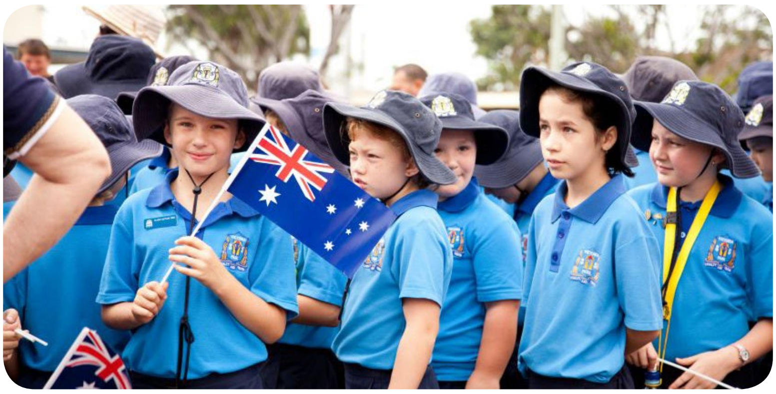
PERSONAL FINANCIAL STRATEGIES

YOUR PERSONAL GUIDE TO WEALTH CREATION



Saving for children's education

Every parents wants the best for their children and that starts with providing them with the best education possible.

Sending children through school is often the second largest expense after a mortgage for most Australians, so it is important to plan ahead. There are many options for parents wishing to set up an education savings plan for their children.

1. Managed funds

Managed funds are ideal for long term growth and can be started with as little as $1000. By making small contributions regularly, the initial capital and contributions will continue earning interest over the years.

Parents should be wary of setting up the fund in their children's name, as children may be subject to higher tax rates.

2. Investment bonds

These are similar to managed funds and can be started with an initial deposit of $500, set up mostly though insurance companies or friendly societies.

A benefit over managed funds is that if the investment is held under the child's name and is held for more than 10 years there may be some tax advantages.

3. Trusts

Whether for children or grandchildren, a trust determines in advance how assets are to be distributed in the future. The 'trustee' legally distributes the assets, or income from the assets to beneficiaries, i.e. the children or grandchildren for the purpose of paying for their education expenses.

Testamentary trusts can be an effective way of ensuring that the benefits of a deceased estate are distributed in line with the wishes of a Willmaker. It can be set up to operate over an extended period to meet education costs of future generations.

4. Education funds

Education funds are similar to other savings plans and used to be very popular, but tend to have high fees and be restrictive. For example, if the child does not end up going to university or leaves school early an exit fee or other penalty may be charged.

5. Wealth protection insurance

Income protection may be a good idea to safeguard against illness, accident or financial troubles. Insurance benefits can help pay for day to day bills as well as school fees and costs if a parent is out of work for even a short time.

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Maximising retirement when selling a business

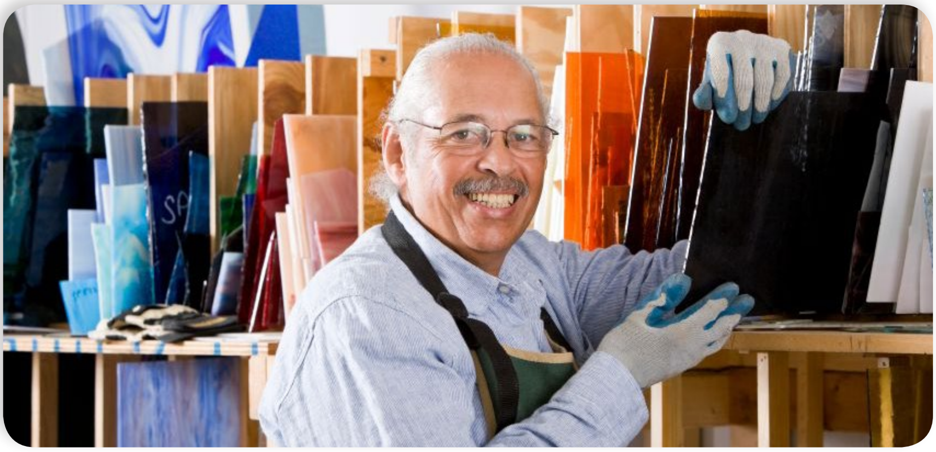
With baby boomers now reaching retirement age, many are selling their businesses as a way of topping up their superannuation and preparing for retirement.

There are various tax implications involved in selling a business that owners should be aware of to ensure that funds from the sale are maximised.

GST. The sale of a continuing business will be GST free only if certain conditions are satisfied on a case by case basis. If the business is GST registered, this may need to be included in the price of the individual business assets that are sold.

CGT. A capital gains tax may be charged when selling or disposing of assets. However there are also various CGT concessions for small business owners. These are:

- 15 year exemption for a business owned for at least 15 years
- Retirement exemption if selling the 'active' assets of the business to fund retirement
- Rollover allows the capital gain to be deferred for 2 years
- 50% active asset reduction which reduces the capital gain arising from the sale of a business asset



Lodging final income tax returns. Once a business and partnership has ceased trading and all assets have been distributed during the year, the ATO must be notified that the tax return filed is the final one.

Cancelling registrations. The ABN must be cancelled within 28 days of ceasing business. Cancelling an ABN will also cancel some other registrations with the ATO.

Record keeping obligations. Business records including sales and purchases, sale of the business, payments to employees and payments to other businesses must be kept for 5 years even though the business has been sold.

Business owners should also prepare the business for a buyer investigation:

- By looking at underperforming inventory, unused warehouses and inefficient systems. Dealing with these issues will help the business perform better and will motivate a buyer into acquiring a business which is geared up for productivity gains.
- If there is an identifiable strategic value in the business, then it will be worth the time and effort to prepare the business for a strategic buyer.

This will mean working out how a potential buyer could effectively exploit the potential within the firm. Once this connection has been made, the process of positioning it to prospective buyers and negotiating the sale will be quite straightforward.

Auto-reversionary pensions

The Federal Government has updated rules for SMSF pension benefits in the recent Mid Year Economic and Fiscal Outlook report (2012-13).

From this July, funds are allowed to sell any investments tax-free if the purpose is to pay out a death benefit.

Under the previous system, once a fund member died, the ATO reverted the pension benefits from the tax free pension phase back to the accumulation phase, at which point the investments became taxable. This left the surviving beneficiary of the investments, usually a spouse, with a capital gains tax on the investments and a loss in investment earnings.

One way of offsetting this potential setback was to set up an auto-reversionary pension, which may still be a preferable means of securing superannuation benefits despite the Government's changes.

An 'auto reversionary' pension is one that automatically reverts to the surviving fund member i.e. spouse or in some cases, child, so that the fund assets remain in the tax free pension phase. This allows the earnings to remain tax free.

Setting up an auto-reversionary pension

1. Members should firstly make sure that their SMSF Trust Deed allows for the payment of auto-reversionary pensions as not all do.
2. SMSF estate planning documents must be set up to cater for auto-reversionary pensions, which may be achieved by using a definitive binding death benefit nomination.

Benefits of auto-reversionary pensions

1. Saves in administrative paper. All that is required to administer the pension is a series of trustee minutes noting the member's death and reversion to the tax dependant beneficiary.
   If an auto-reversionary pension has not been set up, actuarial work for year-end tax calculations will need to take place where the fund is not 100 per cent tax exempt.
2. Auto reversionary pensions are also able to handle multiple pensions, where each pension may contain different tax components. For example, a pension may comprise of totally tax free components or be a mixture of tax free and taxable parts.
3. Having a pension with a tax free component allows an adult child to inherit the pension as a tax free lump sum death benefit.

A beneficiary may also able to roll back the income stream back to the accumulation phase if they wish to use it as an income stream.

Issues to consider when writing a Will

A Will is an important part of keeping estates and finances organised, and also holds emotional and familial obligations.

If a deceased does not leave a Will behind, their loved ones lose control over what happens to their estate, which may be particularly troubling for those leaving behind significant finances tied up in property, trusts, managed funds, SMSFs and small businesses.

Creating a Will involves appointing an executor to manage the affairs and estates of the deceased as well as naming the beneficiaries of the Will.

Duties of the executor:

- Locate the Will
- Ascertain and secure the assets
- Prove the Will in court
- Discharge debts
- Establish trusts
- Prepare income tax returns and attend to capital gains issues
- Distribute the assets according to the terms in the Will.

Beneficiaries

Beneficiaries are the recipients who receive the assets of the deceased. They can be people or organisations. In general anybody can be designated beneficiaries of the Will but it is recommended that proper provisions are made for children, spouses and ex-nuptial children. In particular, the Will should pay special attention to the guardianship of minor children, especially if there are no surviving spouses.

Marriage

Marriage revokes a Will and a new one should be prepared immediately providing for the spouse.

Superannuation implications

When a person dies, their superannuation is paid to their beneficiaries, either directly or as part of their estate. Lump sum death benefits paid to dependants are generally tax free.

Capital gains tax (CGT) implications

When the assets of a deceased estate are distributed, a special rule applies that allows any capital gain or loss made on a CGT asset to be disregarded if the asset passes to the executor, a beneficiary, or from the executor to a beneficiary.

However, if an executor sells an asset of the deceased estate and then distributes the proceeds to the beneficiaries, the sale is subject to the normal rules and CGT applies.

In Australia there are considerable differences between the states in regards to what assets can be claimed as part of a deceased estate. One needs to consider the potential state differences to eliminate any risks associated with the Will.

Caution for SMSF property investments

The ATO has warned SMSF trustees to be cautious when investing in property. There are concerns that people are using SMSFs to invest in property without completely understanding the obligations under the law.

If a trustee is found to be using their super fund to bypass investment regulations, it can result in disqualification, civil penalties or even criminal charges. Trustees should consider whether property is the right investment for their SMSF and to check that all arrangements are legal before signing any contracts.

The ATO is paying attention to:

- Making sure holding trusts are legitimate and have been established prior to any contracts being signed
- That the title of the property is not held in an individual's name, but in the name of the trustee of the holding trust
- SMSFs illegally gearing in a related unit trust.

It is important to ensure that all investment arrangements have been structured correctly, as they are not always able to be simply restructured or rectified.

In these instances the only option may be to unwind the arrangement which could involve the forced sale of assets, resulting in expensive stamp duty and tax consequences for the fund.

Alternatives to cash investments for retirees

Since the Reserve Bank started cutting interest rates last year, many self funded retirees and part time pensioners have found that their term deposit and online saving account returns have gone down 15-30 per cent.

During the global financial crisis many retirees switched from shares to cash, but as the economic climate improves, many are switching back, with the share market and investments growing steadily and offering more stable long term income.

There are many alternatives to cash investments, such as bonds, shares and property. Retirees should be aware of the benefits and risks of these options before making a decision.

Corporate bonds. Investing in a corporate bond is essentially lending money to a business in return for interest payments.

Advantages

- Regular Interest payments, such as every quarter or 6 months for the life of the bond
- Fixed term investments
- Bonds are less volatile than shares

Disadvantages

- If the company becomes insolvent then those who hold bonds in the company may not receive interest payments and/or see the initial capital returned
- Risk of bonds not selling on the secondary market
- Debt security ranking may be low

Listed property trusts. Listed property trusts provide access to a portfolio of managed properties that are normally too expensive for most retail investors to invest in individually such as office towers and shopping centres.

Advantages

- Regular rental returns
- Higher liquidity than investing directly in property as LPTs can be traded on-market at any time
- Tax advantages available to the trust (such as depreciation) may be passed onto investors through dividends.

Disadvantages

- Earnings from the property market may fluctuate greatly between each year
- Possible reductions in asset valuations and rental returns

Shares. Investing in shares is essentially buying a portion of the business and becoming a part-time owner.

Advantages

- Potential capital gains from owning an asset that can grow in value over time
- Potential income from dividends
- Lower tax rates on long term capital gains
- Easily traded on the secondary market

Disadvantages

- Shares are highly risky and share prices can fall dramatically
- Shareholders rank lower than other investors and are the last to be paid should the company go bankrupt
- Dividends are subject to company performance and will go up and down from month to month, which means shares are not the best option for retirees looking for reliable income.

The Bookshelf

Thinking, Fast and Slow

Author: Daniel Kahneman

Daniel Kahneman, recipient of the Nobel Prize in Economic Sciences for his work in psychology that challenged the rational model of judgment and decision making, has brought together his many years of research and thinking in one book.

In **Thinking, Fast and Slow**, Kahneman takes us on a tour of the mind and explains the two systems that drive the way we think, the fast intuitive and emotional system, and the slower, more deliberate and logical side.

In this book Kahneman exposes the extraordinary capabilities and faults of fast thinking and reveals the influence of intuitive impressions on our thoughts and behaviour.

The impact of overconfidence on corporate strategies, the difficulties predicting what will make us happy in the future, the challenges of properly framing risks at work and at home- from playing the stock market to planning the next vacation-each of these can be understood only by knowing how the two systems work to shape our judgments and decisions.

Kahneman offers practical and enlightening insights into how choices are made in both our business and our personal lives—and how we can use different techniques to guard against the mental glitches that often get us into trouble. **Thinking, Fast and Slow** will transform the way you think about thinking.

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