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Investment taxes

Interest

Gains in value

Rent from property

Dividends from shares

Leveraged investments

Investment tax strategies in Australia

You need to be able to ...

1. **Explain how interest is taxed**
2. **Explain how gains in value of investments are taxed**
3. **Explain how rent on property is taxed**
4. **Explain how dividends on shares are taxed**
5. **Explain how leveraged investments are taxed**
6. **Explain investment tax strategies in Australia**

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Interest

Interest in Snowland

Interest on bank accounts is treated as ordinary assessable income

Example:

John earns $1,000 interest on bank savings account so $1,000 is added to his assessable income

Interest in Australia

Australia is the same as Snowland

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Gains in value

Gains in value in Snowland

Any gains in value of investments (such as property or shares) are treated as 'assessable income'

If you have held the investment for more than 1 year then only 50% of the gain is 'assessable income'

Primary residence is exempt from tax on gains if it has not been rented out to tenants.

Example:

> **John buys some shares for \$5,000 and then sells them 2 years later for \$7,000. Assessable income of \$2,000 x 0.5 = \$1,000 is recorded in the tax year in which he sold the shares**

Gains in value in Australia

Australia is the same as Snowland

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Rent from property

Rent from property in Snowland

Rent income on property is assessable income

- Split between owners of property

There can be a lot of allowable deductions:

- Interest on an investment loan used to purchase the property
- Maintenance
- Agent fees
- Depreciation on fixtures

Gains on primary residence are tax free

Rent from property in Australia

Australia is the same as Snowland but get an accountant as the deductions can be tricky and the ATO audits!

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Dividends from shares

Dividends from shares in Snowland

When companies earn profits they pay some of those profits to shareholders in the form of 'dividends'

Dividends are taxed at a rate of 15% in Snowland

They are taxed at a reduced rate since the company has already paid corporate tax on profits.

Dividends on shares in Australia

Most governments "double dip" with taxation!

- **Companies pay tax on their profits (30% tax)**
- **Dividends are paid to shareholders out of the after-tax profits**
- **Individuals pay tax on their dividends (up to 46.5% tax).**

Australia has stopped this through "franked dividends"

A fully-franked dividend consists of a cash payment and also some "franking credits" (tax credits).

Government refunds any corporate tax paid by the company to the individual shareholder as tax rebate.

… continued

Add the total of the cash amount plus the franking credits to your assessable income.

> **Corporate tax rate is currently 30% so for fully-franked dividends:**
>
> **Assessable income = cash dividend / 0.7**
>
> **Franking credit = assessable income – cash dividend**

Calculate income tax.

Deduct the “franking credits” from your total tax payable.

The net result is that the government refunds any company tax that the company has paid.

For example, if your marginal tax rate is 45% then you effectively pay an extra 15% + ML on your dividends.

Dividends example for Australia

You receive a cash dividend of $700

Dividend notice advises “franking credits” are $300

You report your income as $700 + $300 = $1000

> **Even though you only received $700 in cash!**

Calculate tax at your marginal rate (say 41.5%) = $415

Report the “franking credit” as a tax rebate on tax return

You receive a tax rebate of $300

You only pay an extra $115 in tax

Total tax received by government is $300 in corporate tax plus $115 in personal income tax = $415 = 41.5% tax

Leveraged investments

What are leveraged investments?

A leveraged investment is when you borrow money to fund an investment.

Usually you borrow money from a bank in the form of an ‘investment loan’

If it is a property then the interest rate is similar to an ordinary home loan rate.

If you borrow to buy shares then it is called a ‘margin loan’ and the interest rates are <u>much</u> higher.

Leveraged investments in Snowland

If you borrow money in the form of an investment loan to fund an investment then the interest on the investment loan is an allowable deduction.

If it is an 'interest only' loan then the full payment is an allowance deduction.

If it is a 'principal and interest' loan then only the interest component is an allowable deduction

The investment loan must be separate from a home loan used to purchase the investor's primary residence.

Leveraged investments in Australia

Australia is the same as Snowland

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Investment tax strategies in Australia

Negative gearing

When the costs of an investment (deductions) exceed the assessable income from the investment.

Usually from borrowing money to invest in property or shares.

Main assessable income is rental income or dividends.

Main allowable deduction is the interest on the loan. Can also claim property expenses and depreciation on fixtures.

If investment's assessable income < allowable deductions … then it DECREASES your overall taxable income!

However!!

- **No point getting tax deductions on a dud investment**
- **The goal is to maximise after-tax returns NOT minimise tax!!!**
- **Geared investments magnify possible returns AND losses!**

Franking credits

Franking credits on dividends are a tax credit

So the reduce income tax by $1 for each dollar of franking credit

They are very valuable for legitimately reducing tax

If you also negatively gear the share investments then you can often reduce the tax on the investment income to zero

Superannuation

Any money salary sacrificed into your superannuation is a tax deduction.

For example:
Salary $60,000 + 9% employer super
$60,000 is normally assessable income
If salary sacrifice another $5,000 then
taxable income = $60,000 - $5,000 = $55,000
total contributions = $5400 (employer) + 5000

Salary sacrifice taxed at just 15%, NOT 30% or more

More on this next unit!

Interest offset accounts

Normally any interest in your savings account is assessable income.

In a mortgage-offset account, your savings account balance is "off-set" against your home mortgage.

Any savings are used to reduce the principle of the loan (your loan amount).

As such, you don't really earn interest (you just pay less interest).

Good way to reduce tax.

However, interest rates on offset accounts are higher than variable rates. Do the tax savings usually outweigh the added interest costs????

Beware of …

Complex personal finances

- Added accounting and financial planning fees
- Increased personal time
- Increased “switching costs” to change structure
- Decreased happiness because of time and hassle

Adequate records

- You must keep detailed records of deductions for 5 years.

Stay away from investment tax schemes!!!

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