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Effective Tax Planning – Jim & Sophie’s Story

Last year around May a new client was introduced to us by one of our existing clients. We get most of our new clients by referral or word of mouth. They thought we would be able to assist their friends because the friends had sold a property that they had held for many years as an investment and were facing a huge Capital Gains Tax bill. They knew it was late in the financial year leaving not much time to manage the situation.

The clients (Jim and Sophie) were absolutely fed up with dealing with issues regarding the property. They had delinquent tenants who were always behind on their rent; the real estate agent who managed the property did a very poor job generally and the property was quite an old property and therefore needed quite a bit of maintenance on a regular basis.

Jim and Sophie managed to sell the property for \$750,000 and had made a capital gain of \$300,000. The property was jointly owned, they were both employees working for wages, and they were in their mid 50’s, had very little in superannuation and were getting quite concerned about their ability to retire comfortably in the near future. They were smart enough to know that in retirement the most tax efficient vehicle is superannuation and they wanted to take advantage of this.

One strategy to minimise the amount of Capital Gains Tax payable is to for the individuals to reduce their taxable income in the year in which they receive the gain.

Note: You are deemed to have received a gain at the date at which a contract is signed not the settlement date! I had a client who signed a contract in mid June one year not knowing that this was the deemed date of disposal and this left him with a huge tax bill he was not expecting.

For Jim and Sophie we discussed many options that were available to them which included:

1. Accept that they had made a gain from the property investment and pay the applicable tax.
2. Make salary sacrifice contributions to super.
3. Establish a new investment with deductible interest.
4. Look at other ways of minimising the Capital Gains Tax.

Accept that they had made some money from the deal and pay the tax.

Jim and Sophie had worked very hard all of their life and felt that they had paid their fair share of tax. They struggled for years to hold this investment property, giving up quite a deal of their personal and family time over the years dealing with the tenants and the maintenance issues not to mention paying the loan repayments for many years.

Even though they were entitled to a 50% discount on the Capital Gain they could not bear the thought of paying around \$75,000 in cold hard cash to the tax office.

Make salary sacrifice contributions to super.

As Jim and Sophie were salary and wage earners and most of the financial year had passed they were not able to make deductible superannuation contributions. A salary sacrifice arrangement can

only be done prospectively. That is you cannot back date a salary sacrifice arrangement with your employer.

They had less than two months of the year remaining so this option just would not have solved their problem. If they had the whole financial year in front of them they could have made sizable salary sacrifice contributions and all but wiped out the Capital Gains Tax bill. Obviously they would have paid 15% tax on the super contributions but this was far better than 46.5% tax on half of the gain.

Establish a new investment with deductible interest.

Another option would have been to establish a new investment and look to prepay the interest on the loan this year. This was not particularly desirable for a few reasons. The first being that in order to wipe out the CGT liability Jim and Sophie would have needed to establish an investment of around \$1,500,000 to achieve this. They would then have quite a large interest bill each year to service.

The risk associated with an investment of this size would have been quite large. For example say the investment went down in value by 10% they would still owe \$1,500,000 but the investment would only be worth \$1,350,000 in the short term. This was simply a risk they did not wish to expose themselves to.

Look at other ways of minimising the Capital Gains Tax.

So what other ways can be considered. There are not many.

One very effective way though is to consider agricultural investments. Many Agribusiness investments offer a 100% tax deduction to the investors in the scheme. This can help with the tax outcomes mentioned above for Jim and Sophie. You must first ensure that the investment stands up in its own right otherwise why bother investing in it in the first place.

Primary industries are one of the largest and oldest industries in the world. An investment in this area is nothing new. In fact some of the richest people in Australia have significant investments in Agribusiness. (E.g. Packers, Holmes a Court etc.)

Investments in these projects are quite often offered through what are known as Managed Investment Schemes (MIS). In years gone by many of these investment schemes have had a chequered reputation because some failed, or they focused mainly on the tax aspects, rather than determining whether the project was viable. Sometimes people would invest in these schemes only to find out the Tax Office would disallow their deductions after they had already invested.

Things have changed quite a bit these days. All projects that we deal with have a Tax Office Ruling. They have been thoroughly researched by independent researchers and must demonstrate a sound business case before they will be recommended for investing. Tax is not the sole focus.

When you grow things there is obviously a risk that something will affect this adversely, so diversification and risk minimisation, such as having insurance in place, is a must.

Agribusiness can be broken up into three broad categories:

Forestry

Planting, growing and harvesting trees. Governments and industry have been doing this for a very long time in Australia and a lot of plantations currently exist in many locations.

Fast Growing Eucalypt trees are harvested for pulpwood or woodchip which is used to produce paper.

Sandalwood trees are used for joss sticks (incense) for religious ceremonies or to make things smell nice, and the oil is used to produce perfumes or fragrances.

Pine and other Eucalypt species are used to produce structural timbers and veneers for construction and high grade flooring.

Horticulture

This is where crops are produced such as wheat, barley, canola, almonds, grapes, olives and other fruits to name a few.

Aquaculture

This is the farming of plants or animals in water such as barramundi, salmon, prawns, crabs, pearls or abalone.

So what did we do for Jim & Sophie?

We recommended Jim and Sophie invest \$150,000 combined (\$75,000 each) in a diverse range of quality agribusiness investments this year, which offered an income return at varying periods in the future.

These projects all had tax office rulings to secure the deductions required. This gave us the ability to then look at using a range of the other strategies we mentioned above, such as salary sacrifice and further investment to minimise tax in the years ahead.

Jim & Sophie essentially said to me if they do nothing they will definitely pay the money to the tax office and not see it ever again. They discussed it and felt at least this way, whilst they understood there was some, albeit minimised, risk involved, (there always is when you invest) they were giving themselves a good chance of not only reducing their tax in this particular year but he also had the possibility of generating significant returns into the future.

They effectively bought the time needed to structure their affairs in a manner that suited them best. They reduced a large potential tax bill to nil.

We continue to work with Jim and Sophie and have since implemented a Transition to Retirement strategy for them. We also restructured their super with their respective employer super funds and completed a full insurance review managing to save them thousands on the cost of their personal insurance.

To summarise – regardless of your financial situation or age it is important to seek professional advice to ensure you have the correct strategies in place to maximise your position from a taxation, investment and protection perspective.

Of course this is intended to be general information only and you should seek personal advice before undertaking any financial strategy.