Centuria

Tax-effective investing - alternative structures

Most investors consider superannuation for long term tax-effective savings. Both the Government and the Opposition are now targeting its concessions away from wealth creation and estate planning. Investors seeking greater certainty and more **flexibility** may look outside of superannuation to build **wealth, plan for various life events (including enhanced retirement living)** and to implement appropriate estate planning strategies (including inter-generational wealth transfers).

So what other investment structures should investors consider?

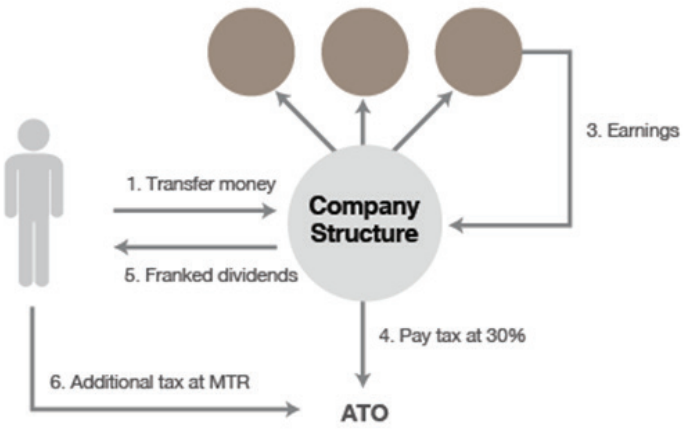
Companies and investment bonds are both potential alternative investment structures, where income can be earned limiting the tax rate to 30% (currently). However, investment bonds have some unique features that in certain circumstances may give them an edge over company structures.

Company structures may suit high net wealth clients who are happy to set up a private company to hold investments. But this may only be a tax deferral mechanism, as eventually funds may need to be paid out of the company and personal tax becomes payable at the investor's marginal tax rate, less any franking credits (if an Australian tax resident).

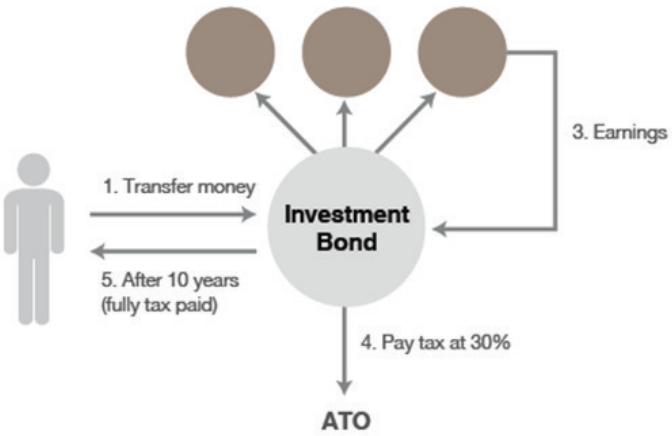
Investment bonds offer an alternative long-term strategy given that personal tax relief becomes permanent after 10 years[1].

Let's take a closer look at how these two alternatives outside of superannuation compare and the benefits of each option.

Investing via a company structure



The Investment Bond



Generally, individuals on higher marginal tax rates may seek tax-effective investments that achieve long term wealth creation over and above their superannuation, which is now limited by policy-driven contribution caps.

As an investment vehicle for tax-effective wealth creation, Centuria Investment Bonds are an alternative option to a Company Structure. However, from a tax strategy point of view, there is a fundamental difference between these two options.

1Assuming the 125% rule on deposits is not broken and withdrawals are not made within the first 10 years.

Fundamental differences from a tax strategy perspective

Investing via a company structure:

While earnings remain within the company

- Company structures are usually a tax deferral mechanism, therefore are not a tax effective solution if they do not actually reduce the eventual tax.
- Earnings on the funds are currently taxed at the company rate of 30%, while the funds are held within the company. This also assumes the anti-avoidance 'personal services income' rules do not cause the use of a company structure to become invalid for tax purposes.

Upon withdrawal or distribution of earnings

- When company profits are withdrawn, they are normally treated as a dividend payment, which must be included in the investor's assessable income.
- In the case of a private company, company profits can also be transferred to an individual as salary/wages, director's fees, or interest on any loans advanced to the company, etc. Such transferred amounts can be expected to be included in the investor's assessable income.
- Any distributed company profits are taxed at the investor's marginal tax rate, less any franking credits. Any tax offset for franking credits merely compensates for taxed company profits – so the value of franking credits should be regarded as merely avoiding double-taxation.
- Tax is only reduced (on distributed company profits) if the investor's marginal tax rate is lower in the tax year of withdrawal, than in previous years. Conversely, tax can be increased if the opposite were true.
- Also, tax is only reduced (on distributed company profits to an Australian tax resident) if the investor's marginal tax rate is lower than the company tax rate. Again, conversely, tax can be increased if the opposite were true.

Upon sale of investor's share interest

- Lower tax can also be achieved, if the investor's share interest is sold for a capital gain (after holding that interest for at least 1 year) and if 50% of the 'discounted capital gain' became exempt from tax. However, unless no other income amounts were drawn from the company, any discounted capital gains tax would be additional to full tax at marginal rates on such other income drawn from the company – including dividends and undiscounted capital gains.
- Conversely, if the investor's share interest is sold for a capital loss, such a loss can only be offset against any current or future capital gains, and is not deductible against ordinary assessable income. If a capital loss is never offset, its tax benefit is lost permanently. Also, if a capital loss is offset under the discounted mechanism, its tax benefit is effectively halved.

Note: Use of a private company structure also needs to recognise the tax pitfalls of Division 7A of the Income Tax Assessment Act 1936. Division 7A may apply to a private company that makes tax-free distributions to its shareholders or their associates in the form of payments, loans or debts forgiven.

Investing into an Investment Bond:

Taxation within the first 10 years

- During the period of investment, ongoing earnings are taxed within the bond, currently at 30%. They are not included as income of the investor and therefore do not increase the investor's taxable income, or attract (or increase) the investor's marginal tax rate.
- If the investment is held for at least 10 years, none of the withdrawn earnings will be included in the investor's assessable income.
- Thus, tax on investment earnings can be permanently capped at 30%, and never attract personal tax (or Medicare levy).
- With a few exceptions*, the earnings component of withdrawals within the first 10 years must be included in the investor's assessable income, however a 30% tax credit is then applied – to offset the impact of tax already paid in the bond.

*Exceptions to tax on withdrawals within the first 10 years

- If a withdrawal is made in the 9th or 10th years, only a portion of the earnings is included in the investor's tax returns.
- If funds are withdrawn at any time (even within the first 10 years) due to special circumstances, such as death, disability or serious illness of the bond's nominated life insured (which can be the investor or another person), neither the investor nor the investor's estate will pay any further tax.
- Similarly, if funds are withdrawn at any time (even within the first 10 years) due to unforeseen serious financial difficulties affecting the investor, no further tax is payable by the investor.

Nominated beneficiary's tax position

- A nominated beneficiary (who receives fund proceeds if the investor has died) will not be taxed.

As a long term strategy for tax-effective wealth creation, an investment bond may be an appropriate vehicle given there could be no personal tax obligations on reporting and payment by the investor.

Tip: Investing money via a company structure may only defer tax payable. The earnings are still taxable at the investor's marginal tax rate upon withdrawal. Tax is only reduced if the investor's marginal rate has fallen at that point.

Tip: Investment bonds offer a tax-effective savings solution for middle to high income earners, especially if funds remain invested for at least 10 years. A real tax saving occurs if the investor's marginal tax rate is greater than the bond tax rate (of 30%) – as is the case with most working Australians on marginal tax rates of 34.5%, 39% and 49%. This can also apply to minors, who attract high tax rates (between 45% and 66%) on Division 6AA income above the small $416 tax-free threshold. Investment bonds can also provide a tax advantage when compared to a company structure as the bond tax offset (unlike imputation credits from franked dividends paid by a company) is not part of the gross-up tax rules – and required to be included in the investor's taxable income.

Example:

Scenario 1: Using a company structure for wealth creation

Julie establishes a private company and invests $120,000 into the company. The company invests in a range of investments and all earnings are retained within the company.

- After 3 years, the company declares a fully franked dividend of $36,000* and the investor withdraws the $120,000 invested.
- The investor is on a high marginal tax rate of 49% (45% plus 2% Medicare Levy plus 2% temporary Budget Repair levy).

The investor's tax position after receiving the dividend:

Fully franked dividend	$36,000
Add: Imputation credit ($36,000 x 30/70)	$15,429
Total included in taxable income ($36,000 + $15,429)	$51,429
Tax at 49%	$25,200
Less: Imputation credit	$15,429
Net tax payable ($24,171 - $15,429)	$9,771
Net earnings ($36,000 - $9,771)	$26,229

Scenario 2: Using a Centuria Investment Bond for Wealth Creation

Jason places $120,000 into a Centuria

Investment Bond

- After 3 years, the investor withdraws the investment of $120,000 plus all realised earnings amounting to $36,000.
- The investor is on the same high marginal tax rate of 49%.

The investor's tax position after receiving these funds:

Investment	$120,000
Amount withdrawn	$156,000
Growth portion (included in taxable income)	$36,000
Tax at 49%	$17,640
Less tax offset ($36,000 x 30%)	$10,800
Net tax ($17,640 - $10,800)	$6,840
Net earnings ($36,000 - $6,840)	$29,160

Important: In this scenario, it is assumed that the after-30% tax franked dividend declared is the same as the after-30% tax growth within the investment bond. This example is purely for illustration purposes and shows only taxation impacts in the hands of investors. It gives no consideration to the underlying assets and the likelihood of the return. Investors should be mindful of the underlying assets into which each investment vehicle invests and, in particular, the income and capital gains or losses (and their taxation effects) that may be derived from those assets. These factors will impact on the franked dividend or investment bond growth at the end of the period. We recommend that you talk to a licensed financial adviser on the impact of income and capital returns on taxation within each structure.

Each investor includes their earnings in their tax return, however because only the net earnings received from the Centuria Investment Bonds are taxable, in the second scenario – the bond investor pays $2,931 less tax – than the company investor.

Scenario 3: using a Centuria Investment Bond for Wealth Creation (after 10 years)

Jason had retained his investment within the Centuria investment bond for at least 10 years (or received it under any of the special circumstances mentioned above), he would not pay any personal tax. Under these circumstances, Jason (or his estate, of he has died) receives a significant tax saving of $9,771 – compared to Julie who had invested her money using a company structure.

Centuria Investment Bonds Offer:

Simplicity:

- Once established, no ongoing tax reporting and payment is required.
- Does not require any entity structure to establish or maintain, so no ongoing administration and compliance costs.

Flexibility:

- The flexibility and freedom to invest and withdraw at any time. Also to transfer bond ownership.

Certainty:

- If held for 10 years, you can be certain that total tax will be capped at 30% with no further tax to pay.

* In this scenario it is assumed that the quantum of the franked dividend declared is the same of the growth with the investment bond. This example is purely for illustration purposes and gives no consideration to the underlying assets and the likelihood of the return. Investors should be mindful of the underlying assets into which each investment vehicle invests and, in particular, the income and capital gains or losses (and their taxation effects) that may be derived from those assets. These factors will impact on the franked dividend or investment bond growth at the end of the period.

Side by Side

	Feature	Investment Bond	Investing via Structure Company
1.	**Entity Tax Rate** **Whether on income or capital gains**	30%	30%
2.	**Personal Tax Rate** **When entity income is distributed on an on-going basis, such as dividends** **When entity income is distributed upon a wind- up, effectively a final dividend**	No personal tax, if bond withdrawn (or part-withdrawn) after 10 years … or if withdrawn anytime due to - Death or disability of life insured - Unforeseen serious financial difficulties of bond investor. 30% tax rate cap remains.	30% company tax replaced by personal tax at marginal tax rate (via operation of dividend imputation system). In effect, the 30% company tax rate is only temporary (or provisional).
3.	**Personal Tax Rate** **On Capital Gains (only applicable when an individual's investment is disposed of)**	Bond income is treated as ordinary income. No capital gains tax [CGT] reporting or compliance required.	Effective 50% tax reduction applies to discounted capital gains (on shares held for more than a year). Capital gains tax reporting or compliance required.
4.	**Investment Transfers** **On Capital Gains (only applicable when an individual's investment is disposed of)**	Bond assignment can be seamlessly made. Retains original start date. No personal tax event for transferor, if assignment is for nil consideration.	A share ownership transfer creates a CGT event, with personal tax consequences.
5.	**Bankruptcy Protection**	Full protection from creditors, if nominated life insured is either the bond investor or investor's spouse. Protection extends also to future bond payout monies.	No protection from creditors
6.	**Nomination of Beneficiaries**	If there is no separate life insured (to the investor), specific bond beneficiaries can be nominated, outside a Will – and may also be better quarantined from any Will contests.	Company share investment generally falls to be with part of a person's estate, and dealt with in terms of a Will (if one exists).
7.	**Investment Life after Death**	If the life insured survives the bond investor, a bond can continue – and be held as an asset of the estate.	Generally no, as share investment has to be transferred (via the estate).

1. If bond is withdrawn (or part-withdrawn) during first 8 years, 70% of bond income (after 30% bond tax) is personally taxed – but a 30% tax offset automatically applies. So, of the total bond income, effectively 30% is taxed at 30% (at bond level), the balance is taxed at personal tax rates. No imputation-style gross-up occurs. If bond is withdrawn (or part-withdrawn) in 9th year, the amount personally taxed is 2/3rd (with 1/3rd being tax-free). If bond is withdrawn (or part-withdrawn) in 10th year, the amount personally taxed is 1/3rd (with 2/3rd being tax-free).

2. The 'life insured' can be any natural person(s) nominated by the bond investor, who is the default life insured (unless another person is nominated). The life insured has no interest in the bond, but whose death or disability can be a trigger point for a bond termination.

Other advantages of investment bonds

Investment bonds offer a number of advantages and can complement an investment in superannuation. These advantages compare favourably to investing through a company structure and are summarised below:

Flexible investment options

Investment bonds allow clients to access many asset classes and provide a market-linked investment vehicle to help meet investment goals.

No limit on the investment amount

There is no limit on the amount that can be invested to establish an investment bond. Investors can also make subsequent investments up to maximum of 125% of the previous year's contribution without restarting the ten year period. Investors can choose to start new investment bonds if higher amounts are to be invested.

No excess contributions tax

Investment bonds can provide a tax effective means of investing, and avoid excess contributions tax that may otherwise apply in superannuation.

Flexibility

Investment bonds give investors the flexibility to access funds at any time, which can act as a hedge against the restricted access for superannuation. No capital gains tax compliance and complexities need to be considered. Investment bonds provide simplicity as earnings are automatically reinvested in the bond. This means reinvestment dates do not need to be tracked for capital gains tax purposes. Investors can also switch between investment options without triggering personal capital gains tax.

Transfer of ownership

The ownership of the investment bond can be easily assigned or transferred at any time. The original start date is retained for tax purposes. This may not be achieved within a company structure without creating tax liabilities.

No tax file number [TFN] reporting obligations

Under current tax and privacy rules, a bond investment does not require a TFN to be quoted. This also means no high tax deductions from withdrawals, where a TFN has not been quoted.

Non-residents treated the same

An investor who is not an Australian tax resident (who can be an Australian living overseas as much as a foreign investor) is treated similarly to a resident, for Australian tax purposes.

Equal entitlement applies to the bond tax offset (unlike an imputation credit from franked dividends).

Also, no non-resident withholding tax deduction is requirement – on a withdrawal by a non-resident bond investor.

Bankruptcy protection

Investment bonds may offer protection from creditors in the case of bankruptcy (subject to certain rules), which may not be provided through a company structure.

Start investing today.

Simple | Flexible | Versatile

For more information contact Centuria on 1300 50 50 50 or visit www.centuria.com.au/investment-bonds to download the PDS.

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