Investing

A Financial Planning Technical Guide

financial solutions
VICTORIA - PTY LTD

Investing is the process of getting money to work for you. It is a powerful way to grow your wealth. This guide is designed to tell you about the key principles of investing.

The following information is current as at 1 September 2016.

Why invest

People invest for many different reasons. Maybe you are saving for a big holiday, or to fund children's education, repay your home loan faster or increase your retirement nest egg.

After factoring in tax and inflation, chances are that funds held in low interest savings accounts may lose value in real terms over time. So, to stay ahead of inflation and taxation, you may need to invest in assets that deliver a higher return over time.

The key to successful investing is identifying your investment goals and the time frame over which you want to invest.

Your goals and time frame

When investing money, most people have a specific goal (or a number of goals). These goals can help you determine what investment time frame is required – short, medium or long term.

The time frame may influence how your money should be invested. The longer you invest, the longer you have to ride out ups and downs in the value of your investment (known as volatility). If you have only got a short-term investment goal, it may make more sense to invest in more secure assets, such as cash.

Take a look at the following table.

Investment Goal	Time Frame	Suitable Investment
Short Term	1 – 3 years	Cash, fixed interest & money market securities
Overseas holiday		
New car		
Medium Term	3 – 5 years	Emphasis on fixed interest with some cash and growth assets (shares and property)
Home deposit		
Extended work leave		
Long Term	5+ years	Emphasis on growth assets (shares and property) with some access to cash
Children's education		
Retirement		

Short-term investors would be more likely to choose a more conservative investment like cash, to ensure that their capital is available in the next one to three years. Long-term investors generally would be more inclined to invest in growth assets such as shares, as they do not need to access their capital for at least five years, so they are usually less concerned about short-term ups and downs. They recognise that the potential returns are higher in growth investments and they are held over the long term, the risk associated with short-term volatility is reduced.

Investment structures

You have several investment structures to choose from, each with different tax and legal considerations. We have described below some of the advantages and disadvantages of three common investment structures: superannuation, companies and trusts.

Type	Description	Advantages	Disadvantages
Superannuation	Specifically designed as a concessionally taxed investment structure for accumulating retirement savings	• The government provides tax incentives to encourage you to use superannuation to provide for your retirement • Most superannuation funds are "complying" funds meaning they enjoy concessional tax rates. In accumulation phase, the maximum tax rate is 15% on income and effectively 10% on capital gains made on assets held for at least 12 months within the fund. In pension phase, no tax is payable on income or capital gains	• Lack of accessibility until a 'condition of release' is satisfied • No tax free threshold
Company	A separate legal entity and generally used when carrying on a business. It can also be used for investment purposes	• Limited liability • Flat tax rate of 30% (or 28.5% if annual turnover less than $2.0 million) • Tax deferral on profits made by the company for shareholders, by retaining profits within the company • Shareholders can be paid fully franked dividends and the payments can be timed appropriately • Able to claim 100% tax deduction for superannuation contributions made on behalf of employees	• No tax free threshold • Companies are not entitled to use the 50% discount on any capital gains derived
Trust	There are many different types of trusts. Common trust types include: • A fixed trust – the beneficiaries generally have fixed entitlements to income and/or capital (e.g. unit trust) • Non-fixed trust – the trustee has discretion to determine the levels of income and/or capital that are distributed to beneficiaries (e.g. discretionary or hybrid trust) • A family (discretionary) trust is generally a non-fixed trust and is usually the most flexible investment structure – in terms of administration and income splitting	• May provide protection in the event of a beneficiary's divorce or bankruptcy or death • Tax advantages – ability (within discretionary trusts) for high net worth individuals to split their income and/or capital gains at their discretion among the beneficiaries • The taxable income of the trust (adjusted for imputation credits, foreign tax credits and any allowable deductions) together with any tax credits may flow through to the beneficiary • If the trust incurs a loss, it may be able to carry the loss forward and this loss may be offset in a later year	• A trust is not required to distribute all of its income to beneficiaries each year, but may allocate it for tax purposes. Any unallocated income of the trust is generally taxed at the highest marginal tax rate plus Medicare levy. Tax losses are quarantined within the trust

Investment vehicles

Investment vehicles are simply the different structures in which you hold your investments.

Deposit products

Deposit products include the vast array of cash savings accounts primarily offered by banks, building societies and credit unions. These are generally low interest rate bearing accounts that allow frequent transactions.

Deposit Products have an important role to play in a well-structured portfolio as they generally offer immediate access to funds. So, it is a sound idea to keep enough cash in reserve to cater for both foreseeable expenditure and contingencies. This may minimise the risk of having to sell any long term growth assets in your portfolio to meet your cashflow needs.

Term deposits typically offer a higher fixed interest rate for money invested over a fixed period of time. The interest rate is specified at commencement and applies for the duration of the term. Generally, unless interest rates are expected to decline over the long term, the greater the funds invested and the longer the term, the higher the interest rate.

Whilst deposit products offered by banks, building societies and credit unions are the most secure investments, this low level of risk generally means low returns – and as a result your capital may be eroded over time due to the effects of inflation. Further, all income generated on a deposit product is fully taxed, at your marginal tax rate.

Property trusts

Property trusts are investment vehicles which typically own a portfolio of property related assets. Listed property trusts (LPTs) are quoted on the stock exchange, and their prices fluctuate with supply and demand, in the same way that shares do.

Unlisted property trusts are generally managed by a fund manager who determines the unit price based on the value of the fund's assets.

Property securities invest predominantly in listed property trusts and also in companies that are involved in building and development. They can invest in various locations e.g. particular states or cities, and in different types of property e.g. office blocks, hotels, shopping centres and factories.

Property trusts have the potential to provide higher returns when compared to cash. Further, they can also offer tax effectiveness by providing some tax-free and tax-deferred income components.

Insurance bonds

An insurance bond is an investment product typically issued by or through a life insurance company.

Insurance bonds are useful investment structures that are often used for long term savings goals, such as children's education. One of their most attractive features is their favourable tax treatment – when held over the long term.

The income derived by the life insurance company is taxed at the company tax rate (currently 30%) and does not form part of the investor's assessable income. Instead, should the investor withdraw their funds, any 'growth' paid under the policy to the investor will be taxed under the 10 year rules as follows:

- Where the policy has been held for less than 8 years then the growth is fully assessable. The investor is entitled to an offset of 30% based on the amount of this growth.
- Where the policy has been held for between 8 and 9 years then two thirds of the growth is assessable. The investor is entitled to an offset of 30% on the assessable part of the growth.
- Where the policy has been held for between 9 and 10 years then one third of the growth is assessable. The investor is entitled to an offset of 30% on the assessable part of the growth.
- Where the policy has been held for at least 10 years then the insurance bond is considered tax paid, i.e. the investor does not have to pay any further tax on the growth.

To be eligible for these tax concessions, the total contributions paid in a year cannot exceed the amount of the premiums paid in the previous assurance year by more than 125%. If the premiums exceed 125% of the previous assurance year's premiums, the 10 year rule recommences. An assurance year is the period of 12 months commencing on the anniversary date of the commencement of the policy.

Managed funds

Managed funds, also known as managed investments or unit trusts, are investment vehicles that allow you to pool your money with many other investors so that you can purchase a wide range of assets managed by a professional team.

What are the benefits?

- Managed funds enable you to access some assets that may not otherwise be directly available to you – e.g. international shares, large-scale property and infrastructure projects.
- They provide diversification to manage risk.
- There are a wide variety of funds available to suit different risk profiles and objectives.

How do they work?

Managed funds are typically structured as unit trusts. When you invest in a managed fund, your money buys 'units' in the fund. The unit price is calculated by dividing the value of the fund's assets on the day you buy your units, by the number of units issued. The value of your units will therefore change with the changing value of the fund's investments.

Your units give you exposure to all the assets in which the fund has invested – which may include shares, property, fixed interest, cash or other investments. You share proportionately in the capital growth of these assets and any income they generate, according to the number of units you hold in the fund.

Management of the day-to-day investment decisions rests with an experienced fund manager. Assets are bought and sold in line with the investment strategy and objectives of the fund.

What kinds of managed funds are available?

There is a wide array of managed funds to choose from. Most are classified according to the types of assets in which they invest:

- **Share funds** invest in a portfolio of shares aimed at producing capital growth (from a rising share price) and income (typically from dividends). There are two main categories – Australian shares and International shares.
- **Property funds** typically invest in property trusts listed on the Australian Stock exchange, although some may invest directly in specific properties.
- **Diversified funds** invest in a number of different asset classes – typically shares, fixed interest, property and cash. There are three main categories:
  1. Growth funds which invest mainly in shares,
  2. Income funds which invest mainly in fixed interest and cash,
  3. Balanced funds which are weighted more evenly across shares, property, fixed interest and cash.
- **Multi-manager funds** take diversification one step further, investing across a mix of asset classes through a mix of investment managers with different management styles and investment strategies.

Managed funds can also be classified by their objectives – a growth fund is designed to achieve an increase in asset value, whereas an income fund is designed to generate income – e.g. from company dividends, or interest or rent.

Listed Australian shares

When you buy shares you become a part owner of a company and share in the company's future profitability. It is possible to buy shares in unlisted companies but the most accessible shares are in listed public companies traded on the Australian Stock Exchange (ASX).Australian listed shares are often divided into two main categories:

- Industrial shares (e.g. manufacturing, finance and retailing); and
- Resource shares (e.g. mining, oil).

There are other types of shares. 'Blue Chip' shares are shares in large companies that tend to have a long track record and a strong financial structure. Each different type of share tends to have its own risk and return characteristics.

Listed shares on international stock exchanges

The Australian sharemarket makes up a very small percentage of developed global markets. Each country's sharemarket tends to reflect their underlying economy, so while Australia has relatively large banking and resource industries, its technology and pharmaceutical sectors are relatively small. One of the reasons for diversifying into international investments is that it gives you access to companies and industries not available in Australia.

You can invest directly in international companies or through international equity funds that invest your money in companies listed on sharemarkets around the world. International equity funds tend to spread their investments across the major markets of the US, Japan and Europe. They may also invest in emerging markets such as Asia, South America and Eastern Europe. Most global funds tend to diversify across sectors (such as consumer staples, financials or technology) as well as regions.

There are global funds that invest in a particular region or country rather than around the world. These are called 'regional' funds while funds that invest in certain sectors are called 'specialist' funds.

As buying assets in another country involves using a foreign currency, the performance of international funds can be affected by movements in currency values. Some funds hedge this currency risk – that is, they try and restrict or neutralise the effect that currency movements would have on performance.

Wrap accounts

A wrap account is an administration service that 'wraps' around investments such as a portfolio of shares, managed funds and margin loans. Wraps are a simple and convenient way of managing your investments because they offer access to a wide range of investment funds from a number of different investment management companies and direct shares. They provide one consolidated set of reports on your investments for administrative ease and tax reporting purposes. You may also consolidate existing investments into a wrap service, by transferring your existing managed funds and listed securities into the service. Unlike investing through a managed fund, with a wrap service you remain the beneficial owner of the underlying managed fund units and listed securities. From a tax perspective, it means that you can transfer investments in and out of the wrap service without triggering capital gains tax as long as the beneficial owner remains the same.

Advantages:

- Allows for diversification by investment choice across different product providers and product types.
- Central point where you are able to make changes to your account and investments.
- Consolidated portfolio valuations and tax reporting for all your investments in the wrap.

Asset classes

There are a number of different asset classes in which you can invest. Each asset class carries with it a different level of risk and return and may perform differently at different times of the market cycle. By spreading your investment across a range of asset classes, known as diversification, the higher returns that you receive from one asset class may offset low returns from another asset class.

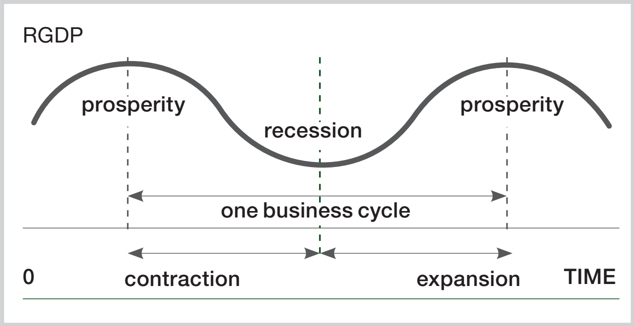
When constructing an investment portfolio, it is important to consider the characteristics of each asset class – such as how they are taxed and how much income or capital growth they are likely to deliver. This will help you decide what level of investment in each asset class would suit you based on your risk profile, investment timeframe and objectives.

- **International shares:** These typically carry a relatively high level of risk. However, whilst past performance is not a reliable indicator of future performance, they have also produced some significant historical returns over the longer term. There is an emphasis on capital growth with a low level of income and limited tax benefits.
- **Australian shares:** These generally carry a high level of risk and have the potential to generate high returns. There is an emphasis on capital growth however some Australian shares can generate reasonable income and the income generated can be very tax effective. Franked Australian dividends offer imputation credits that can offset other tax liabilities.
- **Property:** You can invest in many different types of property – residential, commercial, retail, industrial, or rural. While direct property is relatively illiquid, property trusts typically offer better liquidity and because of diversification, a more moderate level of risk. Property trusts tend to produce returns that are a balance of capital growth and income. The income from a property trust is very tax effective as it can contain some tax free and tax deferred income.
- **Australian fixed interest:** These are generally an income driven investment with low growth, typically offering moderate investment returns over the long term. Interest bearing securities such as Commonwealth, State and corporate bonds are types of Australian fixed interest securities.
- **International fixed interest:** These are generally an income driven investment with low growth. Government, corporate and typically other investment grade international fixed income securities are types of international fixed interest. The interest payments from fixed interest securities are fully taxable at marginal tax rates, providing no tax advantage. Fixed interest securities provide regular interest income for medium term investors. During the term your initial investment is not guaranteed and may rise or fall depending on the current interest rate market.
- **Cash:** These investments are the least volatile and consequently offer the lowest return. They may be suitable if you require some ready capital to meet short term needs. Due to the effects of inflation and as there are no tax advantages it is not usually advantageous to hold long-term cash based assets.

Economic principles

Economic Cycle

The economy tends to go through cycles and these cycles can affect the return from different asset classes. These economic (or business) cycles typically contain four distinct phases – expansion, prosperity, contraction and recession. While these economic fluctuations move in a cycle, the length and strength of each phase can vary significantly.



The phases of the economic cycle are characterised by changing levels of employment, productivity and interest rates. Naturally, these factors affect investment assets.

Real Gross Domestic Product (RGDP) is a measure used to indicate change in the actual quantity of goods and services produced by a country. Economic growth is defined as a situation in which real GDP is rising.

Inflation

Inflation is an increase in the price we pay for goods and services. From an investor's perspective, inflation is detrimental as it erodes your returns and helps increase interest rates. When deciding on the return you want from your investments – and therefore what investment strategy to pursue – it is vital to take into account the likely effect of inflation. If the after-tax return is less than the rate of inflation, the real value of your money will decline.

To overcome the effects of inflation on the real value of your investments, you could consider having some exposure to growth assets – like Australian and international shares, and property. Growth assets have historically outperformed inflation over the medium to long term.

This is particularly important for retirement investing. Many retirees focus on 'protecting' their capital. Yet longer life expectancies and the effects of inflation mean retirees can easily outlive their capital.

Debt

Debt is often divided into two categories:

- **Non-deductible debt** – where the interest on the loan is not tax deductible. The most common example is the home mortgage.
- **Deductible debt** – where the interest on the loan is tax deductible. An example would be an investment loan such as a margin loan.

Many experts suggest that non-deductible debt should always be repaid before deductible debt. The interest on a non-deductible loan is paid with after tax income. For example a person with a marginal tax rate of 49% would need to earn $196 to pay $100 in non-deductible interest. In contrast, the person would only need to earn $100 to pay $100 of deductible interest. Non-deductible debt has a significantly higher after tax cost than deductible loans.

Investment principles

Risk and return

Most people know that different investments carry different levels of risk. Generally, the riskier the investment, the greater the potential returns. Working out the level of risk you are comfortable with can help you in your choice of investments.

Some people prefer to give up the potential to earn a higher return in the long term for the knowledge that the value of their investment is unlikely to fall in value in the short term. Others accept that the value of their investment may go up and down over short periods of time in return for potentially higher returns over a longer period. It all depends on your needs, goals, personal circumstances and investment timeframe. There are two key principles to consider when working out your risk/return comfort level:

- The length of time over which you will be investing.
- The fact that investments which provide higher returns over the longer term will typically have wider variations in return from year to year, and may even deliver a loss over the short-term.

The most important element of the risk/return equation is you. Your attitude to risk should be the main driver of your investment decisions. You need investments that will allow you to sleep soundly at night but still work hard towards achieving your financial goals.

Volatility

Volatility relates to the tendency for the value of your investments to fluctuate over time. It can apply to either the market price or the income of a particular investment. The greater the volatility of an investment, the greater the potential fluctuations in returns.

To understand your risk comfort level, you should consider the volatility of returns associated with differing investment types.

For example, sharemarket volatility can be high. Markets can be affected by sentiment as well as economic and business fundamentals and these are reflected in the sharemarket.

By comparison, changes in real property values usually take place more gradually. This is because, unlike liquid assets like shares, real property cannot be bought or sold in a day. However, property income can be volatile as a result of change of interest rates, vacancies, tenancy problems and the unpredictability of maintenance costs.

Capital liquidity

When considering the appropriateness of an investment, it is important to know how easily funds can be realised and on what terms. This is known as liquidity. For example, listed securities (shares) can generally be sold with ease on the stock exchange. Direct property, on the other hand, is often difficult to dispose of quickly.

Diversification

It is generally risky to put all your eggs in the one basket. Diversifying your investments can help reduce risk and may improve your returns.

Diversification offers two main benefits. It seeks to ensure that your investment is not excessively affected by over-exposure to a few poorly-performing assets and that you have some exposure to the better-performing assets.

You can diversify by spreading your investment money over:

- Asset classes (property, shares, fixed interest and cash).
- Sectors within asset classes e.g. manufacturing or mining shares.
- Securities (individual bonds or shares).
- Regions.
- Investment styles.

To diversify across investment styles, you can seek to invest with a range of fund managers with different investment styles.

By blending fund managers with complementary investment techniques you can achieve more consistent returns whilst potentially reducing volatility.

The main investment styles can be categorised as:

- **Value:** An investment style that seeks to buy assets when they are under priced and take profits when their price exceeds their value. This style can sometimes under-perform when markets are rising rapidly. However, it can tend to outperform other styles when markets are weak.
- **Growth:** An investment style that seeks to buy assets that are expected to enjoy a high level of earnings growth. This in turn will lead to an increase in the price of the asset.
- **GARP:** GARP or 'Growth-At-a-Reasonable-Price' is an investment style that is an alternative to value or growth investing. A GARP manager seeks attractive investment opportunities by purchasing stocks that are relatively cheap but have potential for growth.
- **Style neutral:** Style neutral managers do not employ a value, growth or GARP investment philosophy. Their aim is to deliver consistent performance by not following a particular style but instead concentrating on the investment fundamentals of individual assets.

Dollar cost averaging

Investing would be simple if you could always pick the best time to buy and sell. However, timing the market in this way is extremely difficult, if not impossible. A useful approach for most investors is what is known as 'dollar cost averaging'.

With dollar cost averaging, you do not focus on where share prices or interest rates are headed.

You simply invest a set amount of money on a regular basis over a long period of time. Dollar cost averaging can be a simple way to reduce volatility within your portfolio. Using this investment technique you are automatically buying less when the market is up, and more when the market is down.

Of course, dollar cost averaging does not guarantee a profit, but with a sensible and long term investment approach, dollar cost averaging can smooth out the cost of investments in a fluctuating market.

It is important to remember that, as with any long-term investment strategy, you should regularly review the amount that you are contributing to your investment so that the real purchasing power of your investment keeps up with inflation. For example, this year you may commit $100 per month but next year you could increase this amount to $130 per month.

Example:

The following illustrates how dollar cost averaging works. It assumes you invest $100 per month into a managed fund that initially had a unit price of $10. Over the next few months, the market falls (which causes the unit price to drop) before recovering to its original value. At the end of the five months you have invested a total of $500 and hold 65 units. The average cost per unit is $7.69. If each unit is worth $10, your investment is worth $650. The value of your investment would fluctuate over time.

Month	Investment	Unit Price	Units Purchased
1	$100	$10	10.0
2	$100	$8	12.5
3	$100	$5	20.0
4	$100	$8	12.5
5	$100	$10	10.0
Total	$500		65.0

* This table is for illustrative purposes only. It is not representative of any particular investment product or investment strategy.

Time in, not timing

It is easy to get emotional about money and to react to sensational headlines about investment markets. That is why many people jump in and out of investments – or put off investing because now is not the 'right time'.

However, experienced investors understand that timing the market is very difficult. Instead, they focus on buying quality assets and setting a realistic time-frame.

Investing involves risk

There is a general trade-off between risk and return. However, there are ways to manage those risks. It is human nature to want the highest return possible, so often the best way to choose an investment is to understand the level of risk associated with different investment types, and determine whether they fit your needs.

Let’s have a look at some different types of risk

- **Market risk:** Investment markets are affected by a range of factors, including the economic environment, political events, currency movements, interest rates and government regulations. A change in any of these factors can almost instantly be reflected in investment returns. Pessimism or optimism about future events can also affect supply and demand for investment assets and therefore influence returns. This is known as ‘market sentiment’, a phenomenon that can contribute to market volatility. Diversification can help manage market risk. For example, share funds that invest in a number of different companies and over a variety of industries, sectors and countries greatly minimise the risk that poor performance from any one company will affect your returns.
- **Investment specific risk:** An investment in a company or fund may be affected by changes in that company’s or fund’s operation or business environment.
- **Inflation risk:** This is the risk that inflation will erode the purchasing power of your money over time.
- **Interest rate risk:** This is the risk that changing interest rates will affect the performance of a company you invest in or make an existing fixed interest asset less attractive because the new rates are higher. If you have borrowed to invest then interest rates will also affect the net profitability of your portfolio.
- **Diversification risk:** Being over exposed to one specific asset class or sector can hurt your overall portfolio should that one asset perform poorly. Increasing diversification reduces the effect any one asset has on your overall portfolio.
- **Currency risk:** If you are investing in overseas shares, you face currency risk — the risk that changes in exchange rates may affect your return. In a managed fund, the fund manager may use various hedging strategies to attempt to reduce this risk.
- **Credit risk:** Credit risk applies to investments such as term deposits, debentures and bonds. It is the risk that the company you have entrusted your money to will become insolvent – unable to meet interest payments or to repay your funds. Information regarding a company’s credit rating and past performance can give a good indication of the quality of the organisation and is one key to managing credit risk. Understanding the risk/return trade-off will also help you manage credit risk. Bonds or debentures that are riskier have to pay a greater return to attract investors. That is why government bonds generally pay less than corporate bonds, and why bonds issued by blue-chip companies generally pay less than those issued by new or smaller companies. Diversification will also help you manage credit risk. By spreading your money amongst a number of institutions, you can reduce the effect a credit problem in one investment could have on your portfolio.
- **Liquidity risk:** The lack of liquidity, or access to your money, is a risk often overlooked by investors. Sometimes, unforeseen circumstances force us to draw on the money from our long term investments to meet a short term expense. This can result in a loss, either because there are transaction fees or because we have to sell investments when their market price is down. Certain types of long term investments, such as direct property, may be difficult to dispose of quickly. Sometimes the sale price has to be reduced to achieve a quick sale. This is also true of unlisted shares. To reduce liquidity risk, it is wise to keep some emergency funds in an accessible, short term investment (such as a cash management trust).
- **Legislative risk:** When you map out a particular investment strategy, you naturally make decisions based on the laws and regulations at the time. However, there is always the risk that the law could change. As governments do not like to change investment laws that are well established and trusted by large numbers of voters, legislative risk often only becomes an issue if an investor has tried to take advantage of short-term loopholes or weaknesses in government regulation. Governments are much more likely to amend those regulations without warning or compensation. Legislative risk can therefore be reduced if the investment is undertaken on its investment merits and not on the chance of one-off tax advantages.

Income from investments

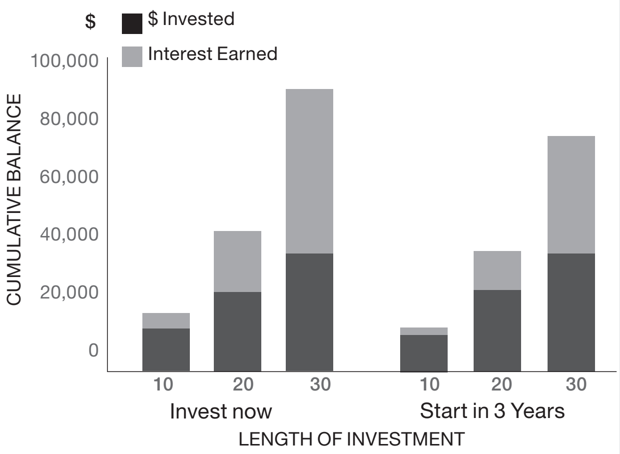
Many, but not all, investments pay income to investors. You can receive interest from cash or bonds, dividends from shares, rent from properties and distributions from managed funds.

You need to decide what to do with this income. For example, you could:

- Take the money as cash; or
- Reinvest the income and take advantage of compounding returns.

Compounding returns simply refers to the fact that the income you receive in the future will come not only from the amount that you originally invested, but also from the additional money you reinvest. This effectively enables your investment to increase in value at an exponential rate.

The following graph illustrates the benefits of compounding by comparing how much you would have if you started investing today, compared with how much you would have if you delayed investing for three years. It assumes an initial investment of $2,100 with regular savings of $100 per month into a cash management trust generating income of 5% pa (compounded monthly). All earnings are reinvested.



Note: This example is provided for illustrative purposes only. It is not representative of any particular investment product or investment strategy. No allowance has been made for inflation, taxation, fees or expenses.

If you start investing now, in 10 years you would have $19,052, of which $4,952 has been earned in compound interest. However, if you start investing in three years' time, you would have just $12,911 of which only $2,511 has been earned in compound interest – less than half as much.

This highlights the fact that the longer you are invested for, the greater the difference in compound interest. As the above illustration shows, the effects of compounding become more dramatic over time. Starting three years late, over a 30 year time frame means you miss out on more than $12,000 of compound interest!

Tax on investment income/earnings

All investments have their own tax implications.

As an individual investor, investment income such as interest and dividends is generally taxed at your marginal tax rate. However, if dividends from Australian shares have been franked, you will also receive franking credits. If you invest via a managed fund investing in Australian shares, you may also receive the benefits of franking.

Capital gains are taxed differently from income. While income is taxed annually, you can enjoy a 50% tax concession on capital gains on certain assets held for more than 12 months and capital gains tax is not payable until you sell the asset.

Taxation is both a complex and individual matter. You should seek professional tax advice whenever you make important financial or investment decisions.

Taxation of resident individuals – 2016/17 income year

As an Australian resident for taxation purposes, your investment earnings will be subject to the following personal tax rates for the current financial year.

Taxable Income	Tax Payable/Marginal Income Tax Rate
Up to $18,200	Nil
$18,201 – $37,000	Nil + 19% of each dollar over $18,200
$37,001 – $87,000	$3,572 + 32.5% of each dollar over $37,000
$87,001 – $180,000	$19,822 + 37% of each dollar over $87,000
Amount over $180,000	$54,232 + 47% of each dollar over $180,000

* Medicare levy is not included

The Medicare levy is an additional charge calculated against the taxable income of a resident taxpayer. It is generally calculated at a flat rate of 2.0% of a taxpayer's taxable income. A temporary Budget Repair Levy may apply to income in excess of $180,000 in 2016-17. An additional levy may be payable where a taxpayer's income exceeds certain thresholds and they do not have private patient hospital cover.

Taxation of non-resident individuals – 2016/17 income year

Generally, a person who maintains a home outside Australia and who does not intend to live in Australia permanently will be a non-resident for Australian income tax purposes.

Whilst Australia does not tax the foreign-sourced income of non-residents, in most cases, non-residents will be subject to tax on their Australian sourced income.

When determining the tax consequences of a non-resident, it is important to make a distinction between the various types of income derived and whether Australia has a Double Tax Agreement (DTA) with the non-resident's country of residence.

Australian sourced interest and unfranked dividends are generally subject to withholding tax of 10% and 15% respectively for residents of countries covered by a DTA. Unfranked dividends distributed to a resident of a non-treaty country would generally attract a withholding rate of 30%. Withholding tax is not applicable to fully franked dividends.

Annuity and pension income may be exempt from Australian withholding tax when paid to a resident of a DTA country. If an annuity or pension is not exempt from Australian tax, the income stream will be subject to PAYG withholding tax.

Australian sourced personal exertion income or rental income will be subject to the following non-resident tax rates for the current financial year as detailed in the table below.

Taxable Income	Tax Payable/Marginal Income Tax Rate
Up to $87,000	32.5%
$87,001 – $180,000	$28,275 + 37% of each dollar over $87,000
Excess over $180,000	$62,685 + 47% of each dollar over $180,000

Note: Non-residents are not liable for Medicare levy

Since 1 July 2010, residents of countries with an effective exchange of information on tax matters have been subject to a final withholding tax on fund payments from managed investments.

Fund payments will predominantly relate to income and capital gains from non- taxable Australian real property and will include:

- Dividends.
- Interest.
- Royalties.
- Capital gains from assets that are not taxable Australian property.
- Foreign source income.

The rates of withholding tax on fund payments are as follows:

Residents of countries with effective exchange of information	Residents of countries with no effective exchange of information
15%	30%

Franked dividends

Franking credits represent tax paid by a company on its profits and may be attached to dividends paid to shareholders.

Dividends may be fully franked, partially franked or unfranked. It is important to understand that a franked dividend is not necessarily exempt from tax. The dividend and attached franking credits are assessable but Investors receive a tax credit to offset against their personal income tax liability equal to the franking credit.

An example of the benefit of franked dividends is illustrated in the table above. Of course, in comparing an investment in shares with a term deposit product, you need to remember that shares are a riskier asset class.

	Shares ($)	Term Deposit ($)
Initial investment	10,000	10,000
Dividend income return of 5% pa fully franked	500	–
Interest return of 5% pa	–	500
Plus imputation tax credit*	214	–
Taxable income	714	500
Tax due at 49.0*	350	245
Less imputation tax credit	214	–
Tax payable	136	245
After tax income	364	255

* Based on a corporate tax rate of 30% pa and a marginal tax rate of 49% pa including Medicare Levy. No allowance has been made for inflation, fees or expenses. This example is provided for illustrative purposes only. It is not representative of any particular share, investment strategy or the returns on any investment.

Non-resident shareholders are not entitled to the benefit of Australian imputation credits. However, franked dividends are exempt from dividend withholding tax.

Excess imputation credits (i.e. imputation credits received in excess of your tax payable) attached to franked dividends are refundable to resident individuals and complying superannuation funds.

Capital Gains Tax

Certain assets that were acquired on or after 20 September 1985 may be subject to capital gains tax (CGT) on disposal. Capital gains or losses made upon realisation of such assets will be included in your assessable income and subject to income tax.

How does a capital gain or loss arise?

A capital gain or capital loss is realised if a CGT event occurs. You can also realise a capital gain if a managed fund or other trust distributes a capital gain to you.

The most common CGT event occurs when you sell or give away an asset to someone else. Some other CGT events from which you may realise a capital gain or capital loss include:

- Shares you own are cancelled, surrendered or redeemed;
- A trustee makes a non-assessable payment to you from a managed fund or other unit trust which reduces the unit cost base below zero;
- A company makes a payment (not a dividend) to you as a shareholder; or
- You stop being an Australian resident.

Generally, a capital loss will be realised when an asset is sold for an amount less than the reduced cost base relating to its purchase. Such a capital loss can be used to help reduce the amount of assessable capital gains that may be generated from:

- Distributions of a capital gain from a unit trust in which you hold units; or
- The sale of other assets held individually.

Capital losses may be used to offset any capital gains but cannot be used as an offset against ordinary income such as salary. A net capital loss can be carried forward from year to year and is available to be offset against future capital gains. In calculating the capital loss, the cost base cannot be adjusted for inflation.

Determining your net capital gain

Your net capital gain is your total capital gains for the year minus your total capital losses (including any net capital losses from previous years) minus any CGT discount or concession to which you are entitled.

For an asset acquired before 21 September 1999 and disposed of after that date, provided you have held it for at least 12 months, you have a choice of including:

- 50% of the realised gain in your assessable income (without any indexation of the cost base); or
- The whole of the difference between the disposal price and the frozen indexed cost base as at 30 September 1999 (the Government froze indexation of all cost bases in September 1999).

For individuals who have acquired and sold assets after 21 September 1999, provided they have been held for at least twelve months, 50% of the realised nominal gain will be assessable for CGT purposes.

If CGT assets have been held for less than twelve months, then the whole gain is assessable for CGT purposes.

In any year, current year capital losses are always used first to offset current year capital gains. Only when all current year capital losses have been used can one begin offsetting any remaining capital gains with capital losses carried forward from previous years. These ‘carried forward’ capital losses must be offset in the order that they were incurred – with the earliest capital loss utilised first.

Capital gains tax small business concessions

There are four principle capital gains tax (CGT) CGT concessions for small business taxpayers which may be available on the sale of a small business asset, in addition to the 50% capital gains discount (if applicable). These concessions are as follows:

- A total exemption of the gain on assets held for at least 15 years;
- A further 50% discount on the capital gain;
- A CGT retirement exemption; and
- A deferral of the capital gain if a replacement asset is acquired.

The basic eligibility requirements for all four of these small business concessions are as follows:

- There is a capital gain arising from the disposal of a CGT asset;
- The maximum net asset value test ($6m) or the small business entity test ($2m turnover) is satisfied;
- The CGT asset satisfies the active asset test; and
- If the CGT asset disposed of is a share in a company or an interest in a trust, the entity meets the 80% active asset test and either:
  - The entity claiming the concession must be an individual holding at least 20% small business percentage (significant individual) in that company or trust; or
  - If held indirectly through a trust or company the CGT concession stakeholders in the company or trust together must have a small business participation percentage in the interposed entity of at least 90 per cent.

An active asset is generally an asset that is used or is held ready for use in the course of carrying on the business by you, your affiliate, or an entity connected with you.

An individual is a CGT concession stakeholder of a company or trust if they are a significant individual or are the spouse of a significant individual and they have an interest in the company or trust.

In addition to the basic eligibility requirements, some of the small business concessions have further conditions that need to be satisfied.

The Capital Gains Tax (CGT) cap currently allows up to $1,415,000 to be contributed into superannuation from the disposal of qualifying small business assets. The CGT cap is a lifetime cap and is subject to indexation[1]. Contributions allowed under the cap are:

- Capital gains from the disposal of assets that qualify for the CGT retirement exemption provided the lifetime limit of $500,000 has not been exceeded; and
- Capital proceeds from the disposal of assets that qualify for the 15 year CGT exemption, including capital proceeds that would have qualified for the 15 year CGT exemption, except that:
  - The disposal did not result in a capital gain or loss;
  - The asset was a pre CGT asset; or
  - The disposal occurred before the 15 year holding period has elapsed because of permanent incapacity.

[1] Indexed to AWOTE each year, however will only increase in increments of $5,000

For a contribution to be counted towards the CGT cap, you must notify your superannuation fund before or when the contribution is made. There are also strict rules around when the contribution must be made by.

Following is a brief examination of each of the four principal CGT concessions for small business taxpayers.

The 15 year exemption

This exemption applies to active assets which have been owned for at least 15 years and that have been used in your business or that of a connected entity or affiliate for at least seven and a half years collectively during the period of ownership. The asset does not have to be an active asset just before the CGT event. If the eligibility criteria are satisfied, the asset will be totally exempt from CGT upon disposal, provided:

- the individual claiming the exception is either:
  - 55 or older and is retiring; or
  - Is permanently incapacitated at the time of the CGT event;
- If a company or trust is claiming the exemption, then the entity had a significant individual for a period or periods totalling 15 years during the period of ownership of the asset; and
- If an individual is selling shares in a company or interest in a unit trust then the company or trust had a significant individual for a period or periods totalling 15 years during the period of ownership of those shares or interest.

Any capital gain qualifying for this exemption is disregarded entirely i.e. not included for tax purposes. Capital proceeds from the disposal of assets that satisfy the 15 year exemption will count towards your CGT cap where contributed to superannuation, assuming that you have notified your superannuation fund.

There is no requirement for any current year or carry forward capital losses to be applied to the gain. Further, this concession is applied before any of the other three concessions described below.

The 50% reduction

Capital gains resulting from the disposal of an active business asset may be reduced by 50% upon satisfaction of the basic eligibility requirements. This is in addition to the standard 50% discount available to individuals where the asset has been held for more than 12 months, and results in an overall 75% reduction in the assessable amount of the gain. This concession applies automatically unless the small business individual or entity chooses not to apply it.

The CGT retirement exemption

This concession provides for a capital gain of up to $500,000 to be disregarded. The $500,000 figure is a lifetime limit and is not subject to indexation.

The concession applies to individuals, partners in a partnership and also to individuals who directly or indirectly have a significant interest in a private company or private trust. If a private company or private trust owns a relevant business, that company or trust may be able to claim a CGT exemption and pay the CGT exempt amount to a CGT concession stakeholder.

If you are less than age 55 before making the choice to use the retirement exemption (generally at the time you lodge your tax return), the CGT exempt amount must be contributed into a complying superannuation fund and it will be preserved until a condition of release has been met. A tax deduction cannot be claimed for the contribution of the CGT exempt amount, however the contribution will count towards your CGT cap, provided the appropriate notification is made to the receiving fund.

If the choice to use the retirement exemption occurs on or after the person's 55th birthday, the CGT exempt amount may be taken in cash or contributed to superannuation. The CGT exempt amount will be a personal contribution counting towards your non-concessional or ` cap unless you notify the receiving superannuation fund that the amount is to count towards your CGT cap.

Rollover

A small business rollover concession enables you to defer a capital gain from a CGT event occurring in relation to one or more small business assets if a replacement asset is acquired. A replacement asset can be a newly acquired asset or an improvement to an existing asset, but must be at least equal to the amount of the deferred gain.

In order to claim the rollover concession the following conditions must be met in addition to the basic eligibility requirements:

- A replacement asset is acquired; and
- The replacement asset must become an active asset, generally within two years after the disposal of the original asset for which a small business rollover is chosen.

The capital gain 'rolled over' from the disposal of the original asset will be disregarded to the extent that it does not exceed the acquisition and incidental costs of the replacement asset. When the replacement asset is subsequently disposed of, or its status changes, the capital gain will be realised.

Contact Financial Solutions Victoria Pty Ltd for further information on 03 51532507 or visit www.finsolvic.com.au