

Tax-Effective Investing



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Tax Effective Investment

The Australian taxation system is very kind to tax-effective investment. So kind, in fact, that it can be said that the Australian taxation system actually encourages the use of tax-effective investment strategies for the long-term generation of wealth through the deductibility of losses from other income, otherwise known as ‘negative gearing’.

The majority of Australians are in the 31.5% tax bracket, and as this book is written with the majority of Australians in mind, the taxation benefit calculations are based on this. If you are fortunate enough to be earning more income than the 31.5% bracket implies, and are paying maximum rates of 46.5%, the taxation benefits are even better again.

The tax-effective investment chapters of this book discuss the following subjects:

- Rental properties
- Buildings depreciation
- Australian shares
- Imputation credits
- Superannuation
- Primary production activities

There are obviously more tax-effective investments than this list suggests, but these are the main ones, and each has a dedicated chapter in this book, with practical examples of how they actually work.

This book is reality-based, and written to inform as well as to show the benefits of tax-effective investment. Most importantly, though, it shows that whatever the type of investment, it must be a *good* investment. There is absolutely no point to tax-effective investment unless there is a profit (capital growth).

Before we begin looking at tax-effective investing, though, some understanding of negative gearing principles is required, and so this is where we begin.

Negative Gearing

The whole concept of tax-effective investment revolves around the words 'negative gearing'. Negative gearing, however, essentially requires making a loss. So why, if negative gearing represents a loss, do we do it? Investors negative gear in the expectation of long-term capital gains - capital gains that are greater than the income losses.

The four key points of negative gearing are as follows:

- Losses are offset against other income each year, with a tax refund received annually (at worst).
- Gains in capital are not taxed until an asset is sold (if it is ever sold), reaping tax deferral advantages. In other words, the value of receiving any benefit now is always higher than paying a liability later - time is money.
- Under current taxation rules, a capital gain is halved before tax is paid (only when the asset is held longer than 12 months). In other words, tax is paid on only half of the gain, while a full deduction on expenses has already been claimed.
- A capital gain can be timed (via effective tax planning) to coincide with a low income year, or other strategies. For example, claim the expenses in high income, high-tax years, and incur the gain in low income, low-tax years.

Example:

A \$300,000 investment with an average increase in value of 12% p/a, and an income return of 3% p/a, theoretically makes \$36,000 in capital growth and \$9,000 in income each year.

If \$300,000 is borrowed at 8% p/a (costing \$24,000 p/a) to fund the investment, the \$9,000 in income can be offset against the \$24,000 borrowing expense, creating a loss of \$15,000. This \$15,000 represents the negative gearing element, and enables a 31.5% tax deduction of \$4,725. As a result, the actual investment cash flow cost is \$10,725. Combined with capital growth (\$36,000), this provides a net positive result of \$25,725 each year.

After-tax cash flows can be even further enhanced, however, via building depreciations (in the case of rental properties) and imputation credits (in the case of shares), and worked examples will be shown for both.

Remember that the capital growth will be taxed when the asset is sold. The beauty of a capital gain, however, as discussed previously and in more detail later, is that it is not taxed *until* the asset is sold. When and if the asset is sold (although most assets are sold at some time or other), under the current capital gains tax (CGT) laws only half of the capital gain is taxed when the asset has been held longer than 12 months, and this liability can be further reduced by effective tax planning and timing strategies.

Sound too good to be true? Well it isn't, and the following chapters will demonstrate via practical, worked examples, precisely how it can be done.

There are many other negative gearing CGT strategies (other than the ones already listed) to reduce taxable elements. These include selling the asset after the age of 60, when on a tax-free superannuation pension or, if retired, by making non-supported contributions to superannuation. Alternatively, other strategies, if still employed, include salary-sacrificed superannuation, prepaid interest on other investments, and primary production deductions. The list really is endless. Just let a financial planner and tax accountant like myself off the leash, and see what we can do.

In summary, negative gearing essentially means making a loss, but the strategy utilises that loss to obtain tax deductions/refunds to assist with funding the investment.

One point I want to drive home in this book is that negative gearing is pointless unless there is an expectation of capital growth, and the primary consideration should always be the actual investment. Taxation benefit considerations come later.

I encourage you to do something, no matter how small (some margin lending investments require as little as \$5,000 to begin), and to consider investment even more when you're young. It's never too late to start. The effects of time, in terms of increasing (compounding) the capital value of your investments, and inflation, in terms of reducing the value of your borrowings over the years (both of which are further assisted by the immediate benefits of our taxation system and growing yields), provide a level of financial security far beyond the effect of doing nothing at all.

One of my favourite sayings to people is 'if you are doing nothing - you are going backwards'. So please do something; go forward.

Rental Property Investments

The first tax-effective investment I'll discuss is rental property. The reason property is considered first in this book, and by most people in preference to shares, is that rental properties are perceived to be the far safer investment option. One of my wealthy clients continually tells me shares are for fun, but property makes you rich. He is proof of that. Equally, though, I have many long-term share investors who are in the same position. Both options are good.

Rental properties are certainly one of the best tax-effective vehicles for negative gearing. Over time, capital returns of 10% p/a or more (depending on the area) have been shown to be very achievable. However, in the examples that follow, I have used a very conservative capital growth figure of 7.5% (conservative for major city capital growth); feel free to put in a lower figure if you're looking at low growth areas or a higher figure if you're expecting something greater.

Example:

| | |
|-------------------|---|
| \$500,000 | Investment Property |
| \$40,000 | 8.0% interest |
| \$5,000 | Rates, repairs, body corporate fees, etc |
| <u>(\$18,000)</u> | Rents received |
| \$27,000 | Cash flow loss |
| <u>\$2,000</u> | Non cash - chattel depreciation |
| \$29,000 | Tax loss |
| \$9,135 * | Tax refund (31.5%) |
| \$17,865 | Cash flow loss (Refer to next chapter to see how this cash flow loss can be reduced to even less) |
| <u>\$37,500</u> | Capital growth at a 7.5% |
| \$19,635 | In front |

** A reminder: in this example we have used a tax rate of 31.5%. The tax refund rises to \$13,485 for a tax payer in the 2008 top tax bracket.*

It's always important to briefly inform people about the effects of the passage of time. For the most part, it's not until someone hits their mid-thirties that they start to fully understand how this works.

Here are some points:

- Rent yields rise over time (rents go up), but the borrowed amount stays the same, narrowing the cash-flow gap.
- Interest rates can rise and fall but can be locked in (although I rarely recommend it), providing a level of certainty.
- The interest-only loan (in this example) remains at \$500,000 forever, but the value of the property keeps rising.

I hope this example has shown you the benefits of negative gearing a property. It isn't rocket science, or a secret that you need to spend thousands of dollars on property seminars to learn. Spend an hour with your accountant or financial advisor and you will probably learn more!

The next chapter on buildings depreciation is the real cash flow saver for rental property investment. Here, the benefit comes not from cash flow, but from non-cash flows (capital costs).

Building Depreciation

I'll let you in on a secret here. This is (mainly) how all the property spruikers of the past decade sold units: on the basis of tax deductions and cash-flow savings, and mainly through buildings depreciation. Please don't get me wrong, as many investment units were actually good investments. Further, not all property spruikers were snake-oil salesman (though a few famous ones certainly were). At this point, feel free to skip ahead to the Primary Production chapter and the discussion about ensuring that you're making a good investment. As mentioned, there's no point doing anything for a tax concession alone.

Buildings can be depreciated (only those built after the mid-1980s) over a 40-year period at a rate of 2.5% per annum.

But what does this mean?

What it means is that part of the capital (cost) base can be depreciated, and tax deductions for no additional cash flow can be claimed. What follows is a worked example, and using the previous chapter's rental property example is the best way to highlight the huge differences in cash flows.

Example:

| | |
|---------------------|--|
| <u>Assumptions:</u> | <i>The building element of the property is \$450,000</i> |
| \$500,000 | Unit |
| \$40,000 | 8% interest |
| \$5,000 | Rates, repairs, body corporate fees, etc |
| <u>(\$18,000)</u> | Rents received |
| \$27,000 | Cash flow loss |
| <u>\$2,000</u> | Non cash - chattel depreciation |
| \$11,250 | <i>Non cash - building depreciation 2.5%</i> |
| \$40,250 | Tax loss |
| \$12,680 * | Tax refund |
| \$14,320 | Year loss |
| <u>\$37,500</u> | Capital growth at a conservative 7.5% |
| \$23,180 | In front |

**A reminder: in this example we have used a tax rate of 31.5%. The tax refund rises to \$18,715 for a tax payer in the 2008 top tax bracket.*

This example demonstrates two ‘in front’ positions: \$19,635 *without* building depreciation versus \$23,180 *with* building depreciation. This represents a \$3,815 p/a difference.

Depreciating both the chattels and the building reduces the cost base of a property for CGT purposes. Remember, though, that CGT is taxed on a concessional basis (and then only upon sale). There are many other strategies to reduce the CGT taxation effect when the investment strategy is correctly planned.

These worked examples show you the real benefits of negatively gearing property, especially via building depreciation. Once again, it isn’t rocket science, or a mystical secret that you need a salesman to sell you or that requires you to spend thousands of dollars learning at a property seminar. Please consider spending an hour or two with your accountant or financial advisor - it will be thoroughly worthwhile in terms of deepening your understanding of how these strategies work.

Australian Shares

It's funny how people are often either in the property camp or are settled as 'shares' people (my great passion). Depending on the era reviewed, it is generally accepted that, over the longer term, shares provide a slightly higher return than property, but at a greater risk. *Or is it just a perception of greater risk?* The fact is that this perception depends on your perspective. Judging from history, particularly the Global Financial Crisis (GFC), it really doesn't matter which way you are inclined to invest, as long as you are doing *something*.

So why not, as I do, do both?

In this chapter, I'll discuss three very different ways to invest tax-effectively in the Australian share market, starting by showing people how to effectively **hedge** (protect) their position.

Risk Averse or for Someone Wanting 90-100% Leverage

It is possible to fully protect (**hedge**) share values, so, if (*or when!*) the share market crashes, you don't face a capital loss. On balance, risk and return are linked. When you lower the risk, for example by fully protecting shares from loss, you inevitably lower the return. Simply put, it costs to protect. Think of it as buying an insurance policy with or without an 'excess'. To fully protect your position the hedging (insurance) cost may be around 8%. To protect 90% of the value (thus giving up a 10% excess) protection costs will likely drop to around 2% as in the following.

Example:

Assumptions: *\$500,000 in fully protected shares*
 8.0% interest on borrowings
 5.0% fully franked dividends
 2.5% franking credit on the dividends

| | |
|----------------|---------------|
| \$40,000 | Interest |
| \$37,500 | Income |
| \$2,500 | Tax Loss |
| <u>\$790</u> * | Tax refund |
| \$1,710 | Out of pocket |

| | |
|-----------------|---------------------------------------|
| <u>\$37,500</u> | Capital growth at a conservative 7.5% |
| \$35,790 | In front before hedge costs |
| <u>\$10,000</u> | Hedge at 90% |
| \$25,790 | In front |

** A reminder: in this example we have used a tax rate of 31.5%. The tax refund rises to \$1,165 for a tax payer in the 2008 top tax bracket.*

The lower returns (due to protection costs) are in exchange for lower downside capital risk, but with full upside exposure. But before you discount this strategy, the big advantage (other than the assurance of sleeping better at night) is that the Loan Value Ratio (LVR) is 90%. For a risk taker this allows you to leverage even more (as borrowing more lets you invest more), while never facing the prospect of margin calls - ever.

To take on this strategy, you will need to fund 10% of the investment as well as the upfront annual cost of hedging. Remember that the hedge will cost (relatively) more each year if the shares fall in value but will conversely reduce in cost to renew if market rises. If this is the case you also have the ability to protect/ lock in your profits over time.

Margin Lending and Stock Specifics

Most advisors subscribe to the belief that time reduces risk, and recent history certainly shows this to be true. No one knows what the future holds, but the probability is that this belief will continue to be born out. In this respect, margin lending has no capital protection and should be contemplated as representing a higher risk. In exchange for higher risk, however, the costs are lower, being 2% (or more from the previous example).

To margin lend, you use equity (your home, for example, or existing shares or cash) as security. A bank or margin-lending institution will typically lend on LVRs of around 50-80% (meaning they will lend an amount representing 50%-80% of the value of the asset). For example, if you already own stock and the stock has an LVR of 80%, the bank will lend you up to 80% of that share value to buy more shares. If you do not yet own any stock, and want to buy shares with an 80% LVR, you need to put up 20% security and the bank will lend you the remaining 80% to buy the share.

With margin lending, you pick the stocks for your portfolio (with the assistance of a broker or financial planner if you so choose). Never forget, though, that the major drawback to margin lending is that when/if the share market dips significantly, you will be called upon

to make a margin call, which means putting in more security, or being forced to sell some stock to meet the new LVR.

Example:

Assumptions:

\$500,000 in margin lent shares

8.0% interest rate on the borrowings

5.0% fully franked dividends

2.5% franking credit on the dividends

| | |
|-----------------|---------------------------------------|
| \$40,000 | Interest |
| \$37,500 | Income |
| \$2,500 | Tax Loss |
| <u>\$790</u> * | Tax refund |
| \$1,710 | Out of pocket |
| <u>\$37,500</u> | Capital growth at a conservative 7.5% |
| \$35,790 | In front |

**A reminder: in this example, we have used a tax rate of 31.5%. The tax refund rises to \$1,165 for a tax payer in the 2008 top tax bracket.*

Exchange Traded Funds (ETFs)

Hand picking share stocks (active investing) is usually beyond the scope of an individual investor's expertise and time commitment.

A series of inexpensive, passively managed funds, known as Exchange Traded Funds (ETFs), are now gaining popularity. These funds track indices such as the all ordinaries, the top-200 stocks, or even a segment of the market (e.g. resources) without requiring you to do a thing in terms of management.

The down side to managed funds is often in the cost, described as the 'Management Expense Ratio' (MER). The MER is effectively a payment towards the running costs of the fund which is shared amongst members of the fund on the basis of relative amounts invested. However ETFs are very simple and very cheap to run (at around 0.1 - 0.3% MER).

This is much cheaper than the so called ‘cheap-to-run’ superannuation funds (in most cases, in the 1%-1.5% MER range), and cheaper yet again when compared to more complex investment funds, at 2.5% MER and more. As a result, ETFs provide an excellent way to diversify, enabling a ‘set-and-forget’ approach at little cost to the investor. (See www.etfpro.com.au, an excellent ETF site to which I contribute submissions).

Example:

Assumptions:

\$500,000 in Exchange Traded Funds (ETFs)

8.0% interest rate on the borrowings

5.0% partly franked dividends

1.0% franking credit on the dividends

| | |
|------------------|---------------------------------------|
| \$40,000 | Interest |
| \$30,000 | Income |
| \$1500 | MER |
| \$11,500 | Tax Loss |
| <u>\$3,625</u> * | Tax refund |
| \$7,875 | Out of pocket |
| <u>\$37,500</u> | Capital growth at a conservative 7.5% |
| \$29,625 | In front |

**A reminder: in this example, we have used a tax rate of 31.5%. The tax refund rises to \$5,350 for a tax payer in the 2008 top tax bracket.*

There are other ways to margin lend (especially when buying into more sophisticated funds and products), but the three already discussed represent mainstream general examples. The level of risk or the suitability of the product you use to margin lend on entirely depends on your particular risk profile.

The next chapter looks at imputation credits on franked dividends (which form a critical element to understanding the previous three examples) and the effect on after-tax cash flows.

Imputation Credits

The current Australian tax system does not have the double taxation problems that used to exist prior to the mid-1980s (accountants all thank ex-Treasurer Paul Keating for this). Now you actually receive the same taxation credit for taxes paid by a company pre-dividend, and it can't get any more tax effective than that.

Example:

| | |
|---|--------|
| XYZ Company makes a profit of: | \$100 |
| The company pays 30% tax on its profit: | (\$30) |
| The company now has in its bank: | \$70 |

XYZ Company pays all its profit as a dividend and the shareholder receives \$70, but also receives a credit for the \$30 in tax the company has already paid. In the shareholder's tax return they declare \$100 as income and claim the \$30 tax credit as a rebate. Even in the top tax bracket, this means that on the \$70 dividend received, the shareholder will only pay a 2008 tax-year maximum of \$16.50 in tax.

A shareholder on a lower tax rate of 0.20 in the dollar will actually receive a refund when they declare \$100 in income (\$70 dividend plus the tax credit of \$30). In this case, the shareholder's tax bill will normally be \$20, but as they already have a tax credit for \$30, the tax office actually ends up paying a refund of \$10.

Imputation credits in a superannuation environment are better yet again. With a maximum superannuation tax rate of 15%, each time a super fund receives a dividend, the effective rate of return is higher by the 15% difference between the superannuation tax rate and the 30% company tax rate. No - it's not too good to be true - it is true.

The Australian taxation system is particularly kind to investors, and imputation credits are just another example of how to use the tax system, tax effectively - to use the system to your best advantage rather than trying to fight against it.

Super Superannuation

Even after the Kevin Rudd/Labour attacks on 'Super Superannuation' it still remains 'Super' (though at a lower capped level depending on your age) when making pre-tax contributions to superannuation. The contributions to super are taxed at a lowly 15%. Compare this to the 31.5% tax rate most taxpayers face, and for every \$100 you 'salary sacrifice' into superannuation, you have an immediate saving of \$16.50* in tax.

Example:

Assume you pay the 31.5% tax rate and receive a \$10,000 bonus. You lose \$3,150 in tax. Alternatively, assume you declare to have your bonuses paid directly into superannuation. You lose only \$1,500 in tax. That's a big difference of \$1,650. 'The catch', of course, is that you cannot get to this money until you retire.

**A reminder: in this example we have used a tax rate of 31.5%. The tax saving rises to \$3,150 for a tax payer in the 2008 top tax bracket.*

With superannuation, though, the tax-effective savings don't stop at the contributions level, as superannuation fund earnings are only taxed at 10%-15%. After you have retired, it gets even better, with the earnings attracting an unbelievable tax rate of zero! Further, the tax paid on a superannuation payout after the age of 60 (and retired) is again zero!

There is simply nothing more tax effective than superannuation, which is why nearly all accountants and financial planners keep pushing the superannuation barrow.

Superannuation is so effective, in fact, that I believe it should be viewed as a major way for divorcing spouses (especially higher income earning, supporting spouses, usually with a lower value home, or no home at all) to begin to invest/recover tax effectively. My belief in this aspect is so strong that I have devoted a separate chapter to it later on.

A general rule with superannuation is that *before* making additional salary sacrifice payments to superannuation, repay *all* your non-deductible loans (such as home loans) and expenses. Please keep this in mind when considering superannuation as a tax-effective investment vehicle.

As an advisor, I see a lot of resistance from people when considering the idea of contributing more to superannuation. This is because many people don't like managed superannuation funds (due to the fee structures, poor performance in some cases, and the fees paid to financial planners). For these people, running a self-managed superannuation fund (SMSF) is the answer.

Example:

Sometimes it is very difficult to advise someone who is resistant to superannuation investment to put \$250,000 into the XYZ Managed Fund. In these cases, it is much easier to offer an alternative: investing the \$250,000 in their own SMSF, which then buys a factory (for example), and then rents it back to either the investor's business or someone else's.

SMSFs provide investors with the ability to make investment decisions for themselves. As of September 2007, borrowing funds is now a reality for SMSFs, with the use of easily constructed instalment warrants. An instalment warrant is a form of derivative, and I am well placed to advise on the benefits of using them. SMSFs are something I am particularly passionate about - so passionate, in fact, that my doctoral thesis was about SMSF investments.

In closing, superannuation is STILL clearly the most tax-effective investment method (though the amounts you can contribute have been reduced) and should form a solid foundation for any tax-effective financial strategy, especially after non-deductible loans are fully repaid.

If you are ignoring superannuation, then get over it and let someone like me show you its true worth and flexibility - I just love superannuation.

Agribusiness & Primary Production

Ostriches, emus, wine grapes, olive oil, worm farms, pine trees, blue gums and avocados are just a few of the primary production offerings seen over the past decade. Some have even been successful (just), with the occasional one proving a raging success. Most, however, have had such poor financial returns that the money might as well have been left in the bank earning interest.

The point is, with tax-effective investment, it is absolutely essential to look at the return on the investment, not just the tax savings (a sin many have been guilty of in the past and clearly highlighted with the recent collapses of Timbercorp and Great Southern).

Example:

Put \$10,000 into a primary production project and you will receive a tax refund of \$3,150*. BUT - guess what? You have still spent \$6,850. Now let's say the project returns you a total of \$1,000 of your original \$10,000 after 10 years (maybe!).

The result is that you have made a substantial loss. As an investor you are much better off paying your \$3,150 in tax, keeping the \$6,850 after that tax, more effectively investing it, and over the same 10-year period having an after-tax return exceeding the original \$10,000 investment.

*A reminder: in this example we have used a tax rate of 31.5%. The tax saving rises to \$4,650 for a tax payer in the 2008 top tax bracket.

So why raise this example, when the same can be said of any investment? Over the years, I have witnessed much madness in people doing precisely what is being described here, and mainly on the back of glossy brochures, advertising primary production investment products. The phenomena is certainly not contained to primary production ventures, as many people have lost on everything from franchise agreements to a myriad of other schemes that popped up in the early 1990s.

Putting the warning to one side for a moment, I do believe there are some very good primary production investments, worthy of consideration, (such as hardwood, and the growing sophistication of Pine and Blue Gum plantations), which represent some worthwhile tax-effective investment considerations.

Primary production does provide a very good tax-effective investment strategy and is especially good at offsetting gains (especially large capital gains) within a financial year, so are very useful in the right circumstances.

Do It Yourself

Don't like paying sales commissions and management fees for someone to do it all for you? Then why not do it yourself? Why not combine the benefits of 'super' superannuation and primary production?

Example:

Your SMSF buys farming land and rents it back to you. You plant a tree plantation on it, claiming the tax deductions to do so - which include annual expenses such as the rent you're paying to your superannuation fund, insurance, plantation and financing costs - while your plantation grows (I have done similar myself).

As discussed earlier, your own superannuation fund can even borrow through an instalment warrant to buy the land. It's almost too good to be true, but it isn't - it's a tax-effective reality!

Capital Gains Tax

As far as taxes go, Capital Gains Tax (CGT) becomes a whole lot friendlier if you hold an asset for longer than 12 months, at which time the actual gain is effectively halved and only 50% of the gain is actually taxed.

But the major attraction (major in my mind) to capital gains tax is it is only paid when you actually incur (by selling) the gain. With this in mind, 'why sell' is a notion I regularly put to my clients.

Consider an investment where the gains are not taxed over the investment asset's lifetime (deferral of a taxing point), and may not ever be taxed until that asset is sold. If you die, the investment can be passed on to your beneficiaries, again tax free, and it's not until they then sell the asset that it is actually taxed.

Timing your capital gains is important. It is best to take capital gain hits in low income years, such as when you have retired and have no other income, are away on a year's holiday, or when you can make/claim significant contributions to superannuation to offset or prepay interest expenses etc. There are many ways to significantly reduce the impact of CGT, but it takes a good advisor to know them all. Little can be done after the event, so PLAN it!

In summary:

- Reduce other income.
- Make contributions to superannuation.
- Prepay interest on investments.
- Crystallise (by selling) any other capital losses you may have.
- Delay by selling in the next financial year.
- Don't sell, borrow against.
- Take out other (new) tax-effective investments.
- See an advisor to explore the many other methods.

Tax Effective Divorce

Tax-effective recovery strategies for parents coming out of a divorce are a vital part of getting through a very difficult time. Divorce is a time when decisions are made under duress, financial mistakes are rife and the stakes high.

I have written two separate booklets on tax-effective investment and recovery strategies for mums and dads. Both are freely available at www.ciawealth.com.au and are an essential read if you are facing divorce. Each parent has very different challenges to face.

Let's keep this generic and focus on the higher income, non stay-at-home parent (usually the dad, but often the mum). When marriages break down (for whatever reason), and there are children involved, it is usually but not always (gee, I'm starting to sound like a lawyer) the case that the dad moves out. As a result, the departing spouse faces significant costs to establish a new home. They begin paying child maintenance, and in some cases spouse maintenance, then fund their additional costs of living like rent, electricity, water gas etc. But here is my point - it's all in after tax dollars. In this respect, the taxation system really works against you, and cuts particularly deep.

Then the inevitable asset split usually favours the child-rearing parent (and rightfully so). The growth of the assets the child-rearing parent receives is usually *tax free* (as it is most likely to be the family home). In most cases, the dad (or mum) is left with a smaller capital base (which appreciates less), and usually the increase on that smaller capital base is *taxed*.

For example, a cash marital settlement generally goes into a bank account that earns interest, which naturally is then subject to tax. In short, it's all bad, and when left for a period of time (whilst one emotionally recovers), much worse. The answer is to immediately see an advisor who understands the tax ramifications of investment.

The good news is that there are lateral ways to address what I believe to be this 'unjust' imbalance (for the dad or the mum depending on the circumstances). Hedged margin lending is a favoured method (as discussed in a previous chapter) along with superannuation *as* another method, where being taxed on a concessional basis, so that when you reach the age of 60 (and retire) the proceeds are tax free. Other strategies include, for example, not buying the home you live in, and using the tax system to assist with purchasing another property instead.

Example:

Buy a home and rent it out (rather than living in it). Keep your own rent costs low by sharing a place, or even move in with someone special. In this way you reduce housing costs by exposing yourself to growth, albeit taxed on sale. Alternatively, consider doing this via one of the superannuation investment strategies already described, and after 60 (and retired) face no tax on the sale at all.

| | |
|-------------------|--|
| \$500,000 | Unit |
| \$40,000 | 8.0% interest |
| \$5,000 | Rates, repairs, body corporate fees, etc |
| <u>(\$18,000)</u> | Rents received |
| \$27,000 | Cash flow loss |
| \$2,000 | Non cash - chattel depreciation |
| <u>\$11,250</u> | Non cash - building depreciation 2.5% |
| \$40,250 | Tax loss |
| <u>\$12,675 *</u> | Tax refund |
| \$14,325 | Year loss |
| \$37,500 | Capital growth at a conservative 7.5% |
| <u>\$10,400</u> | Cost for you to rent a cheaper place |
| \$12,755 | In front |

**A reminder: in this example we have used a tax rate of 31.5%. The tax refund rises to \$18,715 for a tax payer on the 2008 top tax bracket.*

The killer in this example is the cash flow (verses hedged shares, where cash flow can become positive very quickly as dividends rise). You need to fund \$14,325 in loss and your own \$10,400 accommodation costs. If you can - great. If you can't, you should seriously consider looking at superannuation (or protected shares) as your way to recover from divorce, especially if you're nearing your mid 50s. Sometimes it's best to put aside the dream of owning your own home again (in the mid-term, at least).

To sum up, with immediate tax-effective returns on your contributions, concessional tax rates on the earnings, tax free at age 60 (and retired), and now with the ability to borrow through instalment warrants (enabling your SMSF to buy a home that you can't live in until you retire), superannuation offers a fantastic way to recover from divorce.

Income, Trauma & Life Insurances

As tax-effective investing only works when you have an income to be taxed, it pays to at least consider protecting that income. Usually, tax-effective products require a longer-term perspective, so protecting your income (and ultimately your investment assets) over the longer term is something that should be strongly considered; I always recommend this approach. There are three main types of insurance you should think about.

Income protection insurance - as its name suggests, protects your income during periods of sickness or injury. The premiums are tax deductible, but the payout (if you are in a position to need one) is taxed.

Trauma insurance - pays a lump sum in most cases, on the diagnosis of a serious medical condition. This is a less affordable type of insurance, as the premiums are not tax deductible. To counter this effect, however, any payout received is tax free.

If Trauma insurance is not affordable, then consider Total Permanent Disability (TPD) insurance as a fallback position paid by your superannuation fund, obviously more affordable but to receive the payout, in most cases you must not physically be able to return to the workforce.

Life insurance - premiums are not tax deductible. In most cases (with a spouse or other dependent beneficiaries) it is best to make them tax deductible and have your superannuation fund pay the life insurance premium instead.

The payouts are tax free if you have been paying the premiums. If your superannuation fund has been paying them, however, they may be taxable, either to the fund or to the nominated beneficiaries (depending on their status). You should always speak to an advisor before deciding how to pay your premiums - this is very general advice and your situation will need to be analysed.

In Closing

This book has been written in layman's terms to de-bunk the mysteries of tax-effective investment. As you have seen, it isn't rocket science. The examples used in this book are simple enough, but two situations are rarely ever the same. Before embarking on any strategy, please sit down with an advisor, even if it's just to check your own calculations - two heads are always better than one.

You need an advisor who is a tax agent and an advisor who is a registered financial planner (or one advisor with expertise in both) to really work for you. This is because investment and taxation should never be considered in isolation, and an advisor with expertise in one field cannot advise on the other unless they are registered to do so.

At CIA tax, we work with many clients with tax-effective investments. Being registered financial planners (through CIA wealth), CIA tax is much more than a tax agent. Tax-effective investment is our passion and we love sharing our knowledge with our clients.

Personally, I practice what I preach and, at the time of writing, have invested (or still do) in every single tax-effective strategy mentioned in this book. I even have the unfortunate personal experience of divorce, so in terms of the investment methods covered here, I know we can help you. If you think you're in a position to start investing, don't hesitate to get in touch with us - just do it now.

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About the Author

Dr Steven Enticott 'practices what he preaches', and has invested (or still invests), in some way shape or form, using every method raised in this book.

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