



TAXATION MANAGEMENT

Income, Capital Growth and Tax Planning

Generally investments are purchased for their income producing potential or because the capital value is expected to grow over time. Income can come in the form of interest from cash and fixed interest assets, dividends from shares or rentals from property. Capital growth can come from shares and property growing in value. When comparing interest income investments with those producing capital growth it is important to compare total return from each.

- **Interest Income Investments**

Interest income investments include bank deposits, mortgages and debentures with major finance companies. The main advantage of these methods of investment is that the original capital invested is usually secure. This is because the investment organisation takes all the investment risks and guarantees to pay back the capital at the end of the period of investment. They may pay a defined income return for a specified period, so the rate of return is known in advance.

Two disadvantages of these investments are

The return is fully taxable in the year in which the interest is received.

The original capital does not usually grow in value so the investment does not have the potential to maintain its purchasing power against inflation.

Thus, interest income investments provide good security and may provide a defined income stream for a time period, but they are not tax efficient and their value does not grow over time.

- **Tax Effective Income Investments**

An alternative to interest income is Australian share dividend income or property rental income, both attracting taxation advantages.

Share Dividends and Dividend Imputation

Dividends from Australian companies are distributed to investors after companies have paid tax on their profits. Under the dividend imputation system investors receive a credit for the amount of tax that their company has already paid. The system works as follows:

If a company makes a fully taxable profit of \$1000, it pays tax at the current company tax rate of 30%. Thus it pays \$300 in tax and has \$700 left to distribute.

If there are ten shareholders and all the after-tax profits are distributed, each receives an after-tax dividend of \$70, with a franking credit of \$30.

Since the profits associated with the dividends have been fully taxed, the after tax dividends are said to be fully franked. However, there are situations (which will

not be detailed here) when this is not the case, and dividends can have partial or no franking.

For after-tax dividends, the grossed-up amount, i.e. the shareholder's share of the pre tax profit, must be included in the shareholder's tax return as assessable income. In this example, the grossed-up dividend amount is \$100 (\$70 plus \$30 company tax paid with respect to that dividend). However, a tax credit of \$30 is also given.

The effect of the credit is that, if the shareholder's marginal tax rate is less than or equal to 30%, no tax except Medicare, will be paid on the dividends.

If the shareholder's marginal tax rate is above 30%, then tax must be paid. For example, where the marginal tax rate is 46.5%:

	Calculation
Grossed Up Dividends	= \$100 (i.e. \$70 + \$30)
Taxed at Marginal Rate	= \$100 * 46.5% = \$46.50
Imputation Credit	= \$30
Net Gain	= \$46.50 - \$30 = \$16.50

Dividend imputation applies whether the investment is made directly or through a unit trust. For example, a retiree on a marginal tax rate of 18.5%, including Medicare Levy, can receive dividends with no tax liability and can use franking credits to offset tax payable on other income, e.g. interest income. Should the investor not be able to use the excess franking credits then these will be refunded via the tax system upon lodgment of the annual tax return. For example

The retired person receives \$70 as a dividend with a credit of \$30. Total tax payable is \$15 (15% of \$100) but franking

credits of \$30 reduce this tax to zero leaving an excess franking credit of \$15 (\$30 - \$15).

If, say, \$100 income from a fixed interest investment is also received, the \$15 tax liability on this amount is reduced to \$0 by using the \$15 excess franking credit.

Rental Property and Depreciation Allowances

Purchasing property, either directly or through a unit trust, provides rental income that is deemed assessable. Thus any expenses or losses which are incurred in gaining that income are tax deductible. Three of the major deductions are Interest on borrowings.

Building allowances (for new buildings).

Depreciation allowances (for fixtures and fittings).

Building depreciation is an allowable deduction for new investment properties. Each year an amount representing 2.5% to 4% of the cost of the building (the rate depends on the year of purchase) is allowed as a tax deduction. Unit trusts that hold newly built property are able to distribute this amount to investors tax-free. Thus, this source of income is more tax effective than interest income.

Depreciation allowances are also available for building fixtures and fittings, and can be distributed to investors. This type of allowance is not completely tax free, because when the investment is sold, the depreciation allowance reduces the cost base of the asset, and increases the amount on which capital gains tax is payable. Therefore, tax is only deferred to the point of sale of the asset, not eliminated.

Capital Growth Investments

Capital growth investments include property, Australian and international company shares, and a range of more specialised investments, e.g. pine plantations, collectables and futures contracts, each with their own risk and return characteristics. Capital growth occurs when investors believe that future profits or rental from an asset will increase and are therefore prepared to pay more to purchase the asset. Similarly, capital values fall if investors believe that future profits and rentals will decline.

As investors' perceptions about the future change, the value of capital growth investments fluctuates. However, in the long run, the total returns on capital growth investments are likely to outperform fixed interest and cash investments. This is particularly true if the investment is based on profits from reputable companies and rentals from quality properties.

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