



## STEP 3 – PROPERTY INVESTMENT VEHICLES

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This is one of the most important investment decisions as it has a big influence on returns. The vehicle or structure also impacts on

- Asset Protection
- Income Tax
- Capital Gains Tax
- Succession of Assets
- Financial borrowings
- Legal liability
- Many other factors

The following background does not constitute advice as the legal, tax and finance implications are quite complex. We simply submit this as a means of initiating discussion with your financial advisors, should you choose to do so.

### *The Refinancing Principle*

This is simply the ability of property investors to convert or refinance their equity at some later date. This is done by converting the equity to debt.

This can be utilised with Discretionary Trusts, Unit Trusts, Companies and some Partnerships, but not by Individuals, Super Funds or Syndicates.

With companies and Trusts property investors can re-borrow their equity in the Company or Trust. The interest is tax deductible.

Take for example an investor buying property in a Unit Trust. He/she borrows money to do so and can claim a deduction for the interest paid on that loan. When the loan is repaid, the Unit Trust borrows funds to buy back his/her units in the Trust. The interest on that loan in the Unit Trusts' name is also deductible. Check the currency and longevity of this strategy with your advisor if this is considered advantageous in your case.

### Individuals & Partnerships

This requires little explanation except that in both cases, each person is exposed as to his/her share of the asset, liability wise e.g. any action against the owner may effect the property, and vice versa.

Refinancing principles (as described above) do not apply to individuals and some partnerships.

#### ***Individual***

Given the lack of tax flexibility, asset protection, and refinancing principle options, most experts advise that individual ownership be restricted to the family home. This is purely from an investment viewpoint but there could be personal issues.

### **Partnership**

Note the difference between say a husband and wife partnership as per taxation definition (Section 6 (1) of the Income Tax Assessment Act 1936) and a Common Law Partnership. Up until the mid 1990's the refinancing principle applied to all partnerships. However it now only applies to Common Law Partnerships (See TR95/25).

### **Companies**

Many professional advisors point out that companies are less suitable for purchasing appreciating assets. Tax losses are locked into the company structure and cannot be offset against personal income for tax relief.

Companies still offer no real form of asset protection as actions against the company flow through to the Directors. Shareholding in a company is still an actionable asset.

Some form of flexibility is possible with the distribution of income with different classes of shares. However this flexibility is limited.

Because most people are familiar with company structures, they are attracted to them, but the investor should explore all other options, with his advisors.

### **Superannuation Funds**

These are a popular vehicle option if they are self managed.

The legal owner is the trustee and the member is the beneficial owner.

Super funds may own property. However the prohibition on borrowing for Super Funds caused investors to purchase the property through a Unit Trust, with the Super Fund owning the units. This provides flexibility and allows for borrowing by the Unit Trust, effectively gearing the property.

However borrowings by the Unit Trust in this form ceased as of 18/8/1999.

If a fund had borrowed prior to this, benefits continue only up to the amount of borrowings already incurred to this date, i.e. borrowings cannot be increased.

However recent announcements concerning future relaxation of Superannuation Fund Laws have seen continual ongoing changes giving a new look to these vehicles, which can be very lucrative.

This is a highly specialised area and we have excellent contacts in this area which does not require you to change your existing Accountant.

### **Trusts**

We exclude here large property trusts which are discussed after this section as they are not a direct form of property investment.

The investor should familiarise himself with the existence of the trusts listed below before approaching his advisor.

The law does not allow for a loss made by a trust (capital or revenue) to be distributed and utilised by trust beneficiaries

There are two types of Trusts.



### ❖ Discretionary Trusts

These are regarded by many Tax Lawyers and Accountants as the best vehicles for holding appreciating assets.

This is the most flexible structure. New beneficiaries can be added easily.

#### *Tax*

Income and Capital Gains can be distributed to various beneficiaries at the discretion of the Trustee.

In addition, this does not have to be done until 30<sup>th</sup> June. Therefore the best tax strategy/apportionment decisions can be made depending on the various beneficiaries financial positions.

New beneficiaries can usually be added without any capital gains tax liability.

The return of non assessable capital problems associated with companies (Section 1602L) and Unit Trusts (Section 160ZM) do not apply to Discretionary Trusts.

#### *Asset Protection*

Because the beneficiaries of the trust have no equitable interest in the trust, any legal action against them does not affect the assets of the Trust.

#### *Refinancing Principle*

With the use of “special units” the refinancing principle can be applied.

### ❖ Unit Trusts

Unlike Discretionary Trusts, Unit Trusts have unit holders who have an equitable interest in the assets held by the Trust.

Distributions of capital and/or income are made to unit holders, proportionate to the number of units held.

In common with Discretionary Trusts, Unit Trusts may issue “special units” with various restrictions and/or rights.

### ❖ Other Trusts

Variations to the above two trusts can occur. These include “hybrid” and “class trusts”.

They are simply variations to the rights of beneficiaries or unit holders. They may also have different rules as regards the Trustees capacity to distribute capital and Income.

### Joint Ventures & Syndicates

The term joint venture does not have a defined meaning or legislative structure in Australian law. A syndicate is a joint venture. However the term Joint Venture is often used to describe an arrangement where two or more parties participate in a project, using the own skills or trades, for their own benefit, but requiring the contribution of others to complete the project.

In legal terms the structure of a property syndicate is a joint venture.



The distinction between a joint venture and partnership are subtle. The arrangements should be structured to avoid it being classified as a Partnership. Among other problems, if it is classified as a partnership (which it can formally be if the members so desire) the investors can become jointly and severally liable for the actions and debts created by, say one member. Simply having a clause in an agreement stating that it is a joint venture and not a partnership is worthless, if the activities are defined as a partnership.

A partnership is defined in partnership legislation in Australia, which we will not expand on here. Suffice to say, however, that joint ownership of a property does not constitute, in itself, a partnership. The distinctions between partnerships and joint ventures can be confusing for the layman.

To add to the confusion, a property syndicate, even if structured as a joint venture at law, is still taxed as a partnership for income tax purposes under the Income Tax Assessment Act 1997.

In a syndicate/joint venture, all investor's names will appear on the title (unless they are too numerous whereby a nominee is used).

*"Carrying on Business"* (As defined by ATO)

This will immediately classify you as a partnership, with inherent downside risk. For example a joint venture of specialists developing a subdivision for sale are likely to be deemed as carrying on a business – care is needed here.

With a group of people attempting to access high return well diversified property investments, there are three basic syndicate methods.

- \* Offer Shares in a Company
- \* Offer Units in a Property Trust
- \* Offer Interests in a Property Syndicate

Company and Property Trusts have been discussed above and this section concentrates on Non Company, Non Trust syndicates.

*Syndicate Operations and General Characteristics*

- \* A syndicate is regulated and bound by a constitution, or a syndicate agreement, depending on size.
- \* Property is held directly (in all names or a nominee).
- \* A promoter/manager puts together and runs the syndicate.
- \* Investors receive distributions, not dividends.

*Tax*

- \* A syndicate is taxed as a partnership.
- \* All tax benefits flow through to investors directly and immediately. For example, there may be a large depreciation allowance available in the first year creating a tax loss (but a cash surplus) with the loss deducted off personal income.



- \* “Tax Free” and Tax deferred benefits available.
- \* CGT averaging provisions were abolished for disposals after 21/9/99.
- \* If syndicate borrowings are done at investor level, then the CGT cost base will be higher than the amount invested.

#### *Asset Protection*

There could be liability issues if the syndicate borrows money. Alternatively, action against the syndicate for uninsurable risk means the investor could be sued or exposed to uninsurable risk issues. (Although it is generally accepted that this does not occur in a trust, the law is yet unsettled on the issue).

There are many different property syndicate vehicles.

1. Small Property Syndicate
2. Participating Property Syndicate
3. Fixed Term Property Syndicate
4. Development Syndicate
5. Strata Development Syndicate
6. Rolling Property Syndicate

The latter three do not have any legal meaning or technical definition but are listed to define specific purpose syndicate agreements.

This is a specialty area which requires the input of your legal and accounting advisors.

#### **Managed Investment Scheme**

When dealing with groups of investors, particularly if you are promoting the investment, care should be taken to ensure you do not breach the Managed Investment Act or Financial Services Reform Act.

Get advice from your professional advisors.

#### **Exclusions from the Classification “Managed Investment Scheme”**

The Managed Investment Act came into force on 1/7/98. Compliance with this scheme is bureaucratic and costly and it is best for the small investor to avoid being caught up in the provisions. Exclusions are set out below.

- Investors contribute over \$500,000
- Less than 20 investors if no promoter involvement
- Body Corporates
- Some Partnerships (“application order” Section 9I definition) e.g. Accounting & Legal Firms.
- Funds Managed under Life Insurance Act 1995
- Super Fund or Approved Deposit Fund
- Banks, Finance Companies/Institutions



- Barter Schemes
- Syndicates where members hold dealers licence ASIC regulation 7.12.05(a)(i).
- Franchises

### **Large Property Trusts**

These are more suited to people who do not wish to make input decisions on selection and management of property, and large funds who want to include them in their investment portfolio.

They are a form of indirect property investment.

The questions to be addressed in this section are: -

- How do they operate?
- Advantages & Disadvantages
- What are the returns?
- What are the risks?

Property trusts consist of “stapled securities”. This means that the shares attach to a number of units in the trust. These trusts can be listed on the Australian Stock Exchange or can be unlisted.

Typically, they come under the provisions of the Managed Investment Act, which requires “responsible entities” and “compliance committees”. This can be very expensive to administer.

Unlisted trusts are such that there is no guaranteed means of exiting the investment. The fund manager can buy back units usually with charges. Stamp Duty is not payable.

There are many listed property Trusts, following many recent mergers and acquisitions.

### ***Operational Management of Property Trusts***

The property is held by the paid trustee on behalf of the beneficiaries.

A Trust Manager administers the trust and the property for a fee, and a trust deed sets out the rules.

Investors receive distributions of the total income each year less management fees.

### ***Advantages and Disadvantages***

#### *Advantages*

- Listed trusts are quick and easy to invest/exit.
- Smaller sums can be invested, and these can be partially cashed in.
- Partial redemption can spread tax liability over two or more tax years.
- Like syndicates, investors can access high priced property.
- Some trusts diversify risk by covering several property classes.
- The management of established trusts is usually well documented.



### *Disadvantages & Risks*

Remember here, you are investing in shares on the stock exchange, not property.

- If there is a crash on the stock exchange, the share value can go down. This can happen even where the underlying property is performing strongly and possibly going up in value in its own right.
- Taxation benefits can be disallowed if the managers breach the requirements of the Australian Taxation Office. Sometimes these benefits form a substantial component of the overall financial gain.
- With direct property investment, the property “does not disappear” (even if vacant!). Share certificates can be illiquid or possibly worthless if the Trust collapses through bad management/forced sale where there is a rush on redemptions in unlisted trusts, or a lack of buyers in listed trusts.
- The returns over a long term (say 5 years) can be lower than direct investments, although very often the underlying property is not comparable.
- Listed Trusts are not subject to the takeover provisions of the Corporations Law. If trading too far below their asset backing, they may abandon their listing status.

