Getting the edge with managed funds

Managed funds - a guide to the potential tax benefits

Perhaps one of the best kept secrets of managed investments is the potential tax savings they offer to investors. Not always obvious to the naked eye, the following topics offer a starting point to using your managed investment to bolster your tax position.

Dividend imputation

Dividend imputation was introduced in 1987 to eliminate the double taxation of company profits. Before this, companies paid tax on their profits, then paid out dividends to their shareholders, who paid tax on these earnings as part of their income tax.

Now when Australian resident shareholders receive dividends they receive a tax credit for any tax already paid by the company. The shareholder's tax liability can then be reduced by the amount of the tax credit.

How it works

To keep it simple, let's say that a company makes a profit of $1.00 (per shareholder) and pays tax of 30% (the current company tax rate) on this, leaving $0.70. The company then distributes all after-tax profits to shareholders (unlikely in real life). Each shareholder receives $0.70, but needs to include $1.00 in their tax return - the $0.70 dividend plus $0.30 imputation credit.

What about shareholders who pay tax at different rates?

	15% tax rate*	30% tax rate*	40% tax rate*	45% tax rate*
Taxable income	$1.00	$1.00	$1.00	$1.00
Tax payable on the income (excluding the Medicare Levy)	$0.15	$0.30	$0.40	$0.45
Offset imputation credit against tax owing	-$0.30	-$0.30	-$0.30	-$0.30
Tax position	-$0.15	$0	$0.10	$0.15

* Excludes Medicare Levy

Fully franked or partially franked

If an imputation credit is fully franked it means that the company has paid the full company tax rate of 30% on the profits before distributing them as dividends. If the company doesn't pay the full tax rate, then its dividends will only be partially franked and the shareholder will receive a partial credit.

It works for managed investments too

Imputation credits are not just for individuals. If a managed investment holds Australian shares and receives franked dividends, the credit is passed on to the investor. If you own a managed investment with Australian shares, your manager will notify you of any tax credit to include in your tax return each year.

Dividend imputation is also known as imputation credits and franking credits.

Capital gains tax discounts

Capital gains tax (CGT) is a tax on the growth in the value of assets or investments, which is payable when the asset is sold and you've made a profit. If the asset has been held for more than a year, the capital gain receives concessional treatment - for individuals that means at least a 50% discount.

There are three methods to calculate a capital gain or capital loss:

1. Indexation

   This method can be used for assets acquired before 11:45am on 21 September 1999. The asset cost (purchase price) is increased by an indexation factor based on increases in the Consumer Price Index up to September 21, 1999 (this is available from the Australian Taxation Office). The result is subtracted from the sale price of the assets to arrive at the capital gain.

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2. Discount

   If the asset has been held for 12 months or more, this method can be applied. Capital gains are reduced by deducting any capital losses and then a discount is applied.

3. Other

   If the investments or assets were purchased after 11.45am on 21 September 1999 and have been held for less than 12 months, then simply subtract the asset cost from the sale price.

How it works

Here is an example of the discount method. Let's say an investor purchased 1,000 units in a managed investment at $6 each, 3 years ago. The investor has recently sold all of their units for $10 each.

Purchase price	$6,000
Sale price	$10,000
Capital gain	$4,000
Assessable capital gain (50% discount)	$2,000
Tax payable at top marginal tax rate ($2,000 x 45%*)	$900

* Excludes Medicare levy

If the investor had purchased the units before September 21, 1999 they could choose to use the indexation method to calculate the capital gain. The aim is to choose the method which results in the lowest amount of CGT.

When calculating CGT you are able to deduct capital losses made in the same year or carried forward from previous years.

Who benefits?

In general, CGT applies to assets acquired after 19 September 1985, when the tax was first introduced.

Individuals, trusts and complying superannuation funds benefit if they have made a capital gain from an asset they owned for at least 12 months. However different discounts apply to different entities:

- 50% for individuals and trusts
- 33 1/3% for complying superannuation funds

Companies are not eligible for the CGT discount.

Keep in mind that CGT is not a separate tax - the net capital gain is taxed at your marginal tax rate.

Managed investments and CGT

If you hold units in a managed investment, a capital gain can result:

- when you sell your units in the investment (as in the example above); or
- when assets within the managed investment are sold by the manager.

In the latter event, a capital gain is distributed to investors following the sale of investments and investors must then pay CGT on their share of these amounts. Your manager will notify you of any CGT amounts to include in your tax return each year. The distribution of a capital gain from a managed investment is taken to have been made in the income year shown on the statement you receive from them.

Deferred income

Some types of managed investments offer tax advantages by deferring income until an asset is sold.

Listed Property Trusts (LPTs), for example, allow investors to purchase an interest in a professionally managed portfolio of real estate. Returns to investors come from changes in the value of the properties and from rent.

Investors in LPTs receive regular income in the form of distributions, part of which may be tax deferred. The tax deferred portion of the dividend reduces the investor's cost base for capital gains tax (CGT) purposes. This means investors do not pay tax on this portion of the dividend until they sell their investment, and then possibly at the concessional CGT rate.

Managed investments in infrastructure may also defer income.

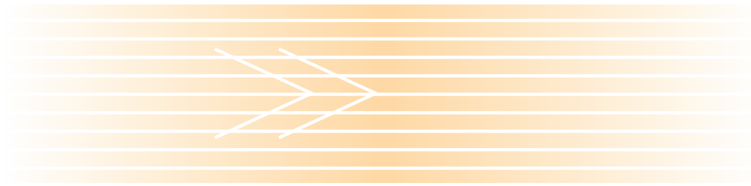
How it works

Again to keep it simple, let's imagine that an investor puts $10,000 in a LPT which pays a 6% distribution and which is 40% tax deferred.

Each year

Distribution	$600
Tax payable on 60% of distribution	$360
Cost base reduced by 40% of distribution	$240

After 5 years the investor sells their holding in the LPT for $12,000. Let's assume there have been no changes in the amount of the distribution or the tax deferred portion (again, in reality unlikely).



Original cost	$10,000
Reduction in cost (5 years x $240)	$1,200
New cost base ($10,000 - $1,200)	$8,800
Sale price	$12,000
Capital gain ($12,000 - $8,800)	$3,200
Taxable capital gain (50% if asset held for more than 12 months)	$1,600

Helping your investment grow

Apart from the tax advantages, deferring income also means that more money stays invested. You receive returns on a larger amount - when returns are positive your investment earns more.

Super gets these tax breaks too

Any earnings you make in super are taxed a maximum rate of 15%. However, because super funds take advantage of tax breaks, such as those outlined in this fact sheet, the actual tax rate paid by most super funds is usually much lower than this. Generally, this rate will be lower for most people than the tax they pay on their non-super investments, such as managed investments, which are taxed at personal income tax rates (up to 45%).

For more information about ways to minimise your tax through super see IFSA's *7 super tax tips*.

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