Cuffelinks
Connecting investors with ideas

Edition 28, 23 August 2013

This Week's Top Articles

- **FOFA and ASIC's five red flags** *Peter Kell*
- **Where to now for term deposit investors?** *Graham Hand*
- **Exciting times in superannuation research** *David Bell*
- **Estate planning for families with care responsibilities** *Claire Williamson*
- **Reversionary versus non-reversionary pensions** *Graeme Colley*

FOFA and ASIC's five red flags

Peter Kell

Six weeks into FOFA and ASIC's Deputy Chairman, Peter Kell, writes about ASIC's approach to FOFA and surveillance work.

The future of financial advice (FOFA) reforms are now live. Since 1 July 2013, compliance with the FOFA reforms has been mandatory.

The aim of all of us – regulator and industry – is to improve the standards of advice. FOFA provides an opportunity to take a positive step towards improving consumer confidence and trust following the turbulence in the market during the previous decade.

The FOFA reforms focus on improving the quality of financial advice provided to consumers and addressing current issues for consumers such as trust, access and affordability. Promoting the interests of clients through a best interests duty will drive advice that is better focused on the actual needs of the client. The removal of a range of conflicted forms of remuneration will help ensure that the interests of the client are given priority.

These reforms will also improve communication, engagement and transparency between advisers and clients, as well as providing a greater focus on strategic financial advice. The advice industry must increase the level of professionalism and needs to move from a sales-based culture. These are all outcomes that ASIC is very keen to see realised.

Engaging with industry

ASIC has been very busy working to facilitate the smooth implementation of the FOFA reforms. We have provided information and guidance to industry, through formal Regulatory Guides, presentations and industry liaison. We have devised solutions to some transitional implementation issues, for example in relation to fee disclosure statements, and provided some no action letters.

The success of FOFA relies on the financial advice industry accepting and meeting its legal responsibilities, and applying professional judgement during the implementation phase and beyond. Particularly in the first 12 months, you will need to apply judgement and common sense to smooth out any wrinkles and implement the reforms in a consistent and workable manner. Our guidance takes a common sense and principles-based approach to allow industry space and flexibility to implement FOFA into their business model, noting of course that there will be changes to business models.

ASIC's approach to surveillance work

In the year ahead we will be conducting both proactive and reactive surveillance activities.

We intend to visit a representative sample of licensees to understand the changes they have made to deal with the FOFA reforms and any challenges they are facing.

We will also be communicating and conducting risk based surveillances on a sample of life insurance licensees to assess the extent of life insurance churn.

We will gather information about these licensees' understanding of and compliance with FOFA to see whether we need to provide further guidance or assistance to industry.

We consider a strong compliance culture is fundamental to meeting the obligations under the FOFA reforms. If we see a poor compliance culture, it may result in a much tougher regulatory response.

We have also identified some practices which will raise red flags for us when we conduct our surveillances on advice provided after 1 July 2013. These include licensees:

1. taking advantage of exemptions from the conflicted remuneration provisions - we will be paying close attention to advice which recommends switching insurance products or changing levels or types of cover
2. over-servicing clients - we will be on the look-out for advice providers who put their clients into structures which are more complicated than the client's circumstances demand, and/or which will require more frequent or costly advice than alternative strategies
3. ineffectively managing conflicts of interest created by vertical integration - we will be looking at licensees' conflicts management arrangements to ensure they are up to date and adequate, and effectively implemented in their day to day business activities
4. keeping clients where they are even if their circumstances or needs have changed - we will pay particular attention to advice provided to clients to remain in existing arrangements and advisers who seek to avoid servicing clients in grandfathered arrangements, for example by not providing periodic reviews even though such reviews were done previously
5. avoiding giving advice – we will be focusing on examples of existing businesses who have changed their business model to offer factual information or general advice only, or product issuers who are planning to sell products on an execution only, 'no-advice' basis. Such

businesses need to be very careful that they are not unlawfully providing personal advice or holding themselves out as providing such advice

ASIC's 'facilitative' approach

ASIC has been clear that we are taking a facilitative approach for the first 12 months of FOFA. This means that where we see evidence a licensee has attempted to comply with the new requirements but has inadvertently breached them we will look to work with the licensee to rectify any problems and ensure future compliance. We will also take a facilitative approach where systems changes are underway.

We will not however take a facilitative approach to breaches which occur because a licensee failed to make sufficient effort and devote the necessary resources to prepare for FOFA, or because they or their representatives deliberately organised their activities to avoid or breach some of the requirements of the reforms.

We will also continue to take strong action against breaches which would also have been considered unlawful conduct under the pre-FOFA legislation.

We expect breaches to be reported to ASIC in the usual way, as required by the legislation. We will be more inclined to work with you in respect of a breach which has been self-reported than one which is reported to us by a third party or client.

We will continue to liaise with industry to enhance industry's understanding and implementation of FOFA.

See link to FOFA related pages on ASIC's website

http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Future%20of%20financial%20advice

Peter Kell is Deputy Chairman of the Australian Securities and Investments Commission (ASIC)

Where to now for term deposit investors?

Graham Hand

The cupboard is looking bare for the defensive allocation in a portfolio. The real cash rate in Australia is zero. The largest issuer of term deposits in Australia, the Commonwealth Bank, has a top rate out to 12 months of 3.55%, with many terms at 2.65% or less. There is no significant retail corporate bond market in Australia. The hybrids raising billions of dollars are higher risk and near the bottom of the capital structure. Bond funds are suffering price falls as longer term rates rise. High-yield equities are risky in a stock market propped up by money printing and low rates, and direct property is experiencing its own mini bubble and supply shortage – just join one of the queues at an off-the-plan launch in Sydney if you don't believe it.

Where do term deposit investors turn as billions in the 'safe cash' allocation mature?

Investors who were enjoying term deposit rates of up to 6% in the last couple of years now realise that their biggest risk was not the credit on the bank (and deposits less than $250,000 carried a government guarantee anyway), it was the rollover risk of investing for short terms. Those who shied away from equities after near-death experiences in 2008 are now facing something that was never in their financial plan – effective returns after inflation of nil.

The biggest fear is that the risk-averse investor will go into equities or property out of desperation, facing a declining standard of living as 2.5% does not generate enough income. At some stage, they will be hit by a volatility of share prices which will cause sleepless nights.

So let's look at the range of mainstream interest-earning assets available.

Priority of payment in event of liquidation

The most important starting point is where an investment sits in the risk spectrum.

Figure 1: Priority of payment in event of liquidation

Security and ranking		
	Recent corporate issuance	Recent financial issuance
Term deposits		
Preferred and secured debt		
Unsubordinated and unsecured debt	AFIC Notes Tatts Bonds	Heritage Bank Retail Bonds
Subordinated unsecured debt	APA Group Notes Caltex Notes Crown Notes Colonial Notes Origin Notes Tabcorp Notes AGL Energy Notes Woolworth Notes II	ANZ Subordinated Notes NAB Subordinated Notes Westpac Subordinated Notes
Preference shares		ANZ CPS Westpac CPS IAG CPS
Ordinary shares		

Higher ranking ↑ / ↓ Lower ranking

Source: National Australia Bank 2013

Every investor must consider the consequences of moving away from the security of cash and term deposits held by banks, but the rate improvements are tempting. For example, at major banks:

- at-call cash account, 2.5%
- 12 month term deposit, 3.5%
- subordinated debt, for example recent Westpac issue priced at bank bill rate plus 2.3%, which currently totals about 4.8%
- hybrid (preference shares), based on recent ANZ issue, BBR plus 3.4%, or about 5.9%
- ordinary shares, adjusted for franking, say 7.5%.

The most appropriate alternative depends on each unique investor circumstance.

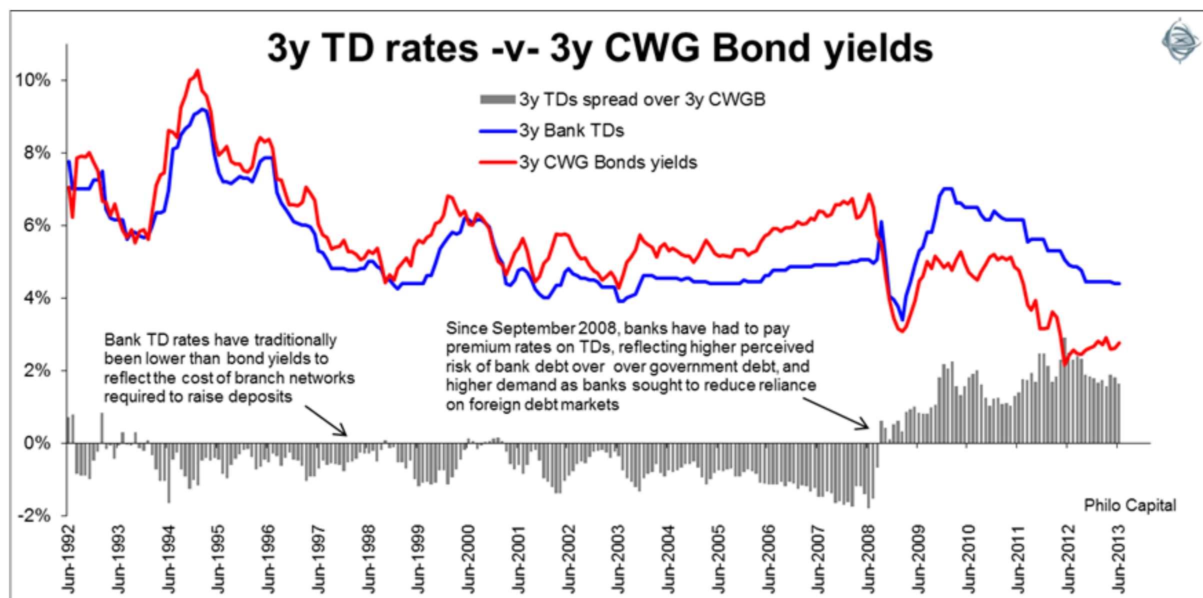
1. Online, direct at call offers

On the surface, the online savings accounts offered by many banks, including Rabobank, INGDirect, Ubank and ANZ Online, seem attractive, currently paying around 4.5%. But most have this special rate for the first 4 months only, which equates to 1.5% over that time (4.5%/3). For example, ING's Savings Maximiser drops to a miserly 2.75%. It's hardly worth the paperwork and effort for the short term 'limited time only' additional return, especially for an SMSF where several forms of identification are necessary to open a new account. Furthermore, the rate will drop in response to easing cash rates.

However, for the most risk averse, an online account which carries the government guarantee and which does not revert to a lower rate after 4 months is well worth considering, removing the argument with the bank each time a term deposit matures. For your 90-year-old mother-in-law, who may want access to cash, complete security and minimum paperwork, this is hard to beat.

2. Term deposits

Prior to the GFC, banks issued few term deposits for less than 12 months, and usually did not even match the government bond rates (CWG in the chart below). However, the GFC changed everything, not only as the banks competed hard for retail deposits to replace more volatile wholesale and offshore sources, but because investors sought the undoubted security of government bonds (in the pre guarantee days). Term deposits became the investment of choice for hundreds of billions of deposits fleeing the share market, desperate for a safe home.



That is, until the rates dropped. While term deposits are the best quality investments generally available, the 3 to 4% returns are pushing investors away, even with 'blackboard specials'. For undoubted security and a half-decent rate, there is a place in most portfolios for a term deposit allocation. By shopping around some of the international, less well-known banks in Australia, it's possible to earn 4.5% for 3 to 5 years, with the comfort of the government guarantee. But this might be a stretch on the longevity side for the 90-year-old mother-in-law.

Another factor to watch is that wholesale bond markets now deliver a cheaper cost of funds than term deposits, and so banks will gradually wind back their term deposit rates. Even a smaller bank like Bendigo and Adelaide advised this week it was keeping deposit pricing "towards the bottom end of the competitive range" and leaning towards wholesale sources.

3. Subordinated debt and hybrids

Investors who normally go for term deposits have bought hybrid instruments by the billion, but most are sold to retail investors rather than institutional. This suggests they are not priced attractively enough. As the majority are issued by Australian banks, conservative retail investors have convinced themselves they are fine, in return for the yield pick up over the bank bill rate of between 2.3% (for the better subordinated) to 4% (for the lesser convertible preference shares).

This is not the place for a full review of the myriad structures offered in this space, where almost every transaction has its unique features, making like-for-like comparisons of margins almost impossible. To make a few points:

- APRA has tightened up the rules on capital eligibility, requiring bank convertible preference shares to have genuine loss-absorbing characteristics in stress conditions. In some issues, APRA can insist on a hybrid being converted to ordinary equity if it decides a bank would be non-viable without it, but APRA refuses to explain when this might occur. Arguably, some hybrids now carry the same risk as equity in an extreme event.

- Even before these strict clauses were introduced, hybrids gave investors little protection during the GFC. For example, as shown below, the Commonwealth Bank's PERLS3 fell as low as $125 from its issue price of $200, a mark to market loss of 37%, and has not recovered pre GFC levels because spreads on bank capital instruments have repriced. The subsequent recovery is little comfort to those forced to sell in stress conditions.

  Commonwealth Bank PERLS3 Prices 2006-2013

  Source: CommSec

- In repayment rank, subordinated debt sits below term deposits but above the hybrid structures such as convertible preference shares, and conservative investors should probably limit themselves to this one rung down in the credit quality spectrum.

- The new hybrid structures are untested in stress conditions, which inevitably will face the banks again at some time. It is easy to be complacent about our best banks in stable times, but consider this recent quote from ASIC Commissioner, Greg Tanzer (AFR, 24 July 2013):

  "The figures suggest, with respect to hybrids [interest-paying debt-equity instruments], the larger proportion are bought by retail investors, and a lesser proportion by institutional investors. That does give us some cause for concern about the extent to which people are appreciating the risks involved in that area."

  ASIC is further cracking down on hybrids, including this criticism:

  "Spruiking the potential higher returns of hybrids and the brand name or reputation of the issuer without balancing that with the risks of the product can also cause investors to be misled."

With the bank bill rate potentially heading to 2%, even with these hybrid spreads over 3%, investors will be earning only 5% or so for taking equity-like risks.

4. Bond and fixed interest pooled funds

Managed funds and ETFs help to diversify exposure by holding a wide range of securities, but they are marked to market each day, resulting in price fluctuations which many investors would rather avoid. Although cash rates have been falling, the 10 year Australian government bond yield has risen from a low of 2.9% on 3 October 2012, to about 3.7%. Bond prices are more volatile than most people realise – a 10 year bond yielding 2.5% will lose 19% of its value if rates rise to 5%, and 37% of value if rates rise to 8%. Such rises are unlikely but there is enough uncertainty in the world that it's a tail risk worth thinking about, especially when the US enters its QE tapering.

The legendary fixed interest fund manager, Bill Gross of Pimco, controls US$268 billion in his flagship fixed interest fund, but it recently delivered a 4% loss in two months in the face of rising US Treasury rates. Gross compared the losses from his funds to one of the bloodiest battles in human history, the Battle of the Somme, where one million soldiers died, and his funds are in massive outflow. Even for long term investors, these are painful times for many bond fund holders.

While a direct holder of a term deposit or fixed rate bond may not actually mark their investment to market, knowing they will hold to maturity and be sure of a defined rate and a certain payment, all income-producing investments, whether they are marked-to-market or not, will behave like bonds and lose economic value when interest rates rise.

5. Unlisted corporate bonds

The lack of development of a quality corporate bond market which retail investors can access easily, supported by an active secondary market, is a major failing of the Australian financial system. There are nascent signs of its uprising, led by a few small brokers who specialise in fixed interest. These include FIIG Securities, Mason Stevens and Evans and Partners. The major investment banks such as UBS and Macquarie and their private wealth departments also source bonds for clients, but these services come at a significant cost, perhaps 1% or more of the balance under management. That's quite a hit when rates are low.

A common requirement, however, to access these bonds is a Certificate under Section 708(8) of the Corporations Act, requiring the investor to be identified by a certified accountant as a sophisticated investor (net assets of at least $2.5 million or gross income of $250,000 a year). Once this hurdle is achieved, bonds can be bought in smaller parcels, usually with a $50,000 minimum but in FIIG's case, a range of stocks is offered in $10,000 lots (but at a 'retail' price).

FIIG has probably done the most to deliver new corporate names to the market, introducing three heavily-oversubscribed borrowers in the last year – Silver Chef (8.5% for 6 years), Mackay Sugar (7.25% for 5 years) and G8 Education (7.65% for 6 years). All these bonds have rallied since

issue. FIIG has also been at the forefront of offering inflation-linked bonds (for example, Sydney Airport 2020 and 2030 and Envestra 2025) while Mason Stevens has a speciality in attractive mortgage-backed security tranches (for example, a AA- tranche can be bought for about 325 basis points above 1 month bank bill rate).

These are all welcome developments, although obviously with higher returns come higher risks. These securities do not have the credit strength of bank term deposits, but they are well worth a look for qualifying investors. It's a pity the top corporate names, such as Woolworths, Wesfarmers and BHP, are not supplying bonds to the retail market, to offer diversification away from the banks.

6. Listed corporate bonds

Take a look at the back of *The Australian Financial Review* and there is a section called ASX Interest Rate Securities. Under 'Corporate Bonds', it lists only the Heritage Bank transaction, as shown in Figure 1 above. Then there is a longer list of 'Floating Rate Notes', 'Convertible Notes' and 'Hybrid Securities'.

While this is a pretty meagre list for a developed financial system like Australia's, there are interesting opportunities worth exploring with a financial adviser. As they are listed on the ASX, they can be bought like ordinary shares in small volumes (but subject to brokerage costs), giving retail investors access to a wider variety than is often realised.

Simply to illustrate the point that there are listed corporate bonds out there, but not to recommend any of these in particular, here are a few examples:

- Peet Group is a residential real estate developer. In June 2011, it issued 500,000 convertible notes at $100 each with a fixed semi-annual coupon of 9.5% per annum. The maturity is 5 years, and it is cumulative and unsecured but ranks equally with all other unsubordinated debt. Ignoring the value of the conversion price, at its current market price of about 102.5%, it is yielding to maturity about 9%. Peet has a market capitalisation of $520 million.
- Whitefield is one of the longest established Listed Investment Companies in Australia, dating back to 1923. In August 2012, it issued $30 million (since increased to $40 million) of Convertible Resettable Preference shares paying a non-cumulative 7% fully franked dividend semi-annually, equivalent to 10% including franking. It matures in 2018, and the Net Tangible Assets are worth about $300 million supporting the preference shares of only $40 million. It is currently trading at about $115 to yield 6.7% to maturity.
- Heritage Bank Notes mature on 27 October 2014 and were issued with a 10% quarterly coupon, now trading at around 106.5% to yield around 6% to maturity. This is senior debt rather than subordinated or a hybrid, but issued by one of the smaller banks.

With any of these issues, there is a long Product Disclosure Statement, and the terms of repayment and obligations of the issuer are even more important than the interest rate. Repeating, these bonds are illustrative only of the way the ASX can provide some hidden fixed rate alternatives which are not exposed to further reductions in interest rates.

7. Annuities

At the moment, the majority of annuities sold are 'term annuities', issued for less than 10 years. They are term deposits by another name, usually backed by life companies rather than banks and commonly repaying part of the principal each year. For example, a $100,000 annuity for 6 years gives an annual 'payment' of $19,482 in the current market. This makes it difficult to compare rates on annuities with other products, which are quoted in rate terms, and investors must realise the principal is falling each year.

Annuities have grown strongly over recent years, aided by the commissions paid by life companies to advisers and the move to post-retirement planning. Lifetime annuities have also increased in popularity, and more recently, there has been innovation in the space, with both Westpac and

National introducing 'annuity deposits'. For example, Westpac's has a minimum of $50,000 and terms out to 15 years. These fit into the term deposit category in terms of security.

8. Listed equities and property

Equities and property are included here for completeness, especially since investors are flooding out of term deposits into high-yielding stocks, listed real estate trusts and direct real estate. But these assets have completely different characteristics to cash and term deposits, are far more volatile, and place the investor in another world of risk.

What are some strategies to cope with the dilemma?

Most investors face a dilemma. They traditionally rolled over term deposit investments for 6 to 12 months, but must go out 3 to 7 years in search of yield and to bed down at least a minimum earning level. However, they are exposing themselves to rising rates which, even if not marked to market, leave the potential for underperformance. On the other hand, there is a convincing case that rates will stay lower for longer.

Here are a few strategies to manage both risks, assuming the investor is managing the portfolio rather than leaving it to a fund manager:

- stagger the term exposure into a series of 3 or 5 year investments, so that there is a regular maturity pattern
- limit the amount of a portfolio committed to the long term, say beyond 5 years, as nobody wants to live on 5% if rates rise to 8%
- shop around the international banks that are less well-known in Australia, that carry the government guarantee
- consider opportunities in high quality senior ranking corporate or infrastructure bonds for qualifying investors
- use a high yield at call account, but only where the rate does not fall away after 4 months
- don't judge the quality of a hybrid by the name of the issuer – many of the new transactions have equity-like characteristics
- subordinated debt sits above preference shares in the capital structure, and may be as far down the credit table as many conservative retail investors should go.

And don't load up on equities as an alternative to term deposits, but at the other extreme, don't leave your money in a cash account earning negative real rates.

Disclaimer: the author owns many of the investment types described in this article, although he gains no financial advantage from the marketing and distribution of any of them.

Exciting times in superannuation research

David Bell

I recently attended the 21st Annual Colloquium of Superannuation Researchers. As someone driven to see better population-wide retirement outcomes, the contributions coming from the academic research community are exciting. The broad range of research areas, the techniques used to address different research questions and the overall quality of work instil me with confidence that the academic researcher community will contribute significantly to improving retirement outcomes.

While many in industry may suggest that academic research is not easily applicable to industry, the tide has well and truly turned. This conference and many others coordinated by universities (for instance the Paul Woolley Centre Conference held at UTS, another favourite of mine), involve academics, industry practitioners and representatives from industry bodies, regulators and other government agencies. There is an expanding line of engagement between academia and industry.

Highlights of the conference

The 21st Colloquium was a great event, coordinated by Hazel Bateman, with assistance from Ralph Stevens and Kevin Liu. It was originally established by David Knox, now at Mercer, when he was an academic at Melbourne University. So what were some of the highlights at this year's Colloquium? Four examples illustrate the broad range of research questions and techniques being utilised.

1. Cognitive ability and its effect on managing an SMSF

Joanne Earl presented on research she conducted alongside Paul Gerrans, Anthony Asher and Julia Woodside. Joanne is an organisational psychologist with 20 years industry experience. The focus of her research is making retirement a positive experience and she considers more than just financial outcomes. The research presented explored the influence of cognitive decline on the quality of financial decision-making in retirement, and specifically the case of those with SMSF's, where there are often more decision-making responsibilities. The research consisted of assessing a group of 103 SMSF managers aged 51 and over. The assessment considered their demographic variables (age, gender, education and superannuation balance), psychosocial variables (such as risk aversion and mastery), cognitive ability, and self-reported dementia symptoms. The research generated statistically significant results that those with self-reported cognitive dementia symptoms are more vulnerable to making poor financial judgements. This research has a clear application for those involved in establishing SMSF's, to ensure there are procedures for assessing cognitive ability and stated contingencies to deal with its onset. From a regulatory perspective if this issue is not addressed then they may need to introduce new guidelines to protect against this situation.

2. Consume now or in the future

Dan Goldstein is part of a collaborative research project between Microsoft Research and the London Business School. The project involves Nobel Laureate Bill Sharpe. The focus of the research is on self-control issues, which include saving for the future, and the battle between the desire to consume now (the 'present-oriented self') versus future consumption (the 'future-oriented' self). One interesting outcome of the research was suggestions around some retirement account engagement campaigns.

Two examples really grabbed my attention. One consisted of a photo of yourself, now and a generated projection of your future old age image (scary but also catalysing in its attempts to make you acknowledge you will be old one day). The images were separated by a horizontal slider which you could interact with to change the savings level. If you saved less 'current you', on the

left, would smile more but 'future you', on the right of screen, would develop a frown, and vice versa.

Another example took account of where you lived, and based on different rates of savings displayed pictures of different properties for lease (linked to an online real estate listing) for each savings level. Both examples highlight the need to make retirement projection more tangible and personal. They were much more engaging than what currently exists in industry.

3. Financial literacy improves financial outcomes

There is much empirical evidence that suggests financial literacy improves financial outcomes in retirement. However there has been little in the way of theoretical models which can explain why this is the case. Olivia Mitchell, Executive Director of the Pension Research Council, based at the Wharton Business School (and a leading researcher on everything to do with pensions and retirement), along with Annamaria Lusardi and Pierre-Carl Michaud extend existing theoretical lifecycle models by including financial knowledge accumulation. The model demonstrates the significance of financial literacy in explaining the variation in retirement savings outcomes across the population (based on US data). Even a little bit of financial knowledge is valuable and improves financial outcomes. This type of research provides government and regulators with certainty on this issue, thereby prompting them to act (for example by creating more financial literacy programmes at schools).

4. Deeper analysis of SMSF data

In some cases successful research can be derived by accessing a dataset which no one else can (of course it has to be analysed well!). For instance it is not uncommon for researchers at the Colloquium to wish they had access to some of Treasury's data for their own research (Treasury's Retirement Income Modelling unit provides much comprehensive retirement income research and are annual presenters at the Colloquium). The SMSF industry is an interesting case in point: it is large, fast growing and attracts lots of attention. Yet many characteristics of SMSF's have still not been deeply researched by academia. Adrian Raftery, a PhD candidate at UTS, comes from an industry background (he previously ran his own accounting and tax advice firm) and he has gained access to a large collection of ATO SMSF account-based data (obviously without personal details).

Using this data Adrian explores areas such as account size, account management costs, asset allocation and performance. Where this extends the literature (the key objective of academic research) is that the next best factual piece on SMSF characteristics is based on less than 100 accounts sourced from a single financial advisory firm in a single geographic region (so unlikely to be representative of the broader population). Unfortunately I cannot share the results with you until the paper is published but some of the facts differ from those quoted by industry and industry bodies. Once the embargo is lifted I will share these results with you.

Wide range of research

There is much to be excited about and each of the above examples will be useful for industry, including the private sector, government, regulators or industry bodies. Over time, academic research will make a good contribution to improving Australian retirement outcomes.

Estate planning for families with carer responsibilities

Claire Williamson

In our legal practice, we see families with carer responsibilities and of reasonable wealth wanting to establish special arrangements on their death to ensure that support continues to those that they care for.

Gifting your estate absolutely is not ideal for dependants who are unable to look after their own financial affairs. Our clients are typically concerned with ensuring that their wealth is preserved to provide long term assistance and in a way that does not affect social security entitlements such that those they provide care for are in a worse position.

Some strategies that we find have assisted include:

Building in flexibility – While you can predict to some degree what your financial situation might be when you die, it is more difficult to predict the circumstances of your beneficiaries and also the tax and social security regimes in place. Therefore giving your executors a range of options provides flexibility in how financial support can be structured from your estate.

Advisory team – It is not necessary for your executors to have all the legal and financial skills to assess the options, but it is desirable that they have access to a team who know your affairs and can support the executors and trustees in their decision-making with good advice. This team of advisers for financial decisions can be included in your will. It is also desirable to include a role for technical assistance on the legal aspects for your executors and trustees in case any conflicts or problems arise.

Different types of trusts and income streams – The establishment of a Special Disability Trust is a good option for many clients, as is the establishment of a testamentary trust that gives the trustee access to income and capital for the benefit of the beneficiary. Trust structures can be used to provide funds for the maintenance, advancement and benefit of the beneficiary without giving income directly to them. This retains some control over how the income is used by the beneficiary and how it will be assessed for social security purposes.

A pension from a superannuation fund is also an option where the person you care for is a financial dependant. Additionally, your estate could also be used to purchase an annuity to provide an income stream. With so many options, it is important for your executors and trustees to obtain good advice before making any decisions on the appropriate structure.

Choice of trustee – Many clients feel more comfortable appointing a trustee who has a genuine, affectionate regard for the beneficiary such as a family member or friend. A good advisory team means that this person does not need any particular skills or qualifications but is someone that you could trust to make good decisions in the best interests of the beneficiary after considering advice from your advisers. It is also a good idea to appoint joint trustees who will be able to support each other if difficult decisions need to be made.

While public and private trustee companies are always an option and will be a good solution for some, we find that the fee structure and loss of control over investment decisions make them less attractive for many of our clients.

The law in this area is complex and families should seek specialist advice to develop a plan that will reflect their intentions and be of optimal benefit to those cared for, without creating unintended consequences.

Top 5 tips

1. Give the executor the flexibility to determine the optimum structure for the dependant beneficiary.

2. Build into your estate planning a team structure of financial and legal advisers to support the executors and trustees.

3. Consider a trust structure established in your will that protects the capital of the trust but allows income to be used to support the beneficiary.

4. Plan for a trustee or trustees who have a relationship with the beneficiary.

5. Plan now. The structures do not have to be established in your lifetime but a plan should be formulated so that your wishes will have effect.

Claire Williamson is a Solicitor, Estate Planning at PricewaterhouseCoopers in Sydney.

Reversionary versus non-reversionary income streams

Graeme Colley

In last week's article, we looked at recent amendments relating to death benefit pensions.

This week, we look at whether a reversionary or non-reversionary pension may be better. The decision is not straightforward and depends on the circumstances of the case.

In the case of a non-reversionary pension, the balance of the pension at the time of the pensioner's death retains the same taxable and tax free proportions, but amounts which relate to anti-detriment and the proceeds of an insurance policy will have their own taxable and tax free amounts. In some cases, this may be to the advantage of the beneficiary and in others it may not. It all depends on the age of the pensioner at the time of death and whether the superannuation fund may have claimed a tax deduction for insurance premiums. In the case of an SMSF the funding of an anti-detriment payment is an issue which usually involves transfers of amounts from reserves and may result in issues with breaches of the excess concessional contributions caps – to be avoided at any costs.

In the case of a reversionary pension, the proportioning rule retains the taxable and tax free components of the original pension irrespective of whether the proceeds of an insurance policy are added to the pension balance after it has commenced.

Here is a case study to compare how these rules operate for the proceeds of an insurance policy:

Take the example of Ray who is age 58 and his wife Paula who is 55 and was in receipt of a transition to retirement income stream which was reversionary at the time of her death. The balance of Paula's income stream at that time was $400,000. Under the proportioning rule the income stream was split 80% taxable proportion and 20% tax free proportion. Paula was insured in the fund for $1 million which was paid subsequent to her death. The fund had claimed a tax deduction for the premiums on the policy. Under the rules of the fund the proceeds of any insurance policy may be added to any death benefit at discretion of the trustee. As trustee, Ray exercised the discretion and added it to the pension. Any pension payable to Ray will be taxed on the taxable proportion as he and Paula were under age 60 at the time of Paula's death.

As the superannuation fund had claimed a tax deduction for the premiums on the policy the amount received from the proceeds of the insurance policy would be treated as a taxable component. However, as it is permissible to add the insurance proceeds to a pension that is already in place then the proportions that applied at the commencement of the pension will continue. This means that the 80% taxable and 20% tax free proportion will continue despite the addition of the insurance component which notionally has a higher taxable component.

If Paula had decided to commence a non-reversionary pension the rules differ due to the changes to the superannuation legislation which were backdated to commence from 1 July 2012. As the pension ceased at the time of Paula's death the proportions of 80% taxable and 20% tax free will remain with the balance of the pension. This means that the $400,000 being the balance of Paula's pension account on death will consist of $320,000 taxable and $80,000 tax free amounts. As the proceeds of the insurance policy consist of a taxable component they will be added to the taxable amount. The effect will be to increase the taxable component to $1.32 million and the tax free amount of $80,000 will remain unchanged. Therefore the resulting taxable proportion will be approximately 94% and the tax free component will be approximately 6%. This means that any pension paid will have a greater taxable portion than if Paula had been paid a reversionary pension.

In this case, it would have been better for Paula to have commenced a reversionary pension and Ray receives it as a reversionary on her death. <u>As a general rule, where the proceeds of an insurance policy are expected and will be added to a pension after the death of the original pensioner, a reversionary pension would appear to provide the best results</u> from the point of view of the taxable and tax free proportions. This is relevant prior to both the original pensioner and the reversionary reaching age 60 and subsequently on the death of the reversionary pensioner if the residual amount of the reversionary pension is paid to a non-dependent child as defined for taxation purposes.

Benefits from the changes to the law for non-reversionary pensions

The main benefit arising from the amendment to the law which applies from 1 July 2012 is that trustees of superannuation funds that pay non-reversionary pensions now have greater flexibility to dispose of assets after the death of the pensioner and retain the tax exemption which applied to the pensioner prior to their death.

Similar treatment also applies to the calculation of the tax free and taxable components that applied to the non-reversionary pension. That is, the taxable and tax free proportions applying to the non-reversionary income stream will continue to apply to any lump sum or subsequent pension that arises from the pension assets at the time of death.

While this may sound relatively straightforward, care needs to be taken where amounts from anti-detriment payments or the proceeds of insurance policies are added to the superannuation income stream account. It may turn out in some cases that there may be a greater benefit provided in relation to the taxable and tax free components if a reversionary pension is payable and the proceeds of the insurance policy is added after the reversionary pension has commenced. The reason is that the proportioning rule is not re-calculated despite the fact that technically the proceeds from the insurance policy may include a relatively high taxable component. This, as always, depends on the circumstances of the particular case.

Graeme Colley is the Director Technical & Professional Standards at SPAA, the SMSF Professionals' Association of Australia.

Disclaimer

This Newsletter is based on generally available information and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider obtaining financial, tax or accounting advice on whether this information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information.

For complete details of this Disclaimer, see http://cuffelinks.com.au/terms-and-conditions. *All readers of this Newsletter are subject to these Terms and Conditions.*