PERSONAL FINANCIAL STRATEGIES

YOUR PERSONAL GUIDE TO WEALTH CREATION

ECT on the rise

There are limits on the amount individuals can contribute to superannuation each financial year that are concessionally taxed. Significant penalties apply to those exceeding those limits.

The Australian Taxation Office (ATO) estimated that over 65,000 individuals were expected to exceed the concessional contributions cap for the 2009/2010 financial year.

There are two types of superannuation contributions, concessional and non concessional and the limits are different for both types of contribution.

Concessional contributions include:

- The 9% compulsory super guarantee made by employers;
- Additional voluntary super contributions employers make;
- Salary sacrificed amounts; and
- Personal super contributions made by individuals for which a tax deduction is claimed.

The 2011–2012 concessional contributions cap is either:

- $25,000 for people under 50 years of age;
- $50,000 for people aged 50 years or over.

Non-concessional contributions include:

- Personal contributions made by individuals from their after tax income- this amount cannot be claimed as a personal super tax deduction;
- Contributions made by partners;
- Any contributions in excess of the concessional contribution cap.

The 2011–12 non-concessional contributions cap of $150,000 applies to all individuals.

Many are still unaware of how the excess contributions tax (ECT) operates. As a result, many are facing ECT, turning it into a major source of revenue for the Federal Government. The average ECT liability for the 2009 financial year was around $40,000. Roughly a third of those facing ECT are members of a self-managed super fund.

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The ATO uses information provided to them by superannuation funds and individual tax returns to determine whether an individual has exceeded their contributions cap. An individual that is assessed and required to pay excess non-concessional contributions tax must withdraw an amount equal to the amount of this tax from their super fund. This is in addition to the tax obligation.

Excess non-concessional contributions assessment applies where individuals are taxed at 46.5 per cent on excess non-concessional contributions.

Excess concessional contributions assessment applies where individuals are taxed at 31.5 per cent on excess concessional contributions, including employer contributions. This is as well as costs that employers pay, such as super administration fees and

insurance premiums.

Any excess concessional contributions (which are already taxed at a rate of 31.5 percent) are counted as non-concessional contributions.

The ATO will receive applications to disregard or reallocate contributions. The ATO has received 225 applications to disregard or reallocate contributions relating to the 2009 financial year but only determined 111 applications as at May 2011.

Testamentary trusts – revisited

Family relationships can be difficult during a lifetime and can be potentially more difficult after the death of a loved one. Most people make a will with the expectation that their wishes will be followed after their death. However, serious problems can arise involving an unhappy beneficiary or person who was left out of the will.

There are three different ways that a person can arrange for their property to be managed after their death.

A will

In a will an individual leaves their estate in fixed shares for specific beneficiaries. All assets until death are owned by the person making with will. However upon death, the legal ownership of those assets passes to the executors of the estate. It is up to the executor to pay out all debts of the person that owns the will. Once the administration of the estate is complete, legal ownership of the remaining assets is transferred to the beneficiaries.

Inter vivos trust

An inter vivos trust, such as family trusts or unit trusts, are created during a person's lifetime. Generally, the person making the will has transferred all or a substantial part of their assets before their death and upon death, ceases to have an interest in the assets now held by the trust.

Any assets held in a family trust do not form part of the deceased person's estate and fall outside the scope of the will.

There may be a need to appoint a new trustee, but the rights of the beneficiaries are not affected.

Testamentary Trust

A testamentary trust is a trust established by a will. It does not come into effect until after the death of the person making the will.

This trust operates by retaining some or all of the assets of a deceased estate in a trust for the benefit of the beneficiaries, instead of all of the assets being immediately distributed to the beneficiaries. This is the primary difference between a standard will and a will which established a testamentary trust.

The main role of the executor under a standard will is to administer the estate. This includes receiving all of the assets and paying out liabilities of the deceased. The balance is then distributed to the beneficiaries. Once the administration of the estate is complete, the executor's duties have ended.

If the will establishes a testamentary trust on the other hand, then upon the death of the person creating the will, the role of the Trustee of the testamentary trust commences and is ongoing. As the trustee has control of the trust, they must be able to act in the best interests of the beneficiaries.

Administration of a Testamentary Trust

The Trustee must keep regular and accurate financial records for taxation

purposes. In addition, there will be ongoing administrative costs involved in maintaining a trust, such as accountancy fees for preparation of trust taxation returns. That means that it is important to determine whether the income generated by your estate would be sufficient to justify the establishment of a testamentary trust.

Benefits of a Testamentary Trust

Tax and Income Splitting - A testamentary trust can result in taxation benefits because distributions of income can be made to beneficiaries at lower marginal tax rates. Any income gains, capital gains or franked dividends can be distributed among all family beneficiaries each year in the most tax-effective manner.

Asset Protection - A testamentary trust ensures that assets remain within the family and are used to benefit family members. A testamentary trust can provide protection against financially-irresponsible beneficiaries and beneficiaries becoming involved in matrimonial disputes which place assets at risk. A significant advantage of a testamentary trust is that the assets are owned by the trustee (not the beneficiaries) but the benefit of income and capital of the trust passes to the beneficiaries.

Control - A testamentary trust allows individuals to exercise control over the use or disposition of the assets that form part of their estate. The terms of a testamentary trust are set out in the will. These terms can restrict the ability of any of the beneficiaries to control the activities and investments of the trust or give them complete control.

The drafting of a testamentary trust is more complex than a standard will. The cost of preparing a will and creating a testamentary trust will vary depending on the complexity of the drafting required to meet your wishes.

Super and the bring-forward provision

With recent increases in Excess Contributions Tax, it has become important that individuals clearly understand the bring-forward provision.

The bring-forward provision applies to individuals that are less than 65 years of age at any time in a financial year and who exceed the non-concessional cap in that year.

The bring-forward provision is not available if it has been used in the previous two years.

If an individual makes non-concessional contributions of more than $150,000 in a particular financial year, the bring-forward provision will be triggered automatically. If this happens, the normal non-concessional contributions cap does not apply for the next two years. Rather, the total contributions individuals can make can make over the subsequent two years cannot exceed $450,000 (less the contributions that were made in the year the bring-forward provision was triggered).

You may not be aware when you have triggered the bring-forward provision.

It is important to consult your accountant about this to ensure that you do not contribute too much or you will have to pay extra tax.

Trustees disqualified and penalised

The Australian Tax Office holds a firm disposition and will take action against SMSF trustees who fail to comply with superannuation laws. Actions include making a fund non-complying, disqualifying trustees and making applications to the courts seeking the imposition of monetary penalties.

A recent case highlights the ATO's view on the seriousness of non-compliance.

In Olesen v Parker [2011] the Federal Court imposed penalties on husband and wife trustees whose actions seriously contravened the superannuation laws. Penalties totalling $50,000, plus $5,000 in legal costs, were imposed by the courts.

These penalties were additional to previous action taken by the ATO which included disqualifying the trustees and making their SMSF non-complying, effectively removing their income tax concessions. This resulted in a $139,570 income tax liability.

The husband and wife, as trustees, made a number of loans to related entities. Their actions resulted in breaching the in-house asset rules, the arm's-length investment rules and the sole purpose test.

The court took a number of factors into consideration when looking at the seriousness of the trustees' actions. These included the nature and extent of the breaches, the trustees' understanding of their obligations under the superannuation laws and the amount of loss or damage caused.

The court found that the trustees' actions were deliberate and repetitive, having taken place over a three years period. The trustees also clearly understood their obligations under the superannuation laws, having been permitted to rectify previous breaches by way of an enforceable undertaking.

The market value ratio of the fund's in-house assets exceeded the 5% limit in each of the relevant years. The court also found that the contraventions placed the fund assets at a significant risk. By time the contravening period came to an end, the account balance of the fund was reduced to almost nil.

The courts also took into account the dominant role played by one trustee in relation to the contraventions. The penalty of $50,000 was apportioned in the amounts of $35,000 and $15,000.

The court found that such penalties strike an appropriate balance between deterrence (specific and general) and penalty for the contravening conduct.

This decision provides a sound warning to trustees who do not comply with the superannuation laws.

Property depreciation

Maximising property depreciation deductions requires a clear understanding of how the different parts of a rental property qualify for Division 40 or Division 43 of the Tax Act. A property depreciation report ensures that deductions are maximised by correctly classifying assets so that qualify for Division 40 and Division 43.

Division 40

Division 40 is that part of the legislation that covers the depreciation of "plant and equipment". That is, the removable fixtures and fittings within an investment property. Each plant and equipment item has an effective life set by the Australian Taxation Office (ATO) and the depreciation deduction available on that item is calculated using this effective life.

Some of the Division 40 items commonly found within a property include hot water service, ovens, ceiling fans, dishwashers, rangehoods and air conditioners.

Division 43

Also referred to as 'Capital Works Allowance' or 'Building Write-Off', Division 43 covers the deductions available to owners for the structural elements of a building and the items within the property that are deemed irremovable. These items include the foundations, walls, ceiling, and roof. Other fixed assets like tiles, toilets, built-in cupboards, windows and doors also fall under Division 43. Properties qualify for this allowance depending on their age and type; either 2.5% or 4% of a property's historical construction cost or estimated cost can be claimed by a professional such as a quantity surveyor.

The Great Division

The distinguishing feature between Division 40 and Division 43 is that Division 40 items depreciate faster. For example, while the building structure (Division 43) can be claimed at a rate of 2.5% over 40 years, carpet (Division 40) in a residential property depreciates at a rate of 20% over 10 years (using the diminishing value method).

Some items can be easily incorrectly classified when categorising them into a Division 40 or Division 43 deduction. A common mistake occurs with air conditioning. An air conditioning unit, for instance will fall under Division 40. The ducting throughout the house, on the other hand, for the same air conditioner falls under Division 43. Similarly, a swimming pool falls under the Division 43 allowance, but the pumps for the pool qualify for Division 40.

When these assets are not classified properly, money is lost in the early financial years following the purchase. Often the obvious assets classified as Division 40 and the more inconspicuous items sometimes overlooked. This often results in them being combined with Division 43 and claimed at 2.5% instead of the much higher rate based upon their effective life. That may means a significant difference in the deduction for the property investor.

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The Bookshelf

The Great Crash Ahead
Author: Harry Dent

Known for his theories on the demographic influences of the economy and his predictions for the next Great Depression, consultant and author Andrew Dent returns with his latest release The Great Crash Ahead.

In this book, Dent argues that with the deflation in stocks, real estate and other commodities between 2009 and 2012, the major depression that we are headed towards could last for over a decade.

While Dent's doomsday predictions are depressing, his theories are persuasive and elaborated in descriptions of historic economic trends and cycles. He outlines what we can expect to see in the difficult times ahead and discusses the unprecedented investment opportunities that will arise when assets eventually fall in value.

Dent warns that the worst of the housing downturn will occur between 2010 and 2013 and suggests staying out of the market until then. He advises aging baby boomers to wait until early 2015 to buy their dream vacation or retirement homes and that those hoping to "trade up" should do so between 2015 and 2020.

The book makes a series of other well-supported predictions to consider and, while largely discussing the economic decline in the US, can easily be applied to situations in Australia and globally.

The Great Crash Ahead should not necessarily be used as a guide on which to base your investment decisions but Dent presents an interesting case and his book is certainly worth a read.

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