

# Investing directly offers many tax advantages

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In a world where smart tax opportunities for investors are few and far between, one strategy that remains is prepaying interest. Paying a year's interest in advance prior to June 30 and claiming this as a tax deduction for the current financial year is a strategy available for those who borrow to invest, says Melbourne financial planner Matthew Scholten of Godfrey Pembroke.

Investors who employ this strategy, says Scholten, include those using margin loans to invest in both managed funds and shares, and others with similar investments but using borrowed funds from other sources. This could be a line of credit or a borrowing facility secured against their home, where that lending facility permits them to organise a prepayment.

The attraction in prepayments includes the tax deduction plus locking in an interest rate for the following year in a possible rising interest rates market.

While a smart tax strategy can include a focus on interest pre-payments, where managed funds are involved smart investing with a tax angle has taken on other significance since the global financial crisis, says Scholten.

Given the flat nature of sharemarkets in the past 18 months, investors and their advisers have become very cost-conscious. This has led to a shift away from traditional managed funds with their long-standing management fee structures towards direct investing, particularly in shares or lower cost managed funds, like separately managed account investments and exchange-traded funds.

These managed fund alternatives, says Scholten, can be half or less the cost of investing in traditional managed funds. Another feature of either direct or SMA investing over traditional managed funds is their tax transparency, says Sydney financial planner Peter Mullens of Halcyon Wealth Advisers.

A risk for investors in traditional managed funds that have a unit trust structure is the requirement to distribute all income and realised capital gains each year.

This obligation can mean an investor who commits money towards the end of the financial year to a managed fund could find themselves receiving a taxable income distribution that is built into the unit price. It results in an investor finding themselves converting some of their capital into taxable income. This doesn't happen with either direct investments or SMAs, which are an alternative form of direct ownership of investments. Having an SMA is like having a tailored portfolio.

Most ordinary investors who are personally liable for any tax on income tend to prefer concessional tax on capital gains rather than taxable income.

Alex MacLachlan, managing director of funds management at Dixon Advisory, says not all investors appreciate the tax differences between traditional managed funds with a unit trust structure and listed investment companies. Listed investment companies are not required to distribute income received to investors and can choose to reinvest after-tax gains.

Managed trusts, on the other hand, are required to distribute all income, including unfranked dividends and realised gains. This increases an investor's ongoing tax payments.

Canberra-based financial planner Wayne Lear of Conscious Money says he prefers direct share investments or SMAs or ETFs when recommending a managed fund, especially if the strategy also includes some gearing. He says the concept of housing money in a traditional Australian managed share fund structure also carries the reality that the top 20 companies can represent two-thirds of the sharemarket.

As far as investing using borrowed funds such as margin loans is concerned, says Lear, there has been a rethink since the global financial turmoil, especially when it comes to managed funds. It is increasingly considered to be a selective strategy for younger people. He recommends no more than 50 per cent gearing combined with a dollar cost averaging approach into an ETF or an SMA.

Dollar cost averaging is a strategy for dealing with financial market ups and downs. It involves investing a fixed dollar amount at regular intervals and continuing to do so over an extended period. Investors do this with the awareness they will receive more shares when prices are lower and less after prices have risen. But they will wind up paying an average price that will be lower than the highest price but higher than the lowest price.

A shift to a more direct investments approach when it comes to geared investing has also been confirmed by

market researcher Investment Trends.

According to senior analyst Pawel Rokicki, its latest margin lending report noted an expectation among financial planners for there to be more direct investing rather than managed fund investing, especially when it came to shares.

Currently about 58 per cent of margin loan investment recommendations by planners sees money directed towards managed funds. Planners told Investments Trends they expect the proportion of margin lending money being invested directly against managed funds to be level by 2013.

The Australian Financial Review

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