Personal Wealth Adviser

Managing your personal finances

ISSUE 4

HLB MANN JUDD
ADVISORY AND ACCOUNTING

Our Sydney personal wealth management team provides you with a simple solution for your personal wealth needs. We have specialists in wealth management, superannuation, self-managed superfunds, estate planning, debt advisory and insurance services.

THIS ISSUE ALSO INCLUDES ARTICLES ON:

- Don't just focus on paying off the mortgage, start to invest
- Legal implications of 'the bank of mum and dad'
- Pros and Cons of downsizer contributions
- How high will the cash rate go?
- Family trusts: Tax and legal considerations
- Life Insurance – what do I need?
- Expected falls in Sydney property market

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MICHAEL HUTTON
Partner, Personal Wealth Management

DON'T JUST FOCUS ON PAYING OFF THE MORTGAGE, START TO INVEST

A robust investment plan at the wealth building stage can make things much easier later.

For those who have a mortgage but also want to invest, market conditions are proving a quandary.

For starters, mortgage interest rates continue to rise with no end in sight (not until February 2023 based on current economic trends). At the same time, investment markets have generally been on a downward trend – this includes shares, property and even fixed interest investments.

What should someone with a mortgage and existing investments do in this situation?

Unfortunately, there is no hard and fast answer. The best course of action will depend on the individual's financial resources as well as which financial stage of life they are at.

Life stages

People with a mortgage and investments will typically fall under one of three financial stages of life: the homeowner; the wealth builder; and the retirement planner.

(CONTINUES PAGE 2)

For younger people and families, generally the financial goal is either all about building a deposit or paying the mortgage. Those with children will also have the costs involved with raising them. They also tend to lead very busy lives. These people are usually in the homeowner stage of life.

For those who have their mortgage under control, with perhaps less than 50 per cent owing compared to the current value of the property, it may be time to think about adding to an investment portfolio. This can take many forms, and it is up to the individual to be comfortable with the investment strategy. At this stage, it's usually not worthwhile adding to superannuation even though it can be tax effective, as the money is essentially locked away until retirement. Individuals in this situation are in the wealth builder stage of life.

Finally, those approaching retirement may be inclined to maximise their super contributions. For such pre-retirees, accessing the nest egg won't be a major issue if retirement is within sight, say within the next few years. They are in the retirement planner stage of life.

Building wealth

First, it is important to know how much "spare" cash is likely to remain in the bank account each month. Budgeting can be a difficult process, but most people can get a handle on their total expenditure by analysing their recent credit card statements.

They should then consider their regular monthly mortgage repayments and other non-credit card outgoings to determine an amount that is "spare" each month after all expenses are deducted from their monthly income. They should also think about what expenses could be reduced to increase the "spare" component.

There are three basic places to put any extra money remaining in the account at the end of each month:

- Paying down the mortgage (or adding to the offset account)
- Adding to existing investments or
- Contributing more into super.

Stick to a plan

Regardless of your financial stage of life, it's generally best to stick to the initial plan even through volatile investment markets. Even though interest rates are rising, it is from an extremely low base and buying into deflated investment markets can be a great strategy for long-term wealth accumulation.

Unfortunately, it is the wealth building stage of life that is most often overlooked. It is easy to focus on paying down the mortgage and meeting other essential costs. Once that is under control, it is also easy to allow lifestyle upgrades to creep in and use up all that available cash. Before people realise, their wealth building stage has passed without having any wealth built.

A robust investment plan at the wealth building stage can make things much easier later. By the time retirement looms, a frantic increase in super contributions may not be enough to sustain an individual's lifestyle once they are retired. It may even force a later retirement than planned.

Michael Hutton has a monthly opinion piece in the Australian Financial Review. This article first appeared as part of this series on 12 September 2022.

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ROBERT MONAHAN
Director, Estate Services

LEGAL IMPLICATIONS OF THE 'BANK OF MUM AND DAD'

Despite the recent drop in home prices in Sydney, it is still difficult for many young people to buy their first home. Nowadays it is quite common for young buyers to approach the so-called 'Bank of mum and dad'.

In Issue 2 of *Personal Wealth Adviser*, Michael Hutton's article – 'Bank of mum and dad – beware the risks' looked at some of the ways parents could assist their children in buying a house.

If parents have the financial capacity to help their children to purchase a home, then it can be an excellent way to benefit their children without the children having to wait until their parents pass away. Whilst receiving an inheritance later in life is good, in many cases the beneficiaries were in greater need of the financial assistance when they were much younger.

In providing the financial assistance there are some legal aspects to consider. The following case study explains the issues.

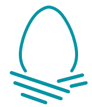
Norm and Nancy have two children, Greg and Rhonda. Consider the following issues.

1. When Greg married Susan, Norm and Nancy gave Greg the sum of $200,000 to assist he and Susan to buy their first home. Ten years later Greg and Susan divorced. The question then arose as to the status of the advance. Was it a gift or was it a loan? Greg argued it was a loan, and Susan said it was a gift to both she and Greg. If it was a loan, then Norm and Nancy could ask for the return of the funds, so that Susan didn't get the benefit of half the advance. There was no written evidence, one way or the other. The usual approach of the Family Court is that if there is no written evidence the Court is likely to decide the advance was a gift. Therefore, Norm and Nancy could not demand the money back.

2. About the time Greg and Susan separated, Rhonda married Paul. Norm and Nancy wanted to provide financial assistance to Rhonda, similar to what they had done for Greg. To avoid the same issue if Rhonda and Paul separated, they got Rhonda and Paul to sign a note acknowledging that the advance of $200,000 was a loan, repayable on demand. When Rhonda and Paul separated ten years later, Norm and Nancy asked for the loan to be repaid. Paul's lawyer advised him that the loan did not need to be repaid. The reason being that the loan became 'statute barred' six years after the loan was advanced. This was because of legislation which provides that if a loan is made 'repayable on demand' and if the lender doesn't ask for the money back within six years from the date it is advanced, then it cannot be recovered.

So, what should Norm and Nancy have done to protect their children? The key points are as follows:

- Make sure there is a written agreement stating the advance is a loan.
- Provide a definite repayment date. That can be something like 30 years, but with provision for an earlier date being on say three months written notice. That means that if a separation occurred after 10 years, the lenders could then give the required earlier notice of three months.
- Whilst the agreement does not need to include an interest provision, it should include an obligation to make some annual repayments of capital, which can be nominal, such as $100 per annum.
- Whilst there does not need to be a formal mortgage agreement, Norm and Nancy should get some legal advice to ensure the written loan agreement is enforceable after the statutory period of six years.



PRUE CHEESEMAN
Adviser, Personal Wea;th Management

PROS AND CONS OF MAKING DOWNSIZING CONTRIBUTIONS INTO SUPERANNUATION

Did you know that if you sell your home you may be able to make an extra contribution to your superannuation of up to $300,000 each?

There are a just a few rules though ...

From 1 July 2022, you may be eligible if you are over age 60 and make a contribution within 90 days of settlement of a sale (or part sale). To qualify, you and/or your spouse have owned it for at least 10 years and lived in it as your main residence at some point. The property cannot be a caravan, houseboat, or other mobile home.

Whether or not you buy a new home, the maximum contribution is $300,000 for each spouse (unless total proceeds were less than that), and you cannot claim a tax deduction for the amount or have previously made any downsizer contributions. You must provide your super fund with the ATO Downsizer contribution into super form. Invalid downsizer contributions will be treated as personal contributions or rejected for individuals over age 75.

... Phew!

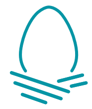
So now that you know you can make a downsizer contribution, the question becomes whether you should.

Pros

- The main reason you would want to put an extra $300,000 each into super is because super is the most tax effective structure for your retirement savings. You can have a superannuation balance of up to $1.7M, to be used to start a tax-free pension, i.e. no tax on earnings or on pension payments.
- Is your super balance over $1.7M or are you retired? Unlike other contributions, it doesn't matter if you are retired or if your super balance is over $1.7M, to be able to make downsizer contributions. This may be the last large contribution you can make to boost your balance for retirement.
- Downsizer contributions can be made even if your property was used partly for rental. The amount of the proceeds that you can contribute is the portion that is applied for the main residence exemption. When the property is more than 2 hectares this can get complicated, and you will likely need to seek advice from a tax specialist.
- You are able to make downsizer contributions using assets you already own. This can be particularly useful if you need the cash proceeds to fund a new home purchase and you have a Self-Managed Superannuation Fund. As long as the market value of the asset is equal to the disposal proceeds, it can used to fund the contribution.
- Do you have a high taxable component in super at the moment? Downsizer contributions are made 'after-tax' and boost your tax-free balance. This means they also come out tax-free and are not subject to 15% tax upon death if passing to a non-dependent beneficiary (e.g. your children).

Cons

- Do you have high personal taxable income? Downsizer contributions cannot be used as a personal tax deduction so if you have higher income you may wish to allocate some of the amount to claim a tax deduction instead.
- You can only use this opportunity once, so depending on your situation, you may consider strategically utilising your non-concessional cap first. This is because once your super balance is over $1.7M, you can no longer make further non-concessional contributions.
- You need to meet a condition of release to access your super. So if you are under age 65 and still working, you need to consider if you will need accessibility to this money e.g. to buy a new home. If so, locking it away in super might not be the best place for it.



- Are you receiving, or expecting to receive Centrelink benefits, including the Age Pension or Commonwealth Seniors Health Card? Selling your home and contributing proceeds to super can affect your eligibility. This is because while the home is exempt from the assets test for Centrelink purposes, superannuation that has not been grandfathered is subject to a deemed rate of income as part of the income test.
- Of course, another aspect to consider is that if you sell your home, what will you purchase to replace it, and will you have any spare funds left over to fund the strategy?

So, as you can see there is a lot to think about when considering if you should make a downsizer contribution and whilst it is a great opportunity for some individuals to boost their superannuation, it might not always be the best path to take.

Superannuation contribution rules are complex. It is a good idea to seek advice. If you are interested in learning more about the types of contributions you can make, please contact us.

BETTY PRESHAW
Director, HLB Debt Advisory

HOW HIGH WILL THE CASH RATE GO?

Since May, the Reserve Bank of Australia has increased the cash rate from a record-low 0.10% to 2.60%, leaving many to ask: how high will the cash rate go?

The big four banks have given different answers to that question, with their economists forecasting that the cash rate will peak at:

- 2.85% for Commonwealth Bank
- 3.35% for Westpac and ANZ
- 3.60% for NAB

In a recent statement to the House of Representatives Standing Committee on Economics, the RBA's Governor, Philip Lowe, practically guaranteed that future rate rises were coming, but did not forecast a peak.

The RBA "expects that further increases will be required to bring inflation back to target", but was "not on a pre-set path", he said.

The link between interest rates and inflation

Governor Lowe's reference to inflation is the key to the question of how high the cash rate will go.

That's because the main reason the Reserve Bank is increasing the cash rate is to crush rising inflation, which rose to 6.1% in the June quarter.

This ties in with the RBA's mandate, which says, in part, that the central bank must aim to "achieve an inflation rate of 2-3 per cent, on average, over time".

Here's the link between the cash rate and inflation:

- When inflation is too high, it means there's too much demand in the economy
- So, lowering inflation means reducing demand
- Higher interest rates reduce demand, by reducing the incentive for consumers and businesses to borrow and spend money
- When the RBA increases the cash rate, banks increase their interest rates
- So, increasing the cash rate leads to lower inflation

Inflation is likely to keep rising

Australian Bureau of Statistics data show that inflation has been trending up over the past quarters:

JUN 2020	-0.3%
SEPT 2020	0.7%
DEC 2020	0.9%
MAR 2021	1.1%
JUNE 2021	3.8%
SEPT 2021	3.0%
DEC 2021	3.5%
MAR 2022	5.1%
JUN 2022	6.1%

Unfortunately, inflation is likely to go higher before it goes lower, Governor Lowe said in his recent statement.

"It is expected to increase further over the months ahead to peak at around 7.75 per cent later this year. Inflation is then expected to start declining, to be back around 3 per cent late in 2024," he said.

Governor Lowe also made it clear the RBA sees rising inflation as a serious threat to the economy.

"High inflation damages our economy, worsens inequality and devalues people's savings. High inflation also makes it very difficult to sustain, or increase, real wages. It is a scourge," he said.

Governor Lowe acknowledged that hiking the cash rate was making life hard for a lot of people. "The alternative, though, of allowing higher inflation to become entrenched would be even more difficult and it would damage our economic prospects," he added.

That suggests the RBA will keep pushing up interest rates until it's convinced it's crushed inflation.

When will that be? And, therefore, how high will the cash rate go?

Well, not even the Reserve Bank knows, according to Governor Lowe.

"At some point, it will be appropriate to slow the rate of increase in interest rates and the case for doing that becomes stronger as the level of interest rates increases. As I have said previously, the size and timing of future interest rate increases will be guided by the incoming data and the Board's assessment of the outlook for inflation and the labour market," he said.

HELENA YUAN
Director, Tax Consulting

FAMILY TRUSTS: TAX AND LEGAL CONSIDERATIONS

In Issue 2 of *Personal Wealth Adviser*, we looked at the general benefits of a family trust, here we will explore some more specific aspects of a family trust.

I thought my trust is a 'family trust', or is it?

The answer is, yes and no. This is where the tax world and legal world diverged. In a traditional sense, the trust you've set up for the benefits of your family group is a family trust. This type of trust generally has a broad group of potential beneficiaries in your family group, and the beneficiaries do not have a fixed entitlement to the trust's income or capital.

However, from the tax perspective, your typical family trust falls under the category of 'discretionary trust', and your trustee has to make a 'family trust election' in order to become a 'family trust' for tax purposes.

It's completely voluntary to make a family trust election (FTE) and when a trust is created, the trustee does not automatically make an FTE.

What are the key benefits of making an FTE?

From a tax perspective, a typical discretionary trust still enjoys many tax concessions, but it is deemed to be unable to pass franking credits to the beneficiaries where the total franking credits in any given year is more than $5,000. This can be a significant limitation for many family groups who use discretionary trusts as an investment vehicle.

Consequently, in 1995 the government introduced the concept of FTE to overcome some deficiencies in a discretionary trust.

One key benefit of making an FTE is the trustee would be able to pass franking credits to beneficiaries.

Another key benefit is allowing the trustee to bypass the complicated rules on how to recoup prior year's tax losses and to access concessional rules to recoup prior year trust tax losses more easily.

Is there a downside with making an FTE?

The main disadvantage of making an FTE is the trustee would be charged a special tax – known as 'family trust distribution tax' – when it makes a distribution to a beneficiary outside a family group of a 'nominated individual', as defined by the tax legislation.

Family trust distribution tax is payable at the top personal marginal tax rate, plus the Medicare levy (for a total of 47% at the time of writing), and the affected beneficiary cannot claim this tax as a credit. If the trustee is a company, the trustee and the directors of the company are jointly liable for the tax.

A well-advised trustee should seek professional advice to weigh up the benefits and disadvantages before making a FTE. The tax professional could also provide guidance on choosing the appropriate person to be the nominated individual – sometimes referred to as the specified individual or the test individual – which is central to making a FTE.

Legal considerations for trustees of family trusts

A trust deed is a legal document created at the start of a trust's life. A trustee of the trust is obliged to act in accordance with the terms contained in the deed and, as such, the trustee must always check the trust deed before distributing any trust income, to identify who is eligible to receive a distribution.

There may be unwanted legal and tax consequences if a distribution is made to an ineligible beneficiary, for example, the beneficiaries may bring legal actions against the trustee for failing its fiduciary duties towards the beneficiaries; the distribution made to an ineligible beneficiary would be deemed to be ineffective and depending on the deed, the tax on that portion of the distribution could be borne by the trustee at the top marginal rate.

However, the author is not a lawyer and the readers should seek their own legal advice if there is any concern raised by comments on legal matters.

Once a trust also has a FTE in place, the trustee would have to manage an added level of complexity, it must carefully ensure a beneficiary is eligible to receive a distribution under the trust deed and is in the family group of a nominated individual for tax purposes.

While a trust structure still has many benefits, it's a complicated arrangement. Trustees should consult the trust deed and consider seeking professional legal and tax advice in order to properly discharge their responsibilities.

ANDREW KENNEDY
Risk Adviser, HLB Insurance Services

LIFE INSURANCE - WHAT DO I NEED?

If you're like most Australians, you know that you probably need Life insurance but you're not quite sure what cover you need or how much you should take out.

Life insurance can be valuable to all Australians at various stages of life, whether you're young and single, starting a family or buying a house, or beginning the transition out of the workforce and into retirement.

Everyone's situation is different, so there is significant value in undertaking a formal review of your circumstances, needs and objectives with an insurance professional. However, here are some of the typical goals and needs that can be addressed with an appropriate insurance portfolio.

Just you - Are you in your 20s or 30s and single?

When most young Australians finish school, tertiary education or trade training and enter the workforce, we're young, healthy and single or in an 'informal' relationship - life insurance is likely to be the last thing on our minds.

Typically, we're in the prime of our lives and feel like we're bulletproof. We're thinking of other expenses and focusing on enjoying the moment or exploring the endless opportunities that lie ahead.

Often, we find out the hard way that life can be unpredictable. So, it doesn't hurt to plan for the unexpected.

If something unforeseen were to happen, would your immediate family be able to cover your existing loans and expenses? If you could never work again, could your family afford to support you financially for the rest of your life?

What's more, you might be able to get a better premium for life if you're able to lock in your policy while you're young and healthy, as opposed to when you're older and health complications start to arise.

All of us - Just married, expecting, buying your home?

As life progresses and we start settling into our career, shifting focus to the longer term, we might get married or think about having children. It might be time to buy the family home and take on a mortgage. We now have dependants who are relying on our ability to work and generate an income for life's necessities - a roof over their heads, food on the table, education and security.

This is when most of us start to consider what might happen to the ones we love if the unthinkable happens. It's at this stage in life when many Australians start to consider life insurance to provide their family with a financial safety net so they're not left struggling to keep up with the mortgage payments, childcare or school fees, or everyday living expenses without you.

Just us - transitioning to retirement

We may think that life insurance is just about providing a lump sum to our family or loved ones if we were to pass away. Life insurance is much more than that.

Many Australians don't start intentionally planning for retirement until later in life, often after the children leave home and the mortgage is paid off. We might leave ourselves with 15-20 years to save for retirement after other expenses end. It is important to protect your ability to earn an income as you approach retirement to ensure your wealth accumulation plans aren't unexpectedly cut short.

Additionally, life insurance can give you the financial freedom to live life on your terms with the knowledge that your family will not be under financial stress to pay for their living expenses, your medical fees or even your funeral costs.

What can HLB Insurance do to help?

A life insurance professional can help you explore what options may be right for your needs.

What's more, there have been significant changes in the insurance sector over the last 5 years, and many Australians who already hold insurance policies are experiencing significant increases in premiums at renewal. Your risk advisor can help to review your policies to determine if they remain competitive compared to the market.

JONATHAN PHILPOT
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SYDNEY PROPERTY - NOT WHAT IT USED TO BE!

It is hard to argue with property investors when they have invested in an asset class that has achieved an annual capital gain of 7.2% for the last 40 years, and that is exactly what a three-bedroom house in Sydney has achieved to 30 June 2022 (source ABS, Tim Farrelly). There have been pauses along the way, but only for a short period of time and then the recovery has been swift and new highs are reached.

However, as Warren Buffett has noted, past returns and future returns are quite different things. A prudent investor will try to understand what factors have driven past performance and then consider how those drivers will behave in the future.

You may be thinking that it is inflation, rent increases and wages growth that is the key to driving such large gains, but further analysis of this shows that it is actually only a small part. The table below shows the total increases rather than annualised increases because it more clearly demonstrates the disconnect between these variables:

Capital gains on median Sydney three-bedroom house prices

PERIOD	40 YEARS	30 YEARS	20 YEARS	10 YEARS
Housing Price Increase	1503%	588%	244%	125%
Inflation (CPI)	296%	111%	65%	25%
Wages	374%	161%	91%	30%
Rents	282%	162%	107%	29%

Source: ABS, REIA; Farrelly's analysis

So, what has driven the surge in Sydney property prices for the last 40 years? It is largely what the banks will lend to us. Many people will recall when we had home loan interest rates that were close to 20% at their peak in 1990, from there it has been a downhill run, up until a few months ago, to about 2%. Yes, there have been periods when we had a rising interest rate cycle, but again for the most part of the last 30 years has been falling interest rates. This has meant that a family can borrow a lot more than 30 years ago.

We can also calculate how much banks are willing to lend, this is based off our earnings, what percentage of our earnings we need for living, and the current interest rate plus a buffer the banks have too allow for rising interest rates.

We can turn the above into an 'Affordability Index' which becomes a predictor of house price movements. While actual house price changes take some time to adjust, they do tend to follow the index over a long period of time.

While we now have higher wages growth than we have had for the past 10 years, which is assisting with the 'Affordability Index', the size of the recent interest rate increases and the expected further rises into early next year is having a significant negative impact on this index. The average variable interest rate will move from 2.5% to be closer to 6%. Banks will lend 30-40% less over the next 18 months. This implies Sydney property prices have about 25% to fall over this same period.

Some of the above fall has already started to come through, but most of the downward movement will be felt next year. For investors the long-term outlook is not great, the growth in Sydney house prices will probably only be 1 to 3% p.a. for the next 10 years. For homeowners, although financial considerations are not as high, if able to sell soon and then rent for a 12–18 month period, you may have a much better outcome.

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Information based on historical performance is often not a reliable indicator of future performance. You should not rely solely on this material to make investment decisions.

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