Wealth Creation

Strategies for wealth creation

2004/2005

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Building wealth with managed investments

Some people think of saving and investing as the same thing. But the truth is, each requires a different approach and a different way of thinking.

Saving is simply putting aside some of your disposable income for a short-term goal, such as a holiday or a car. Saving requires a conservative approach, taking very little risk with your money. A bank account or cash management trust is usually sufficient to reach your savings goal.

Investing, on the other hand, means putting your savings to a more profitable use. So you need to adopt a longer investment timeframe and a measured degree of risk. While a bank account may be suitable for short-term needs, history shows that they have been totally inadequate for long-term goals such as funding your retirement or putting money aside for your children.

Why? Simply because the returns have been too low, especially when you take into account inflation and tax.

To drive your money further, you need to invest in growth assets, such as shares and property, which have historically provided better long-term returns. Growth assets can also be more tax-effective than the other asset classes.

In this guide we show you how to invest your non-superannuation money in growth assets using managed investments such as unit trusts. Together with superannuation, managed investments can help you build long-term wealth.

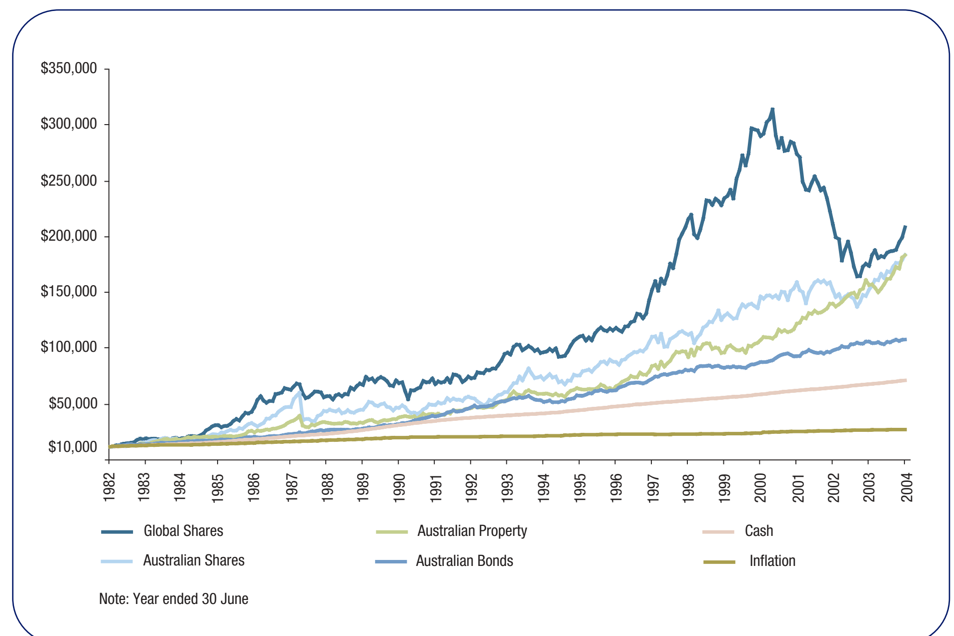
We recommend you visit your financial adviser before acting on any of these strategies.

Investment basics

Choosing the right mix of assets can make a big difference to your investments

As the graph below reveals, growth assets such as Australian and global shares and property, have delivered higher returns for investors over longer time periods (i.e. seven years or more). However, these asset classes have also been more volatile than cash and bonds over the short-term (i.e. one to three years).

Asset class comparison – $10,000 invested



This comparison is based on historical performance and is not indicative of future performance (future performance is not guaranteed and is dependent upon economic conditions, investment management and future taxation). Source data is based upon the following: Australian Shares: All Ordinaries Accumulation Index, Global Shares: MSCI World Gross Accumulation Index ($A), Australian Property: Listed Property Trust Accumulation Index, Australian Bonds: Commonwealth Bank Bond Accumulation Index, Cash: 13 Week Treasury Notes, Inflation: Consumer Price Index. All income is reinvested.

So ...

If you are planning to invest for at least seven years, you may want to consider investing a significant portion of your savings in growth assets. But before you make your investment choice, you should also consider your goals and your comfort with market ups and downs.

To determine a mix of assets that suits your needs, you should speak to your financial adviser.

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Managed investments can help you reach your financial goals

'Direct' versus 'indirect' investment

Some people like to invest in shares through a stockbroker (or via the net). Others like to buy property through a real estate agent. However these direct approaches to investing usually require considerable time and expertise.

A potentially smarter and more rewarding alternative is to invest indirectly, by purchasing units in a managed investment. A notable example is a unit trust, which is the focus of this guide.

Managed investments can also be accessed via superannuation funds, allocated pensions, investment bonds and friendly society bonds.

What is a unit trust?

A unit trust is a type of managed investment that can be purchased with ordinary (non-superannuation) money.

Your money is pooled with other investors to form a large fund, which is professionally managed by a team of investment experts. Depending on the investment objective, a unit trust may invest in shares, property, bonds, cash or a combination of these 'asset classes'.

When you invest in a unit trust you are allocated a certain number of units, depending on the unit price. The unit price reflects the value of the fund's investments at any particular point in time. For example, if you invested $1,000 and the unit price on the date of investing was $2 you would be issued 500 units.

The unit price rises and falls in line with the changing value of the fund's assets. To find out how much your investment is worth, simply multiply the number of units you have by the current unit price.

The benefits of managed investments

Diversification

Even a modest amount of money can be spread a long way to help reduce your risk. For instance, an investment of $2,000 can provide access to shares, property, fixed interest and cash, spread across different markets and geographical areas. Some unit trusts also allow you to diversify your investments across a range of fund managers with varying, yet complementary, investment management styles.

Expert management

Your money is managed by investment professionals who are supported by the latest technology and information. Fund managers and analysts constantly research and monitor investment markets to help build your wealth.

Convenience and ease of management

Unit trusts are easy to use. Accurate records are kept, e.g. for Capital Gains Tax (CGT) purposes, and you are informed of the progress of your investment on a regular basis.

Strategies at a glance

	Strategy	Key benefits	Page
1	Compound returns: the essential ingredient	• Maximise the value of your investment • Save in a disciplined way	6
2	Growth assets can provide a growing income	• Generate a growing, tax-effective income stream • Protect the purchasing power of your money	8
3	A balanced approach beats trying to pick winners	• Achieve more consistent returns • Minimise investment risk	10
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5	Income splitting: a simple way to save tax	• Reduce tax • Increase the value of your investment	14
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8	Use borrowed money to build wealth	• Accelerate the creation of wealth by having more money invested • Reduce tax on other income through negative gearing	20
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10	Defer asset sales to manage capital gains tax	• Defer the payment of capital gains tax • Reduce your capital gains tax liability	24

Compound returns: the essential ingredient

If you start investing now, time can be a very powerful ally. Year after year, the money you invest has the potential to earn more money. And if you reinvest your earnings, you can earn even more money in the future. It's called compounding returns and it's one of the keys to making your money work harder.

For example, if you invest $1,000 at 10% p.a., you will receive $100 in interest during the first year. But if you reinvest your interest, you will have $1,100 working for you in year two. If your investment then earns another 10%, your interest will come to $110 in the second year, and so on.

Over a period of several years, compounding returns can make a significant difference to your wealth. And the sooner you start investing, the more compounding can work to your advantage.

How does the strategy work?

For compounding to work its magic, you need to do two key things:

1. **Reinvest your investment returns** (e.g. dividends and interest), rather than spend the money on other things. This will enable you to turn your investment earnings into capital so that you can generate even more future earnings. An easy way to reinvest income is to participate in a dividend, interest or income reinvestment scheme.
2. **Give your investment time to grow** by starting your investment as soon as possible and keep it going for as long as you can.

For instance, if you invest $10,000 at an 8% annual return until age 65, the table below shows how much you would get back – depending on your age when the investment is made.

Age when you started the $10,000 investment			
20 yrs	30 yrs	40 yrs	50 yrs
$319,204	$147,853	$68,485	$31,722

Note: This example ignores the impact of tax on investment earnings or inflation.

By simply investing ten years earlier, you could more than double your money. A case of delay and you pay!

The rate of return your money earns can also make a big difference if you leave your money to compound over longer time periods (see Case Study).

Strategy # 01

The benefits

- Build wealth by reinvesting the income from your investments.
- Maximise the potential return by giving your investments time to grow.

Case Study

Twin sisters Anna and Ingrid both started an investment plan at age 25. They contributed $2,000 a year and reinvested the investment income.

Anna invested her money in a unit trust share fund that earned 8% p.a. However, she stopped making contributions after ten years and left her money in the share fund to grow over time.

Ingrid, on the other hand, continued investing each year right up until age 65. But she chose a more conservative fund that earned 5% p.a.

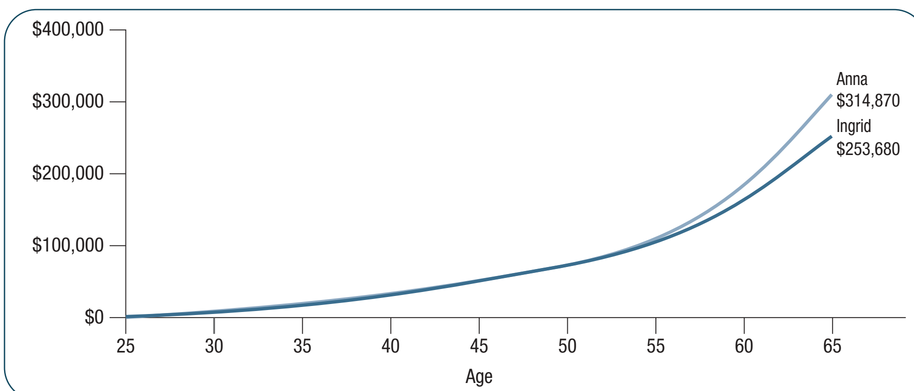
Who do you think ended up with the most at age 65, Anna who only contributed $20,000 or Ingrid who contributed $80,000?

Summary

	Anna	Ingrid
Amount invested	**$20,000**	**$80,000**
Years invested	40	40
Annual return	8%	5%

Intuitively, you would think that Ingrid would end up with more money by investing an extra $60,000. However, this was simply not the case. As the chart below shows, Ingrid and Anna's investments grew to $253,680 and $314,870 respectively. That's a difference of $61,190.

Anna v Ingrid returns over 40 years



Note: This example does not take into account the impact of tax on earnings or inflation.

The reason Anna had a greater account balance, while contributing significantly less than her sister Ingrid, was the compounding effect of earning an extra 3% on her investment each year.

If Anna had also contributed $2,000 a year for 40 years, she would have an account value of $559,562.

Tips and Traps

- To maximise the benefits of compounding, it's important to give your investments time to grow. This could involve investing from an early age where you may be able to take advantage of lower financial and family commitments. Alternatively, you could consider deferring your financial goals to increase your investment time horizon.
- Consider increasing your regular investments as your disposable income rises. The compounding effect of making additional contributions will assist you in generating long-term wealth.
- Before embarking on an investment program, it's important to seek financial advice to ensure that your mix of investments reflects your financial objectives, investment timeframe and attitude towards risk. It's also a good idea to review your financial plan regularly.
- The income distributed by a unit trust is taxable in the hands of investors regardless of whether the income is received directly or reinvested to buy more units. To minimise the amount of tax payable, you could consider holding the investment in the name of a low-income spouse (see Strategy 5) or using a discretionary trust (see Strategy 7).

Growth assets can provide a growing income

Putting money in the bank is safe – or so it seems. Although your capital is protected, the buying power of your money is not. The bogey is inflation, which drives up the cost of goods and eats away at the value of your money.

Remember when a newspaper cost 50 cents and a loaf of bread $1? Now consider what would happen to your money if you invested in a fixed term deposit for the next 20 years. Your capital will be repaid at the end of the term. However, if inflation averages 3% p.a., then the value of your term deposit will decline by around 50% in real (inflation adjusted) terms.

If you want to protect the purchasing power of your money (and the income you receive), then you should consider investing in growth assets such as shares.

How does the strategy work?

Shares have three major benefits when compared to term deposits.

1. **A growing capital value**
   Over the long-term, shares have provided significant capital growth, as a result of increasing share prices (see graph on page 2). With term deposits, on the other hand, you invest a dollar and get nothing more than a dollar back (ignoring interest).
2. **A growing income stream**
   With some companies, the dividend yields (see Glossary) are currently equivalent to, or greater than, the interest rates paid on term deposits. But even if the income from shares is initially lower than a term deposit, it doesn't necessarily stay that way forever. As share prices rise, the dividend income typically increases accordingly.
3. **Tax-effective income**
   The imputation credits that often come with dividends from Australian shares can be used to offset the tax payable on the dividends and other sources of income. What's more, any excess imputation credits are usually refundable (see FAQs on page 28).

Strategy #

02

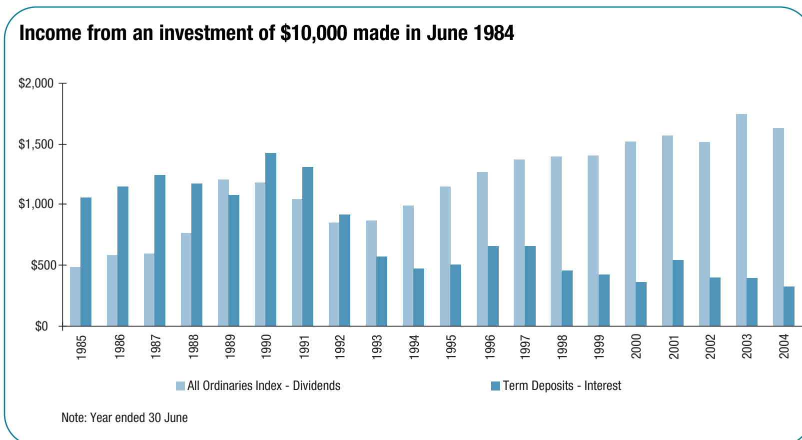
The benefits

- Build wealth by investing in growth assets.
- Generate a growing income stream to keep pace with inflation.

Case Study

Jack and Vanessa are friends and 20 years ago they each had $10,000 to invest. Jack decided it was important to protect his capital, so he invested in a term deposit. After seeking advice, Vanessa invested her money into an Australian Share fund. Both used the after-tax income from their investments to meet their financial commitments each year. The chart below compares the income from their respective investments over this period. Who was the more astute investor?

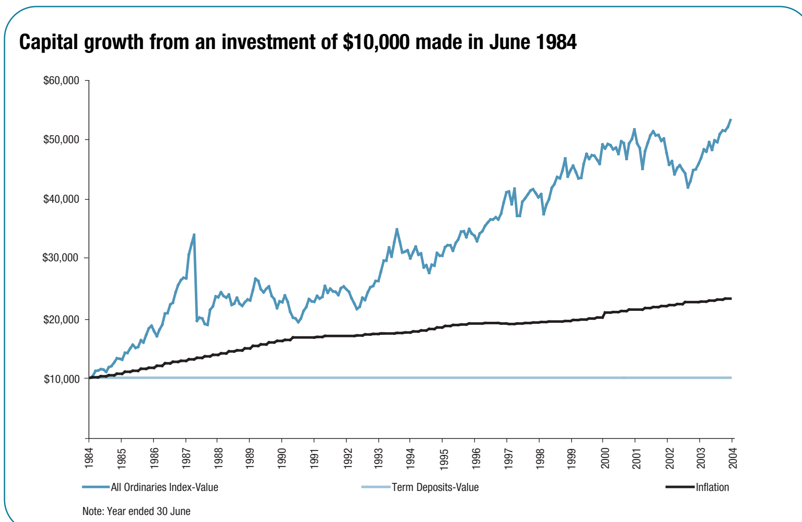
Income



Clearly Vanessa made the right move. Initially, her share fund paid less income than the term deposit but as her capital grew in value, so did her dividend income. By contrast, Jack's term deposit paid interest at the prevailing rates, based on the original capital value only.

Even more compelling is the growth in capital. Vanessa's share fund has grown to $53,579 (before tax), while Jack simply gets his initial $10,000 back (as the graph below reveals). However, the benefits of investing in shares would also have been significant, had Vanessa and Jack decided to reinvest their pre-tax investment income to compound their investment returns (see Strategy 1). In this scenario, their investments would have been worth $119,346 and $47,968 respectively.

Capital Growth



Assumptions for Income and Capital growth graphs: Returns are based on the ASX All Ordinaries Index and RBA Bank fixed deposit rates ($5,000 – $100,000). This example does not take into account tax on earnings or capital gains. This example is based on historical performance and is not indicative of future performance (future performance is not guaranteed and is dependant upon economic conditions, investment management and future taxation).

Tips and Traps

- To access greater opportunities and reduce investment risk, you should consider investing in shares through a unit trust. A unit trust provides broad diversification because your money can be spread over different investments, asset classes, sectors, markets and fund managers. This degree of diversification is hard to achieve when investing directly.
- A growing income stream is also favourable in retirement to help ensure that the purchasing power of your money (and your income) keep pace with inflation, over the longer term.
- Should you need to sell all or part of your investment, the resulting capital gain may be eligible for concessional tax treatment. Provided the asset has been held for at least 12 months, only 50% of the capital gain is taxable.
- Property investments can also provide a growing income stream and long-term capital growth. Investing in property via a unit trust can provide additional benefits, including diversification, lower costs and easier access to your capital when compared to investing directly.

A balanced approach beats trying to pick winners

The difference between good and mediocre investment results often comes down to the approach you take. For example, successful investors usually:

- Set lifestyle and financial goals
- Invest a set percentage of their money in each of the main asset classes (i.e. shares, property and bonds)
- Resist the temptation to switch their money around, based on short-term performance.

We call this the balanced approach.

'Chasers' by contrast, rarely set any goals. They move their money into an investment that has just shown a period of strong returns. They also take undue risks by investing all their money in a single asset class.

Over time, we believe that taking a balanced approach is one of the keys to investment success.

How does the strategy work?

Balanced investors realise that the best performing asset class in one year is not necessarily the best performer in the following year.

Take 1994 for example. A chaser would have invested in Australian Shares based on the strong returns in 1993, only to incur a loss of 8.7%. Then in 1995, they would have moved to cash after its good performance the previous year, only to miss out on the outstanding performance of global shares.

If you are starting to get the impression that chasing returns is like driving a car with your eyes fixed on the rear-view mirror, you're right. Chasing returns can make it more difficult to get where you want in the future.

Year ending 31 Dec	Aust. shares	Global shares	Property securities	Aust. bonds	Cash
1989	**17.4%**	26.7%	2.3%	14.2%	18.0%
1990	-17.5%	**-14.6%**	8.7%	18.4%	15.6%
1991	34.2%	20.9%	20.1%	**24.4%**	10.8%
1992	**-2.3%**	5.1%	7.0%	10.2%	6.6%
1993	45.4%	25.0%	30.1%	**16.6%**	5.2%
1994	**-8.7%**	-7.6%	-5.6%	-6.8%	5.4%
1995	20.2%	26.5%	12.7%	18.3%	**8.0%**
1996	14.6%	**6.8%**	14.5%	11.8%	7.4%
1997	**12.2%**	42.0%	20.3%	12.1%	5.5%
1998	11.6%	**32.6%**	18.0%	9.5%	5.0%
1999	16.1%	**17.5%**	-5.0%	-1.8%	4.8%
2000	3.6%	**2.5%**	17.8%	12.4%	6.1%
2001	10.1%	-9.3%	**14.6%**	3.8%	5.0%
2002	-8.1%	-27.1%	**11.8%**	7.7%	4.7%
2003	15.9%	2.5%	**8.8%**	2.2%	4.9%

Performance indices used to compile this table are: Australian Shares – All Ordinaries Accumulation Index; Global Shares – MSCI World Gross Accumulation Index ($A); Property Securities – Listed Property Trust Accumulation Index; Australian Bonds – Commonwealth Bank Bond Accumulation Index; Cash – UBS Warburg Australia Bank Bill Index. All earnings are reinvested but do not take into account the impact of tax and fees on earnings. This example is based on historical performance and is not indicative of future performance (future performance is not guaranteed and is dependant upon economic conditions, investment management and future taxation).

Strategy #

03

The benefits

- Achieve more consistent returns.
- Minimise your overall risk.

Case Study

Paul and Denise each invested $100,000 on 31 December 1988.

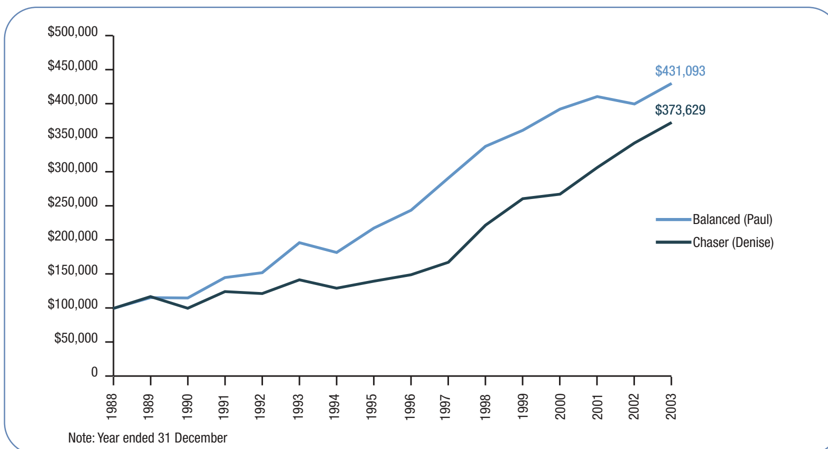
At the end of each year, Denise moved her money from one asset class to another, based on the returns from the previous year. By chasing returns, Denise ended up buying assets at higher prices and selling assets when their values had declined.

Paul, on the other hand, wasn't too concerned with short-term performance. After speaking to his financial adviser, he selected a portfolio consisting of 30% in Australian shares, 20% in global shares, 15% in property funds and 35% in Australian bonds.

Once his portfolio was established, Paul then bought and sold enough assets at the end of each year to bring his portfolio back to its original weighting. By implementing this re-balancing strategy, Paul was able to buy assets at bargain prices and sell assets when prices had reached higher levels.

Over this period of 15 years, Paul came out on top. He earned over $57,000 more than Denise without having to spend as much effort, or suffer as much anxiety.

Value of $100,000 invested over 15 years



Assumption: These returns are based on index performances shown in the table on page 10 and do not allow for fees or taxes on distributed income and capital gains.

Tips and Traps

- It's important to set financial goals to provide direction and help you avoid the temptation to change your portfolio in response to short-term market movements.
- By sticking with your investment strategy, you can minimise transaction costs such as brokerage fees and stamp duty.
- Multi-sector unit trusts provide ready-made diversification. To achieve your own spread across different asset classes, you can invest in a range of specific sector unit trusts.
- Unit trusts that use a multi-manager investment process can offer further diversification by blending investment managers with different but complementary investment styles.
- As investment values change, your allocation to the various asset classes will change over time. In order to maintain your investment strategy, you should consider re-balancing your portfolio regularly. Some multi-sector unit trusts automatically re-balance the portfolios on a regular basis.

Dollar cost averaging: taking the guesswork out of investing

You don't need a crystal ball to build wealth in investment markets. You can make money by simply investing a fixed amount at regular intervals over a period of time. You can also take the guesswork out of trying to pick the right time to buy and sell, and not have to worry about putting all your money in the market at the one time. This strategy is called 'dollar cost averaging' and it can help you to turn the ups and downs of investment markets to your advantage.

How does the strategy work?

Dollar cost averaging is a simple concept that works really well when investing on a regular basis via a unit trust. Assuming you invest a set amount each month, your money will buy more units when the unit price falls, and fewer units when the unit price rises.

Let's say that you invest $200 per month in a managed share fund over a five-month period. During this time we have assumed that the unit price drops from $10 to $5, before returning to $10 at the end of the fifth month.

Intuitively, you may think it would be hard to make any money. After all, the share price ended up at exactly the same point as it started. However, your total outlay would have acquired 140 units in the fund. So the value of your investment would have been worth $1,400 at the end of this period – a profit of $400 on the $1,000 you invested.

Month	Monthly investment	Unit price	Units purchased
1	$200	$10.00	20
2	$200	$6.66	30
3	$200	$5.00	40
4	$200	$6.66	30
5	$200	$10.00	20
Total	**$1,000**		**140**

Average price paid = $7.14 (i.e. $1,000/140 units)
Investment value at the end of 5 months = $1,400 (i.e. 140 units @ $10 each)

Strategy #

04

The benefits

- A disciplined way to invest for the long term.
- Takes the guesswork and emotion out of picking the right time to buy and sell.
- Allows you to start investing earlier as you don't necessarily need to have a substantial amount before you begin.

Case Study

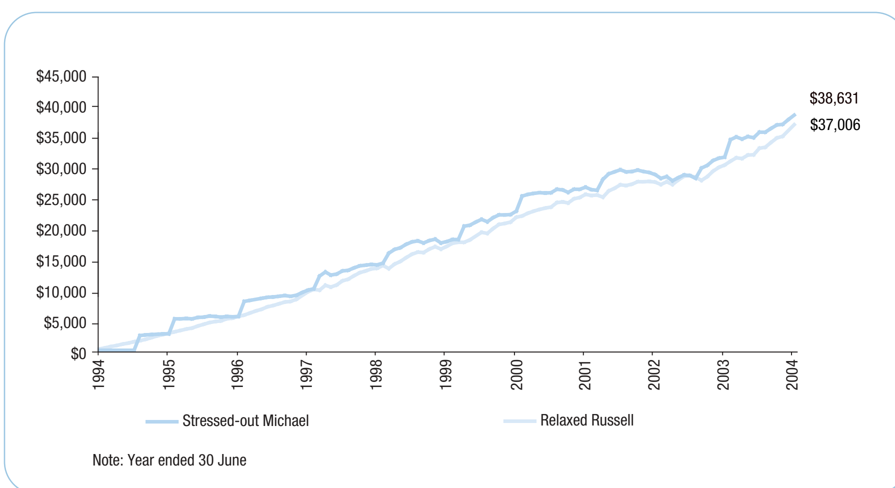
Russell and Michael each want to invest $2,400 a year through a unit trust for ten years. Russell decides to use dollar cost averaging and arranges for $200 to be transferred from his bank account on the same day every month.

Michael, on the other hand, decides he'd like to try and invest his $2,400 as a yearly lump sum when the market is at its lowest. That way, he can purchase more units with his money.

After spending a lot of time monitoring unit prices Michael surprisingly ends up investing at the lowest price every year. But was it worth it?

Despite all of Michael's hard work over the ten years, there is only a $1,900 difference between the value of their investments, as the graph below reveals. This also assumes Michael is lucky enough to pick the right time to invest each year – a difficult task that could easily have backfired.

$24,000 invested over 10 years – balanced fund*



* This example is based on the historical performance of a generic balanced fund comprising 30% Australian Shares, 35% Australian Bonds, 20% Global Shares and 15% Property Securities. The returns for each asset class are calculated using the All Ordinaries Accumulation Index, the Commonwealth Bank Bond Accumulation Index, the MSCI World Gross Accumulation Index ($A) and the Listed Property Trust Accumulation Index. All earnings are reinvested but do not take into account the impact of tax and fees on earnings. Russell invests $200 at the end of each month, whereas Michael invests $2,400 at the lowest price each year. This example is based on historical performance and is not indicative of future performance (future performance is not guaranteed and is dependant upon economic conditions, investment management and future taxation).

How did this happen?

There are two reasons why the value of Russell's investment was so close to Michael's:

1. Russell didn't try to time the market, so that when the unit price was low his money automatically bought more units.
2. By investing on a monthly basis, Russell allowed his money to benefit from the power of compounding returns. See Strategy 1 for more information.

Tips and Traps

- You should consider investing in shares or property (either directly or via a unit trust) to access the potential for long-term capital growth.
- An easy way to implement this strategy is to pay-yourself-first (i.e. invest a fixed amount of your salary each month before you spend your money on other things).
- You can purchase units in a unit trust automatically by arranging to have money transferred directly from your nominated bank account or your salary. Direct debit is available through most financial institutions and fund managers.
- By reinvesting your income to purchase additional units, your regular investments can benefit from the power of compound returns (see Strategy 1).
- To accelerate the creation of wealth, you could consider instalment gearing, which allows you to supplement your regular investments into a unit trust with regular drawdowns from an investment loan (see Strategy 8).

Income splitting: a simple way to save tax

It's no secret that tax can eat away at your investment returns. There is, however, a simple way to ensure you don't pay more tax than you have to. It's called income splitting and it involves placing investment assets in the name of your partner (or another family member).

The benefit is that the owner is required to pay tax on any income and capital gains from the investment. So if he or she is on a lower tax rate or not working at all, you may be able to minimise your household tax bill and make your money work harder.

Note: You can only split income from investments such as dividends, rent and interest. You cannot split income you earn from working.

How does the strategy work?

There are several ways you can split investment income with a lower income partner. The easiest way is to buy all new investments in your partner's name. However, if you currently own the investments yourself, you can achieve income splitting by:

1. **Transferring ownership** of the investments to your partner – but be aware this may have Capital Gains Tax (CGT) and stamp duty implications.
2. **Investing the after-tax income** from your investments in your partners name.

Not only will your partner pay less tax on the income received from the investments held in their name, but they will also pay less CGT when it comes time to sell them.

Before implementing an income splitting strategy, it's a good idea to see your financial adviser.

Strategy #

05

The benefits

- Reduce tax by investing in a lower income earner's name.
- Maximise the value of your investment by reinvesting the after-tax income in the name of the lower income earner.

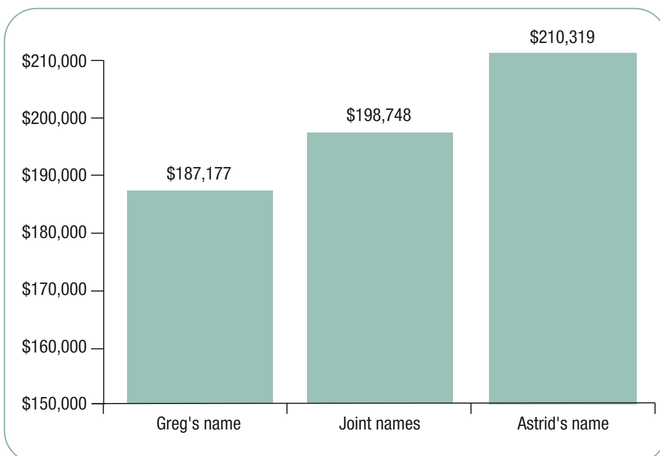
Case Study

Greg and Astrid are married and both aged 30. Greg pays tax at the highest marginal tax rate of 48.5%*, while Astrid works part-time and is on a marginal tax rate of 18.5%*. They wish to invest $400 each month into a balanced fund in a tax-effective way, and they are considering the following options:

- Investing in Greg's name
- Investing in joint names
- Investing in Astrid's name.

The graph below compares the value of the investment under each alternative, in 20 years time.

Value after 20 years ($400 per month)



Assumptions: A 20 year comparison. Total return is 7.5% (split 3% income and 4.5% growth). The overall franking level on income is 20%. All figures are after income tax at Greg and Astrid's marginal tax rates of 48.5%* and 18.5%* respectively but before CGT.

Clearly the balanced fund is more tax-effective if invested in Astrid's name, as the income would be taxed at a rate of only 18.5%*, allowing the money to compound and grow into a much larger amount.

However, the benefit of income splitting also applies to the capital gain made on the sale of the investment. For example, when Astrid withdraws her money after 20 years, the after-tax amount would be higher than if they had invested in either Greg's name or in joint names. This assumes that their respective marginal tax rates don't change over time.

* Includes a Medicare Levy of 1.5%

After-tax returns

	Greg's name	Joint names	Astrid's name
After CGT	$171,101	$187,392	$203,684

Proof again that even the simplest strategies can increase your wealth!

Tips and Traps

- When setting up a new investment, make sure it's in the name of the person on the lower marginal tax rate.
- Negatively geared investments (see Strategy 8) may be better held in the name of the person with the higher tax rate, due to the ability to use tax deductions to reduce tax on other income.
- To minimise CGT when transferring assets between partners, it may be better to defer the transfer to a lower income year (e.g. retirement) or transfer the assets progressively to spread the capital gain over a number of financial years (see Strategy 10).
- You can reduce CGT by using capital losses (see Strategy 9).
- Discretionary trusts (e.g. family trusts) can also be used to distribute income to beneficiaries in a tax-effective manner (see Strategy 7).
- Unit trusts typically pay income distributions at the end of each quarter. Distributions are taxable in the hands of the investor and must be included in annual tax returns, even if the distributions are reinvested to buy more units.

A tax-effective way to invest for your children

Putting money aside for your children or grandchildren can give them a kick-start later in life. It's also a smart way to save for a specific purpose such as their education.

However, for contractual reasons, a child is generally not able to invest in a unit trust in their own name. So for a child to be able to access the many benefits that a unit trust can provide (including broad diversification and expert investment management), you need to consider other approaches.

How does the strategy work?

Generally speaking, there are two main ways you can invest tax-effectively in a unit trust for a child.

1. **A parent or grandparent can invest as trustee for a child.** In this situation, the income is taxed at a special rate (often referred to as children's tax). The first $772 of non-employment income is tax-free, but amounts over this can be taxed as high as 66% (see FAQs on page 29).

   When the child reaches 18, and they cease to be a minor, the investment can be transferred into their own name and no Capital Gains Tax (CGT) is payable. However, if they later decide to redeem the investment, CGT is payable at normal adult marginal tax rates.

2. **A parent or grandparent can invest directly in his or her own name.** In this scenario, all income and capital gains from the investment will be assessed against that person. To minimise tax, it's a good idea to choose an owner that pays tax at a lower marginal rate (see Strategy 5).

   However, CGT is potentially payable by the parent or grandparent if the investment is transferred to the child at a later date.

The best approach for you will depend on a range of factors, including the amount invested and the income generated (see Case Study). Other (non-tax) issues should also be considered – including who should have control over the investment decisions. For these reasons, you should seek professional financial advice before investing money on behalf of children.

Strategy # 06

The benefits

- Accumulate savings on behalf of a child in a tax-effective manner.
- Reduce tax by investing in the appropriate person's name.

Case Study

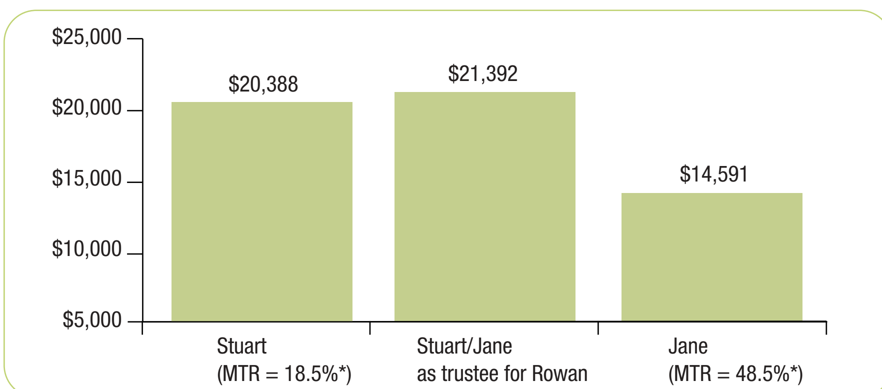
Stuart and Jane would like to save enough money to send their newly born son, Rowan, to university when he turns 18. Stuart is currently paying income tax at a marginal tax rate of 18.5%*, while Jane pays tax at the highest marginal rate of 48.5%*.

They plan to invest $5,000 for Rowan in a share-based unit trust and are considering the following options:

- Investing in Stuart's name
- Investing in Stuart or Jane's name, as trustee for Rowan (where the income will be taxed at children's rates)
- Investing in Jane's name.

The graph below compares the value of the investment under each alternative, in 18 years time.

Final benefit after 18 years ($5,000)



Assumptions: Total return is 8% p.a. (split 2.5% income and 5.5% growth). The overall franking level on income is 25%. All figures are after CGT. Upon sale of his investments at age 18, Rowan is taxed at adult marginal tax rates and receives no other sources of income.

* Includes a Medicare Levy of 1.5%

As you can see, it would have been better to invest in Stuart or Jane's name as trustee for Rowan given that the taxable income from the unit trust would have been less than the tax-free amount of $772 for much of the investment period.

It should be noted however, if the investment for Rowan were larger, say $20,000, then the results would have been quite different.

Final benefit after 18 years ($20,000)*

Stuart's name	In trust for Rowan	Jane's name
$80,758	$74,016	$58,364

* After CGT

In this scenario, Stuart is likely to pay less tax over the life of the investment, highlighting the importance of making the right ownership decision.

Before you decide how you are going to invest, you should speak to a financial adviser, as circumstances vary from person to person.

Tips and Traps

- Regardless of whose name the investment is in, if the parent or grandparent makes all decisions in relation to the investment and uses the income as if it were their own, then they are likely to be considered the owner for tax purposes. As such, all income and capital gains will be taxed at their marginal rate.
- If you want the children's tax rates to apply when investing as trustee for the child you typically need to supply the child's Tax File Number (TFN). You could instead provide the parent's TFN where the income from the investment is less than $772 p.a., however you will need to supply the child's TFN once income exceeds this level.
- Investment income may be exempt from children's tax rates if the child is in full-time employment and/or the investment was made with money earned by the child from employment. If so, you should consider investing directly in that child's name.
- If you are a grandparent investing on behalf of a grandchild, the amount 'gifted' to the grandchild could affect your social security entitlement.
- Discretionary trusts (e.g. family trusts) can be used to redirect earnings from investments to children (see Strategy 7).

Discretionary trusts: a flexible income splitting alternative

Investing in the name of your partner or on behalf of a child (see Strategies 5 and 6) can help you to save on tax as a family unit. Another tax-effective strategy worth considering is holding assets in a discretionary trust arrangement (e.g. a family trust).

When you set up a discretionary trust, all assets are owned by the trustee(s) on behalf of the nominated beneficiaries (usually the primary investor and his or her immediate family members). This gives the trustee(s) the opportunity to distribute income in the most tax-effective manner. However, this is just the tip of the iceberg.

Discretionary trusts offer a number of other benefits – including protection from creditors and estate planning advantages (see Tips and Traps). The trustee can also choose from a wide range of managed and directly owned investments.

How does the strategy work?

Any income from the discretionary trust investments must be allocated to beneficiaries and included in their annual tax return – even if the income is reinvested*. However, provided the trust deed allows, the trustee has the flexibility to decide which beneficiaries receive the investment income each year, and in which proportions.

For example, the trustee(s) could elect to distribute investment income to:

- Children under the age of 18 (who can receive up to $772 tax-free each year).
- Children over the age of 18 (who can earn up to $7,382 per annum without paying any tax).
- A low-income or non-working spouse (to take advantage of their lower marginal rate).

Income can also be directed to different beneficiaries, without having to transfer ownership of the assets.

Given the potential complexities you should always seek legal and financial advice before undertaking a discretionary trust strategy.

* Otherwise the unallocated trust income is taxed at the highest marginal rate of 48.5% (including the Medicare Levy).

Strategy #

07

The benefits

- A discretionary trust can reduce the amount of tax payable by a family group.
- The tax savings mean that more money can be reinvested to build future wealth.

Case Study

Ken and Diane are trustees of a discretionary trust. Ken earns $80,000 p.a., while Diane earns $12,000 a year from part-time employment. The other beneficiaries of the trust are their three children – Andrew (aged 21), Melanie (aged 18) and Sarah (aged 14).

Andrew and Melanie are full-time university students and none of the children earn income from sources other than the discretionary trust.

For the 2004/05 tax-year, the discretionary trust generates taxable income of $18,000. To minimise the amount of tax payable as a family unit, the trustees decide to distribute the income among the beneficiaries in the following manner.

- $772 to Sarah because she is taxed at child rates and can receive this amount without paying any tax.
- $7,382 to both Andrew and Melanie to make maximum use of the tax-free threshold of $6,000 plus the low-income tax offset.
- $2,464 (i.e. the remaining income) to Diane because she pays tax at a lower marginal rate than Ken. Diane will also pay tax at the same (or a lower) marginal rate than the three children, should additional income be distributed to them.

The table below summarises the income allocation and tax payable by each of the beneficiaries.

Beneficiary	Income Allocation	Tax Payable
Sarah	$772	Nil
Melanie	$7,382	Nil
Andrew	$7,382	Nil
Diane	$2,464	$419
Total	**$18,000**	**$419**

By implementing this strategy, they will pay a total tax bill of $419 on $18,000 in investment income. This represents an effective tax rate of 2.33% – a great outcome. They might also benefit further from a refund of excess franking credits, if the taxable income contained franked dividends from Australian shares (held directly or via a unit trust).

Note: If they had not set up a discretionary trust (and invested purely in Ken or Diane's name) they would have paid tax of $8,730 and $4,837 respectively.

Tips and Traps

- A discretionary trust may offer protection from creditors (e.g. in the event of bankruptcy), given that the assets are owned by the trust and are not held personally.
- The assets of a discretionary trust do not form part of a deceased beneficiary's estate and upon death the remaining beneficiaries of the trust will continue to receive income.
- Despite distributing income in a tax-effective manner each year, discretionary trusts are unable to distribute trust losses. Consequently, discretionary trusts rarely work well when implementing a negative gearing strategy (see Strategy 8).
- Before 'gifting' an asset into a discretionary trust, make sure you take into account any capital gains tax and stamp duty that may be payable. Gifting assets may also impact your social security entitlement.
- You should also carefully consider whether the benefits of having a discretionary trust outweigh the costs. A trust could cost several hundred dollars to establish and annual accounting fees may be payable.

Use borrowed money to build wealth

Just like you can borrow money to buy a family home, you can do the same to build wealth. This is commonly known as 'gearing'. A gearing strategy can multiply your profits since:

- You have more money invested than if you hadn't borrowed
- You may benefit from a number of tax concessions (see FAQs on page 30).

However, the down side is that gearing can multiply your losses if your investments fall in value.

For a gearing strategy to be successful in the long term, the investments you acquire with borrowed money must generate a total return (income and growth) that exceeds the after-tax costs of financing the investment (including interest on the loan).

How does the strategy work?

There is a variety of ways you can borrow money to invest:

1. **You can borrow against the equity in your home.** This approach offers the benefit of a low interest rate and there are no restrictions on which investments you can buy.

2. **You can take out a margin loan with a lending institution.** With a margin loan, the investments you purchase are used as security for the loan. The lending institution will typically lend you up to 70% of the value of approved assets.

   For example, if you have $30,000 and you want to invest in an approved asset with the help of a margin loan, you may be able to borrow up to $70,000, thus making a total investment of $100,000. It's also possible to gear on a regular basis by implementing what is known as an 'instalment gearing' strategy (see Glossary).

3. **You could invest in an internally geared share fund.** These are funds that borrow to leverage an investment in Australian or global shares.

To work out which gearing approach suits you best, we recommend you seek financial advice.

Strategy #

08

The benefits

- Gearing increases the amount of money you have to invest and therefore potentially boosts your returns.
- Negative gearing can help you to reduce the overall tax you pay (see FAQs on page 30).

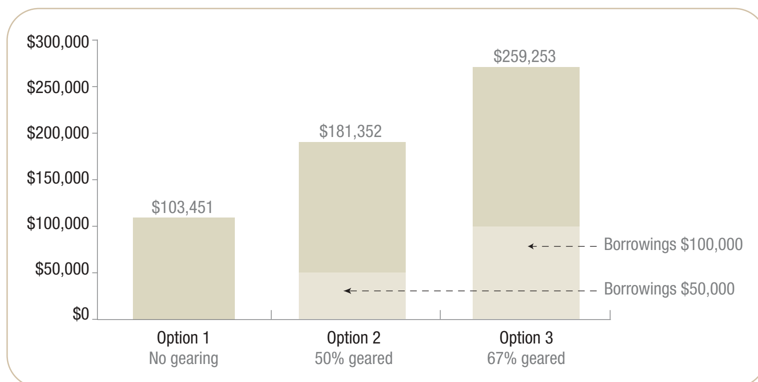
Case Study

Jenny has $50,000 invested in an Australian share fund and would like to increase her return through the use of a gearing strategy. Jenny considers the following three options provided by her financial adviser.

1. Maintain her investment at its current level of $50,000
2. Double her investment by borrowing $50,000 (i.e. 50% gearing)
3. Increase her investment even more by borrowing $100,000 (i.e. 67% gearing)

In options 2 and 3 Jenny will use an interest-only loan with an interest rate of 7% p.a. The following graph illustrates the potential outcome of the three options after ten years.

Value of investment after ten years



Assumptions: Investment return is 8.5% p.a. (split 3% income and 5.5% growth). The franking level on income is 75%. Interest on the loan is 7% p.a. Jenny's marginal tax rate is 48.5% including Medicare Levy. Where investment income and tax benefits are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax savings are reinvested.

Clearly, the higher the gearing ratio the greater the potential returns. It must be remembered, however, that Jenny still has an outstanding loan in options 2 and 3 of $50,000 and $100,000 respectively. If Jenny withdrew a portion of her investment after ten years to repay the outstanding debt (and pay Capital Gains Tax (CGT) on the amount withdrawn), the value of her investment is shown in the table below.

Value of investment after repayment of loan

No gearing	50% geared	67% geared
$103,451	$125,763*	$148,076*

* After CGT on the amount withdrawn.

As you can see, Jenny's financial position could improve significantly by using a gearing strategy, so long as the value of her investments rise sufficiently.

Caution: If Jenny's investment falls in value over the ten years, her financial position would be significantly worse with options 2 and 3 compared to the no gearing approach of option 1.

Tips and Traps

- Gearing should be seen primarily as a wealth creation strategy rather than a way to save tax. Therefore the focus should be on acquiring high quality investments with the potential for long-term capital growth (e.g. shares and property).
- Your geared investments should produce assessable income so that the interest cost is tax deductible.
- If you maintain a conservative loan to valuation ratio, you can reduce the likelihood of a margin call on a margin loan (see Glossary). You should also hold a sufficient cash reserve to meet margin calls if required.
- To reduce your tax bill at the end of each year, you could consider paying interest in advance. Interest deductions for up to 12 months in advance can be claimed in the tax-year they are paid.
- You should take out income protection insurance to make sure you are covered if you are disabled and can't earn an income.
- If the lending institution requires the entire loan to be paid back in the event of your death, you should ensure you have sufficient life insurance.

Use losses to reduce capital gains tax

An easy method to help you reduce your tax bill is to minimise the value of any capital gains you receive. One way to do this is to sell a poor performing asset that no longer suits your circumstances.

By implementing this strategy, you can use the capital loss you incur to offset a realised capital gain from another asset in the same financial year – including capital gains received as part of a unit trust distribution.

How does the strategy work?

When you invest in a unit trust, the fund manager decides when to buy and sell the underlying assets, and usually passes on any realised capital gains to investors via the final income distribution at the end of the financial year.

However, some unit trusts – including the MLC MasterKey Unit Trust – make their final distribution at the end of May each year. This may give you (and your adviser) sufficient time to review the size of the distributed capital gains and the performance of the rest of your investment portfolio.

If necessary, you can then sell any poor-performing investments before the end of the financial year and utilise the capital loss to offset some (or all) of the realised capital gains distributed by the unit trust (as well as realised gains from directly owned investments). You can also use the money you receive (including any potential tax savings) to pursue more suitable investment opportunities.

Note: Some unit trusts make their final distribution on 30 June each year. Given the timing, it can be very difficult to implement this (or any other) Capital Gains Tax (CGT) strategy. Your adviser can help you to select a unit trust that offers you enough time to do some year-end tax planning.

Strategy # 09

The benefits

- You can minimise your CGT liability by selling a poor performing investment and using the capital loss you incur to offset a capital gain on a different asset.
- By redeeming a poor performing asset, you can free-up money for more suitable investment opportunities.
- By investing in a unit trust that distributes realised capital gains prior to the end of the financial year, you can manage your CGT liability more effectively.

Case Study

Bob received a distribution consisting of $6,000 in realised capital gains from an Australian share unit trust in the 2004/05 financial year (with all gains eligible for the 50% CGT discount). Assuming Bob pays tax at a marginal rate of 48.5%*, he will need to pay $1,455 in CGT on this distribution, as shown in the following table.

Before strategy

Distributed capital gains	$6,000
Less 50% CGT discount	($3,000)
Taxable capital gain	$3,000
CGT payable at 48.5%*	$1,455

However, Bob also has some shares in a company called XYZ Limited that he bought two years ago for $10,000 and are now worth $5,000. By selling these shares and triggering a capital loss of $5,000 before 30 June 2005, Bob will be able to make significant CGT savings (see below).

After strategy

Distributed capital gains	$6,000
Less capital loss on XYZ Limited shares	($5,000)
Net capital gains	$1,000
Less 50% CGT discount	($500)
Taxable capital gain	$500
CGT payable at 48.5%*	$243

*Includes a Medicare Levy of 1.5%

By implementing this strategy, Bob has reduced his tax bill by over $1,200!

Tips and Traps

- While there is generally no problem with you selling an asset to crystallise a capital loss, the Australian Tax Office may have an issue if you then seek to immediately repurchase the same asset (if the dominant purpose of the transaction is to gain a tax advantage). You should therefore seek professional tax advice before considering such an arrangement.
- It is possible to crystallise a loss on the sale of units in a unit trust (either by redeeming units in the fund or switching to a different investment option). These losses can then be used to offset gains on other assets as well as distributed gains from the unit trust itself.
- Capital losses can only be offset against capital gains and not against any other type of income.
- Excess losses can also be carried forward to offset against gains in future years.
- If you have different classes of capital gains (see FAQs on page 29), it's generally a good idea to apply capital losses against non-discount gains first (i.e. gains on assets held less than 12 months and gains where the indexation method has been used) and then discount capital gains.
- Investment decisions should not be solely driven by taxation outcomes. They should always be considered in light of an investment strategy designed to meet your lifestyle and financial goals.

Defer asset sales to manage capital gains tax

If you need to sell a profitable asset, you should consider delaying the sale until after 30 June 2005. By implementing this strategy in the new financial year, you can defer the payment of Capital Gains Tax (CGT). Depending on your circumstances you may also be able to reduce your CGT liability.

How does the strategy work?

CGT is generally only payable by individuals after they lodge their tax return for the financial year in which an asset is sold. By deferring the sale of an asset until after 30 June 2005, you may be able to delay paying tax on your capital gain for up to 12 months – in some cases longer.

If you expect to earn a lower taxable income next financial year (eg. because you plan to retire or intend taking parental leave), the marginal tax rate you have to pay on realised capital gains in 2005/06 may also decline considerably – resulting in a significant tax saving.

It may also be a good idea to hold assets for more than 12 months so that you can take advantage of the 50% CGT discount. CGT is only payable on 50% of the capital gain if an asset is held by an individual for more than a year, reducing the effective tax rate on capital gains from 48.5% to 24.25% (for higher income earners).

Strategy #

10

The benefits

- Defer paying CGT for 12 months (or more).
- Minimise CGT by deferring the sale to a lower income year (e.g. retirement).

Case Study

Natalie (aged 32) currently works full-time, pays tax at the highest marginal rate of 48.5%* and is considering selling some shares that have increased in value by $10,000 over the last five years. By selling the shares before the end of the financial year, Natalie will need to pay $2,425 in CGT after applying the 50% CGT discount (assuming she has no capital losses).

Before strategy

Realised capital gains	$10,000
Less 50% CGT discount	($5,000)
Taxable capital gain	$5,000
CGT payable at 48.5%*	$2,425

However, Natalie plans to take 12 months maternity leave next financial year. As a result, she anticipates that her marginal tax rate will decline from 48.5%* to 18.5%*. By selling her shares in the new financial year, Natalie will be able to take advantage of her lower marginal tax rate and reduce her CGT liability to $925 (see below).

After strategy

Realised capital gains	$10,000
Less 50% CGT discount	($5,000)
Taxable capital gain	$5,000
CGT payable at 18.5%*	$925

* Includes a Medicare Levy of 1.5%

By implementing this strategy, Natalie will cut her tax bill by $1,500!

Note: Investment decisions should not be solely driven by taxation outcomes. They should always be considered in light of an investment strategy designed to meet your lifestyle and financial goals.

Tips and Traps

- You may want to defer asset sales when transferring assets into a spouse or family member's name for income splitting purposes (see Strategy 5).
- Depending on your situation, a smarter strategy could involve selling a portion of a share or unit trust investment in the current financial year and the remainder after this date. By spreading the sale of an asset over several financial years, you may be able to reduce your CGT liability even further.
- Some unit trusts (including the MLC MasterKey Unit Trust) allow investors to select which parcel of units they want to sell. For example, if you have made several separate investments in a unit trust (at different prices), you don't have to sell the first parcel you purchased. Selecting the right units to sell can also help you to minimise your CGT liability.
- If you must sell a profitable asset this financial year, there are some other strategies you can use to save on CGT. You may be able to use losses to your advantage (see Strategy 9). If you are self-employed, substantially self-employed or under 65 and recently retired, you could consider making a tax-deductible contribution into a super fund to offset your capital gains. Speak to your financial adviser to find out more about this strategy.

Assets: the building blocks for wealth creation

There are four main asset classes: cash, bonds, property and shares. These are the essential building blocks for wealth creation. A diversified investment portfolio should contain a mix of each asset class, in proportions that reflect your age, personal situation, financial objectives,

Asset class	Investment timeframe
Cash Includes bank bills, treasury notes, term deposits and cash management trusts. Most managed investments keep a small cash reserve to cover transaction costs and withdrawals made by unit holders.	Short term (1-3 years)
Bonds Issued by Governments and large companies to raise capital. When you invest in a bond you are lending money to the issuer in return for interest and your capital back at the end of the term.	Short to medium term (3-5 years)
Property Includes residential, commercial, industrial and retail buildings and land, as well as tourist resorts, farms, vineyards, roads and power stations.	Medium term (5 years)
Shares Buying a share in a company means you become a part owner of that company. Investing in shares indirectly through a managed investment gives you exposure to a portfolio of shares spread across different sectors and markets. Global share funds also give you exposure to larger overseas sharemarkets.	Medium to long term (5 to 7 years)

investment timeframe and attitude towards risk. The right asset mix for you should be determined with the assistance of a professional financial adviser. Each asset class has its own unique characteristics as summarised below:

Benefits	Risks
• Considered a safe investment, as there is little chance of losing your capital. • Ease of access to your money. • Provides a convenient transaction account or a transitional account to 'park' your money while you consider longer-term investments.	• Relatively low returns. • Buying power of your money may be eroded by inflation in the long term compared to other asset classes. • Sensitive to movements in interest rates. • Not tax-effective.
• Relatively secure as your interest is fixed and your capital is generally protected. • Less volatile than other asset classes. • Capital gains can be made in a bond fund and these gains can be passed to you by way of higher income distributions.	• Relatively low returns. • Buying power of your money may be eroded by inflation in the long term compared to other asset classes. • Sensitive to interest rate movements. • Capital loss may lead to no distribution of income.
• Generates stable income and capital growth. Historically, property has outperformed bonds and cash. • Protects against inflation. • Income from direct property may qualify for tax concessions (e.g. depreciation). • Income from property trusts may also qualify for tax concessions (e.g. tax deferred income). • In a managed investment (e.g. a property securities fund), risk is reduced as your money is spread across different property sectors. You also have ready access to your money.	• High initial costs and outlay. • High transaction costs (e.g. stamp duty). • High maintenance. Many of these disadvantages can be overcome by investing in a property securities fund.
• Best potential for long-term capital growth. Over the long term, shares have outperformed other asset classes. • Can generate a growing income stream. • Tax benefits through dividend imputation system (Australian shares). • Relatively liquid as shares can be sold quite easily.	• Volatile in the short term. • Uncertain income stream, as dividend payments can rise and fall over time. • Risk of capital loss if the company's share price falls and you are forced to sell.

FAQs

How is income from a unit trust taxed?

A unit trust does not pay tax if all income and realised capital gains are distributed to unit-holders each year. Instead, the distributions are taxed in the hands of unit-holders, after allowing for any related tax benefits. This is known as the 'flow through' principle and it ensures that distributions are taxed in the same way as income and capital gains received from directly owned investments. The distributions need to be included in your assessable income in the year that they relate – even if they are reinvested to purchase more units.

How is income from Australian shares taxed?

Many Australian companies pay dividends from their profits after tax has been paid to the Australian Tax Office (usually at the company rate of 30%). To ensure that the dividends aren't double taxed (i.e. in the hands of the company and the hands of the investor), the Government allows investors to claim a tax offset for the company tax already paid. This tax offset is called a franking credit (also known as an imputation credit).

Regardless of whether you invest in Australian shares directly or via a unit trust, you are required to include the dividend and the franking credit in your assessable income. The franking credit can, however, be used to reduce the amount of tax you are required to pay on the dividend and other sources of income (see below).

How does dividend imputation work?

The following example illustrates the advantages of dividend imputation, assuming shareholders on different marginal tax rates receive a fully franked dividend of $70.

Marginal Tax Rate	**17%**	**47%**		**This, in very simple terms, is how dividend imputation works**
Dividend	$70	$70	❶	A company pays a fully franked dividend*
Franking credit	$30	$30	❷	You add the franking credit† to your dividend
Assessable income	$100	$100	⇦	to get your assessable income
Gross tax	$17	$47	❸	Then you calculate the gross tax based on your tax rate
Less franking credit	($30)	($30)		and subtract the franking credit
Net tax payable	**nil**	**$17**	⇦	**to get your net tax payable.**
Excess franking credit	$13	nil		If your franking credit is larger than your gross tax, the ATO will offset (i.e. refund) any excess.
Net income received	**$83**	**$53**	⇦	**Deduct your net tax from your dividend, or add your excess franking credit to your dividend, to get your after-tax income.**

* This is the after-tax income distributed by the company.
† This is the tax already paid by the company at the company tax rate of 30%.
Note: Certain investors who are unable to use all their franking credits can claim a refund of these credits in their annual tax return.

How is income from property trusts taxed?

Property trusts usually distribute the following types of income:

1. Assessable income, such as rents received by the trust from the tenants of the underlying properties. This type of income offers no tax advantages and is taxed at your marginal rate.
2. Tax deferred income that arises from the property trust writing off the value of assets such as fixtures and fittings. This income is not taxable in the year of receipt, but reduces the cost base that is used to determine your capital gains or losses when redeeming units.

How is interest income taxed?

The interest you receive from cash accounts (e.g. term deposits) and bonds is fully taxable at your marginal rate. Interest income can vary over time, depending on the Government's interest rate objectives and economic conditions.

What is Capital Gains Tax (CGT)?

CGT is a tax on the growth in the value of certain assets or investments acquired after 19 September 1985, and is only payable when a gain is realised. This usually occurs when an asset is sold or where there is a change in ownership. However, when you invest via a unit trust, you may also receive realised capital gains via the distribution(s) if the fund manager sells underlying investments for a profit.

A capital gain will arise where the proceeds received on disposal exceed the cost base of the asset. For assets disposed of on or after 11.45am (ACT time) 21 September 1999, CGT is usually payable by individuals and trusts on 50% of the nominal gain where the asset has been held for more than 12 months (i.e. the difference between the sale price and the cost base). Because only half the gain is taxable, the effective tax rate for an individual on the highest marginal tax rate (including Medicare Levy) of 48.5% is reduced to 24.25%.

For assets acquired before 21 September 1999, certain investors can choose between two different methods when working out their CGT liability.

1. They can elect to be taxed on 100% of the ‘real’ gain (i.e. the difference between the sale price and the frozen indexed cost base as at 30 September 1999).
2. They can choose to be taxed on 50% of the ‘nominal’ gain.

However, if an asset is held for 12 months or less, neither the 50% discount nor indexation applies (i.e. the investor is taxed on the full nominal gain).

How are capital losses treated for tax purposes?

A capital loss occurs when the proceeds received on disposal of an asset are less than the reduced cost base. A capital loss can be offset against current year capital gains, but cannot be used to reduce other sources of assessable income (e.g. salary). If there is a net capital loss for the income year, the loss can be carried forward and offset against capital gains in future years.

What tax deductions can be claimed when investing?

Certain expenses may be claimed as a tax deduction to reduce your assessable income. The more significant deductible expenses include:

- Interest charged on money borrowed to purchase income-producing investments, such as shares and investment property
- Account keeping fees charged on bank accounts held for investment purposes
- In certain circumstances deductions including retainers and fees paid for ongoing investment advice.

What are the current marginal tax rates?

The table below summarises the marginal tax rates in 2004/05:

Taxable income range	Tax payable (by residents)
$0-$6,000	Nil
$6,001-$21,600	17% on amount over $6,000
$21,601-$58,000	$2,652 + 30% on amount over $21,600
$58,001-$70,000	$13,572 + 42% on amount over $58,000
$70,001 +	$18,612 + 47% on amount over $70,000

How are minors taxed?

A person under the age of 18 may be required to pay tax on non-employment income (e.g. dividends and interest) at the following rates, regardless of whether the income is derived directly or via a unit trust.

Amount of non-employment income	Tax payable
0-$416	Nil*
$417-$1,445	66% on amount over $416
$1,445 +	47% of entire income

* With the low-income tax offset the tax-free amount is increased to $772.

If the minor is engaged in full-time employment at the end of the income year, or for at least three months during the year, the income will be taxed at normal marginal rates.

What is the Medicare Levy?

The Medicare Levy is a levy of 1.5% that is payable on your taxable income on top of normal marginal rates. If you earn less than $15,529 p.a. ($26,205 for couples) you are exempt from the levy. An additional 1% is charged for couples with a combined income over $100,000 ($50,000 for singles) who have no private health insurance.

What is gearing?

'Gearing' simply means borrowing money to invest. You can benefit from gearing if the growth in the value of the investment and the income you receive is greater than the after-tax cost (including interest on the loan).

How does negative gearing work?

Negative gearing arises when the interest payments (and other costs) on your investment loan in a particular year are more than the assessable income received from your geared investment. In this situation, the cash-flow shortfall can generally be claimed as a tax deduction to offset other sources of assessable income.

For example, if you invest $100,000 of your own money plus $100,000 of borrowed money (at an interest rate of 7% p.a.) into an asset that produces an annual income of 3%:

- Your interest bill for the year will be $7,000
- Your investment income will be $6,000
- The cash-flow shortfall of $1,000 can be deducted from other assessable income (e.g. salary) in your annual tax return.

If you are on the top marginal tax rate of 48.5% (including Medicare Levy), this strategy will save you $485 in tax each year.

Caution: Investors who negatively gear should ensure they can meet cash-flow shortfalls during the year.

What is positive gearing?

Positive gearing occurs when the assessable income from your investments is greater than the interest and other costs you pay on the borrowed money.

For example, if you invest $100,000 of your own money plus $50,000 of borrowed money (at 7% p.a. interest), your investment income will be $4,500 (at 3% p.a.) and your interest bill will be $3,500, leaving you with a cash-flow surplus of $1,000 p.a.

How can gearing help you save tax?

Gearing not only increases your potential to make money, it can also save you tax. The potential tax benefits of gearing include:

- Where the interest expense (plus costs) exceeds the assessable income in a particular year (i.e. the investment is negatively geared), the excess expense is generally tax-deductible and can be used to reduce the tax payable on your other income such as salary.
- If you invest the borrowed money in Australian shares directly or via unit trusts (e.g. through an Australian share unit trust), the income you receive may have franking credits attached. These credits can be used to offset other tax payable, with any excess franking credits refunded to you.
- You may claim a tax deduction for the interest expense in the current financial year, but defer CGT until you dispose of the investment. The investment may also be sold in a low-income year (e.g. post retirement) to minimise CGT.
- Where the investment is held for at least 12 months, only 50% of the capital gain can be included in assessable income.
- You may be able to pre-pay interest costs up to 12 months in advance, giving you a greater potential tax deduction in the current financial year.
- Negative gearing will reduce your taxable income, which can assist in minimising the surcharge that applies to superannuation contributions and termination payments for high-income earners. It could also assist in minimising the Medicare Levy surcharge and your CGT liability.

Note: You need to carefully consider in whose name the geared investment should be held. It may be better to hold the investment in the name of a higher marginal tax rate payer (to maximise the value of tax deductions in a negative gearing scenario). However, it could be equally advantageous to have the investment in the name of a low marginal tax rate payer (to reduce the amount of CGT payable at the end of the investment period).

How are unit trusts treated for social security purposes?

Assets test

The capital value of unit trusts are fully assessed under the social security assets test.

Income test

Unit trusts are included with a person's other financial assets, such as term deposits and shares, and are deemed to earn a certain rate of income for the purposes of determining eligibility for Government income support payments.

As at 1 July 2004, a deeming rate of 3% applies for the first $36,400 of an individual's total financial assets ($60,600 for couples), while amounts above these thresholds are deemed to earn income at 5%.

Glossary

All Industrials Index – An index that measures the price of shares listed on the Australian Stock Exchange (ASX) in sectors such as infrastructure and utilities, banking, chemicals, retail, transport, property, tourism and leisure.

All Ordinaries Index – An index that measures the movements in the major shares listed on the Australian Stock Exchange (ASX). The All Ordinaries is broken into a series of subindices including the All Industrials and All Resources Indices.

All Ordinaries Accumulation Index – An index that measures the movements in the major shares listed on the Australian Stock Exchange (ASX), taking into account the reinvestment of dividends.

All Resources Index – An index that measures the price of shares listed on the Australian Stock Exchange (ASX) in sectors such as gold, other metals diversified resources and energy.

Assessable income – Income including capital gains, on which you pay tax (i.e. your total income before deducting allowable tax deductions).

Asset allocation – The process, by which you select where, and into what assets, you invest your money.

Australian Securities and Investment Commission (ASIC) – The Government body responsible for regulating companies and investments, and licensing investment advisers.

Balanced fund – A fund that invests in a mix of different asset classes, including shares, property, bonds and cash.

Bonds – Bonds are issued by Governments and large corporations in Australia and overseas. The bondholder receives interest for the fixed term of the bond, which can typically range from 2 to 20 years and the capital value is influenced by changes in interest rates.

Capital Gains Tax (CGT) – A tax on the growth in the value of assets or investments that is payable when a gain is realised. If the assets have been held for more than one year, the capital gain may receive concessional treatment.

Cash Management Trust (CMT) – A Cash Management Trust is a managed investment that invests in high-yielding money market securities. CMTs tend to provide a flexible, better performing alternative to a bank savings account.

Consumer Price Index (CPI) – A measure of inflation taken each quarter based on the price of a basket of typical household goods and services.

Disposal of an asset – Refers to the sale or transfer in ownership of an asset.

Diversification – Spreading your money across asset classes, sectors, markets and fund managers to reduce investment risk.

Dividend – Distribution of part of a company's profits to shareholders expressed as a number of cents per share. Companies typically pay dividends twice yearly – an interim dividend and a final dividend.

Dividend yield – The dividend expressed as a percentage of the share price.

Equity – Equity is the interest or value that an owner has in an asset, over and above any debt against the asset. For example, the equity of a homeowner is the value of the home less any outstanding loan.

Franked dividends – Dividends paid by a company out of profits on which the company has already paid Australian tax. They entitle resident shareholders to a tax offset.

Instalment gearing – Investing on a regular basis by periodically drawing on an investment loan. Takes advantage of dollar cost averaging (see Strategy 4) and gives you the flexibility to make adjustments to your gearing and investment arrangements, should you need to.

Liquidity – The capacity of an investment to be readily converted into cash. Listed shares, for example, are relatively liquid because they can be easily sold on the market.

Managed investment (or managed fund) – The collective term used to describe investments that pool your money with the money of other investors to form a fund that is invested into assets based on set investment objectives. A 'sector specific' fund invests in only one asset class (e.g. global shares) while a 'multi-sector' (or 'diversified') fund invests in a number of asset classes.

Management expense ratio (MER) – The MER is the total annual fees and expenses of a fund divided by its average net assets.

Margin call – With a margin loan (see below), the lender is prepared to lend up to a maximum limit known as the loan to valuation ratio (LVR). The LVR is usually the loan amount expressed as a percentage of the assets offered as security. If you exceed your LVR, you will be required to make a margin call, which means you must either repay part of the loan (via a cash payment or by selling assets) or provide additional assets as security.

Margin lending – A means of borrowing money to invest in shares and/or unit trusts where the assets themselves form the security for the loan.

Marginal tax rate – The stepped rate of tax that you pay on your taxable income.

Market value – The price you would get if you sold your asset to an arms length party. The market value of a share is the last price at which the share traded on the stock exchange.

Portfolio – A 'basket' of investments. A managed investment contains a portfolio of investments, which is managed by a portfolio manager.

Property securities – Include shares in listed property companies or units in property trusts. They are an alternative to investing in property directly and offer greater liquidity and diversification.

Real rate of return – The return from an investment after taking account of inflation. For example, if your investment pays 5% and inflation is 4%, your real rate of return is 1%.

Reinvestment – Using the dividends from shares or distributions from managed investments to purchase additional shares or units.

Risk – The chance of losing money or not having your expectations met. Risk can mean different things to different people. An investment considered risk-free because the capital is protected (e.g. a term deposit) may still involve the risk of not keeping up with inflation.

Risk-averse – Someone who adopts a conservative approach with their money is usually considered risk-averse.

Taxable income – Your assessable income after allowing for tax-deductions. Usually subject to tax at marginal rates plus the Medicare Levy.

Tax deduction – An amount that is deducted from your assessable income before tax is calculated. You can claim deductions in your annual tax return or, if your total deduction is significant, you can apply to the Tax Office for a variation of PAYG tax.

Tax-effective – The term given to a strategy or investment that provides a return that may lead to a tax benefit, such as a tax deduction or tax offset.

Tax offset – An amount deducted from the actual tax you have to pay. This is usually claimed in your annual tax return.

Term deposit – An account that pays a fixed rate of interest over a fixed term. A penalty can apply if funds are withdrawn before the expiry of the fixed term.

Volatility – Refers to the fluctuating value of an investment. A share is said to be volatile if its price moves up and down frequently over a short space of time.

Yield – The annual income from an investment expressed as a percentage of the current market value.

Notes

Strategies 1-10

Strategy 1, 4 and 5

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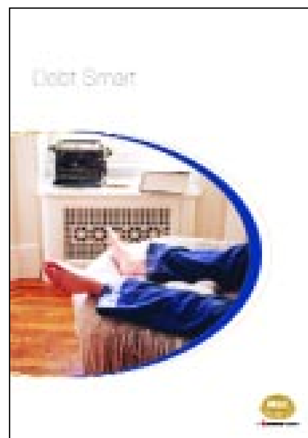

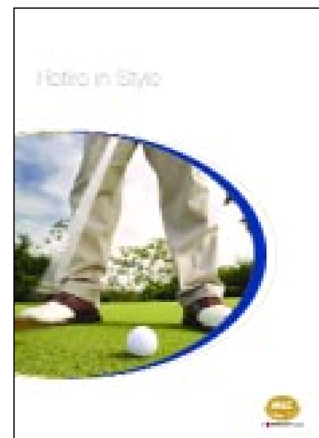

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