

EUREKA *report*



Invest like the very rich

By Doug Turek
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PORTFOLIO POINT: Investors who want to avoid having everything in super will need to become smarter about taxable investing. Here are some ideas.

Changes in the superannuation contribution rules have produced a considerable problem for investors looking to minimise their tax position. Those previously able to take advantage of the maximum tax-deductible super contributions have seen those limits halved, and while limits for making post-tax contributions haven't changed, individuals have developed an allergic reaction to changes in superannuation.

A recent **discussion** between the Minister for Superannuation and Corporate Law, Nick Sherry, and radio host Derryn Hinch showed just how easy it is to erode confidence in a system that is supposed to encourage us to save over the long term and avoid drawing on the age pension.

If this has you thinking you don't want to put all your eggs in the super basket then you'll need to become savvier about taxable investing.

You will also join the ranks of the very rich, who have never been able to use super as much as others do to shelter their overall wealth. Here's a summary of tax-efficient investment strategies you may wish to explore.

Trust in your family

The family trust is the most popular structure wealthy families use to hold and protect assets outside of superannuation and the family home. Their use dates back hundreds of years. While the primary purpose for a trust is to protect assets it may offer some tax advantages. For instance, annual earnings and capital gains derived from investments may be taxed less if distributed to one or more other individuals than if owned in the name of a single family member. You'll need to research this more or speak to your accountant or wealth adviser to learn whether a few thousand dollars of upfront and annual cost to set up and administer a trust is worth it for you. Don't forget super is also a trust with its own special set of rules and rewards.

Spread your burden

If you need to spread your assets across different structures, think carefully whether all entities should invest the same way. For instance, private companies pay tax at the company rate of 30% and therefore they might be a good place to invest income producing assets like bonds if you are paying the top tax rate and not in need of the cash. Since companies don't enjoy the 50% capital gains tax relief on gains earned after 12 months, they can be a poor place to invest in appreciating assets such as shares.

If you invest equally in Australian shares and bonds, you might ask yourself as a "balanced investor" whether you should hold that mix in the same proportion inside and outside super. You could instead hold each asset in the structure differently if it makes more sense.

If you are retired and have ready access to your superannuation pension, you might rationalise that you should hold all your cash and bond investments in super where the yield is untaxed, rather than in your name where you might lose up to a third or a half of that income in tax. Dividend income from shares held outside super might not be taxed, or certainly taxed less because of imputation credits, depending on your taxable income. While your capital gain will be taxable, after the 50% relief is applied you still may be ahead.

It is difficult to generalise and you'll need to do your own analysis or seek tax advice that is specific to your situation. What is clear, however, is that provided you are comfortable with the "legislative risk" of having most of your money in super, it will last longer there if held outside this structure. That means the case for making post-tax contributions to super is growing if you are already hitting the upper limit of your concessional contributions.

Negative gearing

An unforeseen outcome from government tinkering with super and the greater stability offered by residential property prices thus far, will be added impetus for many to negatively gear. By total dollars borrowed, the most popular asset negatively geared in Australia is direct property. If your preference is to invest in shares, try to borrow using real property as security, not shares, so as to avoid problems with margin loans. A key tenet to wealth management is to avoid ever being a forced seller.

Negative gearing is a higher-risk investment strategy, only one feature of which is to earn a subsidy by way of tax savings on any loss between investment income and debt servicing. If you can find a positively geared investment, such as a property that pays rent greater than the cost of debt, that for me that is preferred to losing money every month. Some will argue negative geared investments may offer greater longer term capital gain but that's simply speculation.

Over the long term (a decade or more), gearing can often build real wealth. However, gearing offers far from a certain payoff – your return will depend both on your cost of borrowing and your investment return. The longer you participate the higher is the probability your return will cover your original borrowed investment and servicing costs; however, it may only ever offer an 80% chance of success.

Negative gearing is a relatively modest tax management strategy, since the actual deduction is quite small relative to your investment and probably earned income. For instance if you borrow \$500,000 at 5% to invest in a property earning 3% rental income, then you might only deduct \$10,000 from your income and save up to \$4650 in tax (before depreciation or other allowances). This is 1% of your capital at risk. If \$4650 is a large relative tax saving then borrowing \$500,000 may be beyond your means. Contrast this to directing \$25,000 of income to super where you might save \$7875 of immediate tax if you are top tax bracket earner. That's a 31.5% return.

Are bonds back?

The rise of DIY super meant the near demise of the class of tax-paid investments known often as **imputation bonds**, **investment bonds**, friendly society bonds, **education savings plans** and **insurance bonds**. Investments in these structures redeem after 10 years "tax paid", with no further tax for you to pay.

Further, income earned does not appear in your personal tax return along the way. Instead, these investments pay their own tax at the maximum company rate of 30% and sometimes less, thanks to imputation credits. If you and everyone in your family earn more than \$80,000 annually and would otherwise pay tax at 41.5% or higher, then investing this way may save you. It may also help some qualify for the Low Income or Senior Australians tax offset and some income support benefits.

However you will need to research these as you would any financial product including to minimise fees and charges where possible.

Let's be frank

Investing in dividend-paying Australian companies that derive the majority of profits from onshore business activity is a good tax strategy. The imputation tax credit system rewards you more for investing in franked dividend paying companies than if you receive interest income from cash and bonds. In practice, individuals earning less than \$80,000 annually may pay little or no tax on investment distributions, and may even be able to apply for a tax refund.

When investing in bonds or cash you might lose nearly a third of your income in tax if you earned say \$75,000 annually. The only problem with investing in franked dividend paying companies is that for reasons of diversification we can't only invest in them. You need to also spread your money offshore, particularly in markets where two-thirds of stocks on offer aren't financial and resource companies. You may earn a dramatically better total return by investing in smaller companies that are not yet able to pay out profits. You also need to have money in bonds and cash to smooth returns. Property is another good diversifier, but as recent events show with listed property trusts they are less so if "stepped" to a development company and geared up internally.

Be passive

If you're stuck having to invest outside super then it pays to be passive. Frequently turning over your portfolio shrinks your investment capital by bringing forward tax on capital gains and doubles the tax bill on those realised within 12 months. This hurts long-term returns by about 1–2% annually, according to a landmark US study entitled ***Is your Alpha big enough to cover its taxes?***

As a class, index funds turn over the portfolio only about 10% annually versus a median 50% for more actively managed funds (Morningstar says this can be as high as 150% for some funds) which can seriously erode returns for a high income earner.

Some fund managers, such as Vanguard, MLC and Dimensional Fund Advisors, are beginning to publish both pre- and post-tax returns so you can estimate the impact of tax on investing. According to Vanguard's **published fund performance** the annualised return over the last six years investing in a multi-sector index-style growth fund is 5.01%, however after tax this is 3.44% for a top taxed bracket investor (46.5% tax rate), 3.95% for a mid-tax range investor (31.5% tax rate), 4.85% for a superfund in accumulation mode and 5.51% for a superfund in pension phase or similar nil taxed investor (the excess 0.5% return arising from refund of imputation credits). This wide range emphasises the care one needs to take investing in the taxable world.

MIS RIP

Managed investment schemes, including those that invest in agribusiness to take advantage of upfront tax deductions, are certainly out of favour following the demise of Great Southern and Timbercorp.

Unfortunately with these products you worry about the return OF your investment, not the return ON your investment. Recent events highlight the folly of investing primarily to save tax. Within this broader category of "tax-effective investing" you can also speculate on Australian films, R&D and perhaps green energy. Be wary.

Give or take

Charitable giving can play a role in reducing tax. Donations made to a registered charitable organisation or your own registered private charitable investment fund (including transferred assets) are tax-deductible. The dominant expenditure category in the federal budget is income redistribution. So if you would rather choose where to redistribute your income rather than have the government do it for you, then give to a registered charity. To eliminate personal tax entirely, give a little more than twice what you would otherwise pay in tax (assuming you are in the top tax bracket). For most of us this is impractical, but may be appropriate for those in their 70s and 80s, who have accumulated more assets than they need to live off or want to pass on. In Australia, deceased estates may not receive a tax deduction for giving as they do in other countries, so consider giving while you can still enjoy it.

But be careful abandoning superannuation completely following recent government announcements. Otherwise, you'll need to set aside more money and hence take longer to Make Work Optional and retire. In any regard, it is prudent to be tax-aware when making investment decisions so as to keep more of what you earn. Just make sure you are investing first and minimising tax second.



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