TOP 13 STRATEGIES TO REDUCE YOUR CAPITALGAINS TAX (CGT)

FOR PROPERTY INVESTORS

wealthtoday

Before you get started

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Letter from Wealth Today

Dear Reader

WELCOME TO WEALTH TODAY

Wealth Today was built specifically to facilitate the integration of financial planning into existing appropriate businesses and to provide sound individual financial advice to everyday Australians.

Our mission is to build an accessible, comprehensively supported team of Members who share our vision and commitment to providing tailored financial advice and building a new foundation of financial understanding and security for everyone.

With a national network of like-minded experts, we have the potential to provide the financial building blocks for future generations.

KNOWLEDGE GIVES YOU A HUGE ADVANTAGE

We believe that knowledge gives you a huge advantage in creating and effectively managing wealth; in planning to reach your goals; and in being prepared for whatever unexpected twists and turns life may present.

That's why our team of experts has created this series of eBooks that seek to inform you of not only the benefits but also the potential risks and pitfalls of various strategies and investments.

We trust you enjoy this eBook and find it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

TAKE THE NEXT STEP

We invite you to meet with one of our authorised representative to discuss what it was you were hoping to achieve when you downloaded this eBook and to establish if they can help you achieve your goals and objectives.

At the rear of this book you will find the details on how to book an appointment with one of our experts.

We look forward to meeting you soon.

Wealth Today

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Introduction

We are all familiar with the cliché that states there are only two certainties in life namely death and taxes. This certainty also applies to the area of *Capital Gains Tax (CGT).* If you made a capital gain on an asset bought after 1985 you will (in most cases) be taxed. The purpose of this guide is not to attempt to answer every single question you have about CGT, but rather to provide a user-friendly introduction to some of the main implications of CGT for the individual property investor.

Since this is such a relatively complex area it is recommended that you make use of the services of a professional adviser if you believe that you may have significant capital gains tax liabilities.

Capital Gains Tax Basics

Capital Gains Tax (CGT) is technically not a separate tax at all. It simply refers to the methods used by the Australian Taxation Office (Tax Office) to calculate the tax payable on realised capital gains.

The Tax Office treats capital gains as ***income*** which should be included in your income tax return. This extra income is then taxed at your marginal tax rate.

Some CGT basics:

- Capital Gains Tax was introduced on 21st September 1985. Assets purchased prior to that date do not, in most cases, attract CGT.
- The most common transactions attracting CGT are the sales of real estate and shares.
- There are some disposals that will be subject to CGT exemptions, the most common of these being the main residence exemption.
- Capital gains and losses can be made by individuals, superannuation funds, companies and trusts.
- One of the most important concepts in understanding CGT liability is determining if a capital gains tax event has been triggered. If it is determined that such an event did indeed take place (and there are no applicable exemptions) an assessment will have to be made about the level of liability. This is done by taking into account both the purchase costs and the proceeds on the sale of the asset(s).
- Where a capital loss has occurred no tax will be payable. However, the loss can be offset against other capital gains made in the same financial year or carried forward to reduce capital gains in subsequent years.

Do I need to Pay Capital Gains Tax?

According to the Tax Office you have to consider all of the following areas when attempting to determine if you will be liable for CGT:

- whether a CGT event has happened
- the time of the CGT event
- what assets are subject to CGT
- how to calculate the capital gain or capital loss (how to determine your capital proceeds, cost base and reduced cost base; how to apply capital losses and the methods available to calculate a capital gain)
- whether there is any exemption or rollover that allows you to reduce or disregard the capital gain or capital loss
- whether the CGT discount applies, and
- whether you are entitled to any of the small business concessions.

We will be looking at many of these issues in the rest of this guide.

Capital Gains Tax Events

One of the most important steps in calculating your Capital Gains Tax liability is to determine whether a *CGT Event* actually took place.

Whilst there are various events that will attract CGT, the most common type of CGT event occurs when a capital gains tax asset is **sold** or **change of ownership** occurs. The event happens when a contract of sale is entered into or when the entity stops being the legal owner of the asset.

Capital Gains Tax Assets

The Tax Office divides CGT Assets into three groups: *Collectables, Personal Use Assets* and '*Other Assets*'. From the perspective of the property investor the 'Other Assets' category is the most important as it contains the following items:

- land
- shares in a company
- rights and options
- leases
- units in a unit trust
- goodwill
- licences
- convertible notes
- residential and commercial property (unless it can be defined as your primary residence)
- contractual rights
- foreign currency
- any major capital improvement made to certain land or pre-CGT assets.

For each asset a 'cost base' will have to be worked out.

Calculating your Capital Gains Tax Liability

There are various methods for calculating the amount of the CGT liability that should be added to your income tax return. The following is the most basic method for assets owned by individual investors:

1. Calculate the cost base for each asset or part thereof.
2. Calculate the assessable capital gains: Assessable capital gains = disposal price (less cost of sale) minus the cost base.
3. Offset any capital losses.
4. Offset by any discount amount (e.g. the 50% allowance for assets held more than 12 months).
5. Add the resultant net capital gain to your other assessable income in your income tax return to determine overall tax liability.

It may well be that you are eligible to use other methods (e.g. the 'Frozen Cost Base' method) and that these will leave you in a better position. Your eligibility for this will depend on various factors (including when the asset was purchased, whether you operate a small business etc.)

A tax adviser will be able to steer you in the right direction in terms of using the correct (and best!) formula for your circumstances.

Minimising your Capital Gains Tax Liability

To minimise your CGT liability legitimately some of the following strategies could be considered:

1. Choose your main residence wisely

Any dwelling considered to be a taxpayer's main residence will be exempt from CGT. If individuals (or couples) sell their main residence, which has been their residence throughout the period of ownership, any capital gain or loss is disregarded.

The main criteria for determining whether a property can be classed as a 'main residence' include the following:

- the length of time you lived there
- whether your family lives there
- whether you have moved your personal belongings into the home
- the address to which your mail is delivered
- your address on the electoral roll
- the connection of services (for example, phone, gas or electricity)
- your intention in occupying the dwelling.

If you have more than one property and are considering which one to live in one factor for consideration should be that which is likely to have the greatest capital gain will benefit most from the CGT exemption on the main residence.

2. Maximise your main residence

The Tax Office allows a full exemption for CGT on your principle residence if you are not living in it for up to six years. By taking action so that this property is treated as your principal residence again, an additional six years' exemption is earned.

3. Consider other main residence exemptions

If the property was not your main residence for the whole time you owned it, you still may be entitled to a full exemption or extend a partial exemption you would otherwise obtain. These rules may apply if you:

- choose to treat the dwelling as your main residence, even though you no longer live in it
- moved into the dwelling as soon as practicable after its purchase
- are changing main residences
- are yet to live in the dwelling, but will do so as soon as practicable after it is constructed, repaired or renovated and you will continue to live in it for at least three months
- sell vacant land after your main residence is accidentally destroyed
- have part of your main residence, such as adjacent land or structures, compulsorily acquired.

4. Don't sell

The easiest way to avoid significant CGT liabilities is to prevent the CGT event from occurring in the first place since CGT is only payable on realised capital gains. In practice this means holding onto the property and not selling it. This allows you to have the property revalued in order refinance based on equity available in order to borrow further to purchase another property. It is this strategy that property investment enthusiasts advocate in order to build up your property portfolio. This may not be a realistic strategy for everybody however.

5. Hold on for 12 months

Currently individuals will receive a 50% discount on the amount of assessable capital gain to be included in their taxable income, if the property has been owned for at least 12 months prior to sale.

6. Use capital losses to your advantage

Capital losses can be used to reduce your CGT. In most cases unused capital losses can be carried over to future financial year. Selling your property at a gain following a year in which you made a capital loss makes perfect sense.

7. Self-managed superannuation funds (SMSFs)

Self-managed superannuation fund (SMSF) offers greater control and investment choice, than most other types of funds. An SMSF could be used to purchase an investment property, which could be partially via a loan, which would be paid off with your superannuation contributions in addition to rental income.

The tax rate inside an SMSF in accumulation phase for rental income is 15%, typically lower than your marginal tax rate, whilst the CGT rate for assets that have been owned for at least 12 months is 10% (this is a one third discount). Once the SMSF starts to pay a pension in your retirement, the tax rate is nil.

8. Sell after the end of the financial year

Selling the property after the end of the financial year potentially when you are on a lower marginal tax rate may reduce the amount of CGT to be paid. This also defers the time that the CGT will need to be paid. This strategy is particularly relevant for pre-retirees.

9. Keep detailed records

As the cost of owning a property can in most cases, be offset against your capital gains tax liability it is crucial to ensure you keep adequate records. Back-of-the-envelope estimates of this cost will not be acceptable to Tax Office. You should therefore be sure to keep detailed (written) records and that you keep every scrap of paper related to your ownership of the property

From a CGT perspective the cost base of the property will include:

- incidental costs associated acquiring and selling the property e.g. stamp duty and legal fees
- ownership cost such as council rates, strata fees and interest. Note that amounts claimed as tax deductions are excluded from the cost base of the property
- capital improvements e.g. renovations.

10. Maximising tax deductions to reduce taxable income

If you are purchasing another property in the same tax year you realising a large CGT liability, prepaying the interest for 12 months will bring forward this tax deduction into the same year to offset the CGT.

Tax deductible income protection insurance premiums and charitable donations are two tax deductible expenses that could be used to reduce your taxable income in a year you anticipate a hefty CGT bill.

11. Concessional contributions to superannuation

Self-employed people are able to make a contribution to superannuation and claim a tax deduction, up to a prescribed age based limit.

Employees could elect to salary sacrifice part of their salary to superannuation to reduce their taxable income in the year the capital gains will be added to their taxable income. This is with a view of not creeping into the next marginal tax bracket for the CGT liability.

The above contributions will incur a 15% contributions tax on the way into super. Benefits withdrawn from superannuation once age 60 are tax-free.

12. Increasing your cost base

The cost base of the property is a very important figure as it will eventually be used to determine whether a capital gain or loss occurred. There are several major elements that should be taken into account when calculating the cost base. They are:

- money or property given for the asset
- incidental costs of acquiring the CGT asset or that relate to the CGT event
- costs of owning the asset
- capital costs to increase or preserve the value of your asset or to install or move it
- capital costs of preserving or defending your ownership of or rights to your asset.

You will need to work out the amount for each element, then add or subtract them (as applicable) to work out the cost base of your CGT asset.

This can be quite a complex exercise as various rather complicated formulas and date-based rules come into play. It is, therefore, highly recommended that you get professional help with cost base determination if you have a significant amount of CGT assets.

13. Get the best possible advice

It has been said again and again that Capital Gains Tax is a very complex area. You just have to take a look at the official Tax Office CGT guidelines to get an inkling of the extent to which this is true. It contains page after page of rules, exceptions to those rules and even exceptions to the exceptions! It also describes various timeframes, concessions and formulas. It would be very easy to get lost in this morass of information (the official Tax Office CGT guide is 170 pages long!). This is why we strongly recommend that you make use of an experienced tax adviser if you plan to dispose of a significant CGT asset.

Conclusion

We hope that the information presented in this eBook gets you thinking about some of the issues that you will have to pay attention to in planning your next steps and more importantly your financial future. It would be impossible, however, to present a complete guide to all your financial planning needs in a document as brief as this.

We urge you to continue your explorations by making use of some of the other resources and eBooks available on wealthadvsier.com.au.

We also invite you to meet with us for an obligation free introductory meeting. Details of all our national offices are at the back of this eBook.

Take the next step

We trust you enjoyed this eBook and found it informative and professionally presented. Of course your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

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We look forward to meeting you soon.

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