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Eight investment pools in the new tax hierarchy

INSIDE

1 Eight investment pools in the new tax hierarchy
5 The AI Revolution is No Segway
7 Expansionary Budget'23 adds to interest rate risk
9 Q&A: Ask a Question

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There are only two reasons why people save for their retirement in the superannuation system. One, they are forced to by the compulsion of the Superannuation Guarantee, and two, to take advantage of the favourable tax treatment. The latest tightening of concessions is coming with the new 15% tax on balances over $3 million, and it adds another layer of decision-making for those affected. It is no longer straightforward that the more in super, the better.

Tax planning can become extremely complex and nuanced for individuals. This article looks at the major investment pool choices and taxes but does not attempt to address every individual circumstance.

BEFORE YOU GET STARTED

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Access to superannuation

The tax advantages of superannuation come at the cost of lack of access until one of the Conditions of Release is met. However, despite successive governments and reviews confirming super is intended to finance retirement, there are no limits to taking money out of super when the member:

- has reached their preservation age and retires
- ceases an employment arrangement on or after the age of 60
- is 65-years-old, even if they haven't retired.

Therefore, when a government introduces a new super tax, most members in retirement can adjust their investment structures and if advantageous, take money out of super without paying an exit tax. The new 15% super tax brings other choices into focus.

The tax hierarchy of investment pools

The new tax may bring a level of complexity to investment pool allocation which is more trouble than it is worth. It's a personal decision but many people do not want to spend their retirement years, after decades of working hard, balancing investments between different pools to minimise tax.

On the other hand, retirees are affronted by the constantly-changing rules, when all they have done is used the superannuation system to save as they were encouraged to. They feel the rules of the game are tightening because they have played it well, and they will respond accordingly.

The simpler world of the past was to own a home by the time of retirement, leave some money outside super to spend, and hold as much in super for the tax advantages. For those who can be bothered, it's not so simple anymore.

Let's consider the investment pools according to tax treatment.

Pool 1. Investments outside super using tax-free thresholds

Personal income tax is calculated using tax-free thresholds with concessions for older people, such as the Senior Australians and Pensioner Tax Offset (SAPTO). For Australians generally, the tax-free threshold is $18,200, but for those subject to SAPTO, personal incomes less than about $32,000 for individuals and couples combined above $58,000 are tax-free. Some people will avoid the complexity and costs of other structures by investing in their own names but check eligibility using a SAPTO calculator.

Pool 2. Superannuation in pension mode

A pension fund is tax-free for both income and capital gains, and the member pays no tax on a pension received. The Transfer Balance Cap (TBC) which places a limit on the amount that can move from accumulation to pension was initially set at $1.6 million, is currently $1.7 million and will move to $1.9 million on 1 July 2023. These limits are per person meaning a retired couple will soon have access to $3.8 million when opening new pension accounts (existing caps do not change).

In a few years with indexing and inflation staying stubbornly high, these limits will reach the $3 million level, as the TBC is indexed but the $3 million cap is not. Over time, hundreds of thousands of people will start balancing the opportunities of tax-free super against the $3 million tax.

It is sometimes claimed that Pool 2 is superior to Pool 1 because Section 116(2)(d) of the Bankruptcy Act provides that superannuation is excluded from property divisible amongst the creditors of a bankrupt person.

Pool 3. Investment in a Principal Place of Residence

Although many people argue a home is not an investment, the favourable tax treatment for social security eligibility and lack of capital gains tax means many Australians consider their home as a place to store wealth. The tax system encourages expensive homes and renovations as a way to both enjoy wealth tax-free and qualify for government benefits. There is no cap on this expenditure and a person can live in a $10 million home and receive a full age pension.

The above three pools allow investment without paying any tax.

Now we move into the pools which minimise but not eliminate tax.

> Investors can place money into a personally-controlled company which is a separate legal entity. Unlike a trust, there is no requirement for a company to distribute income each year, allowing the company to accumulate assets like other savings pools such as superannuation.

Pool 4. Superannuation in accumulation mode

In accumulation mode, earnings are generally taxed at 15%, although there are further concessions for capital gains on assets held for longer than 12 months. Franked dividends can also offset tax liabilities.

Pool 5. Superannuation balances over $3 million

The new tax will commence on 1 July 2025 and apply from the 2025-26 financial year onwards for individuals with more than $3 million in super on 30 June 2026. Firstlinks has covered the choices and consequences extensively and we will not repeat all the alternatives in this summary.

It is incorrect, however, to describe this as a 30% tax regime, by adding the 15% tax in accumulation mode and the new 15% tax on balances over $3 million. The definitions of 'earnings' in each are radically different, with the most notable being the taxation of unrealised capital gains in the high balance calculation.

An asset that rises in value by say $1 million in a financial year will face the new $3 million tax calculation, but if unrealised, it is not in the first 15% tax on accumulation funds. It may also not be taxed at 15% because it is the proportion over $3 million that is taxed. Plus it is possible to hold $3 million in a pension account which is taxed at zero, then pay 15% on the rest, without paying 30% in total.

The additional 15% tax brings into play comparisons with other tax structures which pay tax at 30% but are not subject to the tax on unrealised capital gains.

This is where the new tax changes the game for those planning their tax affairs according to the tax consequences.

Pool 6. Family trusts

A trust is a structure that holds assets on behalf of beneficiaries. Family trusts are used to distribute income, and therefore tax obligations, amongst multiple family members, especially to lower-income earners.

For example, a family trust might include two high-income parents on the highest marginal tax rate and two children who are adult full-time students with no other income. The investment income could be redistributed to the students, subject to special rules on taxing income of minors under 18-years-old.

A trust must distribute income in the same year the income is earned but it cannot distribute losses which can be used to offset capital gains either in the same year or carried forward. Trusts are eligible for the 50% capital gains tax discount after holding an asset for over 12 months.

Anyone setting up a trust should seek professional advice and expect ongoing costs, and there are other factors to check. For example, some Australian states charge higher land taxes on trusts.

Pool 7. Private investment companies

Investors can place money into a personally-controlled company which is a separate legal entity. Unlike a trust, there is no requirement for a company to distribute income each year, allowing the company to accumulate assets like other savings pools such as superannuation.

The tax rate is 25% or 30% depending on circumstances, which may be less than marginal tax rates. When dividends are paid by the company, the franking credits held by the company pass to the recipient.

A company is not eligible for the capital gains tax discount afforded to individuals and trusts. Companies have initial set up costs, ongoing advice and administration costs.

Investors may utilise a structure where one of the beneficiaries of a trust is a 'bucket' company. The company receives income from the trust which is then invested by the company and taxed at company tax rates rather than higher marginal personal tax rates. Assets can be held in the company and income distributed later. One advantage of this structure is the earnings in the company are not subject to tax on unrealised capital gains, as the new $3 million super tax imposes.

Financial advisers and accountants are already promoting this structure to clients.

> When personal taxable income is less than the tax-free threshold, the company can pay dividends into the pool allocated for personal income, until the pool is full. Where more income is needed, a company can pay back some of the money invested.

Pool 8. Others such as investment bonds, family loans and philanthropy

All investment portfolios are unique based on individual preferences and circumstances, and an infinite array of ways to accumulate wealth or spend money. Many alternatives can fit into this final pool but three are increasingly popular.

One, investment (or insurance) bonds will become more competitive due to higher tax rates on super and are worth considering by anyone who has a marginal tax rate greater than 30%. As long ago as 2015, Firstlinks published an article called, “Will insurance bonds become the new superannuation?”.

Two, with the rise in residential property prices and interest rates, adult children increasingly rely on the Bank of Mum and Dad (and maybe the Bank of Grandfather and Grandmother) to buy a home. Instead of leaving money to children in an estate, parents gift or loan money earlier. It has also become common for bequests to skip a generation and go straight from grandparent to grandchild.

Three, with wealth accumulated, more people turn to philanthropy, including giving to charities or opening Public or Private Ancillary Funds, which not only help those less fortunate, but give the donor a tax deduction.

Interplay between pools

Faced with many choices, investors do not need to set and forget. They can rebalance between the pools regularly as values rise and fall and tax implications change.

For example, while the limits on the amounts that can be invested in superannuation continue to tighten, there are no limits to the amounts invested in companies, trusts or insurance bonds.

When personal taxable income is less than the tax-free threshold, the company can pay dividends into the pool allocated for personal income, until the pool is full. Where more income is needed, a company can pay back some of the money invested.

Money must be drawn out of a superannuation pension fund each year according to mandated minimums.

And critically, at some stage, a major decision is required when to transfer money out of super to avoid the 17% ‘death tax’ when super is inherited by a non-dependant who is not a spouse.

How does this relate to the common ‘bucket’ strategies?

The use of these pools based on expected tax treatment should not be confused with the common financial planning technique of using ‘buckets’ to manage income needs.

This strategy involves dividing a portfolio into different buckets according to expected cash flow needs. There is a cash bucket of highly-liquid assets for living expenses, maybe based on cash needs for a few years to avoid selling down a share portfolio if the market falls. A second bucket might include bonds or term deposits that provide income but mature in three or four years. Riskier assets such as shares are placed in a third bucket for longer-term growth.

This bucket strategy can operate alongside the pools. For example, a retiree could include cash in each of a superannuation, personal or company pool and draw out as needed. However, a product like an investment bond would need to fit into a longer-term bucket.

Graham Hand is Editor-At-Large for Firstlinks. This article is general information and does not consider the circumstances of any person. Disclosure: Graham personally holds some of the investments mentioned in this article.

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The AI Revolution is No Segway

BY TRENT MASTERS

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Every year in technology there are advances and breakthroughs that are lauded as having the potential to fundamentally transform how we live and work. Sometimes it is true and the economic gains to be made are enormous; think of the transformative impacts of the internet and smartphones which gave rise to the modern-day corporate behemoths of Apple, Google, and Amazon. Then sometimes it is not, such as 3D TV's, the Segway or the Juicero.

But beyond the pure commercialisation potential of a technological breakthrough, there is a second dimension to the investment case which is time, as being too early can be the same as being wrong. Before I had kids, I fully expected that by now I'd be shipping them off to Saturday sport in an electric and autonomous vehicle while being able to watch their games and cheer them on from a personalised drone. Yet there I was last Saturday, some 9yrs later, standing in the mud and rain at a suburban field after battling morning traffic in my internal combustion engine vehicle. In the meantime, EV focused companies such as Faraday Future, Fisker, and Better Place have failed, while in autonomy, Ford and Volkswagen invested $3.6bn into Argo AI before it closed its doors and Uber gave up on any autonomous aspirations. And the 2019 Elon Musk promise of 1m robotaxis by the end of 2020 remains somewhere out on the distant horizon (along with my free time on Saturdays).

Turning to the present, and the past year has seen no shortage of tech-based hype. I sat in the Morgan Stanley TMT conference last year as many Venture Capital Fund titans thoughtfully espoused the virtues of Web 3, the metaverse and crypto architecture. And to be honest my eyes glazed over as it felt like these new technology concepts spanned a hammer looking for a nail, a niche application, and something that was a waste of resources. But there has been one piece of emerging tech that I think has genuine and immediate potential, and that is AI.

Artificial intelligence (AI) is one of the fastest growing and most disruptive technologies of our time. From voice assistants and self-driving cars to personalized medicine and financial analysis, AI is revolutionising the way we live and work. As a result, it has become a major area of investment for businesses, governments, and individual investors alike (FYI Chat GPT wrote that last section). It is a tectonic shift in technology opening a plethora of tangible use cases and commercialisation potential, and the timing is now.

Using Microsoft as an obvious example, the integration of AI across their platform creates tangible and valuable product extensions. Microsoft has close to 500m paying

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Commercial Office users and generates approximately $150 per user per year. One of the first AI product extensions for Microsoft is Teams Premium that comes with automatic minutes, personalised highlights, and AI generated summaries and action points, and comes with a list price of $10 per user per month (or $120 per user per year). This is an 80% uplift in base Commercial Office pricing for just one product extension. Roll these AI extensions out across the broader Office 365 product platform and the pricing uplift could be multiples of current levels. For reference, every additional $50 in average price per Commercial Office user adds $25bn, or 12.5% to revenue. And this is before any uplift in Azure cloud consumption also washes into earnings. Beyond Microsoft, there are the large language models themselves, the infrastructure to support the step up in compute intensity, the interfaces to facilitate application development and the applications themselves. The opportunities are multi-dimensional and significant.

In terms of timing, the reverberations of this AI inflection aren't way off in the future but are happening now. IBM with their recent results announced the suspension of hiring for close to 8,000 back-office roles that they feel could be replaced by AI over the next 5yrs. And on 2nd May, Chegg became what looked like the first victim of the AI inflection with the online education support provider falling more than 40% following signs that Chat GPT is displacing their education support subscription services. The tip of AI related infrastructure demand is also already emerging in some recent earnings reports.

The value creation (and Chegg-like destruction) that will flow off the back of this AI inflection will rival that of the internet and smartphone, and I expect that a future Apple, Amazon, or Google with rise from this current period of dislocation. Could this new giant be around healthcare diagnostics, automation tools, financial advice? It is too early to tell for sure but for the first time in years I am genuinely excited about the explosion in investment opportunities that will unfold in the coming years off this particular technological breakthrough.

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Informed Investor provides financial content solutions at both the retail and adviser investment level. Engaging and informative content solutions.

Expansionary Budget'23 adds to interest rate risk

BY HUGH GIDDY

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As you sip your morning coffee and read this, consider the following questions:

- Have central banks, including the Reserve Bank of Australia (RBA), accurately anticipated inflation historically?
- Do you believe the RBA's modelling of inflation outcomes will be correct now?
- Are their actions in raising the cash rate slowly to the current low level (including the latest small increase), consistent with their commentary that inflation is very damaging to an economy and must be reduced, despite Australia experiencing higher core inflation than other developed countries, with unemployment continuing to be very low?
- Is the RBA not focussed on house prices as they publicly profess? Do they not care about the favourable wealth and consumption effects of rising house prices and feel no need to intervene or act to cushion weaker house prices?

If you are shaking your head to the questions, you are probably fretting about how monetary policy and inflation are eroding your spending power and possibly your wealth. If you are nodding your head and place your faith in the Reserve Bank, it is likely you have not considered the record closely, or are simply a happy beneficiary of the unsustainable asset price bubbles central banks have fostered with loose monetary policy over more than a decade.

Despite inflation falling modestly to 7% in the latest figures, economists think the Reserve Bank will not raise rates much further even though the cash rate at 3.85% is well below headline and other measures of inflation, either because they have done enough or are simply too dovish to really care about inflation.

A recent Resolve Political Monitor poll showed that two thirds of people believe young Australians will never be able to buy a house. In the short term that may have favourable economic effects as young people might spend freely rather than saving towards an unattainable goal, supporting retail sales in the economy. However, the inequality resulting from asset prices rising much faster than incomes is nothing to celebrate.

Common sense should have dictated that inflation would rise significantly at some point. Crazy theories were floated that the governments should spend freely to stimulate the economy, financed by effective money printing by central banks. It is fair to say that modern monetary theory, "MMT", or more aptly, "the magic money tree", has already been disproved. While central banks like to point to Covid impacts on the supply and transport of goods as the cause of higher prices, it is disingenuous to not also point to the massive surge in demand as money poured into the economy with easy money and massive government deficits.

If central banks are unlikely to preserve the purchasing power of your savings and wealth, what are your best options? If you believe house prices will continue their heady progress despite poor affordability, that may be an option. However, net yields on investment properties are generally below funding costs, despite surging rents. Cryptocurrencies so far have not performed well in the face of inflation and the reality check of rising rates. Bonds have been terrible performers since the days when markets believed inflation and interest rates would stay down almost indefinitely. Term deposits are less unattractive than they were with zero rates, but the post tax income still trails core inflation by a significant margin.

The outlook for company shares essentially depends on two factors: profits or earnings (overall these depend on the economy) and valuation (which is influenced by interest rates and sentiment). Higher interest rates are putting some pressure on both the economy and valuations, but the stockmarket is never homogenous. We believe there are appealing avenues for protecting your wealth and purchasing power if you are selective in the current market, despite the index being close to record levels. Features to look for in companies are pricing power or the ability to recover cost increases without significantly impacting sales volumes; providing an essential good or service; and a strong balance sheet; but not at any price of course. A few examples are below.

Aurizon has inflation indexation on its rail haulage contracts with miners and other customers. Volumes have suffered with La Nina's widespread flooding, but are likely to normalise as El Nino reasserts itself. Earnings on the regulated rail tracks or "below rail" rise as the asset base is adjusted for inflation and the regulated return rises as interest rates increase with inflation. Finally, the company's recent purchase of the Adelaide to Darwin rail line (OneRail) is likely to favourably surprise the market if it is successful in signing up new mining customers in the centre of Australia. The longer term vision of moving containerised imports around the country more cost effectively could really change profits and perceptions of the business.

Telstra is finally able to benefit from its extraordinarily strong market position and historical investment in its network. After years of losing fixed line customers to the NBN and facing a price war in mobile services, the company has delivered strong earnings and a higher dividend. Telstra put through mobile plan price increases, telling customers who are becoming conditioned to price increases generally, that plans will go up in price annually with some linkage to inflation. The annuity cash flow from the NBN, which is renting Telstra's ducts and exchanges, is indexed to inflation.

The Lottery Corporation enjoys long-dated licences and a monopoly position. Prices have been increased on various games with players largely accepting the increases. Rule changes on games like Powerball have increased jackpot frequency and hence interest in the games. Increased digital uptake by customers increases the margin for the company, which combined with rising revenues has created a favourable profit trajectory. Although lottery tickets are a discretionary purchase, history has demonstrated that lottery revenues are remarkably resilient in economic downturns.

A portfolio of quality businesses such as these could be a key pillar in defending your wealth against the ravages of inflation. It remains unclear how much central banks are aiding in the fight.

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Q&A: Ask a Question

Question 1

What is the difference between a testamentary trust and a family trust?

A testamentary trust and a family trust are two different types of trusts with distinct characteristics:

1. Establishment: A testamentary trust is established through a person's will, coming into effect after their death. It is created specifically to distribute assets according to the instructions outlined in the will. In contrast, a family trust is established during the lifetime of the person, used for various purposes, including asset protection, estate planning, and tax efficiency.
2. Purpose: The primary purpose of a testamentary trust is to ensure the proper distribution of assets after death, according to the testator's wishes. It is often used to provide for minors, individuals with special needs, or to protect assets from potential risks. A family trust is more versatile and can serve various purposes such as wealth management, asset protection, tax planning, and succession planning.
3. Control: In a testamentary trust, the testator's instructions in the will govern how the trust is managed and assets are distributed. Once the trust is established, the testator has no further control or ability to amend the trust. A family trust is typically more flexible. The settlor can retain control as the trustee during their lifetime and can make changes to the trust provisions or beneficiaries as circumstances change.

Consulting with a financial adviser is recommended to understand the specific implications and advantages in your situation.

Question 2

Should I own my insurance personally or through superannuation?

The decision of whether to own insurance personally or through superannuation depends on your individual circumstances and needs. Here are some factors to consider:

1. Tax deductibility: Life, TPD & Income Protection (IP) insurance through superannuation are tax deductible to the super fund at 15% whilst IP held personally is tax deductible at your marginal tax rate. These can affect the cost-effectiveness of the policies.
2. Cash flow: If you prefer not to pay insurance premiums out of your regular income, having insurance through super can be advantageous since it uses your superannuation balance.
3. Flexibility and control: Owning insurance personally gives you more flexibility and control over the policy, including the ability to customize the coverage and make changes as per your requirements.
4. Consider your super balance: If you have a low superannuation balance, paying insurance premiums from it may deplete your savings faster.

It's advisable to consult with a financial adviser who can evaluate your situation and provide personalized advice based on your specific circumstances and goals.

Question 3

What is a transition to retirement (TTR) and how does it work?

A Transition to Retirement (TTR) is a financial strategy available that allows individuals who have reached their preservation age to access their superannuation benefits while still working.

The primary purpose of a TTR strategy is to provide individuals with flexibility and options as they transition into retirement. Individuals can reduce their working hours or salary while supplementing their income with the TTR pension payments. This can be particularly beneficial for individuals who want to gradually ease into retirement rather than stopping work abruptly.

Here are a few key features and considerations related to Transition to Retirement:

1. Accessing superannuation: The preservation age varies based your age, ranging from 55 to 60, depending on your date of birth. Once you reach your preservation age, you can commence a TTR withdrawing a certain percentage of your superannuation savings as an income stream while still working.
2. Tax on payments: If you're under the age of 60, some of your pension payments may be subject to tax based on your super tax components.
3. Pension payments: The amount you withdraw is based on a minimum and maximum percentage of your account balance, which is calculated annually.

It's important to note that the specifics of a TTR strategy can vary and it is recommended to consult with a financial adviser who can provide personalised advice based on your individual circumstances.

If you have a question that you would like to see answered in **Wealth Adviser**, please send it through to **centraladvice@wtfglimited.com.**

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