

TAX ENTITIES

The different ways investments and businesses can be owned are:

- as an individual
- jointly with one or a number of other people
- by family discretionary trust
- by partnership of family discretionary trusts
- by unit trust
- by company
- through a superannuation fund

Each of these different ownership structures has various benefits and also disadvantages when it comes to income tax. However, if your main purpose for investing is to provide for your retirement the best structure in the long term is superannuation.

The following is an explanation of each of the structures and what their advantages and disadvantages are.

Individually Held Investments

This is by far the simplest way to own investments and is the way everyone starts off. In many cases this investment can take the form of a savings account while at primary school. When you are single it is probably the best structure to own investments that will be held outside of superannuation.

The disadvantage of owning investments as an individual is that all of the income earned is taxable at their applicable marginal tax rate. This could mean, where a large capital gain or other investment income is earned, tax can be paid at one of the higher marginal tax rates.

For a couple, where one of the people isn't working, there can be an advantage to have investments in that person's name. This will ensure any investment income earned will be taxed at the lower marginal tax rates.

Where negative gearing strategies are used it makes sense to have the investment in the name of the person who is earning the most income. This is because the investment loss will generate the biggest tax refund. The disadvantage of this is that when the investment is sold, and a large capital gain is made, tax will be paid to the higher marginal tax rates.

Jointly Held or Partnership Investments

The most common example of this is when investments are held in the joint names of a couple. When both members of the couple are on the same taxable incomes, with the income being split equally, the risk of paying tax at a high marginal tax rate can be reduced. This is especially the case when capital gains are made on investments.

Where a negatively geared investment is involved having it owned jointly does reduce some of the tax benefit where one person is on a high income, but it does mean at least half of any capital gain made will be taxed at the lower marginal tax rate.

Family Discretionary Trusts

There is a general principle that you have to spend money to make money. When it comes to tax structures the principle is, the more complicated and costly the structure, the more tax effective it is likely to be. Owning investments as an individual or jointly is very simple and uncomplicated. A family discretionary family trust on the other hand is complicated and can be costly to set up and maintain, but it is the most flexible and tax effective structure available.

The cost of setting up a trust depends on who the trustee is. Where an individual is the trustee the cost will be approximately \$600. This will cover the cost of drawing up the trust deed and the government fees that apply.

In some cases people choose to have a company act as trustee for the trust. This can be applicable where a trust is being used to operate a business, and a level of protection is desired for the personal assets of the owners of the business, but is not that necessary when considering it as a structure to hold investments. The set up costs increase when a company acts as trustee to approximately \$1,600.

A family discretionary trust is the most tax effective structure to own income producing investments through. This is because the income can be distributed amongst the family members to ensure tax is paid at the lowest possible tax rates.

Family discretionary trusts have been around for many years, and back when Australia had death taxes, they were primarily used to reduce these death duties. Since then they have become a very popular vehicle to own investments and operate a business through.

Unlike when investments are owned either individually or jointly, and the owners must pay tax on the income and capital gains made, the income of a discretionary family trust can be distributed to the members of that family in whatever proportion the trustee decide.

The amount of tax saved by distributing to family members is maximised the more children there are and if they are 18 or older and have not commenced working full-time. This is because non-working children under 18 can only receive approximately \$400 and pay no tax. Income distributed above this will be taxed at least the top marginal tax rate.

When a trustee distributes income to a beneficiary it does not actually have to physically pay them the money. It is often done by the trustee drawing up a minute that states how much of that year's net investment income is distributed to each of the beneficiaries. This distribution is recorded in the books of the trust as an amount owed to each of the beneficiaries. As amounts are actually paid to, or on behalf of, each beneficiary the amount of money owed to them by the trust reduces.

There is a risk attached to distributing income to children. When no amounts are actually paid to them, or they are not recorded properly, large loans can build up that the children are entitled to. In the event of a family dispute major financial problems can be created if the children demand payment the debt owed to them by the trust.

To ensure that these loans do not become too large costs relating to the children, such as education fees, holidays, tax on income distributed to them, and car expenses, should be paid by the trust instead of the parents. By doing this the loan owing to each of the children will not keep increasing and there may even be a situation when money is owed back to the trust by the children.

If trust income is distributed to individuals the 50% general capital gains tax exemption applies when investments are sold for a profit.

Small Business CGT Concessions

For all of the previous mentioned structures owning a business, because individuals are receiving the income generated, if a business qualifies for the small business capital gains tax concessions any gain made on the sale of the business will therefore qualify for the 50% general exemption and the 50% active asset exemption as long as each partner holds at least 20% interest in the business.

Unit Trusts

Unit trusts are not used very often and tend to only apply when an investment is owned by non-associated investors. In their case units are issued and the income and capital gains from the investments owned by the unit trust are distributed to the unit holders in the proportion they own the units.

Unit trusts are often used when a large number of people come together to buy one or several investments. Listed property trusts and managed share funds are examples of unit trusts.

The cost of setting up a unit trust will be determined by whether individuals are going to be trustees or a company. Depending on who you use, and how complicated the trust deed is, it can cost from between \$400 up to more than \$1,000 where individuals are the trustees. Where a company will be acting as a trustee this increases the set up cost by approximately \$900 making a total set up cost of between \$1,300 and \$1,900.

The capital gains treatment for unit trusts is the same as for a discretionary family trust, except a unit trust does not get a benefit from the active asset discount.

Companies

When it comes to owning investments companies are possibly the worst structure that can be used. This is because when capital gains are made on the sale of investments a company does not receive the 50% general discount, and the shareholders do not get a benefit from the 50% active asset discount.

The main advantage of having a company is that tax can be paid on income at the 30% company tax rate, and if the shareholders of the company do not take accumulated profits in the company, the after tax profits can be distributed at a later date when the shareholders have retired and have low levels of taxable income.

The cost to set up and maintain a company are reasonably high and, because of not getting the 50% general capital gains tax exemption or the active asset exemption, they are of not much benefit to most investors.