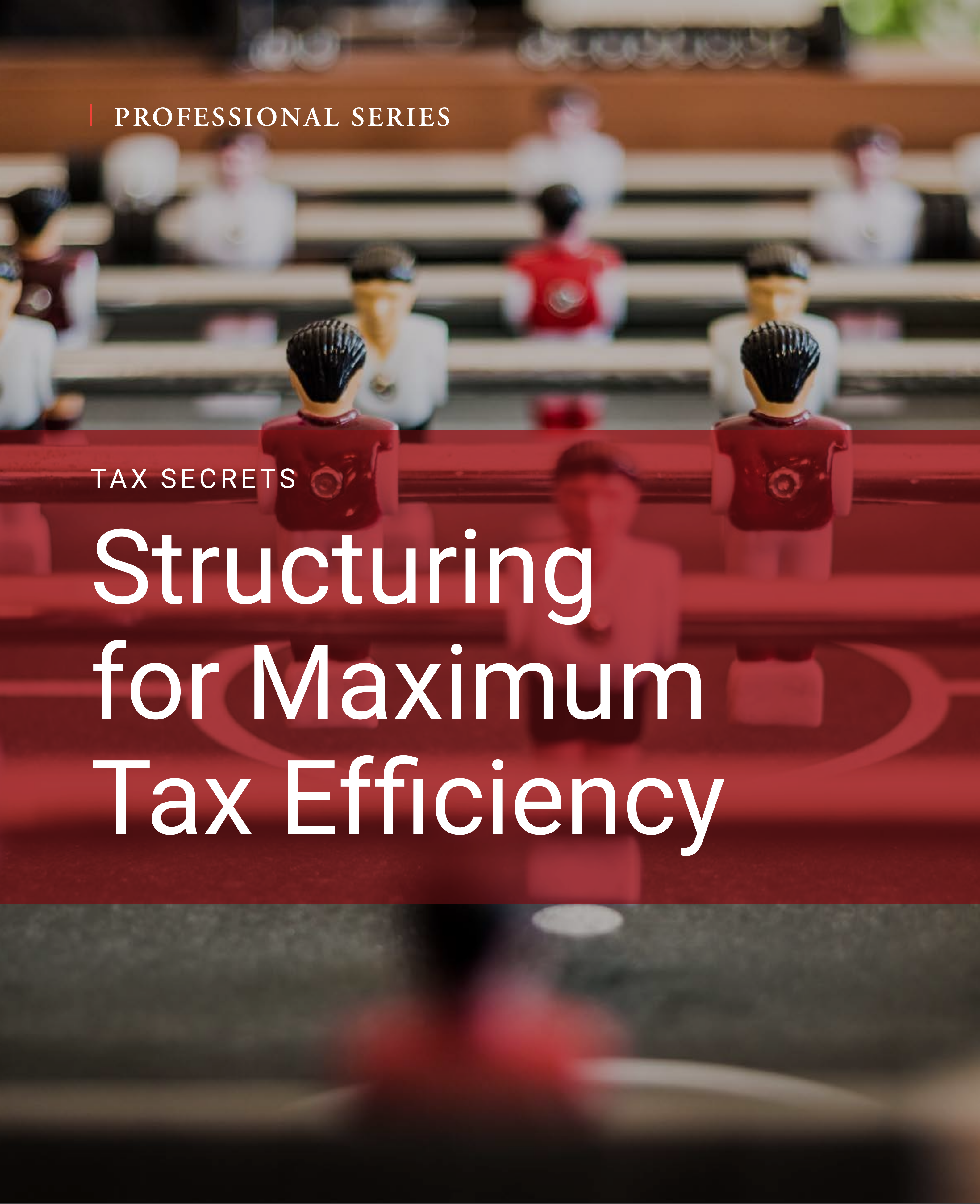


PROFESSIONAL SERIES

TAX SECRETS

Structuring for Maximum Tax Efficiency

DYMPHNA BOHOLT

I LOVE REAL ESTATE

Structuring for maximum tax efficiency

What do I mean by structuring for maximum tax efficiency?

I mean owning your asset or property in the name of the legal entity which will pay the least amount of tax, both now and in the future. Many investors take a very short term view when it comes to reducing their tax and often only think about how much tax they will be saving on their next tax return. They should be taking into account how long they intend to own the property, their reasons for purchasing the property, and how the purchase fits into their overall investment goals.

Let me explain further.

The most efficient way to earn income, and pay less tax, is to even out the family income amongst the adults, and pay the children as much as they are entitled to as either earned or unearned income. This means, in an ideal situation, the adults would earn exactly the same amount, and children able to work (at least part-time after school and on weekends), would earn an amount proportionate to their earning capacity. Children too young to work would earn unearned income of $416. This figure used to be higher when children could claim the low income offset rebate, however, this was abolished in mid 2010.

Using up the children's unearned tax-free threshold can be done by either setting up investments such as term deposits in the children's name that would earn about that amount of income for the year, or giving them a distribution from trust income.

This process is called 'using the lowest common denominator'.

When the family income comes from a business, utilising the income distribution process of the lowest common denominator is relatively easy. Typically, the business would be run through a family discretionary trust or a hybrid trust with a corporate trustee (I will explain the rationale for this later), and through a process of paying wages to family members and distribution of profits, the family income can be easily evenly distributed. Care of course must be taken to comply with the personal services legislation.

The process of evening out the family income is obviously much harder when the adults in the family earn their income from salary and wages, where earnings are fixed, and quite often very disproportionate. Clearly, simple things like putting term deposits and cash investments in the lower income earner's name all help to even out the income. Even investing the family share portfolio or managed funds in the lower income earner's name all makes good sense. But what about property or even a share portfolio that is geared (by this I mean, borrowed money invested in the share market)?

Well, this is where the tax question starts to become complicated. Many investors choose to invest in negatively geared investments in the highest income earner's name so that any tax losses resulting from the investment can be claimed as a tax-deduction against their salary or wage. Whilst this strategy may render a short-term tax benefit to the taxpayer, it will pose a tax problem for the taxpayer a few years down the track when the property (or share portfolio to a lesser extent) is no longer negatively geared, or when the property or share portfolio is sold and a capital gain is made. The additional positive cash flow or capital gain would then be taxed at the higher income earner's tax rate!

So what is the answer? To answer this properly I want to make sure you understand the full implications of what it means to invest in either individual names or in the name of a company or trust, as the ramifications are much broader than just tax.

What structures are available?

Owning property in individual names

The simplest and most obvious way to own/hold assets is in individual names. The problem is that not only do you leave yourself open to litigation, but also any income you receive from that asset is added to the income you earn from your salary or wage and may push you into a higher tax bracket. This may result in you paying more tax than would otherwise be necessary, if you were structured correctly.

Conversely, there may be significant tax advantages through negative gearing etc., that you could be giving up for the sake of asset protection if you choose to hold negatively geared investments in structures rather than in your individual names. This is particularly the case for those who earn their primary income as an individual.

There are other ways to have your cake and eat it too when it comes to negative gearing. By this I mean owning your asset in a structure name, thus protecting it for asset protection purposes and having the tax benefit of flexibility to distribute cash flow profit and more importantly, capital gains profits to the lowest income earner, but I will explain that later.

Owning property in a company name

I am constantly astounded at the number of people who go and buy appreciating assets such as real estate in a company structure and when pressed as to why a company structure was used as opposed to any other structure, the answer varies from asset protection, to, “I thought there would be more tax-deductible expenses,” to “Because the next door neighbour said I should.” All these reasons are flawed.

Companies are great structures to act as a separate legal entity and are useful as part of an asset protection system. They are even a great vehicle to use as part of a tax reduction system, but simply owning real estate, which is an appreciating asset, in a company structure, provides few of these benefits and means you are going to pay more tax in the long run.

Why is that? Let me explain:

If an investment property is bought in your own name, in a super fund's name or even in a trust structure's name, and you sell it, you are entitled to a 50% Capital Gains Tax exemption. However, when you buy the same investment property in a company structure, no such Capital Gains Tax exemption is available. This means that you will pay double the amount of tax for no reason!

I remember reading an article in the Financial Review that was reporting on a luncheon held in Sydney where there was a prominent barrister who was a tax and asset protection speaker, speaking alongside a taxation department representative. One of the discussions to come from the debate was that the Tax Office representative believed the sole purpose for owning assets in trust and company structures was to avoid or minimise tax, whereas the barrister argued both were used primarily for asset protection rather than tax. However, what was more intriguing about the article, was that the barrister was speaking about a common practice of using negatively geared investment properties to reduce tax for small business owners.

He cited a case of a profitable small business which conducted its business directly in a company structure and every time they felt their profits were up and taxes needed to be reduced, they bought another negatively geared investment property. Of course, in order to get the tax-deduction, because their business was working directly out of the company, investment properties had to be purchased in the company name as well.

In the long term, this not only caused a problem for asset protection, but it also created an ever-increasing unnecessary tax liability when the properties were sold, as the Capital Gains Tax payable on the sale of the properties would be double what they needed to be.

Companies can still be very useful structures when combined with other entities. However, we first need to understand the uses and implications of the other available structures.

Owning property in a trust name

Now let's take a look at a little more complex method of owning assets, protecting them, and having the flexibility to always distribute income and capital gains to the lowest common denominator.

The fundamental concept behind the use of trusts has not really changed very much since medieval times. Basically, a trust is a deed, or a book of rules, that sets out the rights and obligations of all the parties. There are a number of important roles described in the trust deed that carry out these rights and obligations. The main participants in a trust are the 'trustee' and the 'beneficiaries'.

The trustee is appointed to look after the assets and income, and distribute them according to the rules outlined in the trust deed. The trustee can be an individual, or more commonly for asset protection reasons, the trustee is most often a company.

The beneficiaries are the collective of ultimate owners of the assets of the trust and are the ones that receive any income and capital distributions from the trust. Depending on how the trust is written, the trust deed may allow for different classes of beneficiaries who are entitled to different classes of either income or capital. These types of trusts are particularly useful as entities that have fixed ownership, but may have the ability to distribute income to other nominated beneficiaries.

Two other positions which have responsibilities to the trust and its beneficiaries are the ‘settlor’ and the ‘appointor’, sometimes called guardian, ‘grantor’ or ‘protector’.

The settlor can be anyone, but is usually the solicitor or accountant who has created the trust deed for you, and is required to sign or execute the trust deed. The settlor is also the person who feeds in gifts, or donates the initial assets of the trust. These initial assets of the trust are usually just a nominal value such as $10 to $20. Be aware that this is a gift – it cannot then be billed to you as part of the setting up of the trust.

The appointor, also known as the guardian or the protector, in most trust deeds, is given the onerous responsibility of being able to sack and appoint the trustee.

Clearly, this means the position of appointor is one of control and the appointment of this position needs to be made carefully.

There are a variety of types of trusts that can be set up including:

Discretionary trusts –

These trusts are called 'discretionary' trusts because the trustees have the 'discretion' to decide how much income, if any, is paid to each beneficiary and how often. These are commonly known as 'family' trusts and are used often in family businesses, and when no third parties are involved. This is because a person does not have a fixed interest in the asset held by the discretionary trust, and, as such, they are dependent upon the actions of the trustee in order to receive any benefit from it.

For example, if there were 10 beneficiaries and the trust made $100, it is totally up to the discretion of the trustee as to who gets what – he or she may decide to apportion the $100 equally into $10 benefits, or may decide to give the entire $100 to one beneficiary only.

It is this flexibility that makes discretionary trusts fantastic structures for evening out the income earnings of a property, business or even share portfolio. Income and capital gains can be distributed to the taxpayer earning the least in any particular year.

Sometimes circumstances change and incomes vary from year to year. Trusts give you the flexibility to change as your circumstances change.

Example:

Mum and Dad decide to buy an investment property. Mum works part-time and Dad is the major income earner. After much consideration they decide to buy the property in a discretionary trust. In the first few years the property makes a small tax loss.

This loss cannot be distributed as only profits can be distributed from a trust. The fact that the tax benefit of claiming the tax loss against Dad's income in the early years would be lost was known to Mum and Dad, however they bought the property for the long term and the long-term tax advantages on trust ownership outweighed the short-term tax-deduction.

As expected, in a few years the property was positively geared and the profits made on renting out the property could now be offset against the tax losses that were made in previous years, thus resulting in no tax being payable until all the losses were used up.

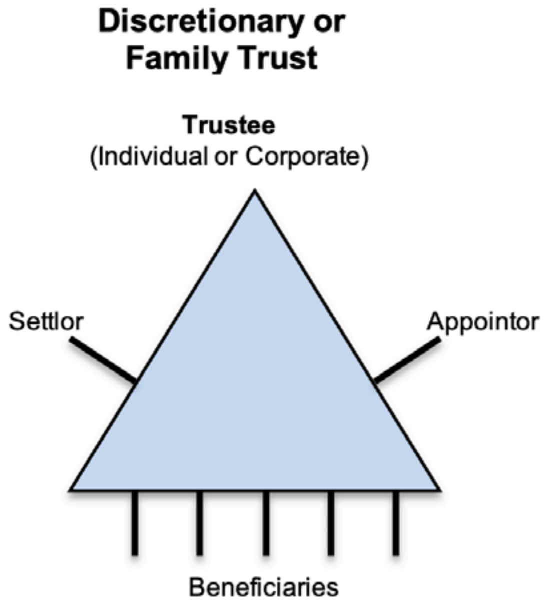
Whilst Mum remained only working part time, any profits from the rental of the property (after using up any carried forward losses) would be distributed to Mum, with a little bit going to the children in unearned distributions up to their tax-free threshold.

Similarly, if the property was sold, the capital gain could be distributed to Mum who would pay less tax than if the gain had to be distributed evenly, or even worse, solely to Dad. However, if Mum ever decided to return to full time work and her income matched that of Dad's, then the distribution of profits could be adjusted to reflect a more even distribution between Mum and Dad – or the use of a bucket company could be used to tax the profits.

Clearly, the utilisation of a trust structure through which to earn your income is not always an option, such as for salary and wage earners, or individuals who come under the personal services legislation of our Tax Act. However, I have seen too many clients wasting money by paying tax unnecessarily, when they are in businesses, and have investments where trusts could be used very effectively, and could have saved them thousands of dollars each year.

The following schedule shows how all the components of a discretionary trust fit together.

Diagram 1.1



Unit trusts

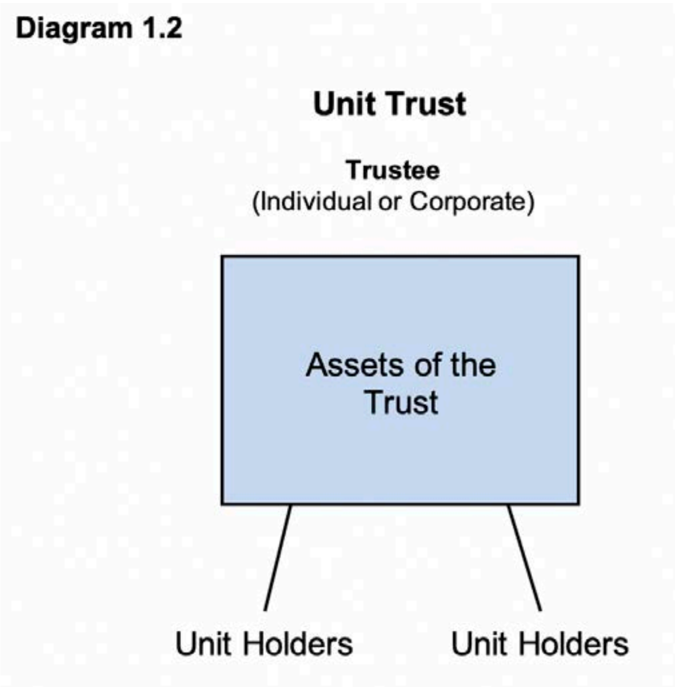
Unit trusts work in a similar way to discretionary trusts, in that they both have a trustee, a settlor and in most cases, an appointor. However, instead of beneficiaries, a unit trust has unit holders. Unlike a discretionary trust beneficiary, a unit holder has an interest in the fixed, present legal entitlement to the assets of the trust. Consequently, on their own, unit trusts are not suitable vehicles for asset protection. However, when combined with other structures such as the discretionary trusts, they certainly have their uses.

Unit trusts are more suitable for businesses carried on by multiple parties. Each of the parties, by holding units in the unit trust, has a defined interest in the assets of that trust. In this respect, unit trusts are like companies, but instead of holding shares, the parties hold units in the unit trust.

Another benefit to a unit trust is that the units can be bought and sold. This is not possible with an interest in a discretionary trust.

A unit trust however does have some associated problems with respect to Capital Gains Tax, and in certain circumstances, depreciation.

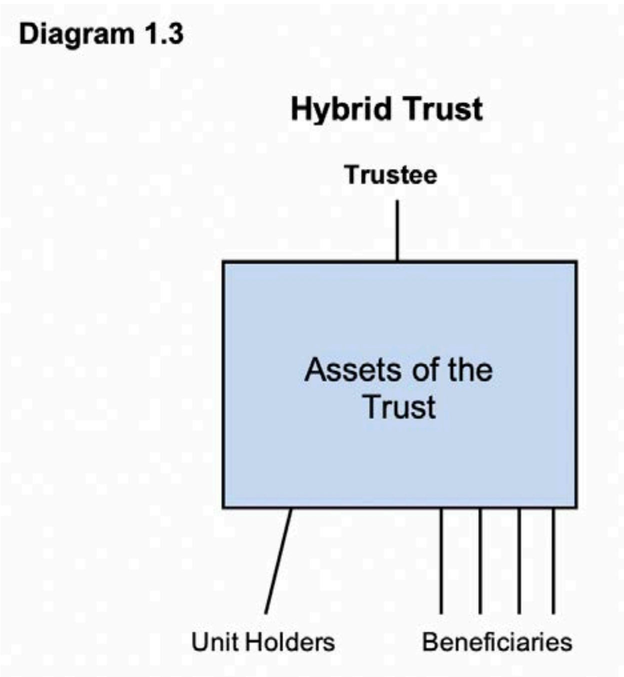
Following, is a diagram of a basic unit trust structure:



Hybrid Discretionary Trusts

A hybrid discretionary trust is simply made up of a combination of discretionary and unit trusts that best suits the needs of the company, family or individual. This type of trust is great for structuring businesses where you need to distinguish between who owns the asset or business, and who gets the income from the asset or business, because you may not necessarily want them to be the same.

This is how a hybrid trust would look:



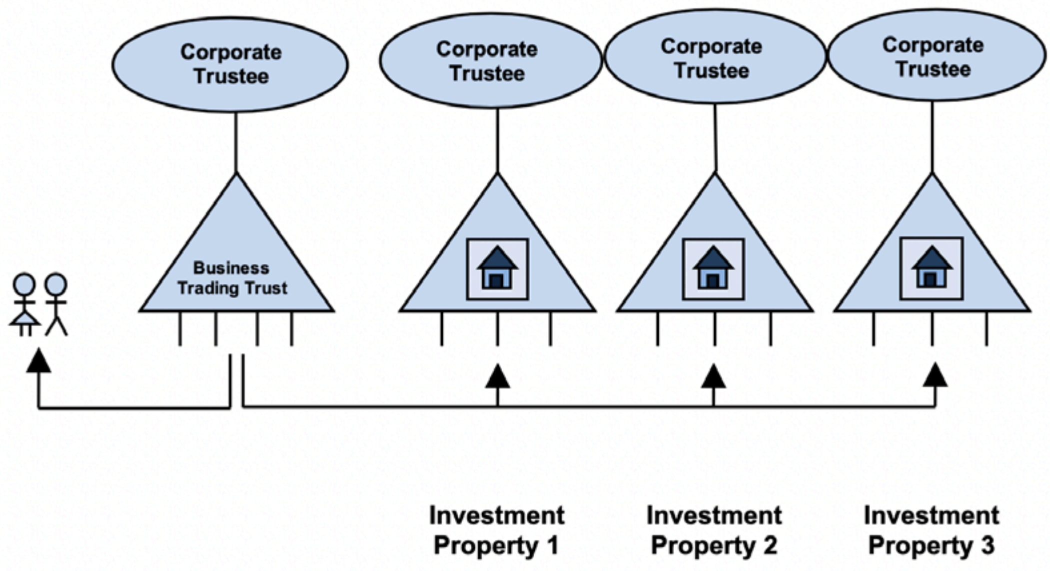
Putting a tax effective structure together

Okay, so we have looked at all the possible options of structures that are available to us. Now, how should we put it all together? Let's first consider the situation of someone in small business who wants to build a sizeable investment portfolio alongside their business activity.

Ideally, you would want to see both the business activity and the investment activity not only separated from each other, but for asset protection reasons, structured in such a way that income can be spread across the structures easily and losses from any negatively geared investment properties or business losses can be taken advantage of.

One solution would be to set up not only their business, but also their property, in a company as a trustee for a trust. This would not only give them the flexibility to distribute profits from the small business to the most tax efficient beneficiaries, it would also be ideal to take up the tax-deduction of a negatively geared investment as well as keeping assets separate for asset protection.

Ideally, their structure should look something like this:



Flexible Income Distribution Model

The best way to fully understand the impact of this, is to look at an example.

Let's consider the situation of Marge and Harry.

Example:

Marge and Harry are small business owners who run a hardware store. They have a profitable business and after paying themselves wages of 80,000 each, and contributing the maximum amount they can to superannuation, their hardware business still makes a sizeable profit of $100,000. Marge and Harry also have a couple of negatively geared investment properties that they bought some time ago for the purpose of getting a little bit of tax relief, as well as accumulating assets that would increase in value and create wealth for them for the longterm.

Now, had Marge and Harry set up their business directly into a company structure, in order to get a tax-deduction as a negative gearing benefit from the investment properties that they own, they would have also had to buy those investment properties either in the company's name directly or in their personal names.

Example:

At this stage you may be asking "why am I saying personal names?" Well you see Marg and Harry could take all the profit out of their company simply by paying themselves a higher wage. If they did that, the benefit of the extra tax-deductions gained from their negatively geared investment properties would then offset the salary that they are paying themselves from the company.

Had this been the case, that they did own the investment properties in their own name, of course Marge and Harry would be giving up any asset protection that could be gained by putting the properties into a separate structure. From a tax perspective however, Marge and Harry, as individuals, would be able to take advantage of the 50% Capital Gains Tax exemption and therefore reduce their tax when the properties were ultimately sold. This is not my favourite structure because of the asset protection implications or the lack thereof. Conversely, if they bought the investment properties directly in the company name, the negative gearing benefits could have been offset against the company profits directly.

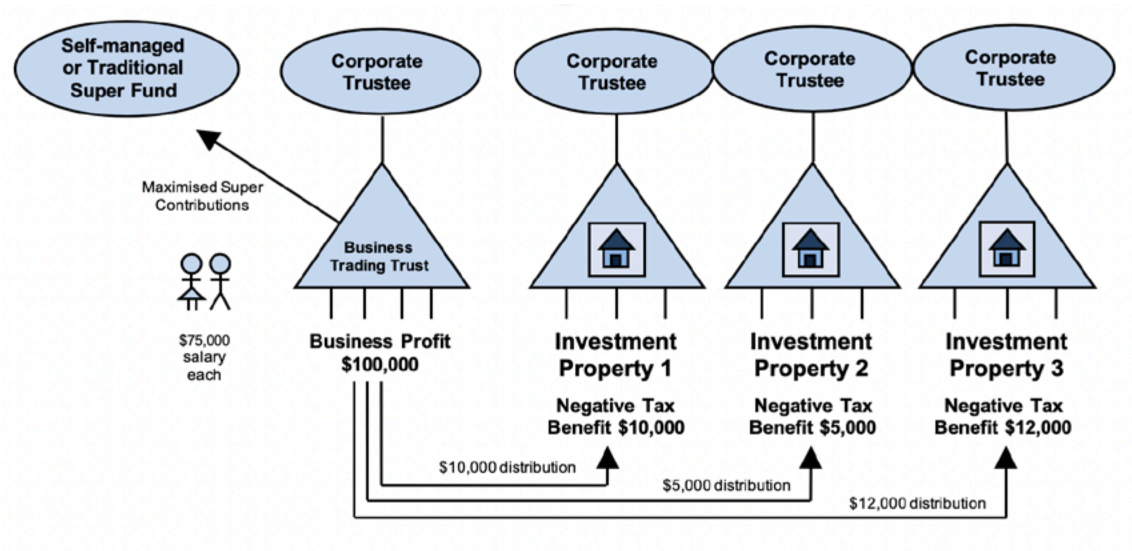
The downside of this is that when those properties were sold, the company would not get any relief or the 50% Capital Gains Tax exemption, and therefore the company would pay double the amount of tax that they would have, had they bought the properties either in their company name or a trust structure. Again, this is not my favoured structure, as the asset protection is when you have a business and real property owned in the same structure. If there is ever a litigation originating from either the business or the properties, then the whole lot is up for grabs.

So how should Marge and Harry have set up their business and how does that structure interact with the structure that they should have set up for their investment properties?

If Marge and Harry had initially structured their business as a company as trustee for a discretionary trust, the trust could have been a hybrid (but that is probably overkill, since Marge and Harry are married and both are listed as primary beneficiaries of their own discretionary trust anyway), and any profits arising from the business could then be distributed to either Marge and Harry or any 'associated entity'.

These words, 'associated entity', are actually quite important, because if Marge and Harry's trust deed was set up correctly, they would have the flexibility to place additional profits in any structure; meaning another company, trusts, superannuation fund, etc., that they are associated with. So when it came to the investment properties, those investment properties could then have been purchased in separate discretionary trust structures. This would have given them not only asset protection away from themselves and their business, but it will also have allowed the profits from their business to be distributed to those trusts, which housed the negatively geared investment properties. Thus, their tax would be reduced on a year by year basis.

The example below shows how the additional excess profits, from their business, could be distributed directly up to their investment trusts to take up the negative gearing benefits:



Example:

After Tax Distributions

Business trading profits yet to be distributed:	$100,000
Less	
Distributed to Trust 1	$10,000
Distributed to Trust 2	$5,000
Distributed to Trust 3	$12,000
Balance	**$73,000**

You will now note that Marge and Harry still have profits in their business to distribute somewhere. This is where the tax strategies start to become really interesting!

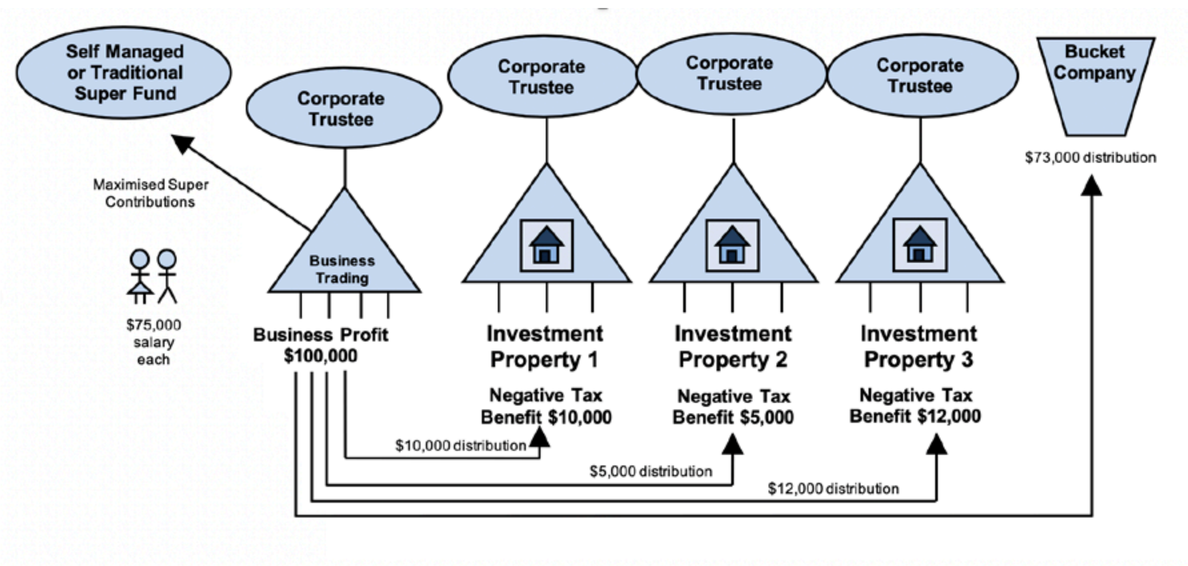
Because Marge and Harry are good little vegemites and they always go and see their accountant before the end of the financial year in about April or May, they have recognised that their profits for the year are extraordinarily high and they need to do something taxwise in order to avoid paying the top marginal tax rate on the extra profits.

Their accountant correctly advises them that it would be opportune to set up a 'bucket company' before the end of the financial year so that excess profits from their business could be distributed to the bucket company.

The bucket company would then pay tax on the excess profits at the company tax rate of 30 cents in the dollar.

For Marge and Harry this represents a tax saving of $7,300.

This is how Marge and Harry's tax structure would look now:



Note 1: DIV7A changes means distributions to a corporate beneficiary must be either actually paid to the company and money transferred into the company bank account, or a commercial loan agreement must be signed and dealt with as any other commercial loan.

Note 2: For asset protection Marge and Harry should also have a discretionary 'piggybank' trust to own shares in the trustee company and any other non-leveraged shares, managed funds, gold, precious metal investments etc. See my book "Asset Protection Secrets of a Real Estate Millionaire"

Example:

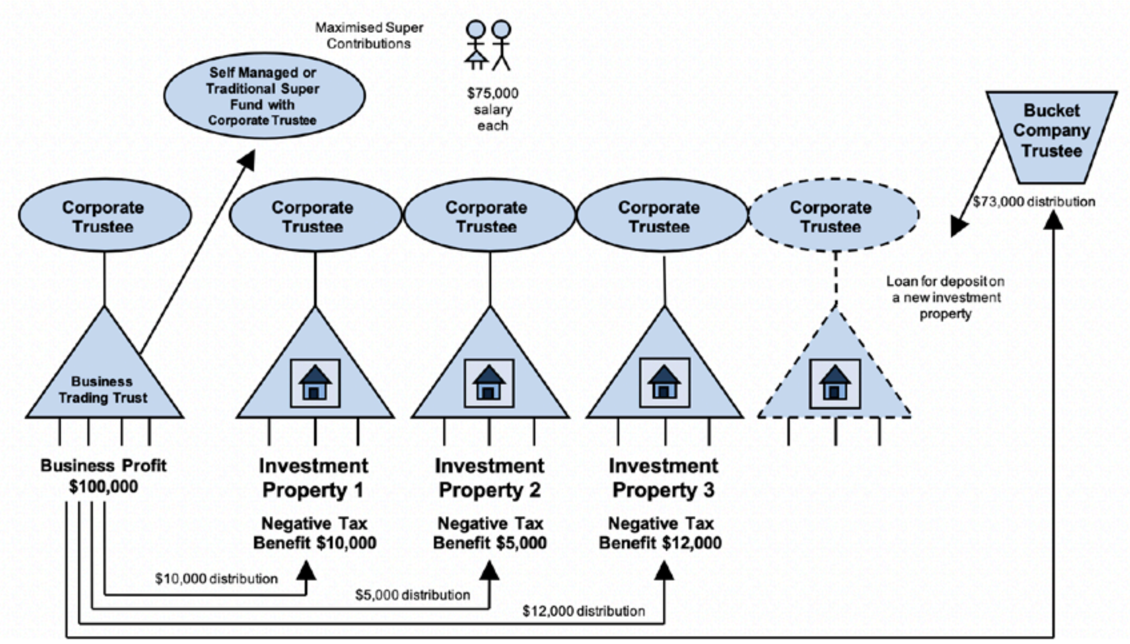
After Tax Bucket Company

Income	$ 73,000
Less Tax	$ 21,900
Tax Paid Available Money	**$ 51,100**

The next obvious question: How can Marge and Harry utilise the money that has already had 30% tax paid on it, sitting in their bucket company?

One solution would be to leave the money in the company. Let it accumulate over the years, add to it as excess profits are made and distributed to the bucket company where it pays tax, and in retirement, pay that money out to Marge and Harry when their marginal tax rates are much lower. Whilst this might be perfect for tax purposes, it is totally ineffective from an investment and wealth creation perspective.

A strategy that would benefit Marge and Harry more effectively would be to use the money sitting in the bucket company to lend out to new investment structures, such as the ones they already have and hold their existing investment properties in, as deposits for more investment properties. Of course, from a wealth creation perspective, this is not only going to create more wealth for them both in the short and long term, it would also mean that they would be able to retire earlier, compound their profits, and balance their portfolio with a selection of both positively and negatively geared investment property, or shares, or other investments. In time, Marge and Harry could utilise the business profits to build a significant real estate, share and cash investment portfolio which would look something like this.



Note: Marge and Harry would set up a loan from their bucket company to their newly formed trust for the deposit on their new investment property purchase. The balance of funds would come from an additional bank loan secured on the new investment property.

Not everyone has the opportunity to earn their income through a business structure, and therefore not everyone has the opportunity to take advantage of the flexible income and tax structures above.

A great percentage of the population earn their income as a salary or wage earner. The main way that real estate tax losses can be offset against salary or wage income, is to own the investment property assets in the same name as the salary and wage earner. As you know, this is not something that I am particularly keen on, as the salary or wage earner is giving up all asset protection by owning everything in their own name. In Chapter 4, I will explain a complex tax structure which enables the salary and wage earner to purchase negatively geared investment properties through a trust structure (a hybrid trust structure) and still claim the negative gearing benefits that they would have been otherwise able to claim had they owned the property in their own names. Because through this method, the property is owned in a trust structure, the property is being asset protected as well as being tax efficient.

Basically, the type of trust you use and how you use it, are decisions that need to be made based on your individual situation. The most important thing to remember is that any use of a trust should be thoroughly investigated. Always carefully review the terms of the trust deed and seek professional advice whenever setting up a structure.

For more information about the uses of company structures for asset protection, see my book "*Asset Protection Secrets of a Real Estate Millionaire*"

Tax Tip:

Even though the purpose of this book is to educate you on the taxation procedures and structures you need to reduce tax as a real estate investor, here is a tip for salary and wage earners who want to maximise their work tax-deductions.

The Tax Office has fantastic tax-deduction publications on their website www.ato.gov.au. These publications detail all the allowable tax-deductions for just about every occupation you could possibly think of. I suggest you check it out for your occupation. You never know. You might be missing out on something!

Problems Using Old Trust Deeds

Changes to Tax/Trust Laws

There have been some changes to the Trust Law. First of all, there was a case called the Bamford Case.

The Bamfords sold a property back in 2002, I think it was. The distributions were made out of a Discretionary Trust in 2002 and 2003 to a number of beneficiaries. Because the sale was a capital sale, they were distributing capital down to the beneficiaries. A discretionary trust, is not a fixed trust, therefore you can distribute capital gains down and keep it as a capital gain, not treat it as income. Therefore you get the 50% exemption for Capital Gains Tax purposes.

In the Bamford's Case, the Tax Office decided to take Bamford to the court. It went all the way to the High Court. The decision came down in March of 2010 - so from 2002 to March 2010 - it took that long to go through the legal proceedings. Can you imagine how much that would have cost? Enormous amounts of money.

Fortunately for the Bamfords, part of their distribution actually went to the Church of Scientology, and the Church of Scientology paid the court costs. The decision went the way of the Bamfords. Had it been somebody else, that didn't have the money to fight it, like the Church of Scientology, it would've been a situation where the use of trusts could have been in question. But they fought the good fight to the end and it went our way.

The result of this court case basically means your trust and your asset protection are as good as your trust deed's words. If you've got a well worded trust deed with good definitions of income and capital and distributions, then you're fine.

If you've got a badly worded trust deed then you probably will not be getting the 50% exemption on any Capital Gains Tax exemptions and it could be taxed at the highest marginal tax rate in the trust's name.

This is why I've been saying all the way along, when it comes to asset protection, don't go and just buy cheap stuff over the internet. There are cheapy little trust deeds that you can buy on the internet, and I can tell you now, some of them are not worth being used as toilet paper. There are others that might be okay, I don't know them all.

What the Bamford Case really highlights, is that you've got to have well worded trust deeds. You've got to be dealing with people who know the implications and have well worded trusts. This is why I give you access to so many people who can do that for you in the network. On top of that, it also means that anyone who has an existing trust deed now needs to take it and get it reviewed. The Bamford Case is a huge case when it comes to trust law.

There's some other changes about bucket companies. In particular Division 7A which basically says that if you have distribution out of a trust going to a bucket company then two things have to happen. The money needs to physically go from the trust up to the bucket company into the bucket company's account and it then gets dealt with from there. You actually have to move the money. It is not just an accounting entry.

If money comes from a trust and gets distributed up to a corporate trustee, then you have to have a formal loan agreement in place. Interest must be paid at commercial rates, and it needs to be an arm's length transaction. There are changes as of December 2009, on the bucket company use, and these need to be taken into consideration also.

To find out more **call (03) 9490 8888** now or go to **www.iloverealestate.tv** to register for our next **FREE Webcast** where you'll discover the strategies, techniques, structures and support you need to successfully invest and prosper from Australian real estate.

Yours in success,

Dymphna.

Dymphna Boholt

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