


# Wealth Creation

Strategies for building long-term wealth

2007/2008





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# Building wealth with managed investments

Some people think saving and investing is 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. It's a conservative approach that involves taking very little risk with your money. A bank account or cash management trust is usually sufficient for this purpose.

Investing, on the other hand, means taking a measured degree of risk to achieve your longer term goals – such as your children's education or your retirement. To do this, you need to purchase growth assets (like shares and property) that have the potential to make your money work harder.

Although growth assets are more volatile over the short-term, they have historically provided higher long-term returns and are generally more tax-effective than other asset classes, such as cash and bonds.

In this guide we outline ten strategies that involve investing non-superannuation money in growth assets using managed investments such as unit trusts. Together with superannuation, managed investments can help you reach your long-term goals sooner.

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

## Important information

The information and strategies provided in this booklet are based on our interpretation of relevant taxation and social security laws as at 16 November 2007 .

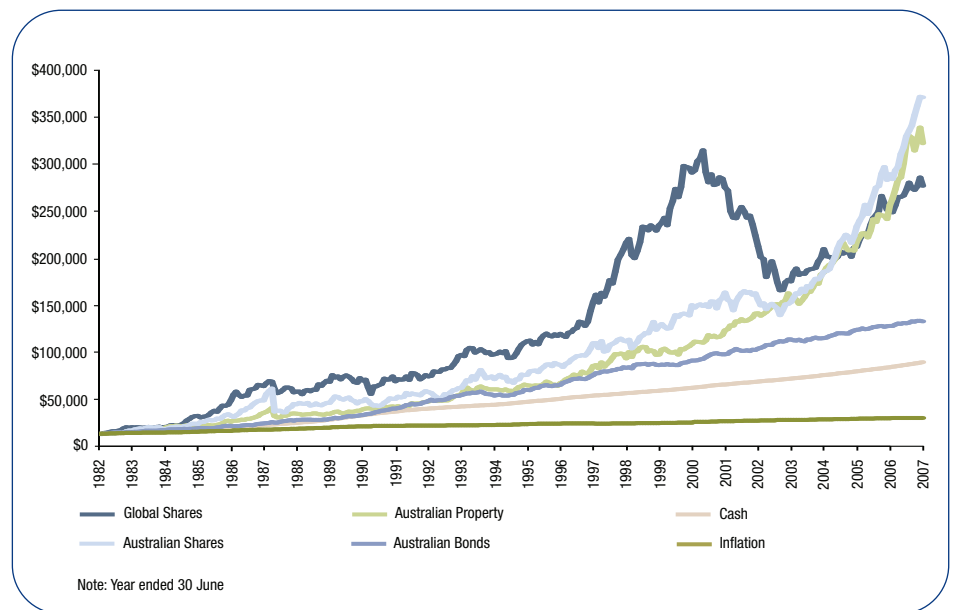
Because these laws are complex and change frequently, you should obtain advice specific to your personal circumstances, financial needs and investment objectives, before implementing any of these strategies.

# Investment basics

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

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

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: Australian Shares: S&P/ASX 200 Accumulation Index (All Ordinaries Accumulation Index prior to April 2000), Global Shares: MSCI World Gross Accumulation Index (\$A), Property: ASX 200 Property Accumulation Index (Property Trust Accumulation Index prior to July 2000), Australian Bonds: UBS Composite Bond Index – All maturities (Commonwealth Bank Bond Index prior to November 1987), Cash: UBS Bank Bill Index (RBA 13 Week Treasury Notes prior to April 1987), Inflation: Consumer Price Index. Assumes income is reinvested.

So ...

If you plan to invest for at least seven years, you may want to consider investing a significant portion in growth assets. Before you make your investment choice, you should consider your goals, needs, financial situation and 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 the internet. 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 super funds, account based pensions, investment bonds and friendly society bonds.

## What is a unit trust?

A unit trust is a type of managed investment purchased with non-super money.

Your money is pooled with other investors to form a large fund, often exceeding millions of dollars. This pool of money is then managed by a team of investment experts. Depending on the investment objective of the fund you choose, the money could be invested in shares, property, bonds, cash or a mix 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 invest \$1,000 and the unit price on the date of investing was \$2, you would be issued 500 units.

Over time, unit prices can go up and down, depending on the changing value of the fund's assets. However, investment managers generally have professional investment experts who act on your behalf to reduce the risk of a negative return and help grow your investment over the longer term.

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 diversify across a range of fund managers with varying, yet complementary, investment 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 (eg for capital gains tax purposes) and you are informed of the progress of your investment on a regular basis.

## Strategies at a glance

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# Compound returns: the essential ingredient

If you start investing now, time can be a 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. This is 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% pa, you receive \$100 interest during the first year. But if you reinvest the 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

(eg dividends and interest), rather than spend it on other things. This will enable you to turn your investment earnings into capital and 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 8% pa 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 invested the \$10,000			
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 and inflation.

By simply investing ten years earlier, and reinvesting your earnings you could more than double your money!

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

Strategy #

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## 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% pa. However, she stopped contributing 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 included cash and bonds and earned 5% pa.

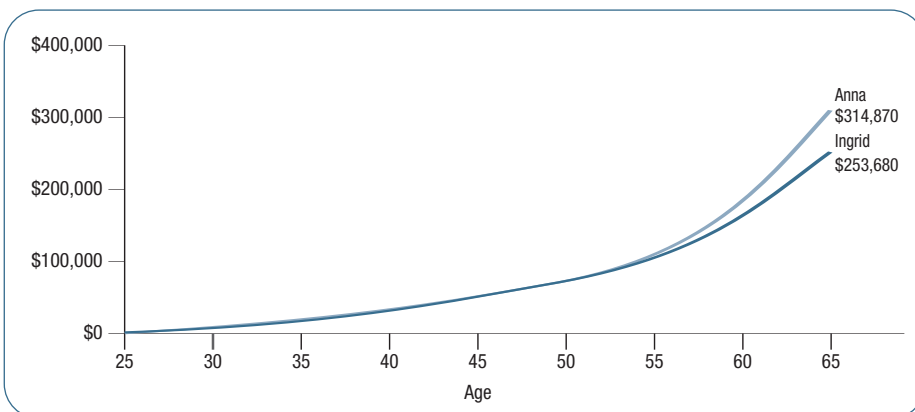
Who do you think ended up with the most at age 65? Anna who only contributed \$20,000 or Ingrid who contributed \$80,000?

## Summary

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

You would think Ingrid should end up with more money by investing the extra \$60,000. But as the chart shows, Ingrid and Anna's investments grew to \$253,680 and \$314,870 respectively. That's a difference of \$61,190 in Anna's favour.

## Anna vs Ingrid (over 40 years)



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

The reason Anna had a greater account balance 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 the 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 your mix of investments reflects your financial objectives, investment timeframe and attitude to risk. It's also a good idea to review your financial plan regularly.
- Investing on a regular basis can enable you to take advantage of dollar cost averaging – see Strategy 4.
- The income distributed by a unit trust is taxable, regardless if the income is received directly or reinvested to compound your returns. 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 problem 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 term deposit for the next 20 years. If inflation averaged 3% pa, the value of your term deposit would 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), consider investing in growth assets such as shares.

\* Assumes you don't reinvest interest received each year.

### 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 case study). With term deposits, you invest a dollar and get nothing more than a dollar back (ignoring interest).

#### 2. A growing income stream

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).

# Dividend income may fall if share prices fall.

Strategy #

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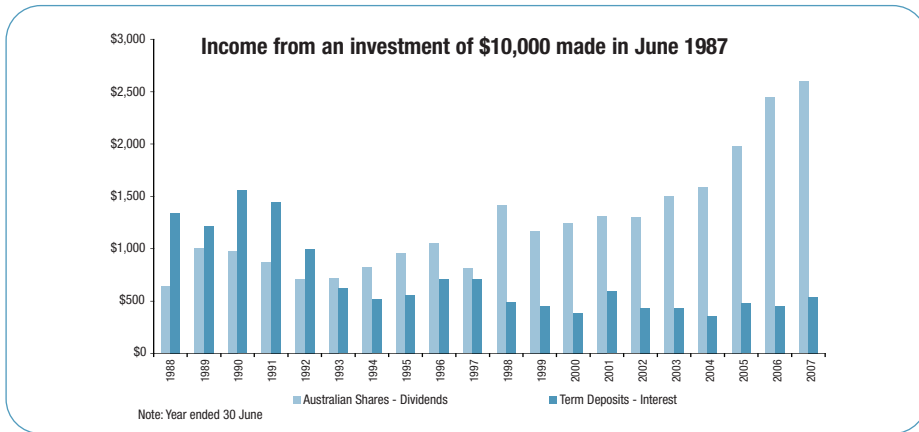
### The benefits

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

## Case study

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

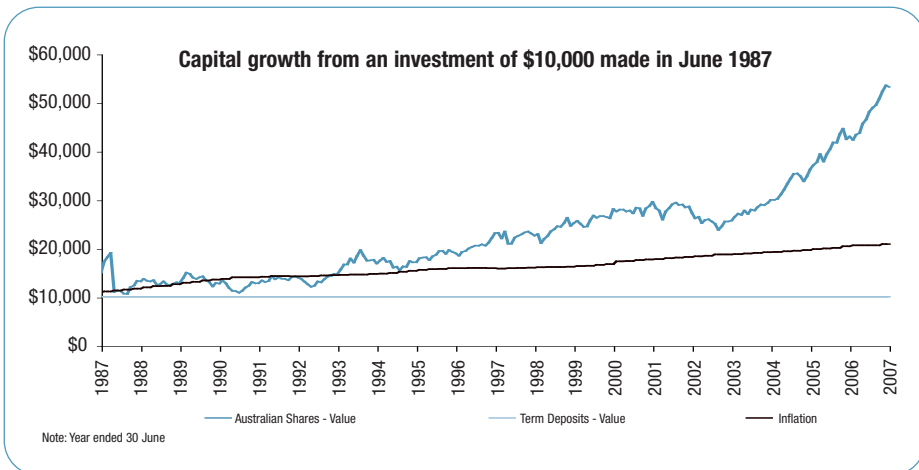
### Income



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 \$53,174 (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 returns (see Strategy 1). In this scenario, their investments would have been worth \$124,462 and \$44,666 respectively.

### Capital growth



Assumptions for Income and Capital Growth graphs: Returns are based on the S&P/ASX 200 Index (prior to April 2000 – All Ordinaries Index) and the RBA Banks' Term Deposit Rate (1yr \$10,000). This example does not take into account the impact of fees or taxes on distributed income and capital gains. This example 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.

## Tips and traps

- Purchasing shares through a unit trust provides greater opportunities and reduced investment risk. 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 the purchasing power of your money (and your income) keeps 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. You could also reduce (or eliminate) capital gains tax by using capital losses (see Strategy 9) or deferring the asset sale to a new income year (see Strategy 10).
- 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

Successful investors usually set lifestyle and financial goals, invest a set percentage of their money in each of the main asset classes (ie shares, property and bonds), and resist the temptation to switch their money around, based on short-term performance. We call this a balanced approach.

Chasers by contrast move their money into an investment that has just shown a period of strong returns and take additional risks by investing in a single asset class.

Over time, we believe taking a balanced approach is key to investment success.

### How does the strategy work?

Balanced investors realise the best performing asset class in one year is not necessarily the best performer 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, and missed out on the outstanding performance of global shares.

Chasing returns can be likened to driving a car with your eyes fixed on the rear-view mirror. When you only look backwards, it can be more difficult to get where you want in the future.

Year ending 31 Dec	Global shares	Aust. shares	Property securities	Aust. bonds	Cash
1981	1.2%	-12.9%	32.1%	8.5%	14.0%
1982	28.1%	-13.9%	5.2%	24.1%	16.0%
1983	34.3%	66.8%	50.2%	12.9%	11.7%
1984	15.1%	-2.3%	10.1%	12.0%	11.2%
1985	71.7%	44.1%	5.2%	8.1%	15.9%
1986	46.6%	52.2%	35.4%	18.9%	17.0%
1987	7.5%	-7.9%	5.7%	18.6%	15.2%
1988	4.8%	17.9%	16.1%	9.4%	12.9%
1989	26.7%	17.4%	2.3%	14.8%	18.3%
1990	-14.6%	-17.5%	8.7%	19.1%	16.3%
1991	20.9%	34.2%	20.1%	21.7%	11.2%
1992	5.1%	-2.3%	7.0%	13.2%	6.9%
1993	25.0%	45.4%	30.1%	10.8%	5.4%
1994	-7.6%	-8.7%	-5.6%	4.5%	5.4%
1995	26.5%	20.2%	12.7%	12.9%	8.0%
1996	6.8%	14.6%	14.5%	12.4%	7.6%
1997	42.0%	12.2%	20.3%	12.5%	5.6%
1998	32.6%	11.6%	18.0%	8.2%	5.1%
1999	17.5%	16.1%	-5.0%	1.5%	5.0%
2000	2.5%	3.6%	17.8%	10.3%	6.3%
2001	-9.3%	10.1%	14.6%	5.8%	5.2%
2002	-27.1%	-8.1%	11.8%	8.4%	4.8%
2003	0.0%	15.9%	8.8%	3.0%	4.9%
2004	10.9%	27.6%	32.0%	7.0%	5.6%
2005	17.6%	21.1%	12.5%	5.8%	5.7%
2006	12.3%	25.0%	34.0%	3.2%	6.0%

Performance indices used to compile this table are outlined on page 11.

Strategy #

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### The benefits

- Achieve more consistent returns by not chasing past performance.
- Minimise overall risk by spreading your money across a suitably diversified mix of asset classes.

## Case study

Paul and Denise each invested \$10,000 on 31 December 1981.

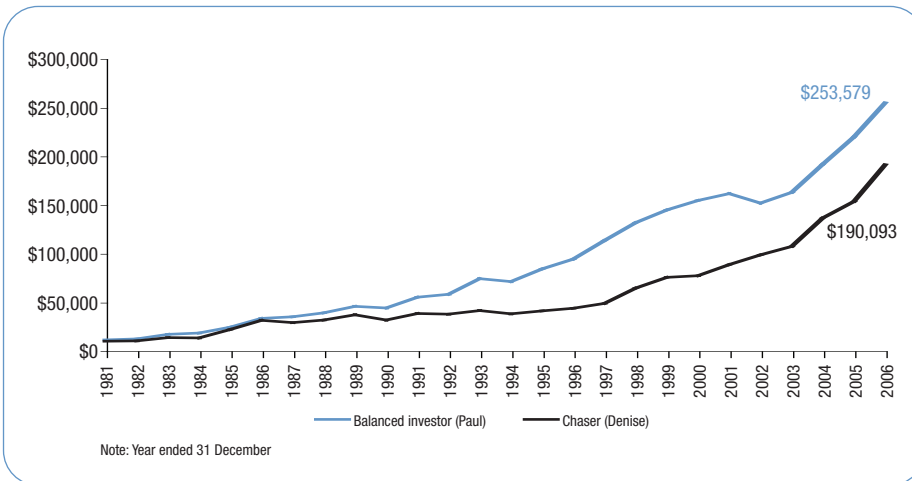
At the end of each year, Denise moved her money from one asset class to another, based on the returns from the previous year. By chasing returns, Denise ended up buying assets at higher prices and selling assets when their values had declined.

Paul, on the other hand, wasn't too concerned with short-term performance. After speaking to his financial adviser, he selected a portfolio consisting 35% in Australian shares, 25% in global shares, 10% in property securities and 30% in Australian bonds\*.

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

Over this 25-year period, Paul came out on top earning \$63,486 more than Denise, with less effort and less anxiety.

### Value of \$10,000 invested over 25 years



\* This is based on the asset allocation of the Average Balanced Fund from the Mercer Wholesale Manager Performance Analytics software as at 30 June 2007, adjusted to take into account only the asset classes included above.

The performance indices used on page 10 and 11 are: Australian Shares: S&P/ASX 200 Accumulation Index (All Ordinaries Accumulation Index prior to April 2000), Global Shares: MSCI World Gross Accumulation Index (\$), Property: ASX 200 Property Accumulation Index (Property Trust Accumulation Index prior to July 2000), Australian Bonds: UBS Composite Bond Index – All maturities (Commonwealth Bank Bond Index prior to November 1987), Cash: UBS Bank Bill Index (RBA 13 Week Treasury Notes prior to April 1987). All earnings are reinvested but do not take into account the impact of fees or taxes on distributed income and capital gains. This example 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.

## 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 rebalancing your portfolio regularly. Some multi-sector unit trusts automatically rebalance 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 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 can work 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 you invest \$200 per month in a managed share fund over a five-month period. For illustrative purposes, we have assumed the unit price drops from \$10 to \$5, before returning to \$10 at the end of the fifth month.

You may think it would be hard to make any money. After all, the unit price ended up at exactly the same point as it started. However, during months when the unit price is lower, you can buy more units with your \$200. As shown in the table below, investing a total of \$1,000 over five months, you are able to purchase 140 units. At the end of the period these units are worth \$1,400 – representing a profit of \$400.

Note: Dollar cost averaging doesn't guarantee a profit or protect you against a loss, particularly if you are forced to sell when the market is falling.

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
<b>Total</b>	<b>\$1,000</b>		<b>140</b>

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

## Strategy #

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## The benefits

- 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.

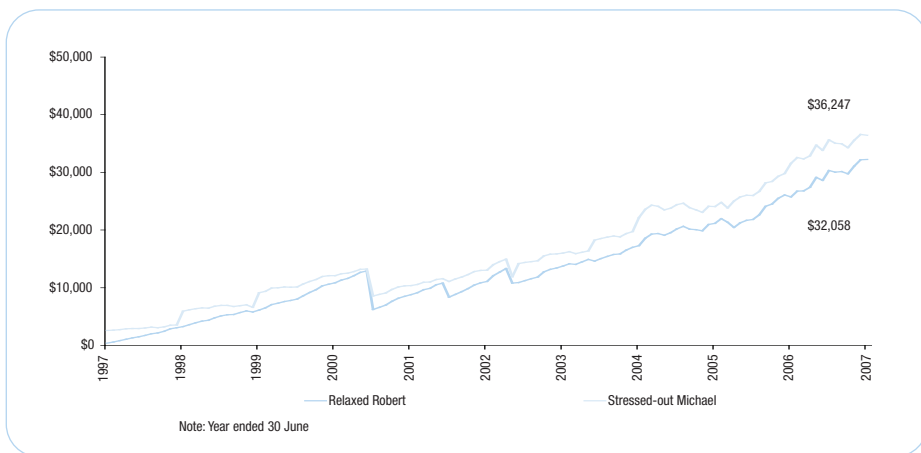
## Case study

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

Michael, on the other hand, decides to 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 Michael's hard work over the ten years, there is only around \$4,000 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.

### Value of \$24,000 invested over 10 years



\* This example assumes Robert invests \$200 at the end of each month, whereas Michael invests \$2,400 at the lowest price each year. It also assumes both Robert and Michael invest in a balanced fund comprising 35% in Australian shares, 25% in global shares, 10% in property securities and 30% in Australian bonds. This is based on the asset allocation of the Average Balanced Fund from the Mercer Wholesale Manager Performance Analytics software as at 30 June 2007, adjusted to take into account only the asset classes included above.

The performance indices used in the graph above are: Australian Shares: S&P/ASX 200 Accumulation Index (All Ordinaries Accumulation Index prior to April 2000), Global Shares: MSCI World Gross Accumulation Index (\$A), Property: ASX 200 Property Accumulation Index (Property Trust Accumulation Index prior to July 2000), Australian Bonds: UBS Composite Bond Index – All maturities (Commonwealth Bank Bond Index prior to November 1987). All earnings are reinvested but do not take into account the impact of fees or taxes on distributed income and capital gains. This example 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.

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

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

## Tips and traps

- Investing in shares or property (either directly or via a unit trust) allows you to access the potential for long-term capital growth.
- An easy way to implement this strategy is to pay yourself first (ie 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 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 of this strategy 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.

For example, a low income earner can now earn up to \$11,000 pa\* before tax is payable.

\* Takes into account the low income tax offset and uses the 2007/08 individual tax rates and thresholds.

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 partner's 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 speak to 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.

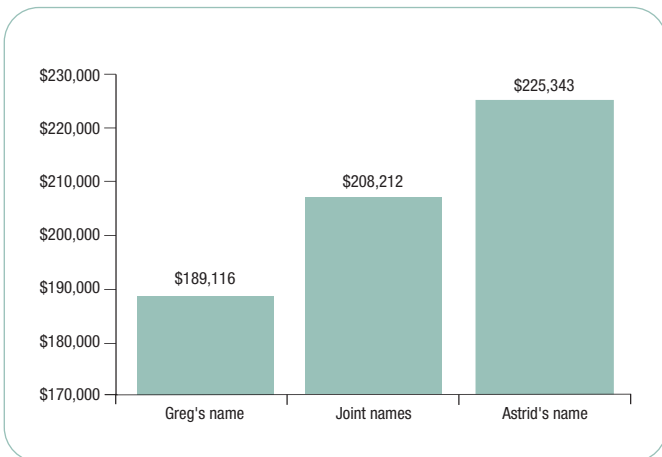
## Case study

Greg and Astrid are married and both aged 30. Greg pays tax at a marginal tax rate of 41.5%\*, while Astrid works part-time and is on a marginal tax rate of 16.5%\*. 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 before it is sold.

### Investment value after 20 years (\$400 per month)



Assumptions: A 20-year comparison. Total return is 7.5% pa (split 3.5% income and 4% growth). The overall franking level on income is 20%. All figures are after income tax at Greg and Astrid's marginal tax rates of 41.5%\* and 16.5%\* respectively. These rates are assumed to remain constant over the investment period.

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 16.5%\*, allowing it 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 their respective marginal tax rates don't change over time.

\* Includes a Medicare levy of 1.5%.

### Investment value (after CGT)

Greg's name	Joint names	Astrid's name
\$176,707	\$199,233	\$219,802

This case study shows even simple strategies can increase your wealth!

## Tips and traps

- When setting up a new investment, it may be beneficial to place it 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 (eg 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 (eg 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 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 \$1,666\* of non-employment income is tax-free, but amounts over this can be taxed as high as 45% (see FAQs on page 29).

When the child reaches 18 and ceases to be a minor, the investment can be transferred into their own name and no capital gains tax (CGT) is payable. 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 who 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.

\* Takes into account the maximum low income tax offset.

## 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

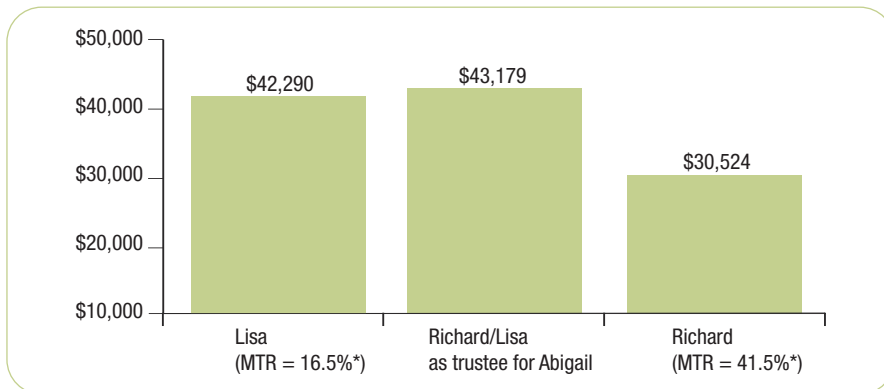
Richard and Lisa would like to save enough to send their new-born daughter, Abigail, to university when she turns 18. Richard is currently paying income tax at a marginal rate of 41.5%\*, while Lisa pays tax at a marginal rate of 16.5%\*.

They plan to invest \$10,000 for Abigail in a share-based unit trust and are considering the following options:

- Investing in Richard's name.
- Investing in Richard or Lisa's name, as Trustee for Abigail (where the income will be taxed at children's rates).
- Investing in Lisa's name.

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

### Investment value after 18 years (lump sum of \$10,000)



Assumptions: Total return is 8% pa (split 3% income and 5% growth). The overall franking level on income is 25%. All figures are after CGT. Upon sale of her investments at age 18, Abigail is taxed at adult marginal tax rates and receives no other sources of income. These rates are assumed to remain constant over the investment period.

\* Includes a Medicare levy of 1.5%.

As you can see, it would have been better to invest in Richard's or Lisa's name as Trustee for Abigail given the taxable income from the unit trust would have been less than the tax-free amount of \$1,666 for all of the investment period.

It should be noted however, if the investment for Abigail were larger, say \$30,000, then the results would have been quite different.

### Investment value after 18 years (lump sum of \$30,000)\*

Lisa's name	In trust for Abigail	Richard's name
\$125,370	\$119,425	\$91,572

\* After CGT.

In this scenario, Lisa 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

- When making larger investments, you may want to invest a small amount 'as Trustee for' a child (to take advantage of the tax-free threshold of \$1,666 pa and the rest in a lower income adult's name (to avoid being taxed at up to 45%).
- 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, 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 \$1,666 pa, 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 you are a grandparent investing on behalf of a grandchild, the amount gifted to the grandchild could affect your social security entitlement.
- Discretionary trusts (eg family trusts) can be used to direct earnings from investments to children in a tax-effective manner (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 save tax as a family. Another tax-effective strategy worth considering is holding assets in a discretionary trust arrangement (eg a family trust).

When you set up a discretionary trust, all assets are owned and controlled by the Trustee(s) on behalf of the nominated beneficiaries. This gives the Trustee(s) the opportunity to distribute income in a tax-effective manner, as well as protect the assets from risks such as spendthrift beneficiaries.

Discretionary trusts also offer estate planning advantages and the Trustee(s) can choose from a wide range of managed and directly owned investments.

### How does the strategy work?

Provided the trust deed allows, the Trustee(s) has the flexibility to decide which beneficiaries receive investment income from the trust each year, and in which proportions. The Trustee(s) can therefore direct income to different beneficiaries in a tax-effective manner.

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

- Children under the age of 18 (who can receive up to \$1,666\* tax-free each year).
- Children over the age of 18 (who can earn up to \$11,000\* pa without paying any tax).
- A low-income or non-working spouse (to take advantage of their lower marginal tax rate).

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

Given the potential complexities involved with establishing and running trusts, you should always seek legal, taxation and financial advice before using this strategy.

\* Takes into account the maximum low income tax offset.

Strategy #

07

### The benefits

- Reduce the amount of tax payable by a family group.
- Reinvest more money to build future wealth.

## Case study

Craig and Nicole are Trustees of a discretionary trust. Craig earns a salary of \$100,000 pa, while Nicole earns \$20,000 pa from part-time employment. The other beneficiaries of the trust are their two children – Laura (aged 19) and Harry (aged 15), neither of whom earn income from other sources.

For the 2007/08 tax-year, the discretionary trust generates taxable income of \$15,000.

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:

- \$1,666 to Harry because he is taxed at child rates and can receive this amount without paying any tax.
- \$11,000 to Laura to make maximum use of the tax-free threshold of \$6,000 pa plus the low-income tax offset.
- \$2,334 (ie the remaining income) to Nicole because she pays tax at a lower marginal rate than Craig. Nicole will also pay tax at the same (or a lower) marginal rate than her children, should this 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
Harry	\$1,666	Nil
Laura	\$11,000	Nil
Nicole	\$2,334	\$385
<b>Total</b>	<b>\$15,000</b>	<b>\$385</b>

By implementing this strategy, they will pay a total tax bill of \$385 on \$15,000 in investment income. This represents an effective tax rate of 2.57% – 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).

If they had not set up a discretionary trust (and invested purely in Craig or Nicole's name) they would have paid tax of \$6,225 and \$3,425 respectively on the investment income of \$15,000 in the 2007/08 financial year.

## Tips and traps

- A discretionary trust can protect the assets in instances where beneficiaries are spendthrift, suffering from addictions, handicapped, unable to manage their own financial affairs or are in unstable relationships.
- 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. Otherwise the unallocated trust income will be taxed at the highest marginal rate of 46.5% (including the Medicare levy).
- The assets of a discretionary trust do not form part of a deceased beneficiary's estate. Upon death the remaining beneficiaries of the trust will continue to receive income.
- A testamentary discretionary trust can be established via your Will for dealing with your estate assets in the event of your death.
- 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 social security entitlements.
- You should 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 and other fees may be payable.

## Use borrowed money to build wealth

Just as you can borrow money to buy a home, you can borrow to build wealth. This is commonly known as gearing and it 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).

The downside is gearing can multiply your losses if your investments fall in value.

For gearing 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).

It is therefore generally recommended the borrowed money is invested in quality share or property investments (either directly or via managed funds).

Shares and property have the potential to grow in value over the longer term and they typically produce assessable income (which means you should be able to claim the interest on the investment loan as a tax deduction).

### How does the strategy work?

There are 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 75% of the value of approved assets.  
  
For example, if you have \$25,000 and you want to invest in an approved asset with the help of a margin loan, you may be able to borrow up to \$75,000, making a total investment of \$100,000. It's also possible to gear on a regular basis by implementing what is known as instalment gearing (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 whether gearing suits you, we recommend you seek financial advice.

Strategy #

08

### The benefits

- Increase the amount of money you have to invest and potentially boost your returns.
- Reduce tax on your other income through negative gearing (see FAQs on page 30).

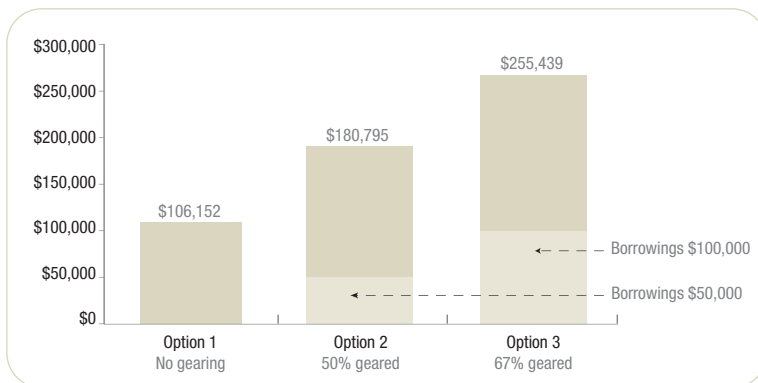
## Case study

Jenny has \$50,000 invested in an Australian share fund and would like to use gearing. She 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 (ie 50% gearing)
3. Increase her investment even more by borrowing \$100,000 (ie 67% gearing).

In options 2 and 3, Jenny will use an interest-only home equity loan with an interest rate of 7.5% pa. The following graph illustrates the potential outcome of the three options after ten years.

### Investment value after ten years



Assumptions: Investment return is 8.5% pa (split 3% income and 5.5% growth). The franking level on income is 75%. Interest on the loan is 7.5% pa. Jenny's marginal tax rate is 41.5% including a Medicare levy of 1.5%. These rates are assumed to remain constant over the investment period. With options 2 and 3, 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 gains. 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 she 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.

### Investment value after repayment of loan

No gearing	50% geared	67% geared
\$106,152	\$126,089*	\$146,027*

\* After CGT on the amount withdrawn.

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

**Caution: If your investments fall in value, your financial situation could be significantly worse than if you don't use a gearing strategy.**

## Tips and traps

- Gearing should be seen primarily as a wealth creation strategy rather than a way to save tax. If you invest in assets that fail to produce enough income or capital growth over the longer term, your losses could outweigh any reduction in your tax bill.
- If you take out a margin lending facility, you may need to meet a margin call if your investments fall in value (see Glossary). To reduce the likelihood of a margin call, you should maintain a conservative loan-to-valuation ratio. You should also hold significant cash (or other liquid assets) to meet margin calls if required.
- To reduce your tax bill at the end of each year, you could consider pre-paying up to 12 months interest on a fixed rate investment loan. This can allow you to bring forward an expense that may otherwise be tax-deductible in the following financial year.
- You should take out income protection insurance to make sure you are covered if you suffer temporary or permanent injury that doesn't allow you to work and 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 way to help reduce your tax bill is to minimise the value of 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, because some unit trusts 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 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

- 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.
- Free-up money for more suitable reinvesting opportunities.
- Manage your CGT liability more effectively by reinvesting in a unit trust that distributes realised capital gains prior to the end of the financial year.

## Case study

Bob received a distribution consisting of \$6,000 in realised capital gains from an Australian share unit trust in the 2007/08 financial year (with all gains eligible for the 50% CGT discount). Assuming Bob pays tax at a marginal rate of 41.5%\*, he will need to pay \$1,245 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 41.5%*	\$1,245

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 2008, 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 41.5%*	\$208

\* Includes a Medicare levy of 1.5%.

By implementing this strategy, Bob has reduced his tax bill by \$1,037!

## 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 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 (ie 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 2008. By implementing this strategy, you can defer the payment of capital gains tax (CGT). Depending on your circumstances you may also 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 until after 30 June 2008, 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 – see case study), the marginal tax rate you have to pay on realised capital gains in 2008/09 may decline considerably.

But even if your taxable income stays the same, you may find your marginal tax rate is lower in the 2008/09 financial year. This is because, from 1 July 2008, the income thresholds at which the 41.5%\* and 46.5%\* marginal tax rates apply will increase significantly.

It may also be a good idea to hold assets for more than 12 months to 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 46.5%\* to 23.25% (for higher income earners).

\* Includes a Medicare levy of 1.5%.

Strategy #

10

### The benefits

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

## Case study

Natalie (aged 32) works full-time, pays tax at a marginal rate of 41.5%\* and is considering selling 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 \$2,075 in CGT after applying the 50% CGT discount (assuming she has no capital losses to offset her gain – see Strategy 9).

### Before strategy

Realised capital gains	\$10,000
Less 50% CGT discount	(\$5,000)
Taxable capital gain	\$5,000
CGT payable at 41.5%*	\$2,075

However, Natalie plans to take 12 months maternity leave next financial year. As a result, she anticipates her marginal tax rate will decline from 41.5%\* to 16.5%\*. 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 \$825 (see below).

### After strategy

Realised capital gains	\$10,000
Less 50% CGT discount	(\$5,000)
Taxable capital gain	\$5,000
CGT payable at 16.5%*	\$825

\* Includes a Medicare levy of 1.5%.

By implementing this strategy, Natalie will cut her tax bill by \$1,250!

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, you could consider 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 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 capital 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, investment timeframe and attitude towards risk.

Asset class	Investment timeframe
<b>Cash</b> 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)
<b>Bonds</b> 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)
<b>Property</b> Includes residential, commercial, industrial and retail buildings and land, as well as tourist resorts, farms, vineyards, roads and power stations.	Medium term (5 years)
<b>Shares</b> Buying a share in a company means you become a part owner of that company. Investing in shares indirectly through a managed investment can give you exposure to a portfolio of shares spread across different sectors and markets. Global share funds also give you exposure to overseas sharemarkets.	Medium to long term (5–7 years)

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
<ul style="list-style-type: none"> <li>• Considered a safe investment, as there is little chance of losing your capital.</li> <li>• Ease of access to your money.</li> <li>• Provides a convenient transaction account or a transitional account to park your money while you consider longer-term investments.</li> </ul>	<ul style="list-style-type: none"> <li>• Relatively low returns.</li> <li>• Buying power of your money may be eroded by inflation in the long term compared to other asset classes.</li> <li>• Sensitive to movements in interest rates.</li> <li>• Not tax-effective.</li> </ul>
<ul style="list-style-type: none"> <li>• Relatively secure as your interest is fixed and your capital is generally protected.</li> <li>• Less volatile than other asset classes.</li> <li>• Capital gains can be made in a bond fund and these gains can be passed to you by way of higher income distributions.</li> </ul>	<ul style="list-style-type: none"> <li>• Relatively low returns.</li> <li>• Buying power of your money may be eroded by inflation in the long term compared to other asset classes.</li> <li>• Sensitive to interest rate movements.</li> <li>• Capital loss may lead to no distribution of income.</li> </ul>
<ul style="list-style-type: none"> <li>• Generates stable income and capital growth. Historically, property has outperformed bonds and cash.</li> <li>• Protects against inflation.</li> <li>• Income from direct property may be offset by deductions (eg depreciation).</li> <li>• Income from property trusts may also qualify for tax concessions (eg tax deferred income).</li> <li>• In a managed investment (eg a property securities fund), risk is reduced as your money is spread across different property sectors. You also have ready access to your money.</li> </ul>	<ul style="list-style-type: none"> <li>• High initial costs and outlay.</li> <li>• High transaction costs (eg stamp duty).</li> <li>• High maintenance.</li> </ul> <p>Many of these disadvantages can be overcome by investing in a property securities fund.</p>
<ul style="list-style-type: none"> <li>• Best potential for long-term capital growth. Over the long term, shares have outperformed other asset classes (see graph on page 2).</li> <li>• Can generate a growing income stream.</li> <li>• Tax benefits through dividend imputation system (Australian shares).</li> <li>• Relatively liquid as listed shares can be sold quite easily.</li> </ul>	<ul style="list-style-type: none"> <li>• Volatile in the short term.</li> <li>• Uncertain income stream, as dividend payments can rise and fall over time.</li> <li>• Risk of capital loss if the company's share price falls and you are forced to sell.</li> </ul>

# 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 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 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 the dividends aren't double taxed (ie 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 (or 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 how dividend imputation works, assuming shareholders on different marginal tax rates receive a fully franked dividend of \$70.

Marginal Tax Rate	15%	45%	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	\$15	\$45	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	\$15	↔ to get your net tax payable.
Excess franking credit	\$15	nil	If your franking credit is larger than your gross tax, the ATO will offset (ie refund) any excess (available for certain tax payers only).
Net income received	\$85	\$55	↔ 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 used to determine your capital gains or losses when redeeming units.

## How is interest income taxed?

The interest you receive from cash accounts (eg 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 generally 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 11.45 am (ACT time) 21 September 1999, CGT is usually payable by individuals on 50% of the nominal gain (ie the difference between the sale price and the cost base) where the asset has been held for more than 12 months. As only half the gain is taxable, the effective tax rate for an individual on the highest marginal tax rate (including Medicare levy) of 46.5% is reduced to 23.25%.

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

1. They can elect to be taxed on 100% of the real gain (ie 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.

If an asset is held for 12 months or less, neither the 50% discount nor indexation applies (ie 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 (eg salary). Broadly, 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 2007/08:

<b>Taxable income range</b>	<b>Tax payable (by residents)</b>
\$0–\$6,000	Nil
\$6,001–\$30,000	15%* on amount over \$6,000
\$30,001–\$75,000	\$3,600 + 30%* on amount over \$30,000
\$75,001–\$150,000	\$17,100 + 40%* on amount over \$75,000
\$150,001 +	\$47,100 + 45%* on amount over \$150,000

\* These rates do not include the Medicare levy (see page 30).

## How are minors taxed?

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

<b>Amount of non-employment income</b>	<b>Tax payable</b>
0–\$416	Nil <sup>#</sup>
\$417–\$1,307	66% on amount over \$416
\$1,308 +	45% of entire income

<sup>#</sup> With the low-income tax offset the tax-free amount is increased to \$1,666.

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 tax rates. If you earn less than \$16,741 pa (\$28,248 pa combined for couples) you are exempt from the levy. If you earn slightly more than these limits, the levy is phased in. An additional 1% surcharge applies to singles with an income (including reportable fringe benefits) over \$50,000 (\$100,000 for couples) not covered by 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 cashflow 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 7.5% pa) into an asset that produces an annual income of 3%:

- Your interest bill for the year will be \$7,500
- Your investment income will be \$6,000
- The cashflow shortfall of \$1,500 can be deducted from other assessable income (eg salary) in your annual tax return.

If you are on the top marginal tax rate of 46.5% (including Medicare levy), this strategy will save you \$697 in tax that year.

*Caution:* Investors who negatively gear should ensure they can meet cashflow 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 7.5% pa interest), your investment income will be \$4,500 (at 3% pa) and your interest bill will be \$3,750, leaving you with a cashflow surplus of \$750 pa.

## How can gearing help you save tax?

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

- Where the interest expense (plus costs) exceeds the assessable income in a particular year (ie 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 (eg 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 (eg post-retirement) to minimise CGT.
- Where the investment is held for more than 12 months, only 50% of the capital gain needs to be included in assessable income.
- You may be able to pre-pay interest costs on fixed rate loans 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 could 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 2007, a deeming rate of 3.5% applies for the first \$39,400 of an individual's total financial assets (\$65,400 for couples), while amounts above these thresholds are deemed to earn income at 5.5%.

# Glossary

**Assessable income** – Income including capital gains, on which you pay tax (ie 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.

**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 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 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** – The interest or value 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)** – An investment which pools your money with 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 (eg global shares) while a multi-sector (or diversified) fund invests in a number of asset classes.

**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 loan security.

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

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

**Property securities** – Includes 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. An investment considered risk-free because the capital is protected (eg a term deposit) may still involve the risk of not keeping up with inflation.

**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 Australian 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 off the actual tax you have to pay. You may be able to claim a tax offset in your end of year tax return (eg franking credits). Sometimes a tax offset may be taken into account in calculating your PAYG rates.

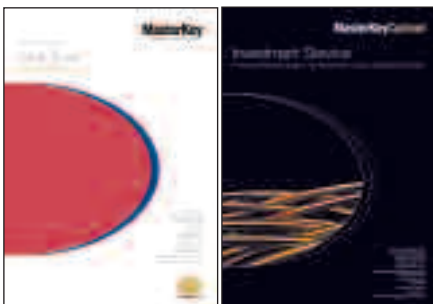
**Term deposit** – An account that pays a fixed rate of interest over a fixed term. A penalty can apply if funds are withdrawn before the expiry of the fixed term.

**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 period of time.

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



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