The hidden benefits of tax deferred income

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Most property trust investors are unaware of tax deferred income, and with a name like that you can understand why. But this unique benefit has the potential to increase your after tax returns. Let's see how.

What is Tax Deferred Income?

The regular income distributions from property trust investments (APN's AREIT and Asian REIT Funds, for example) originate in the rental income received from tenants. These distributions may contain a 'tax-deferred' component, which occurs if a property trust's distributable income is higher than its taxable income.

Why might that be? Because a trust can offset its taxable income through a range of deductions – depreciation on plant and equipment, capital allowances on building structures, interest and costs during construction or refurbishment, and the costs of raising equity to name but a few – a trust's distributable income is frequently higher than its taxable income.

Suppose a property trust earns rental income of $100 and has building allowance deductions of $20. The net taxable income is $80, distributed to unitholders to be included in their taxable income. The remaining $20 of cash is also distributed to unitholders, but is regarded as a reduction in the cost base (see below).

How does Tax Deferred Income benefit property investors?

Well, you don't have to pay tax now on tax deferred income. Instead, the tax deferred amount reduces the cost base of your initial investment, and conversely increases the capital gain when you eventually sell your investment.

The benefit of tax deferred income is the "deferral" of tax until a Capital Gains Tax (CGT) event occurs; for example when an investor sells units or the property trust is wound up. But if your investment is held for more than a year, you can take advantage of the 50% CGT discount for individuals and a 33% discount for superannuation funds.

For long-term investors, the benefits may be even more significant. If the units are held by a superannuation fund that realises the investments during the pension phase, they have the potential to be completely tax-free as opposed to merely reduced significantly.

How does this work in practice?

Imagine these two investment options:

1. John invests $100,000 in a property trust that delivers 50% tax deferred income; and
2. John invests $100,000 in a property trust with no tax deferred income.

Let's also assume that:

- John is on the top marginal tax rate of 49%[1];
- Both property trusts distribute income of 6% p.a. over the term of the investment and that distributions are not reinvested;
- The unit price remains unchanged during the life of the investment;
- After five years, John decides to sell his investment;
- John is entitled to the 50% CGT discount;

Here's how these two scenarios play out:

		Property Trust 1 50% tax deferred income	Property Trust 2 Nil tax deferred income
	Income received	Tax payable (50% x $6,000 x 0.49)	Tax payable (0% x $6,000 x 0.49)
Year 1	$6,000	$1,470	$2,940
Year 2	$6,000	$1,470	$2,940
Year 3	$6,000	$1,470	$2,940
Year 4	$6,000	$1,470	$2,940
Year 5	$6,000	$1,470	$2,940
John redeems investment at the end of year 5	$100k (capital return)	$3,675 CGT is paid $100,000 less reduced cost base of $85,000 ($100,000 initial investment less $15,000 tax deferred income). Tax payable = $15k x 49% marginal tax rate x 50% CGT discount = $3,675	Nil CGT is paid
Total after tax return		$22,650 income less $3,675 CGT = $18,975 plus initial investment of $100,000 =	$15,300 income less nil CGT = $15,300 plus initial investment of $100,000 =
		$118,975	**$115,300**

So, over the lifetime of John's five-year investment, the value of the tax deferred income amounts to $3,675. That's a material difference to many investors' total after tax return.

Best of all, most property funds offer some component of tax deferred income. APN's AREIT Fund, for example, has delivered a component of tax deferred income each year since launching in 2009. For the financial year ending 2016, the fund delivered 51.6% of tax deferred income.

Depending on your personal circumstances, investing in a property fund that delivers tax deferred income each year improves your cash flow and delivers a more attractive after tax return. That's more money in your pocket rather than the Tax Office's.

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1 Includes Medicare levy and temporary budget repair levy

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