Newsletter

July 2016

Edgeworth Partners

Introduction

Welcome to our July Newsletter. In this month issue, we discuss business premises CGT exemption, debt consolidation, borrowing to pay super contributions, Centrelink, income protections insurance and super, Brexit, and various aspects of family home.

Please feel free to pass this newsletter on to any other person who you think would find it beneficial. And, if you would like to discuss your own super situation, please do not hesitate to contact us.

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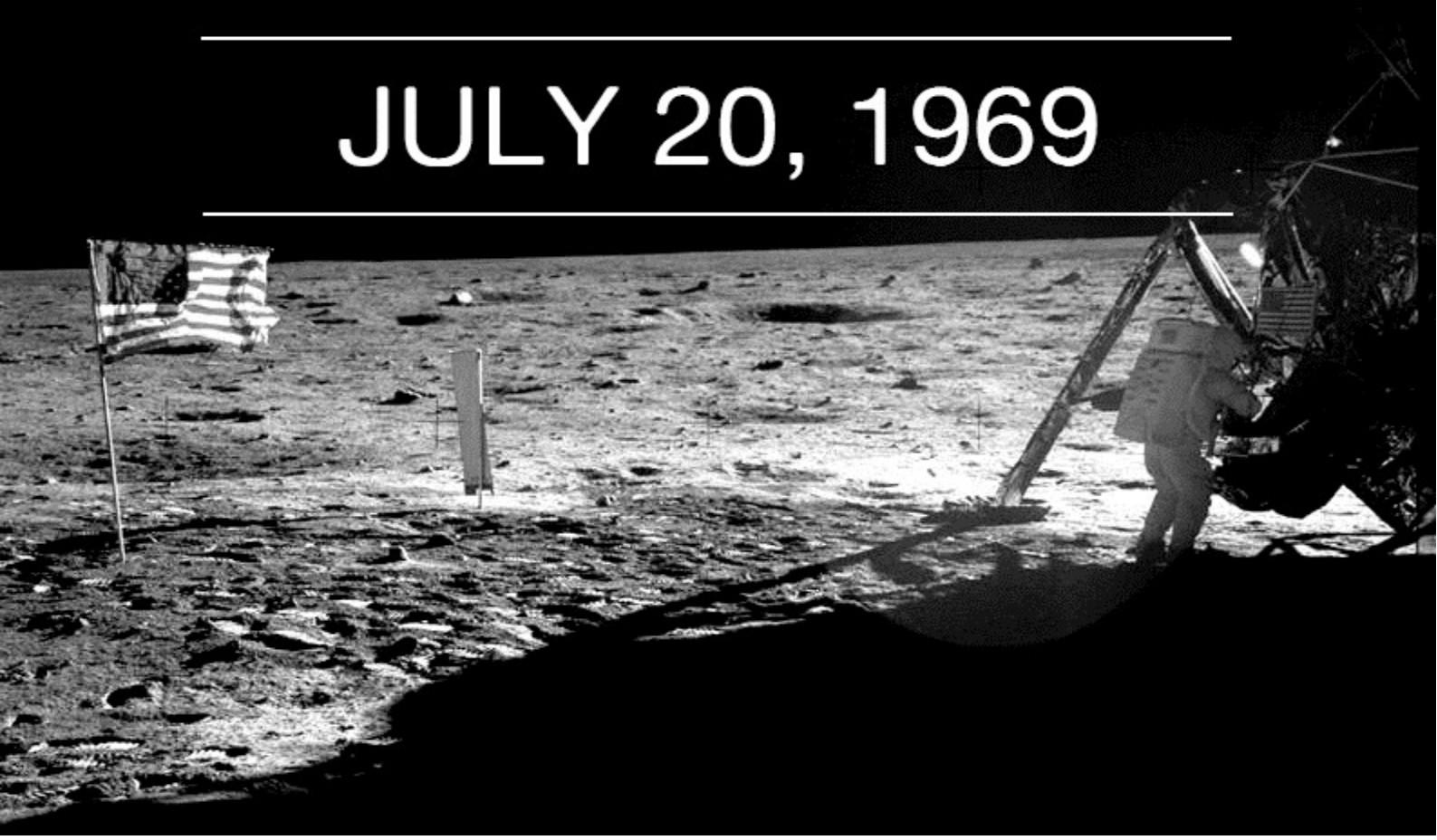

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Business Premises CGT Exemption

Are you self-employed? Do you own your business' premises? If not, should you?

Your business premises can be one of the most effective ways to make money from your business. And best of all, the gain on the property can often be enjoyed tax-free. Let us explain.

Many business owners do not realise their business premises are usually CGT free assets as well: the small business CGT rules apply to business premises as much as they apply to the business itself.

You can read about this yourself if you like, on the Tax Office's own website: **Selling commercial premises.** Let us quote from that site ourselves:

If you are a small business entity and the property you sell is your business premises, you may be able to reduce the capital gain using one of four small business concessions:

- *15-year exemption: If your business has owned the premises for 15 years and you're 55 or over and are retiring, or are permanently incapacitated, you won't have an assessable capital gain when you sell.*
- *50% active asset reduction: You can reduce the capital gain on your premises by 50%.*
- *Retirement exemption: Capital gains from the sale of your premises are exempt up to a lifetime limit of $500,000. If you're under 55, the exempt amount must be paid into a complying superannuation fund or retirement savings account.*
- *Rollover: You can defer your capital gain until another event happens that crystallises the gain. For example, if you sell your existing business premises and buy different premises for your business within a certain period, you can defer your capital gain until the new premises are sold.*

This makes business premises, such as an office, a great investment because it is highly probable that these four exemptions will combine to eliminate any capital gain on the ultimate sale.

Business premises can be any property from which you run a business. It could be a small factory for a plumber, a shop front for a Pilates practice, a farm for a farmer, a bigger factory for a manufacturer and so

on. It can even be a residential property if it is used for business purposes: "business premises" is a function of purpose, not architectural design.

(That said, be careful treating your own home as a business premises. There is not usually any tax benefit in doing so, because the home is a CGT-free asset anyway).

The CGT small business concessions mean that any property investment used as your business premises will generate a better after tax return than the identical property not used as business premises. It is hard to beat a tax rate of 0%.

If you would like to know more about how your business premises could be enjoyed CGT-free, then please get in touch with us. We would be only too happy to show you how to maximise your property investment's performance.

Should you think about debt consolidation?

Are you experiencing high levels of personal debt? If so, then you should think about debt consolidation.

Debt consolidation is where you combine one or more expensive loans into a single loan facility with a lower interest rate. Usually, the new loan is secured in some way and it is this security that allows for a lower interest rate to apply.

A common example is where you have equity in a home and you are also paying higher interest rates on personal debts, such as a personal loan that you may have been taken out to pay for a holiday, a car, or similar. In that case, you will usually be better off taking out a loan secured against your home and use the money drawn on that new loan to pay out the other debts. This will get you an immediate reduction in your total interest costs. Debt consolidation can even allow you to repay an entire loan without needing any extra money.

Think about this example: you have a $15,000 personal loan on which you are paying 14% interest. The loan is for seven years and your monthly repayment is $281. You also have a home loan on which you are paying 5% interest, and from which you can redraw an extra $15,000.

The personal loan is costing you $1,800 a year in interest. If you redraw on the home loan to pay out the personal loan, then the interest bill falls to $750 a year. If you continue to pay $281 per month, you will repay the $15,000 in just five years and one month: the move saves you 23 months of repayments, or $6,463 in extra repayments. Put another way, the move reduces the repayments by more than 40% of the amount that you borrowed in the first place.

Put still another way, the total amount paid over the five years is just $17,141 – meaning the total interest is just $2,141. Under the personal loan, the total repayments were $23,604, which includes interest of $8,604. You reduce the total interest bill by more than 75%.

If you want to see another example, have a look at this article from the AMP. It is a **simple example of a common presentation** where 19% of the interest expense that clients faced each month derived from just 7% of their debts – the expensive credit card and personal loan debts. Consolidating these debts reduces the overall interest bill by 13%.

Debt consolidation can be especially effective where you have credit card debt – the most expensive type of debt of all.

If you have expensive personal debt, or someone you know does, then please get in touch with us to discuss your debt management needs. If we can't help you ourselves, we will happily explain what you need and put you in touch with a licenced credit adviser who can help you.

Borrowing to pay super contributions - a great retirement strategy

If you are self-employed, then you know one thing for sure: there is never enough cash to do everything that you want, and finding money for deductible super contributions each June is tricky.

You should think about whether you can pay your super contributions using debt. The contribution cap for the 2016/17 financial year for clients aged 50 and over is $35,000, or $2,915 per month. If you are under 50 the cap is $30,000, or $2,500 per month.

If cash flow is a problem, consider gearing the contributions. This has always been a relevant strategy but becomes even more if you are approaching 60 as there is no tax, or limit, on the amount of the lump sum benefit able to be taken out of (what is probably your) SMSF at age 60, or later. At this point, the money you take out can be used to retire the debt taken on to finance the contributions.

A 59-year-old client might event can borrow in one year, make the contributions and achieve an immediate tax benefit, and then withdraw from the super fund in the second year to retire the debt.

This strategy boils down to tax deductible debt reduction, and can be a powerful strategy, particularly for those who have left super planning a little late. Which, incidentally, is most business people.

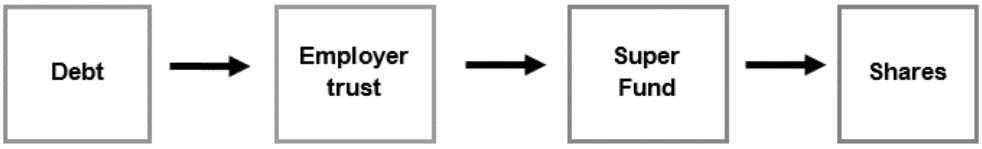
For example, hairdresser using a trust to run her business can have the trustee company borrow to pay a $35,000 deductible employer contribution, pick up a tax break each year and then pay the benefits out, tax free, at age 60 to retire the original borrowing.

Trusts facilitate such strategies because, unlike companies, there is no rule against loan accounts from trustees to beneficiaries. This means a trust can borrow to pay a large

deductible super contribution of, say $30,000, and then remit an equal amount, i.e. the $30,000 cash generated by the business, to the owner without triggering a tax charge.

Unfortunately, the strategy does not work for a business being operated via a company: the loan to the owner would be treated as an un-frankable dividend in the owner's hands, which creates an effective total tax charge of more than 60%.

Diagram - The idea looks like this:



Borrowing to pay deductible contributions is primarily an investment strategy. Borrowing to invest is a sound idea, when done prudently. This is because economic theory and economic history show that in the long run, on average, the rate of return on each of the major asset classes is greater than the cost of borrowing.

Ultimately you have borrowed to buy shares. This is fundamentally a good move. But running it through a concessional contribution strategy means you pick up an extra super/tax driven return. This makes the investment strategy sing, and significantly reduces risk.

Only employer contributions can be geared

Interest incurred by an employer to pay concessional contributions for employees is deductible under the general deduction rules.

But interest incurred in connection with non-concessional contributions or personal contributions is not deductible. So, the tax deduction on the interest can only be claimed by the trustee company, not by you as an individual. That said, if you operate in your own name, you can claim a deduction for interest on money borrowed to pay the deductible super contributions of any employees you may have. This can include family members.

Borrowing $30,000 all in one go might be confronting. Given it is now July, you might consider setting up a series of twelve smaller borrowings of $2,500 each, to be direct debited into your preferred super fund. Doing this also allows the fund to make smaller investments spread out over time, a practice known as dollar cost averaging, which is also a really good idea.

So, don't leave it to the end of the new financial year: start your super and investment strategy this month, and then sit back and let time do the rest.

Centrelink makes virtual millionaires of us all

The **full aged pension in Australia**, with all entitlements, is currently worth $867 per fortnight. This equates to $22,542 per annum. This is paid by the Australian Government, so it is a guaranteed 'return' for the recipient. To use a very simple point of comparison, the current annual return on a 12-month term deposit with the NAB is 2.4%. A client would need a deposit worth almost $940,000 to generate a guaranteed return of $22,542 per year.

Therefore, one way to look at it is that the existence of the aged pension constitutes a safety net for every Australian aged over 65 – and that safety net is worth up to $1 million in terms of its ability generate a guaranteed, inflation adjusted return.

For this reason, when we meet people on a full or aged pension we often observe that they have become a bit too conservative a bit too soon with any money they do have to invest. While the logic is understandable (people on a pension have not got much to lose), the reality is that a person on a pension can consider adopting a less conservative investment strategy than they might otherwise think. This is especially the case given that the pension is paid regularly; this regular payment can actually allow the investor to take the longer term timeframe on their investments that they might otherwise think they need to avoid.

If you receive, or may be eligible for, any type of Centrelink benefit, it is essential that you investigate all the legal ways to maximise your Centrelink benefits. Centrelink is a complex beast, and so it would be our pleasure to meet you, or someone you know, to discuss how Centrelink might be managed to your best advantage.

Income protection insurances and superannuation

Taking out some of your risk insurances using super can be a smart move.

For business owners, doing so effectively makes the premium tax deductible. This maximises the after-tax efficiency of the premium. In summary, it gets a greater after-tax sum insured for the same after-tax premium. It is definitely in many client's best interests to do this.

Of the major forms of risk insurance, traditionally income protection insurance is not held inside a super fund. This was because of concerns about when benefits could be paid: the circumstances giving rise to a benefit being paid may not be a condition of release under the super law. This could result in the super fund receiving a benefit payment form the insurer, but the benefit remaining 'stuck' inside the super fund, where the client could not access it.

Since 1 July 2014 these concerns have disappeared: all insurances offered inside a super fund must have policy wordings that align with the conditions of release under the super law. This means income protection benefits have narrowed, to align with the more restrictive conditions of release.

But premiums can still be funded out of super benefits. This is particularly pertinent to clients with clear and significant risk insurance needs (also known as a mortgage, a spouse or kids. Or all three), but a limited capacity to pay their premiums out of non-super monies (usually because of the mortgage, the spouse or the kids. Or all three).

If cash flow allows, then it is usually a better idea to hold income protection in your own hands, where he premium is tax deductible to you. But, as we say in the previous paragraph, many people simply cannot afford to pay their insurance in this way. If that is you, then it might be a good strategy to hold income protection insurance through a super fund.

Come and talk to us to get an idea about your specific situation. But do be aware that income protection held through super:

i. may mean a less generous definition of disability;

ii. does not create significant immediate tax benefits, because the premiums would have been tax deductible anyway;

iii. will reduce your super balance, which may mean that long term retirement benefits will be less than otherwise; and/or

iv. may create a need for additional catch up super contributions may be needed in later years.

This means you need to weigh the advantage of increased insurance cover in the short term against the disadvantage of decreased long term retirement benefits.

So, income protection through super is not right for everyone. But it may well be right for you, especially if you are short of immediate cash. Why not give us a call and discuss your risk insurances with us.

Brexit and the Market's Volatile Mood

Brexit. One word, and not even a real one. But a reality that managed to **wipe more than $2.7 trillion** off world share markets in just a few days. That is one expensive referendum.

The Australian share market fell in proportion. When the market opened on Friday June 24, the ASX 200 rose ten points to just a tick under 5,300. By the end of the day it had fallen almost 200 points, or just under 3.8%. By the morning of Tuesday, the 28th, it had fallen a further 50 points, meaning that the total fall was almost 4.8%.

Individual prices in the share market are supposed to reflect what the market thinks the whole company is worth. Multiply the number of shares on issue by the share price, and you get the market's view of what the whole company is worth. Work this out for all the companies on the exchange, and you get what the market thinks all of the companies are worth.

So, between Friday the 24th and Tuesday the 28th, the market decided that the total value of Australian shares was reduced by almost 5% because England decided to leave the European Union.

The market got something wrong: there is no way that Brexit reduced the value of Australian companies by that much. Either the market was over-estimating the value of companies on Friday, and Brexit brought the market to its senses, or the market over-reacted to Brexit and the fall on Tuesday went too far.

Our thinking is that the market went too far. But this is what markets do. And it is precisely this tendency to over-estimate the effect of specific events that means that regular trading in the share market is a mug's game. One thing is for sure: no one was predicting on Friday that prices were about to plummet. That is the whole point of a shock: people do not see it

coming. And trying to buy and sell often in a market where you do not know what is coming next is a sure fire way to lose money.

Share investing, either directly or indirectly, is a long-term venture. When you buy a share, you should be thinking of holding that share for at least ten years. This is not to say that you must hold the investment for that long. You might change your mind at some stage, if new evidence comes to light. But you should expect to hold it for a long time.

It is a lot like starting a business. When you start a business, you expect that the business will succeed and that it will give you a good income for many years. But things may change: you may find that business conditions are not what you expected, and you need to cut your losses. This is the same as selling an under-performing share in which you have lost confidence. More optimistically, you may find the business goes very well and you get an offer to buy it that is too good to refuse. This is the same as selling a share that you think has risen beyond its fair value. But you should not start a business expecting either of those things will occur. You expect to run the business for the foreseeable future.

Remember this as you contemplate Brexit. Many people are tempted to jump out of the market after a fall like the one that Brexit triggered. The trouble is, the fall has already occurred, and anyone who sells faces the difficult decision as to when to re-enter the market. Many people will have sold shares in the last few days, only to find that the market will have risen by the time they are again confident enough to buy. Selling low and buying high: an inevitable conclusion to short-termism in the share market.

Death and the family home

For many people, the family home represents a major part of their estate. Family homes are usually owned in one of two ways: either as an individual or as a co-owner. The form of ownership informs how the estate is managed when the home owner passes away.

Individually-Owned Homes

Where a family home is owned by one individual, either because they have always owned it individually or because they are the last remaining survivor (see below), the home typically forms part of the deceased person's estate.

The simplest way for a person to therefore plan for this part of their estate to be managed is to prepare a will. Assuming they do so, the home will then be treated in accordance with the owner's legal will.

For example, if a sole owner has a will that requires that their estate passes to their children in equal shares, then the house will transfer along those lines. This means that if the home is kept, the children will own it as tenants in common (unless they agree to change the ownership to one of joint tenancy). If the home is sold, the proceeds of the sale are distributed between the children.

Co-Owned Homes

There are two ways in which a home can be co-owned by more than one person. The method of co-ownership will determine what happens to the home when a co-owner dies.

The first form of co-ownership is joint tenancy. The second is tenancy in common.

Joint Tenancy

Joint tenancy is the most common way for couples to own a home. It is relatively rarely used by people who are not couples.

Under a joint tenancy, if one owner dies his or her interest in the property automatically goes to the surviving co-owner/s. The passage of the interest to the surviving joint tenant/s is known as **survivorship**. To take the most common example, if a husband and wife own a home as joint tenants, and the husband dies, the wife becomes the sole owner of the whole property.

If there are more than two joint tenants, and one dies, the deceased co-owner's interest is shared between the remaining co-owners.

When it comes to estate planning, the key aspect of joint tenancy is that the deceased's interest in the property does not form part of their estate. This is because that interest effectively ends when they die.

The principle of survivorship means ultimately there will be one remaining surviving owner of the property. This last remaining owner is not a joint tenant: they own the property as an individual. Accordingly, when that person dies, the property does form part of their estate and it is treated as we described above for individually-owned homes.

Estate planning and joint tenancy

Joint tenants must still attend to their estate planning around their property. This is because there is a chance that they will one day own the property as an individual – their fellow co-owner/s might die first. In fact, in most cases one of the joint tenants will end up owning the whole property as an individual. (The only time this will not happen will be if the joint tenants sell the home before the second-last joint tenant dies).

Accordingly, people who own their family home as a joint tenant should still prepare a will that sets out what they want to happen to the home when they die.

Because of the rules for joint tenancy, the order of death of the joint tenants is important. This is particularly the case where the wills of the joint tenants do not treat their estates the same way. For example, a couple in a second marriage might each leave their estate to their respective children from their first marriages. This could mean that the family home passes to the children of just one of the couple – the one who dies second. When the first member of the couple dies, the property passes to the survivor. When the survivor dies, the property passes to the survivor's children.

In cases like this, there are a number of options. One might be for the property not to be owned under a joint tenancy, but instead for use to be made of a tenancy in common. This is discussed below, and means that the deceased's person share of the property passes to their estate when they die. (This arrangement is usually qualified by allowing the surviving spouse to stay in the home until it is sold or they move elsewhere or they die). In cases like this, expert legal advice is typically needed when the estate is being planned.

In very rare cases, joint tenants will die simultaneously (perhaps in a car accident or similar). In such cases, the law usually **deems that the older person died first**. Under the rules for joint tenancy, this means that the home will be disposed of as per the estate planning of the younger joint tenant. Once again, if the joint tenants do not have the same will, this can lead to unintended consequences.

Taxation treatment upon death of a joint tenant

When a property passes from one joint tenant to the survivor/s, no capital gains tax event has taken place. CGT will only become an issue if and when the property is sold by the survivor/s or passes to their estate.

At that point, the proceeds of the sale will be subject to normal capital gains tax rules. For a family home, this will of course typically mean that no CGT will be payable, as the **principal place of residence** exemption applies.

Tenants in common

Under tenancy-in-common the principle of survivorship does not apply. Each co-owner's ownership right is transferable. This means that a share of ownership owned by a tenant in common does form part of the deceased's estate. That is, when a person who co-owns a home as a tenant in common dies, the interest in the home does not automatically pass to the other co-owner/s. Instead, it passes to the client's estate and is distributed according to their wishes.

Tenancy in common is relatively uncommon when it comes to family homes. However, situations do exist for this type of ownership.

For example, consider a female client who owns a property with her sister as a tenant in common. Each of the sisters has a will leaving their assets to their own children. When one

of the sisters dies, those children acquire the co-ownership rights to the property. They will then own the property as tenants in common with their auntie. If the remaining sibling then dies, her ownership rights will pass to her children. The home will now be co-owned by the remaining children of each sister, who are cousins of each other.

Where a home is owned as a tenant in common, it is most commonly planned for **under the client's will**.

Taxation treatment for property inherited from an individual owner or a tenant in common

The inheritance of the ownership of a home will generally not be taxable if the home qualified as the deceased person's **principal place of residence**. The principal place of residence exemption applies if the home is **sold up to two years after the owner's death**. This timeframe exists to allow the deceased's executor to properly manage the estate without feeling time pressure to dispose of assets.

If a home qualified as a deceased person's principal place of residence, and the inheritors decide to keep it, then they will be deemed to have acquired the asset at the time it was transferred to them. When eventually the inheritor disposes of the asset, the tax treatment will depend on how they used the property. If they used it as a principal place of residence, then **they too will qualify** for the principal place of residence exemption and not pay CGT. If, however, they did not use it as a principal place of residence (for example, if they rented it out while they lived elsewhere), it will be taxed as the disposal of an investment asset. This will typically mean that it will qualify for the 50% exemption on capital gains tax if the property is held for more than 12 months.

Importantly, the CGT is calculated from the time the inheritor took ownership of the property – not from the time the deceased person acquired it.

Expert Advice

The taxation of inheritances and deceased estates can be complicated. For that reason, wills can only be prepared by a solicitor. We can assist you to obtain high quality wills from a reputable legal firm who have prepared thousands of wills over the years.

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.

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