June 2016
The Federal Budget Edition

Introduction

The first Tuesday in May is a big day for financial advisers. This is the day that the relevant Federal Government deliver their Budget for the upcoming financial year and beyond.

It is worth remembering what the purposes of these Budgets are. Yes, they are undoubtedly political (perhaps especially the Budgets that immediately precede elections). But they also stand as a main way for the Government of the day to influence the working of the economy and even engage in a bit of social engineering.

This Budget is little different. Most of the major changes took place in the superannuation sphere, and so that is where we concentrate our analysis in this newsletter.

As ever, please never hesitate to get in touch if there is any element of the contents of this newsletter – or any other aspect of your financial management – that you would like to discuss with us. We are always happy to help.

Peter Dugan

02 9476 6700

pdugan@edgeworthpartners.com.au

www.edgeworthpartners.com.au

Contents

BUDGET 2016 .... **1**

- Most people: the 96%ers 1
- Summary of May 2016 Super budget changes 2
- What about the 4%ers? 3

WHAT IS AN INVESTMENT COMPANY/TRUST COMBINATION? **4**

- Franking credits are the key 5
- A no-brainer example 6
- A more complicated example: Dr John and his soon to be adult children 6
- What about other real life client examples? 7

THE LEGAL STUFF **8**

- General Advice and Tax Warning 8
- Contact Details 8
- Licencing Details 8

Budget 2016

When we think of retirement planning we think of super.

Super is huge. It's one of Australia's largest industries, employs tens of thousands of very well paid staff, and manages more than $2 trillion dollars. A Google search brings more data than you can ever read. Near the top of the list you will find KPMG's e-book **The trends shaping Australian's superannuation industry** and it's as good as you will get for a short and simple super summary.

But is super the best way to build assets for retirement? Is there a better way to build assets for retirement? Has the 2016 Budget really changed the game?

Most people: the 96%ers

The answer, to get to the point quickly, is no, at least for most people. For most people super is better than ever. By "most people" we mean about 96% of people: this is the percentage identified in the Budget, and it seems about right.

Most people can now put more into super: the five year contributions catch up rule and the new rule allowing employees to deduct personal contributions more than compensate for the lower $25,000 cap.

The extension of the spouse offset and the super tax offset make super better for lower income families. The abolition of the work test between age 65 and 75 helps too.

Most people will not be affected by the new $1,600,000 cap on tax free pension assets.

By the way, that's $3,200,000 for a couple. Earnings on amounts greater than that are only taxed at 15% (or even 10% on most capital gains). If a 65-year-old couple has $4,000,000 in super, 80% is tax free. The earnings on the remaining 20% are taxed at just 15%/10%. That's an average tax rate of 3%/2%.

That's not a heavy tax charge. That's virtually tax free.

Most people are not adversely affected by the 2016 Budget super changes.

In fact, most people are much better off under the 2016 Budget changes.

The following table contains a summary of the problem that the Budget identified and the way in which the Budget seeks to fix that problem.

Summary of May 2016 Super budget changes

The Perceived Problem	The Solution	The link to a Budget night fact sheet
Super concessions skewed to wealthier persons	A $500,000 lifetime cap on non-concessional contributions from 7.30 pm 3 May 2016.	A lifetime non concessional cap
Super concessions skewed to wealthier persons	From 1 July 2017 concessional contributions capped at $25,000 irrespective of age. From 1 July 2017 individuals with taxable incomes greater than $250,000 pay 30% tax on concessional contributions.	Reforming the taxation of concessional contributions
Super concessions skewed to wealthier persons	Individuals with less than $500,000 super can access their unused concessional contributions cap space on a rolling basis over five years.	Allowing catch up concessional contributions
Super concessions skewed to wealthier persons	From 1 July 2017 a $1,600,000 cap on the super transferred to a tax-free retirement account. The cap is indexed by the CPI. Benefits above the cap can remain in an accumulation account, taxed at 15%. Changes in balances due to profits or losses, or pension payments, are ignored. Individuals with balances above $1,600,000 must transfer the excess back to an accumulation account, or withdraw it.	Introducing a $1.6 million transfer balance cap
Super concessions skewed to wealthier persons	The tax exempt status of income from assets supporting transition to retirement income streams stops on 1 July 2017. Earnings from these assets will be taxed at 15%. This is irrespective of when it commenced.	Transition to retirement pension schemes to be taxed
Inequity between similar retirement orientated investment products	From 1 July 2017 tax exemption on earnings in retirement will extend to products such as deferred lifetime annuities and group self-annuitisation products. Some suggestions there will be Centrelink advantages too	Enhancing choice in retirement income products
Need for better super	A Low Income Super Tax Offset replaces the Low	Low Income

The Perceived Problem	The Solution	The link to a Budget night fact sheet
support for low income earners	Income Super Contribution on 30 June 2017, to support super for low income earners. The LISTO means tax on super cannot be greater than tax on the individual.	Superannuation Tax Offset
Need for better super support for women	From 1 July 2017 the 18% tax offset of up to $540 is available for any individual contributing to a spouse whose income is up to $37,000. (Previously $10,800.) The offset is gradually reduced above $37,000 and stops at $40,000.	Extending the spouse tax offset
Need for better super support for older persons	From 1 July 2017 there is no work test for super contributions.	No work test on contributions
Inequity between different types of taxpayers	From 1 July 2017 employees will be able to claim deductions for personal concessional contributions	Improving access to concessional contributions

What about the 4%ers?

So, as discussed above, the recent Budget changes will have relatively little impact, or certainly relatively little negative impact, on 96% of the population.

But the position is different for the other 4% of people. That is, those who earn more than $250,000 a year and now face a super contributions tax rate (30%) greater than the company tax rate (27.5% and falling).

At this point, we feel we need to point out that this 4% of people are doing well financially. They are probably Australia's wealthiest 4% of people. You can see why a government looking to exercise a bit of social engineering would ask these people to do some of the lifting.

The traditional argument for super was based on individuals agreeing to restrict access to their money, and to certain prudential controls, in return for significant tax concessions. Super's tax profile was generous and, in summary, more than compensated for the restrictions.

But over the last five years the tax profile of super has become less generous, and the tax profile of investment company trust combinations has become more generous. The 2016 Federal Budget upset the balance more than ever: the further downgrading of super's tax profile and the further lowering of company tax to 27.5% from 1 July 2016 and 25% by 2026 tilts the balance even more to an investment company/trust combination, and away from super.

The specific changes to super's tax profile are set out in the appendix, with links to the relevant Budget night fact sheet. They include from 1 July 2017:

- concessional contributions capped at $25,000 a year irrespective of age
- individuals with taxable incomes greater than $250,000 pay 30% tax on concessional contributions
- company tax rate 27.5%, falling to 25% by 2026
- a $1,600,000 cap on the super transferred to a tax-free retirement account and
- from 7.30 pm on 3 May 2016 a $500,000 lifetime cap on non-concessional contributions.

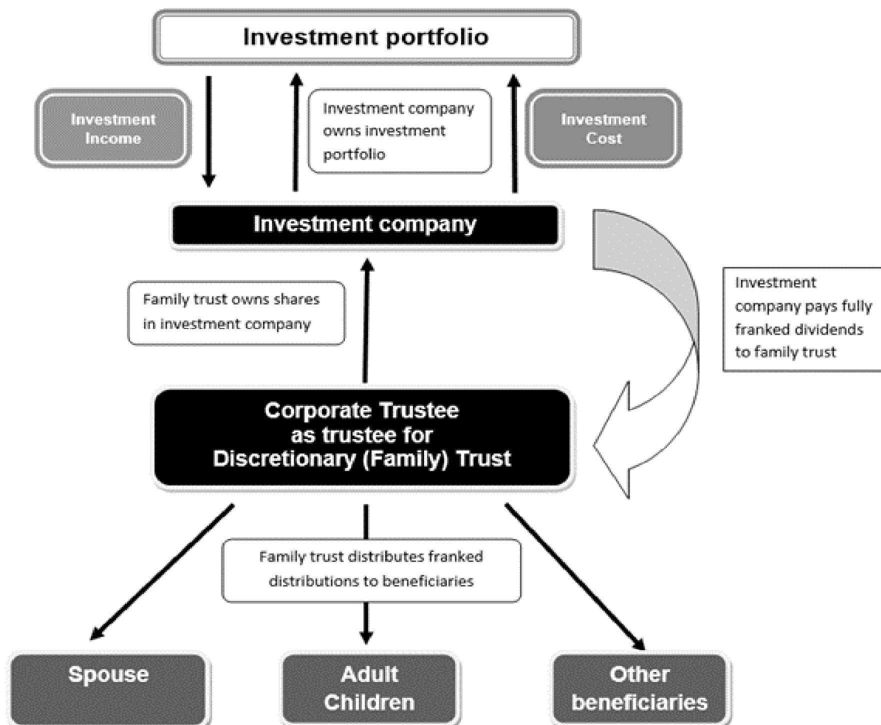
These changes mean most high net worth clients are now better off emphasizing investment company/trust combinations for their long term investing and retirement planning.

What is an investment company/trust combination?

An investment company trust combination is an investment company where the shares are owned by family trust. The company invests in long term growth assets such as properties and shares, and reinvests the after tax net profit in more properties and shares, or debt reduction.

Monies are transferred to the investment company via taxable distributions of net income from business trusts and investment trusts, or as tax free capital contributions. These amounts are taxed at 27.5%, and the balance of 72.5% is available to be invested.

The general idea is discussed in detail in chapter 20 of **Fifty ways financial planners can save tax**.



Edgeworth Partners

Franking credits are the key

Remember that company tax generates franking credits, but super tax does not. There is every chance the investment company/trust combination will generate an effective tax rate close to or even less than the superannuation tax rate. But it's the non-tax rate advantages that complete the argument: the ability to access cash whenever you want, to lend monies to related parties, to hold lifestyle assets and most importantly, the absence of cash.

The specific advantages and disadvantages of a SMSF compared to an investment company/trust combination are tabulated here:

Relative advantages of an SMSF to an investment company trust combination:

	SMSF Accumulation phase	SMSF Pension phase	Investment company/trust
Tax rate on capital gains on assets held for more than 12 months	10%	Nil	Less than 25% to 27.5%[1]
Tax rate on other investment income	15%	Nil	Less than 25% to 27.5%
Tax rate on concessional contributions/distributions	15% (but 30% if member has a taxable income above $250,000)	15% (but 30% if member has a taxable income above $250,000)	Less than 25% to 27.5%
Tax rate on non-concessional contributions/capital/corpus	Nil	Nil	Nil
Limits on concessional contributions/distributions	Yes $25,000 a year	Yes $25,000 a year	Not limited
Limits on non-concessional contributions/capital	Yes	Yes	No
Ability to borrow	Restricted	Restricted	Unrestricted
Lifestyle assets	No	No	Yes
Access to monies under preservation age	No	No	Yes
Vesting rules apply	Yes	Yes	No

1 The effective real rate of tax will not be known until a dividend is paid to the shareholder trust and distributed to an individual beneficiary. It could be nil.

	SMSF Accumulation phase	SMSF Pension phase	Investment company/trust
Protected from trustee in bankruptcy	Yes	Yes	Yes
Audit required	Yes	Yes	No
Loans to related parties	No	No	Yes
Risk of penalties re non-compliance?	Yes	Yes	No
Franking credits attach to payments out?	No	No	Yes
Covered by a person's will? BDBN?	Yes	Yes	No
Earliest tax free access	Age 56	Age 56	When a low tax beneficiary presents
Share benefits with spouse	Limited	Unlimited and easy	

A no-brainer example

Dr Jill runs a sleep clinic that makes $200,000 a year. She also has a 0.5 hospital appointment paying $100,000 a year. Dr Jill now pays tax of 30% on all her super contributions if she distributes more than $150,000 to herself.

Dr Jill is well advised to instead distribute to an investment company trust combination, and only pay tax at 27.5%, with the probability of a full or part refund of a franking credit a few years down the track.

A more complicated example: Dr John and his soon to be adult children

Dr John owns one third of a general practice. The practice is run by a hybrid trust, and is a business for tax purposes. Dr John is 45, and has three secondary school aged children, 13, 15 and 17, and each of them will probably by at university until age 23. This means in about one year he faces a ten-year period where he will have at least one dependent adult child.

Dr John directs the hybrid trust to distribute $100,000 of net income to his investment company trust combination. The company pays tax of $27,500 and invests the rest. In the years ending 30 June 2018

t0 2022 the company will pay a dividend to the shareholder trust. The shareholder trust will distribute a $25,000 fully franked dividend to his eldest child, meaning the original $100,000 has been derived virtually tax free.

About $4,000 tax is payable over about five years, compared to $15,000 under the super strategy.

Dr John will retire at age 65, at which time the investment company will start paying fully franked dividends to him and his partner in the equivalent of a pension stream from a super fund, with each of them receiving a cash refund of excess franking credits.

Dr John preferred this strategy because he could:

1. put more away: the $100,000 was more than he could contribute under the new low cap $25,000 a year rule
2. get the money back early if he needed to
3. lend the money back his practice if there is an emergency
4. use the money in the company to buy a property for his children to live in when they are at university. Don't try this with a SMSF.

What about other real life client examples?

In summary each case is different and has to be thought through on its facts. The investment company/family trust strategy works best for clients who have some of these characteristics:

1. are not employees (since employees are subject to mandatory employer super contributions)
2. may incur business losses in subsequent years (ie an amount distributed to the investment company in a good year can be reversed back in a bad year, reducing overall tax)
3. are older, or are otherwise closer to retirement
4. derive business or investment income (ie not personal services income)
5. can afford to direct large tranches of income to an investment company
6. can afford to transfer a valuable income producing asset to an investment company
7. have children or other relatives who can receive trust distributions
8. wish to invest in assets that are not appropriate for a super fund
9. may wish to access the money as a loan or otherwise before age 65 but have no need to access the monies to fund day to day living.

The Legal Stuff

General Advice and Tax Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

Contact Details

Address Suite 1, Lvl 1, 22-28 Edgeworth David Ave
Hornsby NSW 2077
Phone 02 9476 6700
Website www.edgeworthpartners.com.au
Email partner@edgeworthpartners.com.au

Licencing Details

Peter Dugan is an authorised representative (380321) of Avana.

Avana

AFSL 516325 | ABN 67 631 329 078 | Level 1, Suite 8, 51-55 City Road, Southbank, VIC 3006