PERSONAL FINANCIAL
STRATEGIES
YOUR PERSONAL GUIDE TO WEALTH CREATION

Depreciation - Friend or foe?

If you own an investment property then the Australian Taxation Office (ATO) will generally allow you to claim a tax deduction for depreciation.

Unfortunately, many property investors are missing out on potential credits by not maximising their property's full tax depreciation potential. Property tax allowances can reduce an investor's assessable income when maximised and correctly claimed. Maximising allowances may also allow investors to improve their after tax return from an investment and generate a healthier cashflow.

The ATO also allows investors to claim up to four years of missed depreciation. So for those investors who may not have taken full advantage of the allowances available, all is not lost.

What is depreciation?

Depreciation is an accounting term that describes the non-cash flow cost of general wear and tear of an asset that occurs over time. In other words, depreciation is the cost associated with the reduction in value of an asset that occurs as a result of it being used.

Whether or not a tax deduction can be claimed largely depends on the nature of the asset being depreciated. The amount of the depreciation claimed depends on the method chosen and the useful life of the asset.

What allowances are available?

There are two options available for claiming a tax deduction for depreciation relating to your income producing property:

Building Allowances

Building that are used to produce income may be eligible for building allowances, provided construction commenced after 17 July 1985 (residential) and 20 July 1982 (non-residential). The rate of write-off is either 2.5% p.a. or 4% p.a. depending upon the date construction commenced.

Building allowances apply to the overall qualifying component of the original or refurbishment construction cost.

Depreciation Allowances

Depreciation allowances are available to owners of plant that exist in both new and second-hand income producing properties. The Commissioner of Taxation has issued several rulings dealing with the characteristics that are used in deciding whether or not an item may be considered

continued on page 2

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plant. Despite taxation legislation not providing a definition of plant, rulings point to over 850 items of plant that may be depreciable. These include carpets, air conditioning and light fittings. Owners of income producing property may be entitled to claim between 10% - 20% of the building's value as depreciable plant.

Other Allowances

Other overlooked areas of opportunity include renovations, extensions, repairs, and write-off of demolished works. These can provide additional opportunities for investors to increase the deductions and return on their property.

A strategic approach to depreciation.

It is easy to be seduced into thinking that the benefits of depreciation are the reward for entrepreneurial thinking. It is not. Depreciation is simply a way of recognising that assets have a useful life and over time their value will diminish.

To some degree, the claiming of depreciation and other allowances can be likened to turning capital into cash – no net gain.

Implicit in the concept of depreciation is the assumption that assets will sooner or later need replacing using real dollars and funding. What benefit is derived today in the form of an increased claim must someday be returned to the investment.

Investors need to be aware of the consequences from 'cashing in' on the diminishing value of an asset.

The franked dividend turns 20

Despite the dividend imputation system having been in place since 1987, the concept is still poorly understood by many investors. Investors seeking to reduce their tax can benefit from imputation credits and can receive franking credits by investing in shares directly or through a managed fund.

What are imputation credits?

Dividends paid to shareholders by Australian resident companies are taxed under a system known as 'imputation'. This means that the tax the company pays is imputed, or attributed, to the shareholders.

Imputation credits are also available through managed funds. The difference with a managed fund is that the franking credits received from dividends are taken into account and a franking level is determined for the fund. The credits passed to unit holders in much the same way as with dividends from shares held directly.

Tax benefits

When resident taxpayers receive franked dividends, they are included with imputation credits in their assessable income. The tax credit may then be used to reduce the tax liability from all sources of income, not just from dividend income.

Until 1 July 2000, the tax offset could not create a refund. If taxpayers had any excess imputation credits available after their tax liability was reduced to nil and the balance of the imputation credits was disregarded. However, for dividends paid on or after 1 July 2000 excess imputation credits are refunded to eligible resident individuals and certain other entities.

Tax rates and imputation credits

When a dividend is received by a shareholder it includes a franking credit equal to the amount of tax paid by the company on its earnings. The credit is then used to offset income tax payable on an individual's annual tax return. When lodging a tax return, the full or 'grossed-up dividend' (which equals the cash received plus the franking credits) is shown as income with the franking credits used as a tax offset.

Dividends that have franking credit attached at the 30 per cent company tax rate are referred to as 'fully franked'. However, depending on how much tax a particular company has paid on its profits, the 'franking rate' may fall below the 30 per cent. These are referred to as a 'partially franked dividend'.

The benefits of the imputation system are largely determined by individual tax rate and franking level. For instance, the company tax rate in Australia is 30 per cent. This means that the maximum imputation credit

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MONEY TALK

Unit Trusts

A unit trust is similar to a discretionary trust, except that income is distributed to the unit holders in proportion to the units held by beneficiaries.

Unit trusts are not just used by fund managers. Unit trusts are typically used for commercial purposes, such as holding a property or ownership of a business for two reasons. Firstly units are easily transferred. So it is simply for parties to enter and exit a trust. Secondly, unit trust provide for fixed entitlements to capital and income.

On the surface, owning units in a unit trust is similar to owning shares in a company. The key difference is that a shareholder has no interest in the assets of the company whereas a unit holder has a proprietary interest in all the trust property.

Keeping it in the family

Asset rich individuals and business owners need to take stock of their particular circumstances and take time regularly to review how their assets are held. Individuals should aim to hold their investments in ways that protect assets and are tax effective.

This strategy requires a three-pronged approach to:
1. Minimise tax exposure
2. Isolate business and personal assets
3. Hold assets in a separate entity

There are several methods to achieve this, but none more common than the use of a discretionary trust.

What is a Trust?

A trust is created as a result of forming a relationship where a person (the trustee) has an obligation to hold property for the benefit of another person (the beneficiaries).

A trust is not a separate legal entity. However it is, required to have its own set of accounting records and lodge tax returns with the Australian Taxation Office each year.

What is a Discretionary Trust?

In a discretionary trust, beneficiaries are not entitled to a fixed distribution or interest in the trust funds. The trustee has the discretion to decide which beneficiaries receive the capital and income of the trust and how much each beneficiary receives. The level of discretion is determined by terms of the Trust Deed, which governs the operation of the trust.

A properly established trust will provide asset protection in the case of unexpected financial setback or litigation.

Assets held in a discretionary trust are generally not available to a trustee in bankruptcy. The exception is when assets have been transferred to a discretionary trust with the intention of defeating creditors.

Distribution of Income

The Trust Deed sets out various alternatives for the Trustee in relation to trust income earned in each financial year. These alternatives include:

1. The trustee may distribute the net trust income amongst the beneficiaries. All the trust income can be distributed to one beneficiary to the exclusion of others, the income can be distributed equally, or it can be distributed disproportionately.

2. The trustee may decide not to distribute any proportion of the net income of the trust but to accumulate that income as an addition to the Trust Fund.

3. The trustee may decide to distribute part of the net trust income and to accumulate the balance of that income.

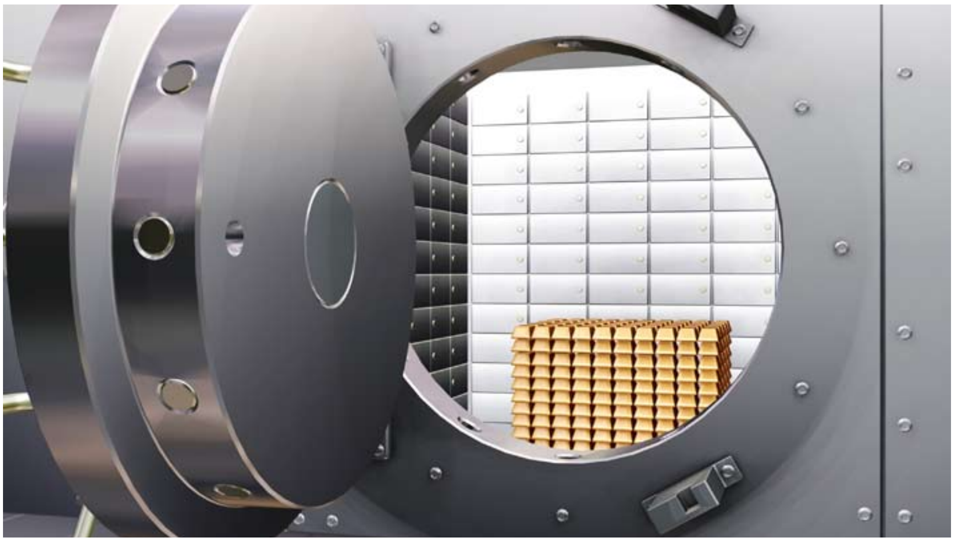
Each option presents the trustee with different tax exposure for the trust or benefician.

From a tax perspective, discretionary trusts are an excellent way to split investment capital gains and income with beneficiaries, particularly when beneficiaries have differential marginal tax rates.

The trustee has the discretion to distribute profits to the lowest-taxed beneficiaries.

The decision to form a discretionery trust is one that must be made by taking into consideration one's personal, financial, and legal circumstances and adopted as part of an overall asset management plan.

Discretionary trusts are an excellent vehicle to protect assets. If you are not sure what steps to take next, or whether or not a discretionary trust would assist you with asset protection, we would be delighted to speak with you about your options.



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available attached to a dividend is 30 per cent of the grossed-up dividend.

For those investors that receive a fully franked dividend and their marginal tax rate is at 30 per cent or below, the net effect of the imputation system is that they would have received tax-free income equal to the full distribution (cash dividend plus franking credits).

For those whose marginal tax rate is below 30 per cent, the benefits of the imputation system is clear. Imputation credits that are in excess of income tax liability are available to be refunded in cash by the ATO.

This advantage of franking credits can be used by individuals as well as complying superannuation funds, including self-managed super funds (SMSF). Remembering that superannuation funds pay tax on income at the rate of 15 per cent tax on income, imputation credits can contribute significantly to any retirement planning strategy.

TFN required to maximise super contributions

One of the requirements of the recent superannuation legislation is that you need to provide your tax file number (TFN) to your superannuation fund. If you don't you may end up paying three times as much tax on your superannuation contributions.

It is not compulsory to give your TFN to your fund. However, if you don't, your fund will be required to pay extra income tax on contributions made to your account. This tax may be taken out of your account by your fund.

The contributions that are most likely to be affected in this way are the contributions your employer makes for you.

What do the changes mean?

Here is a summary of what will happen if your fund does not have your TFN from 1 July 2007:

- Your employer super contributions will be taxed at 46.5% instead of 15%
- Any salary sacrifice contributions will be subject to the same tax
- Your may no longer be entitled to the co-contribution
- You may not make after tax contributions and
- You may not be able to make contributions for your spouse.

Your fund will have to reject any contributions in relation to these last two items.

Don't wait until 30 June 2008

Your fund will work out if it has to pay this extra tax at the end of each year.

Therefore, you have from now until 30 June 2008 to give your TFN to your fund.

If you are not sure whether your fund has your TFN, you should check with your fund immediately.

We are sometimes asked if we are able to help additional clients. We are a growing firm and do appreciate your referals. We consider it a compliment when you recommend us to your friends and business contacts.

What is a prospectus?

A company raising capital by offering its shares or other securities to the public for the first time will issue a disclosure document known as a prospectus).These documents are lodged with ASIC before they can be used to raise funds

Many investors have the wrong idea about what a prospectus is used for. Many view a prospectus as a glossy promotional tool. However, a prospectus contains important information about the company and its securities and is a valuable tool to help make an informed investment decision. It contains information as set out in the Corporations Act to ensure investors are adequately and equally informed. A prospectus should disclose any risks associated with investing in the company and what its future prospects are.

The Corporations Act requires that any application to invest in a company must be accompanied by a prospectus.

The Bookshelf

Random Walk Down Wall Street: The Time-Tested Strategy For Successful Investing (Revised Edition)

Author: Burton Malkiel (John Wiley)

The million-copy bestseller, has been fully revised and ready for post-dot-com investors. Using the dot-com crash as a clear lesson on how not to manage your portfolio, this best seller offers gimmick-free, irreverent, vastly informative advice to navigating the market and managing investments with confidence.

The revised edition includes a new chapter that draws on behavioral finance, the field that studies the psychology of investment decisions.

Malkiel assessed the full range of investment opportunities from shares, bonds, and money markets to real estate investment trusts, home ownership, and tangible assets such as gold and collectibles.

This edition includes some new strategies for rearranging your portfolio for retirement.

A Random Walk Down Wall Street is well established as a staple of the business shelf and arguably the first book any investor should read before taking the plunge and starting a portfolio.

Adopting a life-cycle guide to investing, the book matches the needs of investors at any age bracket.

Whether you want to familiarise yourself in the ways of the market before talking to a broker or follow Malkiel's easy steps to managing your own portfolio, this revised classic remains the best investing guide money can buy.

Once you have read this practical guide it is easy to see why it has been so popular amongst investment novices and academics alike.