WEALTHMATTERS

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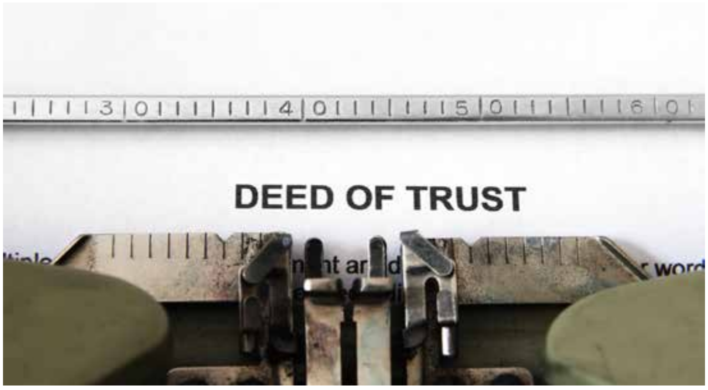
INSIDE



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Testamentary trusts: an overview

A testamentary trust is an effective estate planning tool that can provide greater flexibility when it comes to protecting assets and minimising tax when distributing assets to beneficiaries.

Testamentary trusts are trusts that are established through an individual's Will that do not come into effect until the individual has passed away. The trust outlines a structure whereby assets are managed by appointed trustees for the benefits of the beneficiaries nominated in the Will.

There are two types of testamentary trusts:

Discretionary testamentary trusts

Beneficiaries are provided with the option to take part or all of their inheritance via the testamentary trust. The primary beneficiary can remove and appoint the trustee and can appoint themselves to manage their inheritance inside the trust.

Protective testamentary trusts

This trust requires the beneficiary to take their inheritance via the trust without the option to appoint or remove trustees. This may be useful when a beneficiary is not able to manage their inheritance due to age, disability or spending tendencies.

The main benefits of a testamentary trust are the taxation advantages it creates for beneficiaries receiving income earned from the inheritance, and its ability to protect assets.

When a beneficiary accepts their inheritance in their personal name, they are required to pay income tax on income at their personal marginal tax rate. A discretionary trust can provide significant tax advantages, especially where the beneficiary has:

- a high personal marginal tax rate
- a partner on a lower income
- minor children and grandchildren
- a tax free threshold to $20,542
- children or grandchildren with no, or lower, taxable income

Assets are protected in a testamentary trust since they cannot be taken out of the trust without the trustee's discretion to distribute the benefits to the beneficiaries. Beneficiaries do not legally own the assets which protects the assets from other creditors, waste and dissipation by the beneficiary or claims on the beneficiary's assets in circumstances such as divorce or relationship breakdown.

Testamentary trusts may also protect the inheritance for beneficiaries who operate in a high risk profession where negligence claims are likely.

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Investing for the long haul

Investment bonds are a practical investment option for those who earn a high income and seek long term tax efficiencies.

Investment bonds, also known as tax-paid, insurance or growth bonds, work similarly to a managed fund, except they are combined with an insurance policy. There is a ten year rule which allows tax free earnings on the bond if no withdrawals are made in the first ten years and contributions do not exceed 125 per cent of the previous year's contribution.

Most investment bonds offer a range of investment options to cater for differing risk levels such as cash, fixed interest, shares, property or a range of diversified investment options.

Investment bonds are particularly suitable for high income earners with a marginal tax rate higher than 30 per cent who want to build wealth without increasing their personal tax liability. They are also useful for estate planning purposes as beneficiaries other than dependants can be nominated and will not incur tax upon receiving proceeds.

An investment bond can be used as an investment structure for future financial needs of children such as education expenses. Alternatively, investment bonds can be used for supplementary retirement planning as investment bonds are not subject to preservation age, unlike superannuation investments, which may be more viable for those planning an early retirement.

Investments held in an investment bond are generally not subject to capital gains tax (CGT). Where an investment does not qualify for a CGT discount, the maximum tax rate of 49 per cent may apply on earnings whereas an investment bond generates a maximum rate of 30 per cent.

However, investment bonds do carry some risk that individuals should consider before making a decision. Common fees such as establishment, contribution, withdrawal, management, switching and adviser service fees may be applicable depending on your provider and the investment options you choose.

If you do choose to invest in an investment bond ensure you will be able to make regular contributions over the lifetime of the investment and can comply with the 125 per cent rule. It is important to align your financial and estate planning goals with an appropriate investment structure suitable to your risk profile.

SMSF arm's length transaction

Investment transactions in your self-managed superannuation fund (SMSF) must be maintained on an arm's length basis to ensure no conflict of interest arises.

An arm's length transaction means that investments must be conducted on a commercial basis as if there was no relationship between the parties. For instance, the purchase price of an asset should be at market value. If the asset is publicly available, the arm's length price would match the price advertised to the public. For assets that are not publicly listed, independent valuations should be obtained to ensure the market value is adequately reflected in the purchase price.

When dealing with investment transactions, assess whether you meet the arm's length requirement by considering whether:

- the asking price is a fair price given the expected return on the asset, the risks to which the asset is exposed, and the relative liquidity of the asset;
- the projected returns of income and/or capital are in line with market expectations;
- any investment in a depreciating asset factors in an amount to recover the depreciation

Both parties should seek professional advice to ensure the transaction is based on a fair market value to protect the interests of all parties.

Using the re-contribution strategy

The recontribution strategy can be utilised to reduce the taxable portion of your superannuation benefits passed onto your beneficiaries following the death of an SMSF member.

Superannuation benefits in an SMSF are categorised into tax-free and taxable components. A recontribution strategy works by withdrawing a large sum of superannuation from a member's fund and a re-contribution of the funds as non-concessional contributions. The updated superannuation balance will contain the same funds yet will be considered a tax-free component.

This strategy can be implemented if you are able to meet a condition of release in order to draw the lump sum and also are eligible to make a contribution back into your super. Re-contribution is suitable for those aged between 60-65 as withdrawals are tax-free, regardless of the tax components.

Re-contribution can also be beneficial for those under 60 and commencing a retirement income stream as the increasing tax-free component of your income stream allows for a reduced tax payable, consequently increasing your after-tax income.

However, caution must be exercised for individuals aged between 55-59 accessing the scheme as withdrawals may be taxable and are dependent on the components of your superannuation. Using the re-contribution scheme may not affect your marginal tax rate, however, it can affect entitlements to certain tax offsets and concessions.

Ultimately, the re-contribution strategy can be a beneficial way to reduce or eliminate tax from an income tax and estate planning perspective provided members can meet the necessary requirements.

Refreshing your finances for 2016

Even though managing your financial affairs should be a year-round activity, the start of a new year is a perfect opportunity to get your financial house in order.

A fresh new year is a great point in time to start planning out and monitoring your financial and tax affairs for the year ahead. Even though individuals can get their money and investments on track any given day of the year, psychologically, it can seem easier linking it to the new year milestone.

Here are three affairs to consider reviewing:

Superannuation

Review how your concessional (pre-tax) contributions are tracking against your contributions cap ($30,000 if you are younger than 50, $35,000 if you are 50 and over). Adjust future contributions, if necessary, to ensure you will maximise the tax concessions available through super for the year.

To reach your contributions cap, work out how much you need to salary sacrifice before June 30. Don't forget to take into account contributions received for the year to date, as well as your employer's expected compulsory 9.5 per cent contributions.

For those planning to start a pension with their super and wish to make a personal deductible contribution beforehand, ensure that you provide a notice of intent to the trustee. A notice of intent allows you to claim the tax deduction and have it acknowledged before commencing the pension. Otherwise, the deduction is lost forever. Individuals must also do this before making a withdrawal or rolling over benefits to another super fund.

Investment portfolio

The new year may be an appropriate time to consider rebalancing your portfolio. Off-loading stocks with little chance of recovery and focusing on those with potential upside may be a good move for some.

Be mindful of 'wash sales' that result in a tax benefit e.g. selling an asset to lock in a capital loss to reduce or offset a capital gain and then buying back the same asset. The ATO keeps an eye on these types of transactions, and may cancel the tax benefit.

SMSF

Trustees need to regularly review their investment strategy to ensure that it continues to reflect the purpose and circumstances of their fund. Reviews should take place at least annually and

when circumstances change significantly e.g. when a pension commences, a new member joins or a member dies.

Keep in mind that it is not necessary to change your investment strategy; you are simply required to review it to ensure it is still appropriate.

Check that the value of any in-house assets you own is less than 5 per cent of the fund's total value. If asset values fall to the extent that in-house assets exceed 5 per cent, it may be a good idea to make additional contributions to remain within this limit by June 30.

Reverse mortgages

Even though reverse mortgages can help fund a comfortable retirement, retirees should consider all aspects of this potentially life-changing financial decision.

A financial dilemma that is increasingly being shared by Australia's ageing baby boomer generation is finding a way to fund a comfortable retirement lifestyle, without having to sell the family home.

One solution is a reverse mortgage; a loan that allows homeowners to convert part of the equity in their home into cash. The money can be taken as a regular income stream, line of credit, lump sum, or a combination of these options.

No income is required to qualify for a reverse mortgage, which makes them ideal for those who have retired from the workforce.

However, interest is charged just like any other loan. Since no repayments are made, the interest compounds and is added to the loan balance.

The loan is then repaid in full (including interest and fees) upon the sale of the house, the death of the homeowner, or in most cases, when the borrower moves into aged care.

However, given the nature of this type of loan, it is important that homeowners understand the risks involved, and consider how they can protect themselves as much as possible.

Risks associated with reverse mortgages include:

- The interest rates are usually higher than average home loans
- Debt can rise quickly since the interest compounds over the loan term
- The loan can affect your pension eligibility
- You may not have enough money left for aged care or other future needs
- (For those who fix their interest) the costs to break your agreement can be very high
- If you are the sole owner of the property and someone lives with you, that person may not be able to stay when you die (in some circumstances)

Succession planning for family businesses

Developing a sound succession plan can be a tricky process, especially for business owners looking to handover the business to family members.

A succession plan will help to determine your business' capital value, worth and market price to ensure a smooth transition out of your business. Early planning can help to maximise the value of your business and is also useful if unexpected events, such as illness or death occur.

Succession planning is not necessarily about planning for retirement, instead it ensures the continuity of a business beyond its current management. Poor succession planning can destroy the value of your business and damage long-term wealth.

However, careful planning can prevent complications and prepare potential successors with the capabilities to lead your business. When developing your succession plan, consider accounting for the following:

1. Decide on a successor

Choosing a family member as a successor can be a headache for some business owners, with the fear of impacting family relationships. Business owners should make evaluations based on the skills and passions of potential successors rather than the presumed entitlements of family members.

In some circumstances, it may be more appropriate to choose a non-family member such as a business partner takeover the business. The selection of a successor should occur early, to plan for different potential scenarios.

2. Develop the successor's capabilities

Training the successor is fundamental to prepare him or her for leadership. Identify key skills that form a core part of your business and start teaching your successor how to draw on these skills.

Set expectations and values up front to establish a clear framework for the potential successor. Regular feedback can help to provide support and confidence whilst preparing them for the tougher challenges they may face in the future.

Consider incorporating formal education and encourage the successor to gain experience outside the family business to broaden their knowledge and develop a range of skills.

3. Create a succession plan

A succession plan should commence in the early stages of your business and include financial, operational and legal strategies to pass over the business.

Some operational issues to cover include a timeline for the transfer of responsibilities and ownership, the appointed successor(s) and their responsibilities, and training and development for successor(s). Also, ensuring employee contracts and work agreements are up to date and informing key suppliers and customers about the succession is in good practice.

Financial and legal strategies may include:

- whether you are planning to gift or sell the business
- the market value of the business
- whether a trust needs to be set up as part of the succession
- the insurance policies regarding death, disability or injury you currently hold
- how much income you will need to leave the business
- the taxation implications of succession such as CGT implications of transferring an interest in the business
- if a change in legal structure will be needed
- if you need to change or transfer any registrations, licences etc.
- if a legal document that dictates the terms of succession is required

Your succession plan will need to be reviewed regularly to ensure it reflects changes in the business and meets the proposed successor's needs and aspirations. A regular review will help with implementation of the plan and will confirm all generations are in harmony with the proposed succession.

Splitting assets when couples part

There are both legal and tax implications to be considered when former partners in an SMSF decide to split after the breakdown of the relationship.

It is possible to transfer assets, such as property, from one super fund into another; however, there are four things individuals need to consider:

- Separating couples need to work out how they will go about splitting their superannuation fund. They can choose to enter into a formal written agreement, seek consent orders, or if the separating couple cannot reach an agreement, they can seek a court order.
- Couples must have the necessary documentation readily available, as it is essential in the event of an ATO audit. Due to there being beneficial tax consequences in splitting a superannuation fund, it is essential that the documentation, such as the notice for splitting the super, shows a genuine separation.
- Super funds that hold property as the major form of investment may face a liquidity problem; however, this can be addressed with future contributions. Individuals will also need to aware of the market valuation rules for real estate in DIY funds.
- Where the new fund is to be a single member fund, it is advisable to incorporate a special purpose company to be the trustee. This avoids having a second person as a trustee.