

Tech Time



Perpetual's monthly technical guide

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Investing for children

Irrespective of how the markets are performing, it is always a good time to talk to your clients about investing for their children or their grandchildren. Particularly when you consider that the time-frames are generally much longer than regular investments, there is often more of a tolerance for growth assets.

Some of the details to consider when investing for children, as well as some strategic considerations are:

Who is taxed as a minor?

A person who is under the age of 18 and who is not an excepted person will be taxed at higher rates. An excepted person includes the following children:

- A child in full-time employment
- A disabled child who is eligible for a child disability allowance
- A double orphan who is not dependant on a relative for support
- A child who is permanently disabled and is not dependant on a relative for support.

If the child is classified as an excepted person, they will be taxed at the adult individual tax rates. Even if the individual is not classed an excepted person certain types of income, termed excepted income, is subject to the adult tax rates as opposed to the harsher minor tax rates.

Excepted income generally includes business income, employment income and income from assets inherited directly by the child from a deceased estate or testamentary trust. It also includes interest on 'excepted income' which is invested.

The tax rates in the table below apply to minors:

Eligible taxable income	Tax payable*
\$0 - \$416	Nil
\$417 - \$1,307	66% of each dollar above \$416
\$1,308 +	45% of total income

*excludes Medicare levy of 1.5%



Tech tip: From 1 July 2011 minors no longer receive the benefit of the low income tax offset on unearned income.



Different investment structures

a. Savings accounts

Savings accounts, while simple in structure and nature, provide conservative investment returns when compared to shares and managed funds.

The ATO treats children's savings accounts slightly differently to other investments, although the underlying law is no different. The interest income earned on the account is required to be declared by the person who controls the account and not the person whose name the account is held in. If an account is in a child's name but the parent will ultimately decide how the money is spent, the parent is required to include the interest in their tax return. Conversely, if an account is in an adult's name but the child will ultimately decide how the money is spent, the child is required to include the interest in their tax return.

While the ATO sees these situations as involving a trust, in Taxation Ruling IT 2486 it waives the requirement for a trust tax return to be lodged.

Fortunately however no tax is payable until earnings reach the under 16 tax-free threshold of \$420 (this is the tax-free threshold of \$416 rounded up). Further a tax return is not required to be lodged if earnings are less than \$420 unless tax has been withheld and they wish to obtain a refund.



Example: If the account is in the child's name, a tax file number is not supplied and the income exceeds \$420 tax must be withheld at the top marginal tax rate. If the bank is not aware that the account holder is under 16 they will withhold from amounts less than \$420.

b. Share investments

Share investments provide investors with exposure to both income and capital growth and access to franking credits. Many investors are attracted to this option because of the long time frame generally involved when investing for children.

As with bank accounts, the ATO's view is that the income goes in the tax return of the person who will ultimately control how that money is spent. The ATO recognises that this may be different to the name the shares are held in but views that arrangement as a trust. They will expect a trust tax return to be lodged.



Tech tip: This obligation is often overlooked as the ATO does not actively enforce it.

From a tax perspective, similar to adult investments, there is no requirement to supply a tax file number (TFN). However, where one is not supplied, tax will be withheld at 46.5% on the unfranked amount of the dividend income.

It is important that the TFN provided is whoever's tax return the income will be returned in. For example, if the income will be in a trust tax return, it is the TFN of the trust. The reason for this is that otherwise the ATO's data matching program is highly likely to identify the discrepancy and start compliance action. This can be relatively easily sorted out but it does create unnecessary work.

This does not mean that whoever's TFN is quoted determines who is liable to pay the tax on the dividends and be attributed with any capital gain or loss. The liability for tax will depend on the situation. The following table provides some examples:

Facts	Outcome
<ul style="list-style-type: none"> The money to buy shares was provided by a person other than the child. The person makes all decisions about those shares. That person spends or uses the dividend from those shares as if it was their own. 	<ul style="list-style-type: none"> That person is the owner of the shares and any dividend income or capital gain or loss is attributable to that person.
<ul style="list-style-type: none"> The money to buy shares was provided by a person other than the child. The person makes all decisions about those shares. All the dividends and shares are held for the benefit of the child. 	<ul style="list-style-type: none"> The person is holding the shares on trust for the child. Any dividend income or capital gain or loss is ultimately attributable to the child but the ATO will expect a trust tax return to be lodged.
<ul style="list-style-type: none"> The money to buy shares was given to the child, for example birthdays or Christmas. The person makes all decisions about those shares. All the dividends and shares are held for the child. 	<ul style="list-style-type: none"> The child is the owner of the shares and any dividend income or capital gain or loss is attributable to the child.



Tech tip: If the money invested is a significant sum or there is regular turnover of the investment it may be deemed to be the adult's investment. The ATO has confirmed that \$15,000 is not a significant sum.

c. Managed funds

Managed funds provide investors with a broad choice of underlying investments and access to markets (for example international shares) that otherwise would be difficult to access.

Managed funds are investment contracts between the provider and the investor, and for reasons of contract law many managed fund providers do not allow minors to invest directly in their funds. Investors are therefore required to invest in the adult's name as trustee for the child, or invest directly in the adult's name.

From a tax perspective the decision to invest in the adult's name as trustee for the child can be tax-effective where the minor's tax-free threshold is being targeted. Alternatively, it may be more tax-effective to invest in the adult's name where the income generated will exceed the tax-free threshold, particularly where they are not on the top marginal tax rate.

Tax treatment of assets on death

The ATO has released TR 2011/D3 which addresses how superannuation pensions are treated on the death of its members. The ruling states: 'A superannuation income stream ceases when there is no longer a member who is entitled, or a dependent beneficiary of a member who is automatically entitled, to be paid a superannuation income stream benefit.'

The ruling confirms the ATO's position that, as the pension has ceased, the assets supporting the pension will be subject to 10% CGT, when sold (for example to pay a death benefit) plus any interest or dividend income earned will be subject to 15% tax within the fund.

Impact on your clients

Large pooled pension funds will often be required to sell off assets to pay out death benefits. In any case they generally do not currently adopt the ATO's interpretation on this issue and do not charge any tax when a pension member dies. These large funds are currently looking at the impact of TR 2011/D3 and are considering whether they need to change their processes or not.

For self managed superannuation funds (SMSFs), the consequences could be significant as the fund would be required to dispose of the assets (which had been held to fund the pension) in order to pay lump sum death benefits. This could be particularly expensive to those SMSFs that have held the assets for many years and following the member's death realise large capital gains.

The hardest hit will be adult children who already pay 16.5% tax on any taxable component of a death benefit.

No additional tax will be paid where a spouse or dependent child receives a reversionary pension or where a new pension is started. This is because those assets will continue to support a pension and therefore the tax-free status will be retained.

The ATO have invited the industry to provide comment on the draft ruling with submissions closing on 26 August 2011, after which they will provide a final ruling on this issue.

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