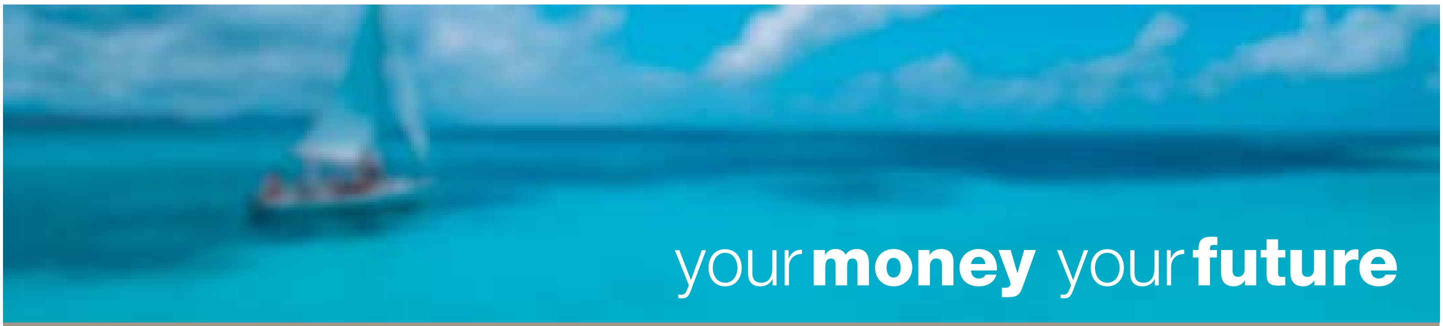

your money your future

FINANCIAL PLANNING NEWSLETTER SUMMER 2007

Q: What is... franking?

The franking system was introduced to avoid double taxation of company profits. Put simply, a franking credit refers to the amount of tax a company has already paid on dividends distributed to shareholders.

Franked dividends are distributed to shareholders when the company has already paid tax – hence the distributions carry franking credits.

The maximum franking credit is 30 per cent, equivalent to the Australian company tax rate. In this case, the franked dividend is referred to as fully franked. When the franking rate is below 30 per cent, shareholders receive a partially franked dividend.

Shareholders can use franking credits to offset their income tax. When shareholders receive a fully franked dividend and their marginal tax rate is 30 per cent or less, the net effect is tax-free income – the cash dividend plus franking credit.

Shareholders with a marginal tax rate below 30 per cent with franking credits in excess of their income tax may actually receive a refund from the ATO.

Franking credits are useful for individuals who own shares directly, or through managed funds, as well as complying superannuation funds, as they reduce your overall tax bill. To find out more about franking credits and how they can benefit your finances, speak to us today.

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charter financial planning

Create wealth by legally paying less tax

Understanding our tax system, and seeking qualified financial advice, can help you to arrange your finances legally so you pay less tax and maximise your wealth. Australia has a progressive tax system, where our individual tax rate increases as our income increases. Our Medicare levy of 1.5 per cent is levied on taxable income. The tax rates for resident individuals at 1 July 2007 are:

Taxable income	Tax on this income
$0 – $6,000	Nil
$6,001 – $30,000	15c for each $1 over $6,000 (15%)
$30,001 – $75,000	$3,600 plus 30c for each $1 over $30,000 (30%)
$75,001 – $150,000	$17,100 plus 40c for each $1 over $75,000 (40%)
Over $150,000	$47,100 plus 45c for each $1 over $150,000 (45%)

Holding money in cash

The interest we earn on our savings is taxed at our marginal income rate. For many individuals, holding large sums in cash does not necessarily produce the most beneficial financial outcome.

Consider Sally, a 27-year-old single woman, who works as an IT consultant and earns $110,000 a year. She lives at home with her parents and is able to save $2,000 per month, which she deposits into an online savings account, paying 7 per cent per annum. At the end of the financial year, Sally earns $930 in interest, of which she needs to pay $385 in tax.[1]

Investing in shares

Depending on Sally's goals, she may achieve a better wealth creation and tax outcome if she chooses to invest her savings into a share portfolio. Depending on the shares purchased and the performance of the portfolio, Sally may receive a higher rate of return, together with dividend income. Franking credits will actually reduce the amount of tax Sally needs to pay.

Investing in shares produces most benefit when utilised as a long-term strategy, taking into account that selling shares incurs capital gains tax. The impact of capital gains tax is reduced when shares are held for a year and a day, as tax is only payable on 50 per cent of any capital gain.

Capital gains tax is less substantial than the tax incurred on interest earnings in the online savings account. This is because capital gains tax is not payable until shares are sold. If Sally holds shares over a relatively long period of time (for example, five years) she effectively defers paying capital gains tax, and when it is payable, she is entitled to a 50 per cent concession.

Salary sacrifice

At first, Sally is reluctant to salary sacrifice into superannuation, as she is unable to access her superannuation funds until she reaches 60 years of age. However, Sally discovers that if she invests $1,000 in superannuation she automatically has 45 per cent more to invest. In addition to this, the earnings on her investments within her super are taxed at 15 per cent instead of her marginal tax rate of 45 per cent. Over time, the difference in tax rates and the effect of compounding will make a significant difference to Sally's total wealth, as well as minimising her tax.

Pre-tax	Tax rate	Non-super	Super	Difference in return
$1,000	0%	$1,000	$850	(15%)
$1,000	16.5%	$835	$850	1.8%
$1,000	31.5%	$685	$850	24.1%
$1,000	41.5%	$585	$850	45.3%
$1,000	46.5%	$535	$850	58.9%

Splitting income

One way to maximise wealth within a family unit is to hold assets and investments in the name of the lowest income earner. Take the situation of a married couple with a young child. Jarrod earns $110,000 per annum, and his wife Kylie has an assessable income of $5,000 per annum from casual employment. Kylie and Jarrod would like purchase a new car. Instead of borrowing, they decide to delay the purchase and open a high-interest savings account in Kylie's name, so that the interest on their savings is not taxed. After some calculations, Jarrod and Kylie see that this strategy means that if they earn $1000 in interest, they are 71 per cent better off.

They also decide to hold their investment portfolio in Kylie's name, so that they pay less tax than if it was held in Jarrod's name.

	Tax rate	Interest earned before tax	Interest earned after tax
Investment in Jarrod's name	41.5%	$1000	$585
Investment in Kylie's name	Nil	$1000	$1000
Difference in return	71%		

Another option for Jarrod and Kylie to enhance their wealth is to use superannuation.

Jarrod already salary sacrifices at the maximum level into his own superannuation fund, and decides to make a spouse contribution to Kylie's superannuation. Jarrod can access the maximum spouse contribution tax offset of $540 by contributing $3,000 into Kylie's superannuation, which is effectively a guaranteed 18 per cent return.[2]

It's important to work with a qualified financial adviser to assess your own situation and determine how to best structure your financial affairs to generate wealth.

1 Assumes interest is paid at the beginning of the month, and that each month has the same number of days.

2 To use this strategy, both the receiving and contributing spouse must be Australian residents, and the receiving spouse's assessable income and reportable fringe benefits must be less than $13,800 per annum. The maximum tax offset is 18 per cent on the first $3,000 contributed to the spouse's superannuation fund.

Extra protection against life's risks

Most of us have been touched in some way by a serious medical condition such as cancer, a heart attack or stroke.

This may be because it's happened to a family member, friend, work colleague, or possibly even ourselves.

You'll probably be well aware of the financial burden that can build up if conditions such as these leave someone unable to work and in need of expensive medical care.

But you can protect yourself and your family against this potential burden by taking out a form of insurance known as trauma insurance.

With trauma insurance in place, if you are unfortunate enough to experience one of an extended list of trauma events, including things such as cancer, heart attack or stroke, you'll receive a lump sum payment from your insurance provider.

And you can use the money to cover living expenses, bills, mortgage payments, medical costs or any other expenses you may have as a result of your illness.

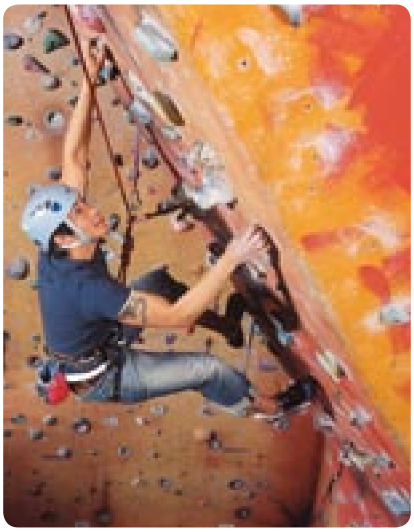
After experiencing a serious medical crisis, however, you may find it hard to replace your previous trauma insurance on the same basis as before.

Thankfully though, there is a way to protect you and your family against the possibility of suffering a serious medical condition more than once in your lifetime. That's by including a trauma reinstatement option with your trauma insurance.

With most trauma reinstatement options, if you suffer serious trauma and receive your trauma insurance payout, a year later you'll be able to put back in place up to 100 per cent of your previous insurance, based on the original medical exam.

As not all available trauma reinstatement options are the same, it's important to discuss the details with your financial adviser, before making a decision about which one would be best for you.

So if you're interested in the extra peace of mind that trauma reinstatement could offer you, speak to your financial adviser for more information.



What type of retirement do you want?

You may have been saving for your retirement for some time, but have you ever thought about what kind of lifestyle you would like to have when the time comes to retire?

Perhaps you wish to maintain your current lifestyle, or you may be happy to live more modestly. Your idea of what retiring 'in comfort' means will be unique. You may plan on travelling overseas, pursuing new hobbies, or settling down to a quiet life. It is important to be specific about your lifestyle requirements so you can work out how much you need to save now, to support your needs later in life.

How much you'll need to save in the future will depend on a range of issues, including your current age, how much you have already contributed to your superannuation and other savings, the age that you expect to retire, and whether you plan to retire fully or remain in the workforce part-time.

One approach to determine how much you'll need in retirement is to aim for about 70 per cent of the income that you earn immediately before retiring. This takes into account some expenses decreasing or disappearing (for example, mortgage and life insurance costs), and others, such as medical expenses, increasing.

Another way of looking at how much you will need to fund your preferred lifestyle is to review the Australian benchmark for retirement. This standard estimates the annual budget needed by Australians to fund a modest retirement lifestyle compared with a comfortable retirement lifestyle.[1]

A modest lifestyle in retirement is defined as better than the Age Pension but still only able to afford fairly basic activities. A comfortable lifestyle would enable a healthy retiree to be involved in a broad range of activities (including travel), to have a reasonable car, private health insurance and participate in modest social activities and entertainment.[2]

The table below illustrates the total amounts required to fund both modest and comfortable lifestyles.

For more information on how much you'll need to save today to fund the lifestyle you want in retirement, please contact us. We can model savings and retirement projections for your situation and goals.

Budgets for Australian households and living standards – June 2007

Lifestyle standard	Weekly budget	Annual budget
Modest lifestyle – single	$357	$18,654
Modest lifestyle – couple	$501	$26,154
Comfortable lifestyle – single	$693	$36,141
Comfortable lifestyle – couple	$927	$48,374

1 The Association of Superannuation Funds of Australia Limited 'Retirement Living Gets Costlier', Westpac Media Release, 29 August 2007.

2 Ibid

How much do emotions contribute to your financial decision making?

"Yes, I guess emotions play a part when I'm buying a house or renovating, but I think I'm fairly rational when it comes to my choice of investments and most day-to-day financial decisions."

If you think this statement rings true, think again. There is a whole discipline delving into the reasons we make the financial decisions we do – behavioural finance. It is defined as the study of sociology and psychology on the behaviour of financial participants, including consumers, and the subsequent effects on markets[1]. Behavioural finance helps explain why and how markets may be inefficient and why consumers may not make rational economic choices.

What is behavioural finance?

The concept of behavioural finance is not a new one. Economists have been writing about it for some three centuries, with Adam Smith one of the first to describe the psychological principles of individual behaviour. Much later, psychologists Taversky and Kahenman (1979) were awarded the Nobel Prize for their contribution to economics. This shows how close the fields of economics and psychology have become in understanding why we make the financial choices that we do.

Even more recently, the science of neuroeconomics[2] has been found to underpin many of the concepts of behavioural finance. This area adds a further dimension – the brain and the nervous system. Its findings tend to confirm that emotions (among them hope and fear) are important, if not overriding, factors in many economic choices.

State of the art brain imaging shows which areas of the brain are active during different types of decision-making. This reveals the mechanisms that drive behaviour and allows scientists to answer questions that cannot be answered by observing behaviour alone.

Today, most economists agree that, left alone, people will act in their own best interest, and that the market will co-ordinate its actions to produce outcomes beneficial to all.

Neuroeconomics challenges both parts of this argument. If emotional responses often override reason, we cannot presume that people act in their own best interest. And if markets reflect the decisions that people make when their basic emotional structures are particularly active, it would appear that some financial outcomes are irrational and can therefore be sensibly improved upon.

Financial literacy and learned behaviour

Research into financial decision-making has established that men are more prone to overconfidence than women, and men trade 45 per cent more than women, often resulting in a reduction in their long-term returns.[3] In other words, it may make more sense to have the female of the family in charge of long-term financial decision-making. This contradicts traditional gender roles in Western society, where the male is often in charge of the family unit's finances. It reinforces the need for both males and females to be financially literate from a young age.

Financial literacy is the ability to make informed judgements and effective decisions regarding the use and management of money. In a modern, consumer-oriented society where credit cards and self-service banking technologies are readily available, deficiencies in financial literacy may have serious implications for an individual's financial wellbeing.

Poor financial literacy can mean bankruptcy, over-capitalised home loans, ill-informed commitment to get-rich-quick schemes, or subscription to high-risk investments without proper consideration.

The Australian Federal Government has established The Financial Literacy Foundation to give all Australians the opportunity to better manage their money. The foundation believes that understanding money is a skill that should be taught to children in their normal school curriculum, and have worked hard to ensure that financial literacy will be included in the school curriculum from the beginning of 2008.

For more information on understanding your finances, please contact us.

1 Sewell, Martin, 2007. 'An introduction to Behavioural Finance', Department of Computer Science, University College London

2 Neuroeconomics combines neuroscience, economics, and psychology to study how we make choices. It looks at the role of the brain when we evaluate decisions, categorise risks and rewards, and interact with each other. Wikipedia, 2007.

3 Barber B.M. and Terrence Odeon, 2001. 'Boys will be boys: Gender, overconfidence and common stock investment.' Quarterly Journal of Economics, 116 (1), 261-292