Keeping wolves from door

NOEL WHITTAKER

It's a big word, but testamentary trusts are simple in operation.

ACCUMULATING enough money to retire on is one issue – trying to protect it for our beneficiaries is another.

In many cases the best option is to include a testamentary trust clause in your will. Don't let the term scare you, it's worth taking the time to get a grip on it.

First, understand how a normal family discretionary trust works. This is a legal entity, created by a trust deed, which is able to own assets and invest money. However, it does not pay tax in its own right. It acts as a funnel that passes the income down to its beneficiaries, who pay the tax instead. It is called a "discretionary" trust because the trustees have discretion as to how much income goes to each beneficiary.

Suppose Harry earned $180,000 a year and was paying a huge chunk of tax. If that income could be diverted through a discretionary trust, $36,000 each may be distributed to Harry, his wife and their three adult children, and the overall tax bill would fall dramatically.

Now I appreciate that normal employees cannot divert their incomes to a trust, and trusts don't save much tax if the children are young. However, a testamentary trust, even though it is generally similar to a discretionary trust, enjoys two major differences. The trust is created by the will when the testator dies, not by a separate trust deed, and there is no $416 restriction on distributions to children. Distributions to minors from a testamentary trust are taxed at normal adult rates, which means the first $18,200 is tax-free.

Think about a couple who have three children and several grandchildren. The eldest child is a well-paid professional with a high net worth and a stable marriage, the second is in a rocky domestic relationship, and the third is battling along in a business whose profitability is doubtful and which might go belly-up at any time.

The retirees have substantial assets that include three rental properties and a large amount of money in superannuation. Naturally they wish to leave these assets to their children, but they are savvy enough to realise that simply leaving a third of the estate to each child could create a minefield. The eldest child has more than enough income now and any extra would be taxed at 49 per cent; money inherited by the second one could be up for grabs in a divorce settlement; while creditors could seize any money left to the third child if his business went bankrupt after their death.

The solution is to leave the money to three testamentary trusts – one for each child. Then, when the parent dies, one third of the assets will go to a testamentary trust for each of the three children and will not be held by them personally. This keeps the assets separate in the event of divorce or bankruptcy but also has taxation advantages if everything goes well.

There is no restriction on what the grandchildren do with the money, but it could be used for such expenses as school fees and uniforms. In other words, the first $18,200 of these non-tax-deductible items could be paid from pre-tax dollars, not after-tax dollars. Furthermore, when the children die, there are no costs to transfer the assets to the grandchildren, because the assets remain the property of the trust.

In short, testamentary trusts are simple in operation, and highly effective in saving tax and protecting your assets. Just make sure you take advice from your solicitor, financial adviser and accountant before you change your will.

Q I was wondering if you have heard of any proposals by the government to tamper with the current negative gearing rules, particularly in relation to claiming rental expenses against income?

A For as long as I have been writing columns in this newspaper, there have been rumours that the government is going to change the negative gearing rules. Obviously this matter is likely to be addressed in the next review of taxation but I would be most surprised if any major changes occur. Remember, it was tried once and was quickly repealed.

Q My wife and I are in our mid-50s and have about $500 a week each for investing. Neither of us has much super – we are both reluctant to pour money into super. What can we sink our money into that will give us the best return over the next 10 years: super, an investment property, a property trust or syndicate, managed funds, blue chip shares, anything else?

A There are two important factors to consider: the type of investment to hold and the best entity to hold it. For a person in their mid-50s earning more than $37,000 a year, the perfect investment is super because you can usually invest in pre-tax dollars using salary sacrifice. Because salary sacrificed contributions lose just 15 per cent and money taken in hand loses at least 39 per cent, you are making big tax savings immediately. Once the money is inside super, you and your adviser can decide what sort of asset mix is appropriate for you.

Noel Whittaker is the author of *Making Money Made Simple* and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making financial decisions. Email: noelwhit@gmail.com.

Ways to reduce the amount of tax you have to pay

By **JOHN COLLETT**

IT may be only five weeks before the end of the financial year, but there are still things that can be done to legally minimise what goes to the tax man.

There are some sophisticated ways to cut the Australian Taxation Office's take – we'll get to those later – but the easiest and quickest fix you can do is to make contributions to superannuation.

❑ **Salary sacrificing:** This swaps the income tax rate that would be paid on earnings with the lower superannuation contributions tax, which, for most people, is 15 per cent.

If you are expecting an end-of-financial-year bonus, consider putting it into your super.

The salary sacrificing of the bonus should be set up with your employer before your bonus entitlement is confirmed, says Kate McCallum, a financial adviser and director of Multiforte Financial Services. That is because salary sacrificing can only relate to future income, not past income.

Another quick fix is to take advantage of the co-contribution scheme. This is where for each dollar of after-tax money that is put into the superannuation account of a lower or middle-income earner, the government pays 50¢ into the super account.

The full 50¢ is paid to the superannuation account of anyone earning less than $34,488 a year. The maximum co-contribution the government will pay is $500. At higher incomes above $34,488, the co-contribution progressively reduces until $49,488, when it cuts out altogether.

The after-tax contribution can come from anyone, not just the person who will receive the co-contribution. For example, a higher-earning spouse could put $1000 of their after-tax income into their lower-earning spouse's account.

A spouse also has until the end of the year to make a contribution to their non-working or lower-income partner. It is called the spouse super contributions tax offset. If the partner earns less than $10,800, the spouse receives an 18 per cent tax offset in their tax return for a contribution of up to $3000, providing a maximum offset of $540. The tax benefit reduces and cuts out altogether once the partner's income reaches $13,800.

❑ **Debt management:** The interest costs on mortgages over investment properties are deductible debt.

That means that the interest costs and other costs of the investment can be used to reduce the income tax paid.

It is worth remembering that there is a debt repayment hierarchy, which, if followed, reduces the total interest costs by the most. That is, any available cash should be used to pay off the tax-deductible debt first.

You pay the non-tax deductible debt with the highest interest rate first, such as the credit card, then the mortgage on the family home and, lastly, the mortgage on the investment property.

❑ **Reduce capital gains tax:** If an asset has been sold this financial year, such as shares or an investment property, and there is a capital gain and the investment has been held for a least a year, you will be taxed at 50 per cent of the gain at your marginal tax rate.

Now is a good time to consider whether to sell any loss-incurring investments, such as shares, to help reduce or eliminate capital gains on other investments.

Capital gains must be paid in the financial year they are realised. Losses can be carried forward, but they cannot be carried back. Tax payable in this financial year can also be reduced by pre-paying deductible interest.

❑ **Claim work deductions:** Make sure you claim all legitimate work-related deductions. Taxpayers can make up to $300 of eligible work-related expenses without receipts, although records should be kept.

Work-related deductions may include mobile phone costs, subscriptions, seminars, computer equipment, calculators, briefcases and technical books.

You may be able to claim travel expenses incurred for meals, accommodation and incidentals while away overnight for work. Fees paid to a tax agent for preparing a tax return are also deductible.

❑ **Deadlines:** Tax returns need to be lodged by October 31 unless you register with a tax agent, when the lodgement date can be as late as May next year, as long as the taxpayer is not in dispute with the Tax Office. For self-lodgers with straightforward circumstances, the Tax Office has myTax, a short form of e-tax. It can be filled out online, including on mobile devices, whereas e-tax must be downloaded and has many more pages.

❑ **Small-business tax breaks:** A centrepiece of the May budget was the immediate tax deductibility of asset purchases of up to $20,000 by small businesses.

It applies to businesses with turnovers of less than $2 million on purchases from budget night, May 12, until July 2017.

Only assets valued at $20,000 or less qualify for the instant deduction. Assets with purchase prices of more than $20,000 will need to be pooled and depreciated in the normal way at a rate of 15 per cent in the first year and 30 per cent each year thereafter.