would pay less income tax on the future profit (in say 10 years and beyond) that the property would produce because of her lower overall income. This 'future income tax saving' was very valuable.

This demonstrates the benefit and necessity of assessing all financial and non-financial repercussions of various ownership structures. Unfortunately, the vast majority of investors generally only focus on the immediate income tax consequences. In the long run, I am sure that they'll regret some of these short sighted decisions.

The moral of the story

I'd bet you can guess what my conclusion is? That's right. When investing, developing an astute strategy is just as important as the quality of the asset you invest in. Without a doubt, asset selection (i.e. the quality of your share and property investments) is critical. A great strategy with poor quality investments won't work. The reverse – that is, high quality investments without any strategy, may work to some degree, but will be incredibly wasteful. If you get both right, you'll have a highly efficient wealth accumulation solution and achieve your financial goals with half the worry, risk and hassle.

What you need to do with this information

- ✓ If you are considering investing in property (or shares), it is important to seek holistic advice, as many issues need to be considered, including tax (income, CGT, land, etc) consequences over life of ownership, cash flow, asset protection, estate planning and so on.

There is no substitute for independent, personal financial advice. We are experts in developing astute property investment strategies. Contact Justine Hendry (Senior Wealth Advisor) if you have any questions about our strategic financial planning services.

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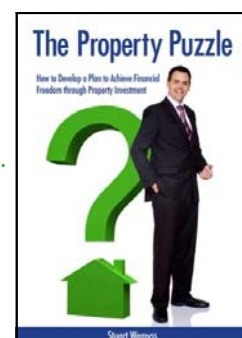
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The Property Puzzle

Failing to have an investment plan is the biggest cause of property investor mistakes such as buying the wrong property, not managing risk, wrong ownership structures, under-performing property and the list goes on. Until now, property investment books and courses haven't addressed key financial planning issues such as working out how many properties you need to buy, correct risk management, retirement strategies, estate planning and so on.

The Property Puzzle is an easy to understand "how to" guide, which teaches readers how to develop their own property-based financial plan. Complementary to all other property books, it addresses topics such as defining goals, choosing a property strategy, developing financial forecasts, managing risks, developing a retirement strategy and much more. Throughout the book, we follow the journey of new property investors, David and Susan, and discuss how they tackled certain issues when developing their own financial plan. We also interview Australia's leading property experts to help you through the planning stage.

Purchase Stuart Wemyss' latest book *The Property Puzzle* online. You can [download the table of contents and preface to learn more by clicking here.](#)



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