SCA Unlisted Retail Funds

SURF

Tax Deferred Distributions

An investment in a property fund typically returns the investor a regular income distribution payment. The majority of the payment is generated by the fund from the rental income associated with the fund's properties. A portion of the payment may contain a tax-deferred amount.

Tax-deferred amounts arise when a property fund's distributable income is higher than its taxable income. The difference is typically attributable to tax deductions that do not arise from cash expenses that are paid during the year. These include tax depreciation on plant and equipment or buildings or other amounts deductible over time such as certain costs of raising equity and borrowing.

The key benefits of tax deferred distributions include:

- Tax-deferred amounts may not require the payment of income tax for the year the investor receives the payment. Instead the amount may reduce an investor's CGT cost base, deferring the investor's tax liability until a CGT event occurs. A CGT event will occur when the units in the fund are sold or tax-deferred amounts exceed an investor's cost base in the investment.
- When tax-deferred amounts are taxed as part of a CGT event, an investor may be entitled to tax concessions in respect of capital gains. For instance, if the units are held for at least a year, once the tax deferred distribution is eventually brought to account upon the sale of the units, the CGT discount could apply to the gain brought to account at that time. Eligible individual investors would be entitled to a 50% discount and eligible superannuation funds entitled to a one third discount.
- If the investor is eligible for a tax exemption on the sale of the units when they are eventually sold, the tax deferred distribution is effectively tax-free.

How does it work?

We have prepared two scenarios based on an individual PAYG income earning investor and a self managed superannuation fund investor to show these benefits of tax-deferred distributions.

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Case Studies

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Example 1 – PAYG Income earning investor

Brad wants to invest $100,000 into an unlisted property fund and is deciding between Fund A and Fund B.

Both Fund A and Fund B have a distribution yield of 7% p.a. That is, Brad will receive income of $7,000 ($100,000 x 7%) from either investment. However Fund A's distribution will be entirely taxable while Fund B's distribution provides a tax-deferred component of 34.5%.

Any taxable income Brad derives from Fund A or B will be taxed at his marginal tax rate of 47%, including a Medicare levy of 2%, and he will not reinvest any of the distributions he receives.

By investing in Fund A, based on his tax rate of 47%, Brad will pay tax on these earnings of $3,290 p.a. (i.e. 7,000 x 47%), resulting in after tax earnings of $3,710 (i.e. $7,000 - $3,290). At the end of a three-year period, Brad will have total after-tax cash earnings of $11,130.

By investing in Fund B, while Brad will still receive a distribution of $7,000 from the property fund, as $2,415 is tax-deferred (i.e. 34.5% x $7,000), Brad will only pay tax on the remaining $4,585 which is taxable. As the tax on this will be $2,155 (i.e. $4,585 x 47%), Brad will have after-tax cash earnings of $4,845 per year.

At the end of three years Brad decides to dispose of the unlisted property trust investment. To keep things simple, let's assume there is no capital growth of the investment over the three-year period.

On disposal, the tax-deferred distributions paid by Fund B will effectively be recouped through a capital gain as the tax deferred distributions would have reduced Brad's cost base in Fund B. As such, he will have a capital gain of $7,245 (3 x tax-deferred income of $2,415). Assuming Brad is holding the investment on capital account, he will be eligible for a 50% discounted capital gain, reducing his capital gain to $3,622. At his marginal tax rate, Brad will have an income tax liability of $1,702.

Overall, Brad will receive $12,833 after tax. This represents $21,000 of distributions less tax on ordinary income of $6,465 and capital gains of $1,702.

Three year investment summary

	Fund A (No tax deferred component)	Fund B (With 34.5% tax deferred compnent)
Income received	21,000	21,000
Income tax (47%)	9,870	6,465
Gain on sale	0	7,245
Capital Gains Tax (23.5%)	0	1,702
Total tax	9,870	8,167
After tax return	11,130	12,833

In addition, if instead Brad disposed of Fund B in a year in which his marginal tax rate was lower, this could further increase his after-tax return. His marginal tax rate could be lower in a year when he ceased employment or did not make as much taxable income on his other investments.

Example 2 – Self managed superannuation fund Investor

Anne thinks she will retire in five years and so wants to invest $50,000 through her SMSF into an unlisted property fund. As Anne's SMSF is a complying superannuation fund, it has a 15% tax rate and is eligible for a one-third discount on its capital gains. Further, once in retirement phase, capital gains realised by Anne's SMSF will not be taxed, provided that the assets supporting the pension are below the 'transfer balance cap' (approximately $1.6m).

Following the same analysis as Example 1, if the SMSF sells its investment in the property fund after five years, the return to Anne's SMSF from each of the two investment options would be as follows:

Three year investment summary

	Fund A (No tax deferred component)	Fund B (With 34.5% tax deferred compnent)
Income received	10,500	10,500
Income tax (15%)	1,575	1,031
Gain on sale	0	3,623
Capital gains tax (0%)	0	0
Total tax	1,575	1,031
After tax return	8,925	9,469