PERSONAL FINANCIAL STRATEGIES

YOUR PERSONAL GUIDE TO WEALTH CREATION

Super or property?

Superannuation has long been a regulatory nightmare. For many people, choosing between superannuation and property investment for the more effective wealth creation vehicle can be a confusing experience.

Over the last five years, changes have been made to simplify superannuation rules, offering some very generous bonus conditions for workers. One of these changes included the opportunity to make extra and un-deducted contributions of up to $450,000 to your superfund over a period of 3 years for those under the age of 65.

This offered an excellent opportunity for people to invest money into their future retirement. But what is the best option when comparing this with property investment?

A super strategy:

What are the key issues when considering superannuation as a wealth creation strategy?

Tax-free redemptions

Superannuation redemptions are tax free for those over 60 years old. Additionally, these redemptions do not have to be treated as assessable income, ensuring income from other sources are taxed at a lower marginal rate.

Low or no tax on fund earnings

Investment earnings are taxed at a maximum rate of 15 percent. On the other hand, earnings outside super may be subject to tax as high as 46 percent. This is significant when you consider the after tax position of either option.

Furthermore, where superannuation benefits are rolled over to an allocated pension, earnings are then tax free.

Salary sacrifice

Employees have the opportunity to make significant tax savings by salary sacrificing more into super to the annual limit on tax-deductible super contributions.

Salary sacrifice contributions are taxed at 15 percent when it is received by the superannuation fund. Employer contributions, including salary sacrifice, of more than $25,000, or $50,000 for those

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over 50 years old, is taxed at 46.5 percent.

The disadvantage of salary sacrificing is the fact that money contributed to super can't be withdrawn until you reach your preservation age and retire. This is not a great concern for someone in their 50s because this group has a major motivation to salary sacrifice as much as possible.

No contributions tax

Property investors that sell a property and place the after capital gains tax proceeds into a superannuation fund (called the "non-concessional contribution" or after tax contribution), can contribute $450,000 over three years.

Property:

Flexibility

Once your money is locked into your superannuation fund it cannot be accessed until you reach what is known as the 'preservation age'. Preservation age can range from 55 to 60, depending on the year in which you were born.

Another downside of superannuation is that you cannot use the money as security to borrow funds for any other purpose. Funds are basically quarantined.

Property on the other hand is more flexible in the sense that it can be sold to meet personal financial obligations. In many respects it is a lower risk vehicle for individuals who circumstances may change suddenly, such as having a family.

Property as leverage

Property investing is a method of wealth generation, distinct from superannuation. In principle, most wealth generation initiatives involve financial leverage or gearing (using borrowed funds) to acquire additional capital growth assets from the equity generated in your existing portfolio. Property, more often than not, serves as the basis of security to borrow additional funds to acquire assets, provided that obligations on investment loans are maintained.

Capital gains tax benefits

Many individuals are using a self managed super fund to purchase property, on the basis that this will provide a means to minimise capital gains tax if the property is sold. Whilst there is an argument for this approach, there is a downside. Property held in a superannuation fund cannot be used as security to leverage an expanding property portfolio. As a result, there are opportunity costs associated with not expanding a property portfolio in order to take advantage of CGT benefits. The forfeited commercial gain may more than offset any tax saved.

Tax deductible expenditure

Wealth generation takes advantage of leverage to accelerate the net worth of individuals by the effective selection of capital assets and taking advantage of taxation benefits that accompany the borrowings for the asset acquisition. Property investing has some generous taxation concessions that allow taxpayers to claim cash and non-cash losses on annual property expenses as tax deductions off their primary income sources.

Deciding on a strategy of superannuation or property to build wealth requires some consideration, taking into account age, personal circumstances and income. Please feel free to contact our office to discuss any of these issues and how they make impact your wealth creation strategy.

A crack down on tax discrepancies

Each year the ATO compares information from tax returns with information they receive from third parties. Where discrepancies have been identified, the ATO will generally take compliance action. This includes the issuing of discrepancy letters and amending returns.

This year, the ATO has indicated that there are two common areas that will again be under review where income is being omitted from tax returns.

Capital gains tax

The ATO, as part of its data matching program, will use information from a number of external sources. These sources will include land title offices, offices of state revenue, share registries and the Australian Stock Exchange to identify capital gains tax (CGT).

Information will then be compared with income tax returns, as well as with those who are not lodging returns.

The ATO's use of technology and sharing of information with other parties has revealed that some tax payers are omitting capital gains from their sales of property and shares.

Foreign source income

The ATO's data sources are not just limited locally, those that drive income from foreign sources need to also be dilligent when reporting their income.

The ATO receive information from their double tax agreement treaty partners, the Australian Transaction Reports and the Analysis Centre (AUSTRAC).

One of the key issues the ATO faces is that some tax payers believe they don't need to include income which they have derived overseas in their Australian income tax returns.

Individuals who derive income overseas may also find that they are eligible for a foreign tax offset for any foreign tax they have paid.

Asset protection - a family affair

Asset rich individuals and business owners need to take stock of their particular circumstances and take time regularly to review how their assets are held. Individuals should aim to hold their investments in ways that protect assets and are tax effective.

This strategy requires a three- pronged approach to:

1. Minimise tax exposure

2. Isolate business and personal assets

3. Hold assets in a separate entity

There are several methods to achieve this, but none more common than the use of a discretionary trust.

What is a Trust?

A trust is created as a result of forming a relationship where a person (the trustee) has an obligation to hold property for the benefit of another person (the beneficiaries).

A trust is not a separate legal entity. However it is, required to have its own set of accounting records and lodge tax returns with the Australian Taxation Office each year.

What is a Discretionary Trust?

In a discretionary trust, beneficiaries are not entitled to a fixed distribution or interest in the trust funds. The trustee has the discretion to decide which beneficiaries receive the capital and income of the trust and how much each beneficiary receives. The level of discretion is determined by terms of the Trust Deed, which governs the operation of the trust.

A properly established trust will provide asset protection in the case of unexpected financial setback or litigation.

Assets held in a discretionary trust are generally not available to a trustee in bankruptcy. The exception is when assets have been transferred to a discretionary trust with the intention of defeating creditors.

Distribution of Income

The Trust Deed sets out various alternatives for the Trustee in relation to trust income earned in each financial year. These alternatives include:

1. The trustee may distribute the net trust income amongst the beneficiaries. All the trust income can be distributed to one beneficiary to the exclusion of others, the income can be distributed equally, or it can be distributed disproportionately.

2. The trustee may decide not to distribute any proportion of the net income of the trust but to accumulate that income as an addition to the Trust Fund.

3. The trustee may decide to distribute part of the net trust income and to accumulate the balance of that income.

Each option presents the trustee with a different tax exposure for the trust or benefician.

From a tax perspective, discretionary trusts are an excellent way to split investment capital gains and income with beneficiaries, particularly when beneficiaries have differential marginal tax rates.

The trustee has the discretion to distribute profits to the lowest-taxed beneficiaries.

The decision to form a discretionary trust is one that must be made by taking into consideration one's personal, financial, and legal circumstances and adopted as part of an overall asset management plan.

Discretionary trusts are an excellent vehicle to protect assets. If you are not sure what steps to take next, or whether or not a discretionary trust would assist you with asset protection, we would be delighted to speak with you about your options.

Voluntary disclosures for SMSFs

If you have a self-managed super fund (SMSF) and you make a mistake when completing your SMSF annual return, you may wish to make a voluntary disclosure.

When making a voluntary disclosure, you must:

- include all the information needed by the ATO; and
- provide the disclosure to the ATO in a specified manner.

In the case of SMSFs:

- if the voluntary disclosure is solely about the regulatory section of the relevant SMSF annual return, refer to the ATO's information about voluntary disclosures;
- for all other voluntary disclosures, you must lodge a complete amended SMSF annual return.

If you are unsure of how to complete your annual return or have any questions regarding voluntary disclosures or your SMSF, please feel free to call our office.

Implications for pre-GST property

The margin scheme was introduced as part of the GST regime in order to determine the GST payable on certain supplies of land. Whilst it usually applies to sales of property by property developers, it may also apply to businesses that have acquired property prior to the introduction of GST.

Properties that are held by companies or other structures, that are now being sold to fund retirement, may be subject to the margin scheme.

Where the margin scheme applies, GST is calculated as 1/11 of the difference between the sale price of the property and the consideration for the property (or its value as at 1 July 2000 - the date that GST was introduced).

If the supplier or developer of the property acquired it prior to 1 July 2000, they may use an 'approved valuation' of the land, as at 1 July 2000, to determine its value at that date (rather than using the price at which the supplier acquired the property before 1 July 2000).

For example, property acquired in 1995 for $100,000, with an approved valuation of $150,000 at 1 July 2000, and sold in 2011 for $225,000, will be subject to GST for 1/11 of the difference between $225,000 and $150,000.

A valuation is considered 'approved' if it meets the requirements set out by the Australian Tax Office (ATO). There have been a number of disputes concerning the margin scheme, commonly in relation to whether valuations obtained are 'approved valuations'. The Federal Court recently considered what constituted an 'approved valuation' for the purposes of the margin scheme in the Brady King case.

In considering whether the valuation in the Brady King case was an 'approved valuation', the Federal Court received evidence from both the valuer, who had prepared the valuation, and an expert valuer, called as a witness by the ATO.

After considering the evidence, the court concluded that the valuation did not meet the requirements of an 'approved valuation' and as a result, the margin scheme did not apply. The court accepted that a valuation could not be ruled out as an 'approved valuation' solely due to a difference of opinion.

In the Brady King case, the failure to satisfy the requirements of an 'approved valuation' came about for several reasons. The property sold was not the same as the one acquired (an office building was converted into strata units). In addition, there was a failure to properly account for the profit margin and GST, the costs of interest on acquisition, transactions costs (such as stamp duty and legal costs) and holding costs (rates and land taxes).

As the Brady King case was subsequently overturned in a decision by a full Federal Court, which held that the margin scheme did apply, it reveals that the application of the margin scheme needs to be carefully considered when being used.

The Bookshelf

Think and Grow Rich

Author: Napoleon Hill

Back in the early 1900s, Napoleon Hill dedicated 20 years of his life to figuring out how a person can achieve the success of their dreams. By studying and interviewing 500 of the most successful people of the time, people like Edison, Ford and Andrew Carnegie, he published his findings in this classic work 'Think and Grow Rich'. Selling over 20 million copies worldwide, Hill has greatly influenced the field of personal development as we know it today.

In terms of its content, Think and Grow Rich teaches readers the 'secret to success' through a series of stories and helpful tips. Without explicitly telling the reader what the 'secret' is, Hill stimulates thought and discussion, leaving the answers for the readers themselves to figure out.

Dating back to the post Depression era, Hill analyses the psychology of thought and how it prevents or supports our dreams. Every action, circumstance, failure, or success is spawned by one thing - thought. It is your thoughts themselves and the way in which you develop and guide your thoughts that brings you to where you want to be.

This is the general idea that Hill offers in Think and Grow Rich.

The answers for what most people need to do in their life are already in their own heads – this book is about having the confidence to get there.

Napoleon Hill's success classic has created more millionaires than any other book ever printed. It is a short, easy to read publication and is a must for every investor's bookshelf. "Think and Grow Rich" is the author's most famous work.

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