

Tax Defferal on Property Trusts (Overview)

Tax deferral is a significant benefit offered by Australian property trusts (REITs), providing investors with greater control over when they pay tax on certain distributions. This feature can enhance the after-tax returns of an investment and is particularly relevant for long-term investors.

When a trust distributes income, part of the distribution may be classified as "tax deferred." This portion is not immediately taxable but instead reduces the cost base of the investment for capital gains tax (CGT) purposes. When the asset is eventually sold, the deferred tax is paid through a higher capital gain.

Often investments in commercial real estate which including recently redeveloped or upgraded properties may have higher eligible depreciation expenses which may result in a higher portion of distributions being tax deferred.

Worked Example: Tax-Deferred vs. Non-Tax-Deferred Distributions

Scenario Parameters:

- Initial investment: \$1.00
- Annual distribution yield: 8%
- Tax-deferred portion: 50% of the distribution
- Holding period: 10 years
- Sale price: \$1.00
- Marginal tax rate: 45%
- CGT discount: 50%

Tax-Deferred Scenario

Annual Distribution:

Total distribution: \$0.08 per year

- Taxable portion: $\$0.04 \times 45\% = \0.018
- Tax-deferred portion: $\$0.04 \times 10 \text{ years} = \0.40 (reduces cost base)

Total Tax on Income (10 Years):

- $\$0.018 \times 10 = \0.18

At Sale:

Adjusted cost base: $\$1.00 - \$0.40 = \$0.60$

Capital gain: $\$1.00 - \$0.60 = \$0.40$

Taxable capital gain: $\$0.40 \times 50\% = \0.20

CGT: $\$0.20 \times 45\% = \0.09

Total Tax Paid:

$\$0.18$ (on income) + $\$0.09$ (CGT) = $\$0.27$

No Tax Deferral Scenario

Annual Distribution:

Entire distribution taxable: $\$0.08 \times 45\% = \0.036 per year

Total tax on income (10 years): $\$0.036 \times 10 = \0.36

At Sale:

No capital gain as cost base remains at \$1.00.

Total Tax Paid: \$0.36

Comparison

Tax-deferred scenario: \$0.27

No tax deferral: \$0.36

Tax Savings with Deferral: $\$0.36 - \$0.27 = \$0.09$

Tax Savings as a percentage: 25%

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