Everyone is interested in paying the least amount of tax they can, and why not?

The Government aren't going to make sure you get that dream house you want, or maybe that nice new car you've had your eye on, so you need to do it yourself.

What many people don't realise is that getting yourself setup correctly before you start your business or buy that property is the biggest tax saver of all.

Tax Planning

There is no substitute for correct planning. The below (overly simplified) example outlines the importance of planning.

Example facts:

- Mr. & Mrs. P are both 48;
- They have 2 children in their early teens;
- Mr. P earns $180,000 a year and is in the top tax bracket;
- Mrs. P earns $50,000 a year from running a small business;
- They are looking to purchase a $400,000 investment property on 1 July 2010;
- The expected rental is $20,000 per year;
- Mr. & Mrs. P plan to retire when they are 63 (15 years away); and
- The investment property will be worth an estimated $1mil in 15 years.

There are two sets of taxes to look for here. Tax on the rental each year, and tax on the sale in 15 years time (capital gains tax). The table on the following page outlines the estimated tax position a few structures:

Ownership Structure	Tax on Rent (Per Year)	Tax on Rent (Total 15 Years)	Tax on Sale	Total Tax Paid	Potential Tax Saving
Mr. P	$9,300	$139,500	$113,050	$252,550	**$17,450**
Mrs. P	$6,600	$99,000	$113,050	$212,050	**$57,500**
Company	$6,000	$90,000	$180,000	$270,000	**nil**
Trust	$6,600	$99,000	$91,400	$190,400	**$79,600**
SMSF	$3,000	$45,000	$60,000	$105,000	**$165,000**

As you can see, there is a big difference between the best and worst outcome.

Does this mean you automatically buy all investments in super? Of course not. What about a trust? It was next best on the list, but won't always come out best. It will surprise people that a company was the worst option here - but only because of the tax on sale (due to the company not getting any tax concessions upon sale, where the other 4 options do).

Different circumstances will have different outcomes for different reasons, which is where proper planning comes into it.

How to Begin Tax Planning

The nature of tax planning is fairly simple - its all about sitting down, looking at what you intend on doing now and into the future, and setting up a structure that suits that plan.

The reality of it is that it can be very complicated.

The above example is a fairly simple one and the possible tax outcomes are fairly easy to quantify, but what if we added any of the following to the mix:

- The children (or a child) of Mr. & Mrs. P were non-working adults who had no income;
- Mr. & Mrs. P were younger and looking to start a family soon;
- The asset they were looking at buying was a business and not an investment property;
- They were planning on living in the property after 5 years;
- There were children from a previous relationship involved; or
- They planned on moving overseas in a few years.

The outcomes could be vastly different. Using the above:

- Non-working adult children means that a trust could distribute income to the children and use their lower tax rates, resulting in less tax being payable each year;
- If Mrs. P stopped working to have children, she would only pay $660 in tax on the rent each year as opposed to $6,600;
- If the asset was a business (or a property used in Mr. P's business), there are very generous concessions available when sold that could reduce the tax on sale to nil - but these may not be available to a SMSF, and possibly not the trust or company;
- If they wanted to move into the property, they would need to buy it back from a trust, company or SMSF, so there would be unnecessary taxes (and stamp duties) payable;
- It may be possible to use a trust to pay child maintenance and do so tax effectively; and
- If they wanted to move overseas, they may no longer be Australian residents for tax purposes and pay higher taxes in all structures bar a company.

As you can see, little variations can result in fairly significant differences. This is why tax planning is so important.

Some people will go off on a whim and sign contracts without even thinking about it, only to visit their accountant at tax time and be disappointed at having to pay more tax than they would like to.

A simple phone call sometimes is all it takes to avoid a mistake like this.

Tax Planning and Super

Superannuation is a big part of tax planning. It is by far the most tax effective structure, made even more attractive when you turn 60 and getting money out is tax free.

Ensuring that you can put money into super **and claim a tax deduction for it** is very important.

In the example given, should Mr. & Mrs. P wish to contribute the rent ($20,000 per year) into super, Mr. P wouldn't be able to claim a tax deduction should they buy it in their names (because individuals who receive super from their employers are ineligible to claim tax deductions for extra contributions). If they purchased the property in the name of a company (or possibly a trust), he may be able to.

When you're 25 and living life like the next day doesn't matter, superannuation is the last thing you think about. However, by getting the structure right to start with, you will ensure that down the track when you want to put that extra money into super, you can do so tax effectively.

A Common Scenario

One scenario that you hear time and time again is this...

A couple have either outgrown their house or are looking to scale down and buy a new one. They are in a good financial position and don't want to sell their current house, and will borrow to buy the second house (which is the one they will live in).

The problem with this is that borrowing to buy a house you will live in is **not tax deductible**. You can argue all you want that you are borrowing to enable you to rent the first property out, or that the mortgage is secured by the rental property, or even that it's just simply unfair, but you will never win.

So what can you do about it?

There are a few options, some more attractive than others:

- Sell your current house and use the proceeds to buy the new house. Then borrow to buy a new rental property;
- Get a trust or other entity involved and sell the house to a trust and have the trust borrow to fund the purchase;
- If the house was in the name of one partner, sell it to the other and have the other partner borrow to fund the purchase; and
- Other more complicated options are out there (some more legal than others).

If you just go and buy the house before getting advice, you could be missing out on some pretty lucrative tax deductions - which is something no one wants (apart from the ATO).

Of course there are other factors to consider. Take the above for example, if the first home has been in the family for generations, you probably won't want to sell it off simply to get a few tax deductions - it may mean more to you than that.

Other Things to Consider

There are other factors that need to be considered when trying to work out the correct structure for a person. Asset protection, estate planning, and retirement planning to name a few. What if something goes wrong - can you effectively sell the asset or undo the transaction without too much pain?

Using the initial example of Mr. and Mrs. P, we can demonstrate how each some of these may effect the decision of who is to hold the investment property.

Asset Protection

As Mrs. P is running a small business, she is at risk of either being sued or simply racking up large debts that she cannot pay.

While Mrs. P has insurances, the industry she operates in is a little volatile and the chances of being sued or otherwise made liable for a defect is larger than both her and Mr. P would like.

They therefore decide that putting the property in Mrs. P's name is not a viable option as they don't want to have that property at risk.

A SMSF, company, and trust provide good asset protection (and generally in that order), so these are the preferable options.

Estate Planning

Estate planning gets more complicated when companies and especially trusts get involved. If something is owned by a company or trust, you can't put that asset in your will as you are not the legal owner -- the company or trust is.

You can put your shares in the company or trust in your will, but if you are not the only shareholder, it gets difficult to ensure that the ownership passes as you desire.

It becomes even harder if the trust is a discretionary trust (which means that no one "owns" the trust, instead the trust decides who gets the income and assets of the trust). In this case, you can't put your "control" of the trust into the will, you have to have other means of ensuring that your children, and not the solicitor or another family member ends up in control of the trust (especially difficult if the children are minors).

So, while a SMSF, company, or trust may be great from an asset protection point of view, its not ideal for estate planning.

Retirement Planning

Retirement planning is not only about paying less tax (or no tax) on any income in retirement, but getting to retirement as quickly as possible with more than enough assets and income streams to support you in the next phase of life.

It makes sense that tax is a big part of that, but what is often overlooked be people when purchasing assets or starting a business is what they will do with those assets as they go into retirement.

Will you sell them as you approach retirement? Pass them onto children? Hold onto them as a way of keeping a steady stream of income?

And will the structure you set up now have any chance of being tax effective when you retire or are approaching retirement?

A SMSF is fantastic in retirement, and generally speaking as people approach retirement you want to get as many assets as possible into superannuation to take advantage of the great tax concessions.

A maximum tax rate of 15% on all earnings within super (which can be lowered to 0% later in life with correct management), and getting money out of super once you turn 60 is tax free.

It's very difficult to get an asset into super after it has been purchased. Not only can it be expensive tax wise (there is a capital gain on transferring it), but a SMSF is restricted in the types of assets it can own, and even more restricted on what it can buy from a related party.

Using our example, it’s obvious that putting the investment property in super will give Mr. & Mrs. P more money, but what if they wanted to live in that property when they retired instead of selling it?

If the property was in super, they would have to buy it back from super, or have it paid as a lump sum payment to them. If they are over 60, getting it out is tax free, but the SMSF has a deemed sale and will pay tax (and possibly stamp duty).

If the property was in just Mrs. P's name, she doesn't have to sell it, and as a result doesn't pay any tax on the sale. All of a sudden, as good as putting the property in a SMSF looks, it can actually result in more tax being paid.

The "What-If" Scenario

Not everything goes according to plan. You may buy an investment with the plan to hold onto it until you retire, but have your job made redundant earlier than you would have liked. Alternatively, it could be an injury, illness, or sometimes worse.

While we hope these scenarios never happen, the reality is that sometimes they do, and it is something that needs to be considered when working out what structure to go with when doing your planning.

Continuing the initial example, but 3 years after purchasing the investment property, Mr. P lost his high paying job and for whatever reason couldn't find a similar replacement, and now earns $40,000 per year.

Now Mr. & Mrs. P are earning a combined $90,000 per year (excluding the rent) and it is about now that the extra $20,000 in rent is pretty valuable (or alternatively the full value of the property should they want or need to sell).

If the property was purchased in superannuation, the money is trapped there until they retire, so they can't access that $20,000 in rent per year, let alone the value of the property should times get really tough. So while superannuation is by far the most tax effective, it doesn't bode so well in a what-if scenario like this.

If the property was in a company, they would need to pay the $20,000 as a wage or a dividend to access it, but seeing as Mr. P is now on a lower income, the tax on that income is not an issue. The issue here would be if the property had to be sold and getting that money out tax effectively - but at least the money is gettable.

If the property was in a trust, its easy, Mr. & Mrs. P just draws down the $20,000 a year in trust distributions (discussed in more detail below). Selling the property wouldn't be overly troublesome, and would be fairly tax effective, and probably more tax effective than holding the property in just Mrs. P's name.

So while a trust isn't the most tax effective structure, in this particular "what if" scenario it holds up very well.

Issues with Companies, Trusts, and SMSF's

While these entities seem great - they have asset protection, can help lower taxes, etc, - they come with their own issues that need to be highlighted.

A separate entity means separate fees. They cost money to set up, and they cost money to run. Having said that, look at the example and see what sort of tax dollars you could save in the long run.

Some have additional requirements from the ATO, and have restrictions on what they can and can't do. Below we have a summary of these issues

Companies

Companies are regulated by the Australian Securities and Investments Commission ("ASIC"), who charge a yearly fee of around $320 (at the time of writing) for the privilege. Part of ASIC's rules is that a Company must complete an annual return each year (separate to a tax return) and have minutes of meetings, and other documentation done.

With a company being a separate legal entity with a tax rate (30%) being less than the top individual rate (47%), the ATO are wise to schemes that see income being taxed at the company rate, but then the money being pulled out of the company and used personally.

If the company earns the income, the money must stay in the company until it is either paid out as a wage, dividend, or used in the company for its continuing operations (e.g. paying expenses or purchasing more assets).

Penalties for breaching these rules are quite harsh, so it is not something to take lightly.

So if a person plans to set up a company, purchase an asset in it, but essentially treat the company bank account as if it's their own, then the company structure is probably not for them.

Trusts

Trusts are not as regulated as companies. ASIC don't get involved so don't charge a fee, but a trust still has to maintain minutes of meetings and other documentation.

Generally speaking, the "owners" of the trust (not technically correct, but more a descriptive term) can draw monies out of the trust at will and not be penalised like a company - however that is because the trust itself doesn't pay tax, it has to choose someone to pay tax on its behalf (again not technically correct, but for ease of description).

It’s a little complicated, but say Mr. & Mrs. P buy their property in a trust. Each year, the trust must pick someone to pay tax on $20,000 (actually the trust gives someone a right to that money - called a "distribution"). As Mr. P is on the top tax rate, it won't be him, so the trust chooses Mrs. P.

Mrs. P then pays tax on the $20,000 distribution as if she earned the rent directly (which is why the tax on the rent in the table is the same as Mrs. P).

Mrs. P then has a right to that $20,000, so she can take that out at any time. This is beneficial compared to a company, but you lose the benefit of the company tax rate.

The trust can distribute to a company, but the trust is essentially forced to pay the monies to the company under separate anti-avoidance Laws.

One problem with a trust is from an asset protection point of view.

Using the example, lets say the trust ran the investment property for 5 years, making $20,000 a year and Mrs. P paid the tax and left the money in the trust so it had a $100,000 bank balance.

Should Mrs. P get sued, all her assets are at risk. One of these assets is a right to $100,000 of distributions from the trust. While one might think that because the money is in the trust and has never left the trust it is protected - but its not.

However, this only extends to the distributions of income, not the actual property so while the asset protection isn't perfect, it’s still a lot better than nothing.

Self Managed Superannuation Fund

A SMSF pays a flat rate of tax of 15%, which is miles better then anything else as you can see from the table on the first page. The problem is that it is expensive to run, is highly regulated, and has severe penalties for breaching the rules.

A SMSF not only lodges a tax return each year, it needs to prepare a decent set of accounts, get audited every year, and pay the ATO around $400 a year for regulating it.

The Laws are very strict on what a SMSF can and can't do. It can only borrow money in very limited circumstances, it can't pay monies out early or lend money to a related party, it shouldn't run a business, there are restrictions on what assets can be purchased and who they are purchased from, and the list goes on.

Breaching these Laws can be very costly. The ATO can effectively take half of the value of the SMSF should you not behave.

It is for these reasons that you think very long and hard about setting up a SMSF. In the right circumstances, and if managed correctly, the SMSF can be the best place to hold assets.

If not managed correctly, the myriad of complicated rules can not only make the experience of running a SMSF a nightmare, but you could see half of your retirement funds going down the drain.

Steer The Course

Once you have your long-term tax planning strategy in place, it is important to stick with it. Knee-jerk alterations to save a few tax dollars now only cause problems and never work out in the long-run.

An example we see time and time again is with assets put into super. Often the long term goal is to take advantage of the 0% tax rate you can obtain upon retirement - but until that point all you see is 15% of your earnings going out the door by way of tax (and for some reason, even though this 15% is lower than almost any other tax rate - it seems to be more painful to people for some reason).

Remember what the reasons are for making the initial decision, write them down at the time with all the sums so that when you look at it in 5 years, you can see it in black and white.

To Summarise

As pointed out at the start - getting the correct structuring and planning done before you purchase an asset (or make any major decisions) is vitally important to ensure the best outcome for you and your family.

Using the example provided, Mr. & Mrs. P have a big decision. Do they save a lot of tax and buy the property in a SMSF and lose the flexibility? Or do they use a trust, take moderate tax savings, but forfeit some estate planning?

What if the asset is a loved family home? Is the ability to pass it to children more important that anything? If so, have it in their personal names.

We never intended to give you a "one size fits all" answer - the fact is it doesn't exist. But planning for your future (and primarily tax planning) isn't as easy as just getting a trust because the person you work with has one. While it may be tax effective now, it may not be in 5 years time when circumstances change.

Getting advice **before** you do anything and doing the proper planning is the best thing you can do.

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