Smart strategies for growing your wealth

2009
Building wealth with managed investments

Some people think saving and investing are the same thing.

But the truth is, each requires a different approach and way of thinking.

Saving is simply putting aside some of your disposable income to achieve a short-term goal, such as going on a holiday or buying a car. It's a conservative approach that involves taking very little risk with your money. A bank account or cash management trust will usually suffice for this purpose.

Investing, on the other hand, means taking a measured degree of risk to achieve your longer term goals – such as funding your children's education or your retirement. To do this, you should consider purchasing 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 10 strategies that involve investing 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.
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 a particular point in time. For example, if you invest $1,000 and the unit price on the date of investing is $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.

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 unit trusts

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 experts who are supported by the latest technology and information. Fund managers and analysts constantly research and monitor investment markets to help build your long-term wealth and reduce the likelihood of a negative return.

Convenience

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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</tr>
</thead>
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Strategy 1
Compound returns: the essential ingredient

When investing for long-term goals, you should consider re-investing your earnings and giving your money time to grow.

What are the benefits?
By using this strategy, you could:
• ‘Compound’ your investment returns, and
• Accumulate a larger amount.

How does the strategy work?
This strategy involves two essential parts.
1. You need to re-invest the earnings you receive from your investment rather than spend the money on other things. This enables you to convert your earnings into capital so you can earn even more money in the future.

For example, if you invest $1,000 at 10% pa, you will earn $100 in the first year. If you then re-invest the earnings, in year two your investment will be worth $1,100 and your earnings will increase to $110 (and so on).

This simple investment principle is called compounding and it can work effectively with a range of investments, including unit trusts.

2. To get the most out of compounding, you need to give your money time to grow. This could involve starting your investment as soon as possible and/or keeping it going for as long as you can.

Over several years, compounding can make a big difference to your wealth. For instance, if you invest $10,000 at 8% pa until age 65, the table below shows how much your investment would be worth depending on your age when you first invested.

<table>
<thead>
<tr>
<th>Age when you invested the $10,000</th>
<th>20 yrs</th>
<th>30 yrs</th>
<th>40 yrs</th>
<th>50 yrs</th>
</tr>
</thead>
<tbody>
<tr>
<td>$319,204</td>
<td>$147,853</td>
<td>$68,485</td>
<td>$31,722</td>
<td></td>
</tr>
</tbody>
</table>

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

By simply investing 10 years earlier (and re-investing 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).
Case study

Twin sisters Anna and Ingrid both started contributing $2,000 a year into a unit trust at age 25 and re-invested the income distributions.

Anna chose an investment option that favoured shares and property and earned 8% pa. However, she stopped contributing after 10 years and left her money to grow until she reached age 65.

Ingrid, on the other hand, continued investing $2,000 a year right up until age 65. But she chose a more conservative investment option that favoured 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

<table>
<thead>
<tr>
<th>Amount invested</th>
<th>Anna</th>
<th>Ingrid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years invested</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>Annual return</td>
<td>8%</td>
<td>5%</td>
</tr>
</tbody>
</table>

You would think Ingrid would end up with more money by investing an extra $60,000. But, as the graph below 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

- Before making an investment, it’s important to seek financial advice to ensure the assets you choose reflect 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 reduce the impact of market fluctuations – see Strategy 4.

- Most managed funds allow you to automatically re-invest the income distributions that are paid on a regular (usually quarterly) basis.

- The income distributed by a unit trust is taxable, regardless of whether the amount is received directly or re-invested 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).
Strategy 2
Growth assets can make your money work harder

What are the benefits?
By using this strategy, you could:
- Protect the purchasing power of your investment, and
- Receive a tax-effective income that grows over time.

How does the strategy work?
After a period of sharemarket decline, investing in a term deposit may seem appealing. But there are some downsides of term deposits too. For example:
- They do not provide any capital growth to prevent the purchasing power of your money being eroded by inflation,
- Interest rates can fluctuate considerably over time, depending on the Government’s objectives and economic conditions, and
- Every dollar of interest earned is taxable at your marginal rate.

As a result, term deposits may not generate the returns you need to achieve your long-term goals, such as educating your children or funding your retirement.

With shares, on the other hand:
- Your capital has the potential to grow in value over the long term and outpace inflation,
- Your dividend income can increase substantially over time, as share prices rise, and
- The imputation credits that often come with dividends from Australian shares can be used to reduce your tax bill (see FAQs on page 26).

While shares can be volatile over the short term, they have a very important role to play in a long-term investment strategy.
Case study

**Jack and Vanessa** 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.

**Income from an investment of $10,000 made in December 1988**

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.

The next graph shows the value of their investments over this period (up to the end of 2008). As you can see, even after one of the worst sharemarket downturns in history, Vanessa would still have come out well ahead by making a long-term investment in the Australian sharemarket.

**Capital growth from an investment of $10,000 made in December 1988**

Vanessa’s strategy of investing in shares would also have come out ahead if they had both re-invested the income to compound their returns (see Strategy 1). In this scenario, Vanessa’s and Jack’s investments would have been worth $57,213 and $34,998 respectively.

**Tips and traps**

- To access greater opportunities and reduced investment risk, you should consider investing in shares through a unit trust (see page 2).
- 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 until a new financial 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.

**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 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.
Strategy 3

A balanced approach beats trying to pick winners

When investing for long-term goals, you should consider sticking with a balanced mix of assets rather than chasing past performance.

What are the benefits?

By using this strategy, you could:

- Achieve more consistent investment returns, and
- Accumulate a larger amount.

How does the strategy work?

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 (eg shares, property and bonds), and
- Resist the temptation to switch their money around based on short-term performance.

We call this a balanced approach to investing.

‘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.

The brown line on the chart to the right shows what a chaser would have done if they’d switched 100% of their money into the asset class that performed the best the previous year.

For example, in 1994 a chaser might have invested in Australian shares based on the strong returns in 1993, only to incur a loss of 8.7% over the next 12 months.

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

<table>
<thead>
<tr>
<th>Year ending 31 Dec</th>
<th>Global shares</th>
<th>Aust. shares</th>
<th>Property securities</th>
<th>Aust. bonds</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>4.8%</td>
<td>17.9%</td>
<td>16.1%</td>
<td>9.4%</td>
<td>12.9%</td>
</tr>
<tr>
<td>1989</td>
<td>26.7%</td>
<td>17.4%</td>
<td>2.3%</td>
<td>14.9%</td>
<td>18.3%</td>
</tr>
<tr>
<td>1990</td>
<td>-14.6%</td>
<td>17.5%</td>
<td>8.7%</td>
<td>19.0%</td>
<td>16.3%</td>
</tr>
<tr>
<td>1991</td>
<td>20.9%</td>
<td>34.2%</td>
<td>20.1%</td>
<td>24.7%</td>
<td>11.2%</td>
</tr>
<tr>
<td>1992</td>
<td>5.1%</td>
<td>-2.3%</td>
<td>7.0%</td>
<td>10.4%</td>
<td>6.9%</td>
</tr>
<tr>
<td>1993</td>
<td>25.0%</td>
<td>45.4%</td>
<td>30.1%</td>
<td>16.3%</td>
<td>5.4%</td>
</tr>
<tr>
<td>1994</td>
<td>-7.6%</td>
<td>-8.7%</td>
<td>-5.6%</td>
<td>-4.7%</td>
<td>5.4%</td>
</tr>
<tr>
<td>1995</td>
<td>26.5%</td>
<td>20.2%</td>
<td>12.7%</td>
<td>18.6%</td>
<td>8.0%</td>
</tr>
<tr>
<td>1996</td>
<td>6.8%</td>
<td>14.6%</td>
<td>14.5%</td>
<td>11.9%</td>
<td>7.6%</td>
</tr>
<tr>
<td>1997</td>
<td>42.0%</td>
<td>12.2%</td>
<td>20.3%</td>
<td>12.2%</td>
<td>5.6%</td>
</tr>
<tr>
<td>1998</td>
<td>32.6%</td>
<td>11.6%</td>
<td>18.0%</td>
<td>9.5%</td>
<td>5.1%</td>
</tr>
<tr>
<td>1999</td>
<td>17.5%</td>
<td>16.1%</td>
<td>-5.0%</td>
<td>-1.2%</td>
<td>5.0%</td>
</tr>
<tr>
<td>2000</td>
<td>2.5%</td>
<td>3.6%</td>
<td>17.8%</td>
<td>12.1%</td>
<td>6.3%</td>
</tr>
<tr>
<td>2001</td>
<td>-9.3%</td>
<td>10.1%</td>
<td>14.6%</td>
<td>5.5%</td>
<td>5.2%</td>
</tr>
<tr>
<td>2002</td>
<td>-27.1%</td>
<td>-8.1%</td>
<td>11.8%</td>
<td>8.8%</td>
<td>4.8%</td>
</tr>
<tr>
<td>2003</td>
<td>0.0%</td>
<td>15.9%</td>
<td>8.3%</td>
<td>3.0%</td>
<td>4.9%</td>
</tr>
<tr>
<td>2004</td>
<td>10.9%</td>
<td>27.6%</td>
<td>32.0%</td>
<td>6.0%</td>
<td>5.6%</td>
</tr>
<tr>
<td>2005</td>
<td>17.6%</td>
<td>21.1%</td>
<td>12.5%</td>
<td>5.8%</td>
<td>5.7%</td>
</tr>
<tr>
<td>2006</td>
<td>12.3%</td>
<td>25.0%</td>
<td>34.0%</td>
<td>3.1%</td>
<td>6.0%</td>
</tr>
<tr>
<td>2007</td>
<td>-1.6%</td>
<td>18.0%</td>
<td>-8.4%</td>
<td>3.5%</td>
<td>6.7%</td>
</tr>
<tr>
<td>2008</td>
<td>-24.9%</td>
<td>40.4%</td>
<td>-54.0%</td>
<td>14.9%</td>
<td>7.6%</td>
</tr>
</tbody>
</table>

Note: The performance indices used to compile this table are outlined on page 9.
### 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 sector-specific 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 frequently.
- Some multi-sector unit trusts automatically rebalance the portfolios on a regular basis.

### Case study

**Paul and Denise** each invested $10,000 on 31 December 1988. At the end of each year, Denise moved all of her money from one asset class to another, based on the best 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 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 lower prices and sell when prices had reached higher levels.

Over this 20-year period, Paul came out on top earning $21,648 more than Denise, with less effort and less anxiety.

**Value of $10,000 invested over 20 years**

The performance indices used on pages 8 and 9 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), Cash: UBS Bank Bill Index (RBA 13 Week Treasury Notes prior to April 1987). All earnings are re-invested 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.
Strategy 4  
Dollar cost averaging: taking the guesswork out of investing

When investing for the long term, it may be wise to contribute a fixed amount on a regular basis.

What are the benefits?

By using this strategy, you could:
- Use the ups and downs in investment markets to your advantage, and
- Take the guesswork out of trying to pick the ‘right’ time to invest.

How does the strategy work?

This strategy involves investing a fixed amount at regular intervals (eg monthly) over a period of time – regardless of whether prices go up or down.

It’s called dollar cost averaging and it can work particularly well with managed investments, such as a unit trust.

Assuming you invest a set amount in a unit trust each month, you can buy more units when prices fall and fewer units when prices rise.

As a result, you can average the price you pay for your investments and potentially profit from a fluctuating market.

Let’s say, for example, that:
- You invested $200 per month in a unit trust share fund over a five-month period, and
- The unit price dropped from $10 to $5, before returning to $10 at the end of the fifth month (see table below).

You may think it would be hard to make any money when the unit price ended up at exactly the same point as it started.

However, your monthly investment of $200 would have bought more units when the price declined and reduced the average price you paid to just $7.14 per unit.

By using this strategy, you would have acquired a total of 140 units and your investment would have been worth $1,400 at the end of this period.

As a result, drip-feeding your money into the unit trust would have enabled you to make a profit of $400 when compared to your total outlay of $1,000.

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.

<table>
<thead>
<tr>
<th>Month</th>
<th>Monthly investment</th>
<th>Unit price</th>
<th>Units purchased</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$200</td>
<td>$10.00</td>
<td>20</td>
</tr>
<tr>
<td>2</td>
<td>$200</td>
<td>$6.66</td>
<td>30</td>
</tr>
<tr>
<td>3</td>
<td>$200</td>
<td>$5.00</td>
<td>40</td>
</tr>
<tr>
<td>4</td>
<td>$200</td>
<td>$6.66</td>
<td>30</td>
</tr>
<tr>
<td>5</td>
<td>$200</td>
<td>$10.00</td>
<td>20</td>
</tr>
<tr>
<td>Total</td>
<td>$1,000</td>
<td></td>
<td>140</td>
</tr>
</tbody>
</table>

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

Robert and Michael each want to invest $2,400 a year for 10 years in a balanced fund (via a unit trust). Robert decides to use dollar cost averaging and arranges for $200 to be transferred from his bank account at the end of each month.

Michael, on the other hand, decides to invest his $2,400 as a yearly lump sum when he thinks 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 10 years, there is only $992 difference between the value of their investments, as the graph below reveals. This also assumes Michael is lucky enough to pick the best time to invest each year – a difficult task that could easily have backfired.

**Value of $24,000 invested over 10 years**

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 re-invested 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

• 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 offered by most financial institutions and fund managers.

• By re-investing 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).
Strategy 5
Income splitting: a simple way to save tax

When investing to achieve long-term goals, you may want to purchase assets in the name of your partner if they pay tax at a lower rate than you.

What are the benefits?

By using this strategy, you could:

- Pay less tax on investment earnings, and
- Accumulate a larger amount as a family unit.

How does the strategy work?

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 advantage 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 than you (or not working at all), you may be able to minimise your household tax bill and make your money work harder.

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 could split income by:

1. Transferring ownership of the investments to your partner – but be aware that Capital Gains Tax (CGT) and stamp duty could be payable.

2. Investing the after-tax income from your investments in your partner’s name.

With both of these approaches, not only will your partner pay less tax on the income received from the investments, they will pay less CGT when it comes time to sell them.

But before you use an income splitting strategy, it’s a good idea to speak to your financial adviser.

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

Greg and Astrid are married and both aged 30. Greg pays tax at a marginal tax rate of 39.5%, while Astrid works part-time and is on a marginal tax rate of 16.5%. They wish to invest $400 each month in a balanced fund (via a unit trust) in a tax-effective way and are considering the following options:

- Investing in Greg’s name,
- Investing in joint names, or
- Investing in Astrid’s name.

The graph below compares the value of the investment under each alternative after 20 years.

Investment value after 20 years ($400 per month)

<table>
<thead>
<tr>
<th></th>
<th>Greg’s name</th>
<th>Joint names</th>
<th>Astrid’s name</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>$188,229</td>
<td>$209,494</td>
<td>$230,463</td>
</tr>
</tbody>
</table>

Clearly the investment is more tax-effective if held in Astrid’s name, as the income would be taxed at 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 this time period.

Investment value (after CGT)

<table>
<thead>
<tr>
<th></th>
<th>Greg’s name</th>
<th>Joint names</th>
<th>Astrid’s name</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>$177,902</td>
<td>$201,873</td>
<td>$225,550</td>
</tr>
</tbody>
</table>

This case study shows even simple strategies can make a significant difference and increase your wealth.

1 Includes a Medicare levy of 1.5%.

Tips and traps

- Negatively geared investments 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 (see Strategy 8).
- 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 on a quarterly basis. The distributions are taxable in the hands of the investor and must be included in annual tax returns, even if the distributions are re-invested to buy more units.

Assumptions: A 20-year comparison. Total return is 7.5% pa (split 4% income and 3.5% growth). Investment income is franked at 25%. All figures are after income tax at Greg and Astrid’s marginal tax rates of 39.5% and 16.5% respectively. These rates are assumed to remain constant over the investment period.
Strategy 6
Invest tax-effectively for your children

When investing in a unit trust for a child, it’s important to consider whose name the investment should be held in.

What are the benefits?
By getting the ownership decision right, you could:
• Pay less tax on investment earnings, and
• Accumulate a larger amount for your child.

How does the strategy work?
When putting money aside for a child, a unit trust can offer a number of advantages, including broad diversification and expert investment management (see page 2).

However, for contractual reasons, you generally can’t invest in a unit trust in your child’s name. As a result, you usually need to consider one of the following approaches.

1. A parent or grandparent can invest as Trustee for a child/grandchild. In this situation, the income is taxed at a special rate (often referred to as children’s tax). The first $3,000 of non-employment income is tax-free, but amounts over this can be taxed as high as 45% (see FAQs on page 28).

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 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 financial advice before investing money on behalf of children.

Note: If you are a grandparent investing on behalf of a grandchild, the amount gifted to the grandchild could affect your social security entitlement.

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1 Takes into account the maximum low income tax offset. This figure applies in 2009/10.
Case study

Richard and Lisa would like to be able to pay for their newborn daughter, April, to attend university when she turns 18. Richard’s marginal tax rate (MTR) is 39.5%\(^2\), while Lisa pays tax at a marginal rate of 16.5%\(^2\).

They plan to invest $15,000 for April in a share-based unit trust and are considering the following options:

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

The graph below compares the value of the investments in 18 years.

Investment value after 18 years (lump sum of $15,000)

<table>
<thead>
<tr>
<th></th>
<th>Lisa (MTR = 16.5%(^2))</th>
<th>Richard/Lisa as Trustee for April</th>
<th>Richard (MTR = 39.5%(^2))</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>$65,363</td>
<td>$66,260</td>
<td>$46,182</td>
</tr>
</tbody>
</table>

As you can see, it would have been slightly better to invest in Richard’s or Lisa’s name as Trustee for April given the taxable income from the unit trust would have been less than the tax-free amount of $3,000\(^1\) for the entire investment period. It should be noted however, if the investment for April were larger, say $30,000, then the results would have been different:

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

<table>
<thead>
<tr>
<th></th>
<th>Lisa’s name</th>
<th>In trust for April</th>
<th>Richard’s name</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>$129,376</td>
<td>$127,161</td>
<td>$92,364</td>
</tr>
</tbody>
</table>

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.

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 $3,000\(^1\) pa) and invest the rest in the name of a lower income earning adult (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 provide the TFN of the parent or grandparent where the income from the investment is less than $3,000\(^1\) 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, for example, the investment was made with money earned by the child from employment.
- Discretionary trusts (eg family trusts) can be used to direct earnings from investments to children in a tax-effective manner (see Strategy 7).

Assumptions: Total return is 8% pa (split 3.5% income and 4.5% growth). Investment income is franked at 30%. All figures are after CGT. Upon sale of her investments at age 18, April 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.
Strategy 7
Discretionary trusts: a flexible income splitting alternative

If you have a family, you may want to hold investments in a discretionary trust (eg a family trust).

What are the benefits?

By using this strategy, you could:

• Pay less tax on investment earnings, and
• Accumulate a larger amount as a family unit.

How does the strategy work?

When you set up a discretionary trust, all assets are owned and controlled by the Trustee(s) on behalf of the nominated beneficiaries.

Provided the trust deed allows, this gives the Trustee(s) the flexibility to decide which beneficiaries receive investment income from the trust each year, and in what proportions.

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

• Children under the age of 18 (who can receive up to $3,000\(^1\) tax-free each year),
• Children over the age of 18 (who can earn up to $15,000\(^1\) pa without paying any tax), and/or
• 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.

While discretionary trusts can be quite tax-effective, you should take into account any establishment and ongoing costs that may be incurred.

Discretionary trusts can also be quite complex, so you should always seek legal, taxation and financial advice before using this strategy.

Note: There are other ways you may be able to reduce tax on investment income as a family unit. These include investing directly in the name of your partner (see Strategy 5) or on behalf of a child (see Strategy 6).

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\(^1\) Takes into account the maximum low income tax offset. This figure applies in 2009/10.
Case study

Craig and Nicole are Trustees of a discretionary trust. Nicole earns a salary of $100,000 pa, while Craig 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 earns income from other sources.

In the 2009/10 tax year, the discretionary trust generates taxable income of $20,000.

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:

- $3,000 to Harry because he is taxed at children’s rates and can receive this amount without paying any tax.
- $15,000 to Laura to make maximum use of the tax-free threshold of $6,000 pa plus the low-income tax offset.
- $2,000 (ie the remaining income) to Craig because he pays tax at a lower marginal rate than Nicole. Craig will also pay tax at the same (or a lower) marginal rate than his children, should this additional income be distributed to them.

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

<table>
<thead>
<tr>
<th>Beneficiary</th>
<th>Income allocation</th>
<th>Tax payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Harry</td>
<td>$3,000</td>
<td>Nil</td>
</tr>
<tr>
<td>Laura</td>
<td>$15,000</td>
<td>Nil</td>
</tr>
<tr>
<td>Craig</td>
<td>$2,000</td>
<td>$330</td>
</tr>
<tr>
<td>Total</td>
<td>$20,000</td>
<td>$330</td>
</tr>
</tbody>
</table>

By implementing this strategy, they will pay a total tax bill of $330 on $20,000 in investment income. This represents an effective tax rate of 1.65% – 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 hadn’t set up a discretionary trust (and invested purely in Craig’s or Nicole’s name) they would have paid tax of $4,450 and $7,900 respectively on the investment income of $20,000 in the 2009/10 financial year.

Tips and traps

- Any income from the discretionary trust investments must be allocated to beneficiaries and included in their annual tax return – even if the income is re-invested. 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.
- 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.
- A discretionary trust can also protect the assets in cases where beneficiaries are spendthrift, suffering from addictions, handicapped, unable to manage their own financial affairs or in unstable relationships.
Strategy 8
Use borrowed money to build wealth

If you want to achieve your long-term goals sooner, you may want to borrow for investment purposes.

What are the benefits?
By using this strategy, you could:
• Multiply your investment profits, and
• Take advantage of a range of tax concessions (see FAQs on page 29).

How does the strategy work?
This strategy, commonly known as gearing, involves borrowing money to make an investment.

Gearing can enable you to build your wealth faster than if you relied exclusively on your own capital. The downside is that it can enhance 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 capital 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 a unit trust).

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

There are a number of ways you can establish a gearing strategy:
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. This type of loan typically enables you to borrow up to 75% of the value of approved share and unit trust investments. For example, if you have $25,000 and you want to purchase an approved investment with the help of a margin loan, you may be able to borrow up to $75,000 and make a total investment of $100,000. It’s also possible to use a margin loan to gear on a regular basis. This is known as instalment gearing (see Glossary on page 30).
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 (and which approach you should use), we recommend you seek financial advice.

Note: Before you use a gearing strategy, you should ensure you have a suitable timeframe (preferably five years or longer) and understand the risks. For example, if your investment falls in value, your financial situation could be significantly worse than if you hadn’t used a gearing strategy.
Jenny has $50,000 invested in an Australian share fund (via a unit trust) and would like to use gearing. After speaking to her financial adviser, she considers the following three options:

- Maintaining her investment at its current level of $50,000,
- Doubling her investment by borrowing $50,000 (ie a 50% gearing ratio), or
- Increasing her investment even more by borrowing $100,000 (ie a 67% gearing ratio).

In options 2 and 3, Jenny will use an interest-only home equity loan with an interest rate of 7% pa. The following graph illustrates the potential outcome of the three options after 10 years.

**Investment value after 10 years**

Assumptions: Investment return is 8.5% pa (split 4% income and 4.5% growth). Investment income is franked at 75%. Interest on the loan is 7% pa. Jenny’s marginal tax rate is 39.5% 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 advantages are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax advantages are re-invested.

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 10 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**

<table>
<thead>
<tr>
<th>No gearing</th>
<th>50% gearing</th>
<th>67% gearing</th>
</tr>
</thead>
<tbody>
<tr>
<td>$104,964</td>
<td>$125,907¹</td>
<td>$146,850¹</td>
</tr>
</tbody>
</table>

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

¹ After CGT on the amount withdrawn.
Strategy 9
Use losses to reduce Capital Gains Tax

If you sell a profitable investment, in the same financial year you may want to sell a poorly performing investment that no longer suits your circumstances.

What are the benefits?
By using this strategy, you could:
- Use the capital loss you incur to offset some (or all) of your capital gain, and
- Free up money for more suitable investment opportunities.

How does the strategy work?
Capital Gains Tax (CGT) is a tax on the growth in the value of an asset, generally payable when a gain is realised.

This may occur, for example, when you make a profit on the sale of certain investments such as directly owned shares or property, or units in a unit trust.

You may also have to pay CGT if you invest via a unit trust and the fund manager makes a gain when selling some of the underlying assets held on your behalf.

In this scenario, the realised capital gains will usually be passed on to you as part of the final income distribution for the financial year.

However, if you sell a poorly performing investment that no longer suits your circumstances in the same financial year, you can use the capital loss you incur to offset some (or all) of your taxable capital gain and reduce (or eliminate) your CGT liability.

You can then use the money you receive from the asset sale (and any potential tax savings) to pursue other investment opportunities.

Note: To offset a capital gain, you must sell the poorly performing investment (and trigger the capital loss) in the same financial year. However, this can be difficult with unit trusts that make their final income distribution for the year on 30 June. To give you (and your financial adviser) sufficient time to review the size of the capital gains and assess the performance of the rest of your investment portfolio, you should consider unit trusts that pay their final distribution earlier (eg at the end of May each year).
**Case study**

**Bob received a distribution** consisting of $6,000 in realised capital gains from an Australian share unit trust in the 2009/10 financial year, with all gains eligible for the 50% CGT discount (see FAQs on page 27).

Assuming Bob pays tax at a marginal rate of 39.5%, he will need to pay $1,185 in CGT on this distribution, as shown in the following table.

### Before strategy

<table>
<thead>
<tr>
<th>Distributed capital gains</th>
<th>$6,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less 50% CGT discount</td>
<td>($3,000)</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>$3,000</td>
</tr>
<tr>
<td>CGT payable at 39.5%&lt;sup&gt;1&lt;/sup&gt;</td>
<td>$1,185</td>
</tr>
</tbody>
</table>

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 2010, Bob will be able to make significant CGT savings.

### After strategy

<table>
<thead>
<tr>
<th>Distributed capital gains</th>
<th>$6,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less capital loss on XYZ Limited shares</td>
<td>($5,000)</td>
</tr>
<tr>
<td>Net capital gains</td>
<td>$1,000</td>
</tr>
<tr>
<td>Less 50% CGT discount</td>
<td>($500)</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>$500</td>
</tr>
<tr>
<td>CGT payable at 39.5%&lt;sup&gt;1&lt;/sup&gt;</td>
<td>$198</td>
</tr>
</tbody>
</table>

By implementing this strategy, Bob has reduced his tax bill by $987. He can also use the tax savings (along with the $5,000 he received from the sale of the shares in XYZ Limited) to invest in more suitable assets to help him achieve his lifestyle and financial goals.

**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.

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<sup>1</sup> Includes a Medicare levy of 1.5%.

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**Tips and traps**

- While there is generally no problem with 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 taxation 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, however, be carried forward to offset against gains in future years.

- If you have different classes of capital gains (see FAQs on page 27), it’s generally a good idea to apply capital losses against non-discount gains first (ie gains on assets held for less than 12 months and gains where the indexation method has been used) and then discount capital gains.
Strategy 10
Defer asset sales to manage Capital Gains Tax

If you want to sell a profitable asset, you may want to delay the sale until after 30 June 2010.

What are the benefits?

By using this strategy, you could:
• Defer paying Capital Gains Tax (CGT), and
• Possibly 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.

So by deferring the sale until after 30 June 2010, 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 2010/11 may decline considerably.

But even if your taxable income stays the same, you may still find your marginal tax rate is lower in the 2010/11 financial year.

This is because, from 1 July 2010, the income threshold at which the 31.5% marginal tax rate applies will increase from $35,000 to $37,000.

Furthermore, the current marginal tax rate of 39.5% (which is payable on taxable incomes between $80,000 and $180,000) will reduce to 38.5%.

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).

1 Includes a Medicare levy of 1.5%.
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 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, or not employed, 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.

Case study

Natalie, aged 32, works full-time, pays tax at a marginal rate of 39.5%1 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 $1,975 in CGT after applying the 50% CGT discount. This assumes 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 39.5%1 | $1,975 |

However, Natalie plans to take 12 months’ maternity leave next financial year. As a result, she anticipates her marginal tax rate will decline from 39.5%1 to 16.5%1.

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%1 | $825 |

By implementing this strategy, Natalie will cut her tax bill by $1,150.

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.
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.

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:

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Investment timeframe</th>
<th>Benefits</th>
<th>Risks</th>
</tr>
</thead>
</table>
| **Cash**    | Short term (1–3 years) | - Considered a safe investment, as there is little chance of losing your capital.  
- Easy 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 long-term 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.  
- Not tax-effective. |
| **Bonds**   | Short to medium term (3–5 years) | - Relatively secure as your interest is fixed and your capital is generally protected.  
- Less volatile than shares and property.  
- 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 long-term 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. |
| **Property** | Medium term (5 years) | - Can generate stable income and capital growth. Over the long-term, property has outperformed bonds and cash.  
- Protects against inflation.  
- Income from direct property may be offset by deductions (eg depreciation).  
- Income from property trusts may also qualify for tax concessions (eg tax deferred income).  
- In a managed investment (eg a property securities fund), risk is reduced as your money is spread across different property sectors. You also have easy access to your money. | - High initial costs and outlay.  
- High transaction costs (eg stamp duty).  
- High maintenance.  
**Note:** Many of these disadvantages can be overcome by investing in a property securities fund. |
| **Shares**  | Medium to long term (5–7 years) | - Best potential for long-term capital growth. Over the long term, shares have outperformed other asset classes.  
- Can generate a growing income stream.  
- Tax advantages through dividend imputation system (Australian shares).  
- Relatively liquid as shares listed on a stock exchange 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. |
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 advantages.

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 were received – even if they are re-invested 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 table).

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.

<table>
<thead>
<tr>
<th>Marginal tax rate</th>
<th>15%</th>
<th>45%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dividend</strong></td>
<td>$70</td>
<td>$70</td>
</tr>
<tr>
<td><strong>Franking credit</strong></td>
<td>$30</td>
<td>$30</td>
</tr>
<tr>
<td><strong>Assessable income</strong></td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td><strong>Gross tax</strong></td>
<td>$15</td>
<td>$45</td>
</tr>
<tr>
<td><strong>Less franking credit</strong></td>
<td>($30)</td>
<td>($30)</td>
</tr>
<tr>
<td><strong>Net tax payable</strong></td>
<td>Nil</td>
<td>$15</td>
</tr>
<tr>
<td><strong>Excess franking credit</strong></td>
<td>$15</td>
<td>Nil</td>
</tr>
<tr>
<td><strong>Net income received</strong></td>
<td>$85</td>
<td>$55</td>
</tr>
</tbody>
</table>

This, in very simple terms, is how dividend imputation works.

1. A company pays a fully franked dividend.
2. You add the franking credit to your dividend to get your assessable income.
3. Then you calculate the gross tax based on your tax rate.
4. Subtract the franking credit and subtract the franking credit.
5. Deduct your net tax from your dividend, or add your excess franking credit to your dividend, to get your after-tax income.

Note: Certain investors who are unable to use all their franking credits can claim a refund of these credits in their annual tax return.

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1. This is the after-tax income distributed by the company.
2. This is the tax already paid by the company at the company tax rate of 30%.
How is income from property trusts taxed?

Property trusts usually distribute the following types of income:

- **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.

- **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 AEST 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 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:

- 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), or
- 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.

3 Includes a Medicare levy of 1.5%.
What are the current marginal tax rates?

The table below summarises the marginal tax rates in 2009/10:

<table>
<thead>
<tr>
<th>Taxable income range</th>
<th>Tax payable (by residents)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0–$6,000</td>
<td>Nil</td>
</tr>
<tr>
<td>$6,001–$35,000</td>
<td>15%(^4) on amount over $6,000</td>
</tr>
<tr>
<td>$35,001–$80,000</td>
<td>$4,350 + 30%(^4) on amount over $35,000</td>
</tr>
<tr>
<td>$80,001–$180,000</td>
<td>$17,850 + 38%(^4) on amount over $80,000</td>
</tr>
<tr>
<td>$180,001 +</td>
<td>$55,850 + 45%(^4) on amount over $180,000</td>
</tr>
</tbody>
</table>

**Note:** Changes to the income ranges and marginal tax rates will occur in the 2010/11 financial year.

What is the Medicare levy?

A levy of 1.5% is payable on the whole of your taxable income on top of normal marginal tax rates. If you earn less than $17,794 pa ($30,025 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 over $73,000 pa (or, for couples, a combined income of $146,000 pa) who don’t have private health insurance. If applicable, this Medicare levy surcharge will be payable on top of the base Medicare levy of 1.5%.

**Note:** The Government proposed in the 2009 Federal Budget that a Medicare levy surcharge of up to 1.5% will be payable by higher income earners from 1 July 2010.

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.

<table>
<thead>
<tr>
<th>Amount of non-employment income</th>
<th>Tax payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>0–$416(^5)</td>
<td>Nil</td>
</tr>
<tr>
<td>$417–$1,307</td>
<td>66% on amount over $416</td>
</tr>
<tr>
<td>$1,308 +</td>
<td>45% of entire income</td>
</tr>
</tbody>
</table>

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 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).

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\(^4\) These rates do not include the Medicare levy (see definition on this page).

\(^5\) With the low-income tax offset the tax-free amount is increased to $3,000.

\(^6\) Includes a Medicare levy of 1.5%.
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 $150,000 of your own money plus $50,000 of borrowed money (at an interest rate of 7% pa) into an asset that produces an annual income of 3%:

- Your loan interest bill for the year will be $3,500 (ie 7% of $50,000), and
- Your investment income will be $6,000 (ie 3% of $200,000).

In this scenario, you will be positively geared because the investment income exceeds the loan interest payments. This cashflow surplus of $2,500 will need to be added to your assessable income when you complete your income tax return.

If you are on the top marginal tax rate of 46.5%, you will pay $1,163 in tax on this surplus income.

What is negative gearing?

Negative gearing arises when the interest payments (and other costs) on your investment loan in a particular year are greater 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% pa) into an asset that produces an annual income of 3%:

- Your loan interest bill for the year will be $7,000 (ie 7% of $100,000), and
- Your investment income will be $6,000 (ie 3% of $200,000).

In this scenario, you will be negatively geared because the loan interest payments exceed the income from the investment. The cashflow shortfall of $1,000 can be deducted from your other assessable income (eg salary) when you complete your income tax return.

If you are on the top marginal tax rate of 46.5%, this strategy will save you $465 in tax.

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

How can gearing help save you tax?

Gearing not only increases your potential to make money, it can also minimise your tax bill. 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 a unit trust (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.
- If you pre-pay interest costs on fixed rate loans up to 12 months in advance, you can bring forward an expense that may otherwise be tax-deductible in the following financial year.
- Negative gearing will reduce your taxable income, which could assist in minimising 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 lower marginal tax rate payer (to reduce the amount of CGT payable at the end of the investment period). A financial adviser can help determine whose name the geared investment should be in.

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 2009, a deeming rate of 2% applies to the first $42,000 of an individual’s total financial assets ($70,000 for couples), while amounts above these thresholds are deemed to earn income at 3%.
Glossary

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

Asset allocation – The process of deciding which asset classes to invest in, and in what proportions.

Asset classes – The different categories of investments (ie cash, bonds, property and shares – see page 24).

B
Balanced fund – A fund that invests in a mix of different asset classes.

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.

C
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 12 months, the capital gain may receive concessional treatment (see FAQs on page 27).

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 typical household goods and services.

D
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.

E
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 minus any outstanding loan.

F
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 (see FAQs on page 26).

I
Instalment gearing – Investing on a regular basis by periodically drawing on an investment loan. It 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.

L
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.

M
Managed investment (or managed fund) – An investment which pools your money with that of other investors to form a fund invested into assets that’s 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 meet 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 loan – A loan that enables you to invest in shares and/or unit trusts where the assets themselves are used as security for the loan.

Marginal tax rate – The stepped rate of tax you pay on your taxable income (see FAQs on page 28).
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%.

Re-investment – 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. Some investments are considered risk-free because that capital is protected (e.g., a term deposit) but there is still a risk that the returns won’t keep pace 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 from the actual tax you have to pay. You may be able to claim a tax offset in your end-of-year tax return (e.g., 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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