Understanding Asset Protection

A guide to understanding the fundamentals of Wealth Preservation

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1. Introduction, aim & objective of the paper

Volatility in the stock market has again focused interest on the property market as a destination for growth investment. As people pour money into property the questions regarding, structuring, asset protection and tax planning are increasing, particularly as property values are rising.

This paper is intended as an introduction to understanding structures used in tax planning and the considerations required when structuring investments in property.

It is assumed that the audience has a minimal to no exposure to the matters to be discussed.

Awareness of issues surrounding structures and understanding the nature of trusts as well as some practical issues helps in guiding the client to what structures are possible but more importantly what is practical. It also helps when changes are being contemplated from one to another structure.

2. How were property investments traditionally held?

Before reviewing what could be done some reflection should be given to what the historical situation has been.

Property has traditionally been acquired with debt finance. Home owners had long mortgages which lasted lifetimes. The goal was to reach retirement and have no mortgage.

Investors on the other hand borrowed loans, many with interest only terms allowing time to reduce the value of the loan. The only requirement was cash flow to maintain the loans. The goal was to eventually have the rent exceed the interest and other expenses producing positive rental in retirement.

High personal income tax rates and reasonable capital growth led investors to borrow heavily to finance their property investments. Interest and property expenses in excess of the rent collected, were tax deductible in negative gearing strategies. The excess was offset against salaried and other business income, reducing income tax liabilities and some of the pain. Refunds from income assessments were used to reduce loans by the astute investors.

Investors cash flow position was further enhanced with deductions for depreciation and write-off for the cost of construction increasing rental expenses and reducing taxable income without further outlays.

With the 50% discount on capital gains for property held longer than twelve months the investors were prepared to trade losses now against perceived capital gains over the longer term. It was a matter of timing.

Generally people held their property assets in

- Own name – primary income earner
- Jointly – with spouse
- Severally – with relatives, friends and associates

3. Why structure?

Some of the main reasons why people want to structure include:

- Protecting assets – particularly the home – quarantining the assets from other business or other assets with much higher level of risk
- Plan to minimise tax – legally
- Hide wealth from the public eye
- Family succession – pass on control to the next generation
- Retirement & estate planning

4. Asset Protection

To help determine how much structuring is needed the following questions should be asked for each individual or family group

- What is at risk?
  Generally the savings/wealth generated over many years – usually a lifetime of blood sweat and tears. For many baby boomers and self funded retirees there is not enough time to replicate the wealth if it should be lost.
  With the loss of wealth accumulated over a long time , what is also at risk is the stress and strain on family relationships and personal health
- Who is at risk?
  Most business operators carry risk whether they are sole traders, partners in a partnership or company directors. The extent of risk depends on their operation and the industry they are in.
  Particularly at risk are professionals including doctors, lawyers, accountants, engineers, financial planners and other similar advisors
  also at risk are high profile public figures and people whose wealth can be seen generally.
  Rental investment property owners also have exposure to risk in the form of action taken by tenant for e.g. negligence relating to lack of maintenance of the property
- What are the risks
  Litigation and the time, energy and resources it consumes is the largest type of risk. Litigation can come from unpaid creditors, injured tenants, dissatisfied customers, disgruntled employees, sub-contractors with a dispute, or jut ratbags who see as an opportunity for quick settlement

5. Minimising tax – legally

If structuring is going to be considered seriously, then paying the minimum legal tax liability should be one of the major objectives. To make the country run better, I am an advocate of paying tax. But that should be the minimum allowed by the law.

In my experience I have always found a trade-off between achieving a minimum tax position and optimum asset protection.

In reviewing someone's tax position consider the following:

a. *Big Picture basics of tax planning*

In my view, one of the major issues of tax planning revolves around how passive income can be split. Passive income includes, rent, dividends, interest, business income.

Usually the split is between members of a family with different marginal tax rate or a group of close friends. For example a high earning dad/mum (46.5 marginal tax rate) and the other partner with no income earning activity as they spend time raising children and attending to family matters.
Personal services income such as employee salaries have limited opportunities to split with structuring

However passive income such as that from rents, dividends and interest can easily be split between e.g. Mum and Dad with opportunities in the structures discussed below.

b. *Timing*

With property assets reference to timing is meant to be a reference to when a property is sold. The effective date for calculating capital gains on disposal is the date on the contract, regardless of any delayed settlement issues.

A major goal of investors, who leverage property through high levels of borrowing and a negative result, is to realise capital gain on sale of the rental property. The growth is based on the total value of the property while the investors equity is minimal being mostly in the range of 0-25%.

If held for longer than 12 months, a discount of 50% is available to be applied to the gain with the net amount being declared on the tax return.

Investors trade off annual rental losses which are supported by a tax deduction against other income over a number of years, against a discounted capital gain on sale.
Property investments are generally held for long periods of time – the general wisdom being that property doubles in value every 7-10 years in the most city and regional areas.

This means the capital gains realised on sale are generally large. Even after the 50% discount is taken into account, the net result usually pushes up the marginal tax rate of an individual.

So before finalising a date for effecting a sell transaction, the circumstances of the individual should be reviewed to determine what their likely taxable income position is likely to be on lodging their tax return for the current year in which the sale is contemplated as well as the subsequent year.

The critical date around which to plan is 30th June.

Consider some of the circumstances below which may provide some relief from large tax bills arising from capital gains on sale of property investments:

- Where the investor has other assets which are not performing and if sold are likely to generate capital losses, then consider the sale of these in the same financial year as the property with capital gains. In preparing the tax return the capital loss can be offset against the capital gain reducing the taxable income.

- Where the investor is being made redundant or receiving any large sum termination payment. Consider effecting the sale in the financial year following the receipt of the large payments.

- Where the investor is planning to retire from employment or business in a financial year, with the subsequent financial year income projected to be low, consider delaying the sale of the property to the next financial year realising the capital gain in a year with little other income.

- Where the investor in a year is projecting a loss from an activity such as business start up then consider realising the capital gain with a sale in that financial year offsetting the capital gain against the business loss.

- Where a sale is imminent and capital gains are to be realised for an older investor who can access super deductions consider making a contribution into their super fund

So the date, when a transaction is effected can improve the overall result achieved on a disposal of an asset.

Where a sale is effected in early July, the realised capital gain would only be declared on the tax return to be lodged 12 month later. So any tax liability will not need to be paid until an assessment notice issues – which can be later depending on the lodgement program of the tax agent with ATO.

The funds are available to invested generating income for longer than a year. The total transaction result improves. They can also be available for short term projects producing a result before tax is due for payment.

Knowing the timing situation may be a determinant in negotiation helping arrive at faster or slower position as the particular circumstance dictates.

c. *Special Provisions*

The tax Act has various sections with exceptions and special provisions, which I do not propose to go into here except for the obvious ones relating to property investment mainly

- Capital allowances – depreciation on plant and equipment
- Capital Works Write-off – depreciation on construction cost of property

6. Individual considerations

Some of the matters to consider when planning for individuals include:

- Risk Profile – of the individuals involved. Is the individual in a profession which high risk or does he own/operate a business with risk exposure.

Usually employees including senior executives have little risk as their employers carry most of it.

- Future outlook – refers to what goals does the individual have for himself and family. Planning and structure should allow for facilitating these future activities. Examples include a 'sea change' in attitude to work and life balance or the type of work.

- Priorities – consideration should be given to which of the following priorities are of most importance to the individual investor. The planning and structures will focus on the client's priorities
  - Asset Protection
  - Income Tax Planning
  - Retirement planning
  - Family Succession
  - Negative Gearing
  - Re-financing – to maximise tax deductions of expenses
  - Costs – initial outlays and administration e.g. preparation & lodgement of tax returns

- Trade-Offs
  As previously mentioned, in my experience, there are always trade-offs between the priorities summarised above. Particularly between asset protection and income tax planning issues.

7. Investment Structures

Before addressing what a trust is and what types of trusts are available to be used consider the vehicles forming part of structures overall.

a. ***Individuals*** – are natural persons in law. They can sue and be sued in their own name. They are vulnerable to being sued by anyone with a grievance as they own all assets in their name. Individuals also receive all income generated by the assets they hold in their name adding to their taxable liability. So if asset protection is an issue, then holding assets in an individual name may not be suitable without further action

b. ***Partnerships*** – a number of persons together. Partnerships are one means of splitting income as well as capital, between individuals. Similarly each partner's assets are exposed to anyone with a grievance.

   There are two types of partnership ownership. Assets can be owned by partners as

   i. JOINT tenants – usually means equal shares. If anything happens to a partner e.g. dies the asset automatically transfers to the other partners.
   The risk with this way of owning property is that should one partner encounter difficulties, circumstances may dictate that the other partner gets dragged into the problem resulting in a loss of the property.

   ii. Tenants in COMMON – usually means that each partner's interest in the property is separate to that of the other partners. Where one partner passes away their interest is the subject of the will on execution as it goes to that person's deceased estate.
   - where one partner is being pursued by a creditor or is involved in litigation seeking to

liquidate his assets, only his/her interest/share of the property is affected. If one partner refuses to co-operate it slows proceedings down allowing additional time to manage the problems. From the perspective of family with children, time to resolve and settle issues is preferable.

Partnerships can be between any combination of structures and not just individuals.

Where partners are at arm's length and are not related family members, it is preferable to have an agreement which specifies how to manage the relationship, how to end the agreement and how to manage the separation including valuation issues. This avoids a lot of heartache

c. ***Companies*** – legal persons. They can sue and be sued. With liability limited to the value of issued shares only, companies are great vehicles to operate businesses carrying risk e.g. restaurant, construction etc. The challenge is to overcome giving personal guarantees to suppliers particularly enormous corporates - who will only deal with small business if personal guarantees of individual directors are provided.
ATO already has powers to pursue individual directors where e.g. PAYG withheld from employees is not remitted

Where shares in a company are owned by individuals there will be little asset protection available in the case of problems

Careful consideration has to be given before investment property is acquired in a company.

The main reason being that a company has no access to the 50% discount on capital gains which may be generated on sale of a property. Capital gains is taxed at the same rate as ordinary income in the company – 30%

Distributing the after tax capital gain from the company will most likely be as a dividend fully franked to 30%. Dividends are distributed in proportion of shares issued. There is little flexibility compared to other structures

In the individual tax return the dividend is declared as income. In calculating taxable income, franking credits are added back. This can push up the individual to a marginal rate of tax which is higher than the 30% paid by the company. In this case the individual has to pay the difference between the marginal rate, say 46.5% with medicare and the 30% franking credit. An additional 16.5%.
Assume a capital gain of $100k. That would mean the company pays $30k and the individual pays 16.5k totalling $46.5k where a shareholder has other taxable income of $150k or more

Contrast this situation to if the individual shareholder owned the property in their individual name and they held it for more than 12 months before the sale. Where $100k is the capital gain, the 50% discount will only include $50k as assessable. Applying a marginal tax rate of 46.5% to this amount would mean a net tax of $23.25k

With careful management company ownership of rental property assets can work, particularly where shareholders are individuals, retired with no need for much of income. Limited dividend distribution can then be made over several years. The franking credits will match the tax payable for those with taxable incomes up to $75k (including dividends and franking credits distributed).

The offset will be exceeded by the 1.5% medicare levy as it applies to the dividend and franking credit

For those qualifying as Senior Australians, with low taxable incomes e.g. below $20k the franking credits could be refunded with no medicare levy

For younger shareholders who need the cash to either start a new project or use it personally, this may not be an option

d. ***Superannuation*** funds
The major attraction of superfunds include the
- low rates of tax
- asset protection while money is in the fund

The major disadvantage includes
- money is tied up until retirement/eligibility age.
- inability to maximise a position with gearing
Other speakers will address this area more fully.

e. ***Trusts***
Known as the most flexible of all structures, they are probably the most difficult to understand by lay people

So let's start by trying to understand the nature of a trust

i. What is a trust

While I am neither a historian nor a lawyer I understand that trusts have their beginnings in the 11th and 12th centuries medieval England. A time when crusades were the popular adventure of the day and Kings were able to reclaim land by getting rid of adversaries by claims of treason etc or on their death

The following fictitious story is shared to illustrate the point

Consider the days of Robin Hood, King Richard and his brother Prince John

In those days, King Richard wanted to go away crusading in the Mid East – in search of the holy grail. While preparing to go on his huge adventure, he would ask his knights, lords, earls etc. those guys who owned land (which he granted – as King), if they wanted to go along.

If they refused, they risked being imprisoned. If they accepted, they may die either in battle or on the journey. Having died, the land is available to be taken back by the king.

So those lovable people who gave us bookkeeping, the monks – being the most educated group of their time, came up with the idea of having control of the land but not direct ownership. So if it not owned, then it can't be lost. Result is protection

Consider these lines (& interpretation) between King Richard and his brother John as he is about to leave on his big adventure:

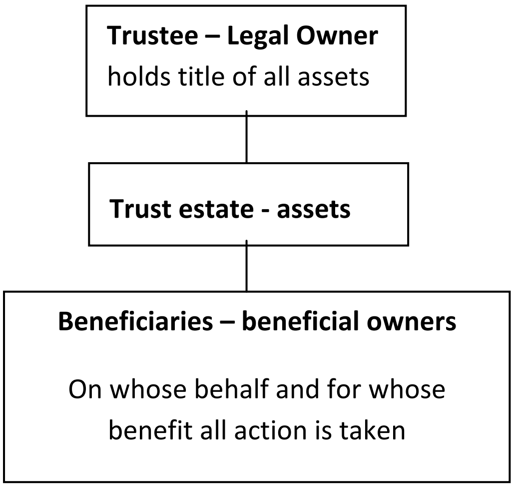
King Richard to brother John “I appoint you trustee”	I appoint you **legal owner -** trustee
“I entrust the estate and lands of England in your care”	Set up the **trust assets -** corpus
“You are to manage and look after them for the benefit of the people and the family”	Identified the **beneficiaries** Identified the responsibilities of the trustee – usually specified in the trust deed

Individuals are referred to as natural persons in law. As such they are entities. They can sue and be sued.

Companies are referred to as legal entities as they are defined in the Corporations Act. They can sue and be sued.

By contrast a trust is only a relationship between the legal owner (trustee) and beneficial owners (beneficiaries). So a trust is not an entity in its own right – even though in talking about it many people make references to it as such. All liability is taken on by the trustee.

Title to all assets is in the name of the trustee and all title deeds show the trustee’s name as the legal owner. He does this only in his capacity as trustee and for the benefit of the beneficiaries



ii. Trustees

Historically, trustees were individuals. Individual trustees are exposed to having personal creditors seeking to access trust assets as they are held in their individual names.

Having a company creates clarity and avoids this situation Individual trustees are also exposed to senility issues arising from aging as well as other health risks requiring their replacement.

For additional protection it is better to have the trustee as a company utilising its limited liability features. It also allows for smoother changes of management when directors resign and others are appointed.

Having a corporate trustee is not intended as protection from banks and financiers - they have mortgage security in just about most cases.

To minimise risk further it is prudent to have the trustee company conduct no other business except to act in its capacity as trustee of the trust. This limits any problems flowing from other businesses or activities which may have adverse risk.

Replacing an individual trustee is more cumbersome and costly as documents have to changed to reflect the new appointees. A company simply has to advise ASIC of the changes in the directorship

8. Types of trusts

Some of the features common to all trusts include:

- Net income must be distributed to the end of every financial year - unlike companies who can pay the tax on income and retain the balance without a dividend distribution
- Losses are carried forward to be offset against future years - like companies. There are strict rules restricting the deduction for prior year losses.

The more common types of trusts we are discussing today include:

8.1 Fixed (unit) trusts

The entitlements of beneficiaries are fixed and the trustee does not have any discretion in relation to how to distribute income and capital. Distribution has to be in proportion to the interest of each beneficiary. Most managed funds operate in this way.

Suitable for parties who are dealing at arm's length where it is desired that each party's share is clearly identified. It can also be an alternative to partnership with the benefit of more streamlined administration process e.g. only one director of the trustee need sign documents instead of all partners.

Where the interests/units are owned by an individual, it is exposed to creditor claims as the equity is clear. All that needs to be done is value the assets in the trust. Protection can be obtained having the units owned by a discretionary type trust.

8.2 Non-fixed (discretionary investment or family) trusts

The beneficiaries of a non-fixed trust are usually broadly defined. Generally they are related to a nominated primary beneficiary.

The deed usually gives the trustee total discretion in distributing income and capital to any of the beneficiaries, at any time and in any proportion. This provides the ultimate **flexibility for tax planning** where the trust has income (as opposed to a loss).

Generally the distribution is determined at the end of a financial year as the income is calculated. This enables the trustee to review the beneficiaries taxable positions before deciding on the portions to be distributed.

Claiming losses of prior years as a tax deduction requires passing tests which try to direct the losses to those who benefited from the trust previously. These rules are eased where an election is made to limit the beneficiaries to a family group. This is still wide enough to be useful. Important particularly as most property investments these days are utilising negative gearing strategies when investing in rental properties with a good prospect for capital growth.

Non-Fixed – Discretionary type trusts are suitable for close families or group of friends – with much ‘trust’.

Asset protection comes from the fact that none of the beneficiaries are entitled to the assets of the trust until a distribution is declared by the trustee. So, if there is no entitlement to the funds or assets, there is no ownership and therefore nothing to account for in the case of a creditor claim. If you don’t own it, you can’t lose it.

Family law appears to override any corporate veil protection afforded by these structures. The family law court appears to exercise its powers in accordance with the principles of the Act with its focus on the welfare of the children in a family situation.

In terms of negatively geared rental property investment the major disadvantage of discretionary trusts is the **quarantining of the losses**. Most new residential property has large amounts of capital allowances (depreciation of plant & equipment) to be deducted as well as capital works write off on the construction costs – usually 2.5% - contributing to the loss positions.

As such, these losses are not available to be offset against other income of an individual including executive salaries or personal business type income.

Depending on each individual’s marginal tax position, this means a loss of cash and a timing disadvantage before a benefit is recouped. If cash is king, then lack of it at an earlier point reduces yield on the investment.

To get a tax deduction, consideration should be given to owning the property in a unit trust or a hybrid discretionary trust with the goal of transferring the units issued by such trust to a SMSF at a later time providing protection and a low tax rate over the long term. Caution should be exercised as there will be CGT implications when changes are made.

The bankruptcy laws allow creditors to claw back assets where they are transferred to a trust after action has commenced or a problem is known to exist.

Capital can be distributed from a trust with no tax implications. Opportunities arise where property can be revalued and distributions of capital made from the revaluation reserve with no tax implications. Where there is no cash, the trust can borrow with interest being allowed as a tax deduction. Great caution has to be taken in taking action like this to prevent conflicts with other issues.

8.3 Hybrid trusts

The word hybrid is used with trusts which have a combination of features. A hybrid discretionary trust for example, is primarily a discretionary trust where the trustee is given power to make most decisions at their discretion. The trustee can also issue units with specific rights to income, capital or both.

A trustee of a hybrid unit trust is able to issue units with differing entitlements to income, capital and/or voting rights amongst other benefits and limitations.

With negatively geared property investment, a hybrid discretionary trust is used to effectively make the loan interest deductions available to the individual.

Assume the following details for a brief example:

- Joe Bloggs applies to the trust to be issued with units which entitles him to income. Assume he applies for sufficient units to cover 85% of the acquisition cost of the property including purchase, stamp duty, legals and others – say $425k

- To fund the acquisition of the units, the individual borrows a loan from the bank for $425k at an interest rate of say 8.5%

- Deposit amount of $75k equivalent to 15% is available in cash and is given as a gift to the trust - using a deed of gift or at least a minute

- Trust acquires the property for $500k including costs using the gift of $75k + $425k from issuing the units entitling the holder to income.

- Assume rent is $25k per year with $5k being rates and other rental expenses. This leaves $20k net rent which is available for distribution

- Assume the whole of the income is distributed to the JB. In his individual tax return he can then show as a receipt of distribution from the trust of $20k, Then JB can claim the interest expense on the loan to finance the acquisition of the units - $36k. This leaves a loss of $36-$20=$16k to be offset against JB's $200k salary. A saving of $16 x 46.5% marginal tax rate = $7440 each year.

Where units were issued to fund purchase of a property class asset, net income of the trust should be distributed in proportion of the how the capital was contributed. In the example above, this would mean that JB should receive at least 85% of the net income. The remaining 15% may be distributed at the discretion of the trustee.

Some accounting and legal practitioners have argued for distributing different portions in future years after capital growth has increased the value of the property, allocating the total growth to the discretionary beneficiaries. While there are no ruling it appears the favoured ATO view is that the original apportionment should be used throughout the life of the arrangement.

For additional asset protection the trust can subsequently approach a bank for a loan to fund the redemption of the units held by the individual.

Redemption is a CGT event. The amount of CGT payable will depend on the valuation placed on the units at the time. ATO indications are that redemption value should reflect the growth and therefore the market value of the property.

Where a property which has grown in value is subsequently sold by the trust then Capital Gain has to be distributed. Distribution to JB risks him being liable for CGT again – on the same vale of the units previously held.

In NSW Stamp duty implications should be examined carefully before redemptions particularly where property values exceeds $1m.

Caution and careful planning and reading of documents is essential. Not all deeds are the same. Their intention may be but where the wording is not appropriate this may result in a collapse of the strategy initiated.

8.4 Class trusts

Class trusts are a type of hybrid trusts. They are not common. These are basically discretionary type trusts where the trustee is limited to distribute a fixed portion to at least one group – as specified in the deed.

Class trusts are useful where two or more families/groups wish to invest in a single asset – perhaps with different capital contributions. Generally income and capital will be distributed to each group in accordance with their interests and then to any beneficiary within that group in discretion

8.5 Superannuation funds

Superannuation funds hold assets on behalf of members/beneficiaries. As such they are considered trusts. But without the flexibility of the others.

Other speakers will cover this area more fully.

9. Other Ways of Using Trusts

Trusts can be used in other ways than simply to hold the assets. The objective is provide asset protection while saving on land tax expense.

In most jurisdictions the land tax thresholds are not available to trusts – particularly the discretionary variety. In NSW this can be worth nearly $5.7k in 2008 and more in future years as land values rise.

So the question arises as to how can asset protection be attained while minimising property expenses such as land tax.

Most rental investment properties purchased these days include a large debt factor and a deposit amount. In my experience the deposit amounts range from 0% to 50%. These deposits are usually funded from savings, inheritances, capital gains on sale of shares etc.

While financial institutions generally take first mortgage security over property assets to cover the loan advance, what's at risk is the deposit.

Making a gift of the deposit to a discretionary trust controlled by the clients provides protection. The individual can then borrow that same amount from trust with a mortgage security over the property. This should ensure that in case of insolvency there will be a claim with the e.g. liquidator for the value of the deposit coming back to the discretionary trust under their family's control.

Having the property acquired under the individual name makes available the threshold before land tax applies, improving the rental yield for properties.

10. Why use a trust?

The fundamental answer to this question is so a property asset can be controlled but not owned. If you don't own it, then you can't lose it. The objective is to make the individual appear as a pauper rather than a prince in the process discouraging prospective legal action.

In brief. some of the main reasons for using a trust structure include:

- Protecting family assets
- Tax planning flexibility
- Hide assets from the public eye
- Succession planning – minimum costs
- Retirement planning – maximise benefits

11. Before setting up

Before setting up structures

- Calculate the economics & cash flow of the proposed property investment
- Get a clear rationale of why a structure is required and what it is supposed to do
- Discuss the proposed structure. Get professional advice before signing on the contract.

- Discuss the finance availability and ensure the bank/financier can work with the proposed structure and objectives
- Test that the structure is suitable for the circumstances of that individual and their family.
- Where the client is acquiring property in another state than the one the practitioner is familiar with ensure that the following issues are reviewed
    - Land tax liability
    - Stamp duty liability
    - Land rich provisions