

16/06/2009

Written by: Tony Sirett, Managing Director, Rodney Gibson Financial Services Pty Ltd.

Schemes and scams can cost you dearly if you are not careful

This time of year sees a plethora of financial products being promoted on the market.

Tax schemes and sometimes scams come out of the woodwork.

Many people are attracted by the lure of obtaining tax breaks to assist them reduce assessable income for the year.

Some can be worthwhile but others are not.

Guarantees – do you need them?

A lot of products offered at this time of year carry guarantees. You have to ask yourself do you really need the guarantee?

If you have the right time frame for investing and are able to withstand the potential ups and downs you are usually better off not to have a guarantee. Guarantees always have to be paid for, therefore a guarantee will act as a drag on investment returns during strong performance periods.

Sometimes Guarantee's are not what they seem (ACR)

Some types of guarantee include:

Threshold management – this can save you potential loss but prevent you from also making gain. (e.g. Macquarie Fusion)

Shorting of futures or derivatives – this can be set up or turned off any time. (AXA North)

Every investor needs to consider their situation in isolation. Guarantees may suit some people but you need to ensure you understand what you are getting yourself into.

How tax schemes really work

Courtesy of ASIC via the FIDO website. www.fido.gov.au

There is a range of great material available on this site and people should have a look before entering any scheme.

A tale of two investors

If someone offered you a scheme to pay less tax and still make money, you might be tempted, especially if you are otherwise facing a large tax bill at the end of the financial year.

However tax schemes are not as simple as they seem. Here FIDO takes a closer look at how tax schemes really work and the extra risks you may be taking for the financial rewards they claim to offer.

How schemes work

In a nutshell, tax schemes generally let you postpone your tax, but you'll still have to pay tax in the end. This may be beneficial but will depend what your tax rate is at the time you receive the income.

To compare a tax scheme with other possible investments you don't need to consider just the short-term, but look at how they work for you over a number of years.

To explain how this can work, let's compare two made-up examples. Franca's going to buy \$100,000 worth of shares, while Ginger's going to put \$100,000 into a tax scheme that's developing a ginseng plantation. We'll assume both of them pay the top marginal tax rate of 45 cents in the dollar.

To keep things simple, we'll also assume they don't receive any dividends or income along the way, but will get all their investment returns when they stop holding their investments.

The numbers

	Expenses and income
Franca buys \$100,000 worth of shares or managed funds. Capital expense and no tax deduction allowed	-\$100,000
She sells her shares at a profit 5 years later	+\$150,000
Capital gains tax payable For investments held more than 12 months, her \$50,000 profit would be taxed at concessional capital gains tax rates. For the sake of simplicity, the rate can be thought of as being half income tax rates, or 22.5% for a top rate tax payer like Franca.	-\$11,250
Franca's profit after tax	\$38,750
Ginger buys into ginseng plantation tax scheme. Structured as meeting the ongoing running costs of setting up the plantation, with no capital value.	-\$100,000
Tax refund received for expenses necessary to produce an income.	+\$45,000
She receives the same \$150,000 as Franca 5 years later.	+\$150,000
Income tax payable Ginger's money is regarded entirely as income, not capital, so she must pay at her income tax rate of 45 cents in the dollar	-\$67,500
Ginger's profit after tax	\$27,500

As you can see, Ginger's tax scheme meant that she ended up paying more in tax than Franca, but she was able to delay the final day of reckoning.

Being able to delay an expense can be valuable. How much could such a delay of tax be worth?

Going back to our example, you can see that Ginger received \$45,000 as a tax refund which Franca did not. Ginger could have invested that money. Let's suppose she was able to invest the money at exactly the same rate of return and on exactly the same basis as her ginseng plantation. In round figures, she would earn about \$10,125 after tax, bringing her total after tax return very close to Franca's.

Return and risk

In real life, it's most unlikely that Franca and Ginger would earn the same returns from such different investments. Each of them would face investment risks.

You probably already know something about the returns and risks of owning shares or managed funds that invest in shares, maybe from your superannuation fund which may invest in shares. Markets and shares in individual companies can rise, fall or stay flat.

Tax schemes involve different risks that may be less well known.

Typical extra risks Ginger could take in a tax scheme:

Risk	What it really means
Tax compliance	<p>Has the scheme been set up properly, and is it sticking to the rules?</p> <p>Good tax schemes will ensure that their investors really do qualify for a tax break, but there have been cases where poor practice has let investors down, and the scheme has fallen apart. Read more about tax schemes</p>
Commissions	<p>Tax schemes may pay commissions to advisers and other people, which must be disclosed to you.</p> <p>ASIC's report on tax schemes showed some schemes paid commissions to financial advisers of more than 20%. This means that only 80% of your money would have been invested in the project to make a return for you.</p> <p>Check the amount of commission your advisor will receive before deciding to invest, and compare it to the commissions paid for other investments, such as a managed fund investing in Australian shares.</p>
Being locked in	<p>Schemes may require investors to lock their money up for many years, even decades while the product or business matures.</p> <p>In our example, Franca can sell some of her shares if she needs money urgently. Ginger's money is all committed to the business, and she will get payments only if the scheme is successful, and then only when her agreement with the scheme specifies that payments have to be made.</p>
Eggs in one basket	<p>Most tax schemes are single ventures, so if the ventures fails, all the money can be lost.</p> <p>A carefully considered parcel of shares or a well-run managed fund will</p>

be diversified and spread your money across a variety of investments.

New ventures

Tax schemes are quite often new ventures without a track record. This makes them harder to judge and to value.

Most shares or managed funds involve investing in established businesses.

Related party dealings

Good schemes will operate free of any compromise produced by conflicts of interest.

Over the years some promoters have not been open with investors about dealing with people, companies or businesses to which they have some personal or business connection. In these cases, the scheme may be buy or sell assets to related parties, the manager may negotiate contracts with related parties, or assets ultimately end up being owned by related parties when the scheme ends.

If the scheme is dealing with related parties there's a risk that costs to you may be inflated, for example, because the scheme pays consultancy fees to a related party, when it would pay a smaller sum if it was dealing with an independent third party.

In addition to this, you have to understand you are growing a crop and this also has risk associated.

Are these risks properly rewarded?

That's the question you or your adviser must answer if you are thinking about a tax scheme. As you can see, the answers may not be simple or straightforward.

The bottom line

A tax refund does not work miracles.

The benefits can be overstated, and a tax refund won't change an unsuitable investment into a suitable one. As with all investing there are risks as well as rewards.

As always you should always seek advice from a licensed and reputable adviser!

For a complimentary appointment call 3252 9990 or visit www.rodneygibson.com.au.

Disclaimer:

This article is produced for general information purposes only and is provided in good faith. This article does not contain investment or insurance advice and is not to be relied on as a substitute for professional financial advice. Such advice should be sought prior to any implementing any strategies. Whilst the information contained herein is considered reliable, responsibility is not taken for errors, omissions or inaccuracies.