



BLa BLa BLa

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Cracks develop

IN THE MORTGAGE AND MEZZANINE FINANCE MARKETS

WESTPOINT, FINCORP, AUSTRALIAN CAPITAL RESERVE, BASIS AND BRIDGECORP.

Over the last six months we have seen two short, sharp corrections in the US share market, which flowed through to share markets around the world. Both of these corrections were attributable to growing defaults in the US mortgage market. This comes at a time when in Australia we have seen an alarming regularity of corporate collapses in the mezzanine finance area. For the past eighteen months the nightly news has produced a continuous flow of investors who 'lost it all', stating that they thought their investment was secure.

Fortunately, none of these investors are BL&A clients, as we have been a strong advocate against these mezzanine finance arrangements. Over recent years we have fielded many calls from clients keen to invest in the 9.85% 'guaranteed return' advertised by Australian Capital Reserve (ACR), but our response has always been that this guarantee and rate of return simply don't add up.

We first addressed this matter in the April 2006 issue of *Bla Bla Bla*, following the collapse of Westpoint. We explained that for any investment to provide a higher rate of return than the Reserve Bank's cash rate simply meant that additional risk was being introduced. For ACR to be offering a 'guaranteed' 9.85% while the official cash rate was 6.25% clearly meant that the guarantee was as good as the company making it. Not surprisingly, the company

has very few assets, so the guarantee of return and investors' principal are both now gone.

As unfortunate as these collapses are, they do provide some very good lessons for the rest of the investment community. Without wishing to pick the bones of the corpses, it is appropriate to spell out those lessons.

In a world of glossy brochures and advertising, it's very easy to believe that if 'it was on TV, it must be OK'.

In Australia, we have corporations law and the Trade Practices Act, both of which make false and misleading claims illegal. Surely then, if a company is offering a 'guarantee', the corporate watchdog would take them to task if what the company is offering is not true.

Unfortunately, as we have seen, this is not always the case. Investors making an investment must do so through a product disclosure statement. Buried somewhere within the 100 pages of this document will be the facts about the investment, but few investors make it past the early pages. The television advertisements bring the investor in, but the devil is always in the detail.

It is therefore critical that investors understand what is 'under the bonnet' of their investment. In the case of Westpoint, Fincorp, ACR and Bridgecorp, investors clearly misunderstood what was actually being done with their money. Most investors would tell you that they had first mortgage security over established properties.

Short of personally going and inspecting the properties, certain questions should be forthcoming. If this



investment is secured under first mortgage, why is the fund paying 9.85% in interest when borrowers could be getting the money from a bank at around 7%? Clearly this doesn't make sense.

Not all property funds are mezzanine finance. There are a number of reputable funds where clients' money enjoys first mortgage security on assets in the fund. Unlike mezzanine finance, where funds are being used to develop property, these mortgage funds are secured through established commercial, residential and industrial property. Once such mortgage fund that we have been recommending to our clients for a long time is the Howard Mortgage Trust, run by the Challenger group.

What makes this type of investment 'safe' is the sheer diversification and security within the fund. For a start, the average loan to value ratio of mortgages within the fund is 58%. Put another way, property prices could fall by 40% across their whole portfolio and the value of the assets would still outweigh the value of clients' funds.

However, it is the number and variety of loans used in a fund like this that provide the greatest security. At present there are a total of 2902 different mortgagors in this fund, with approximately 47% of the mortgages secured by residential property, 28% by commercial property, 16% by industrial property and 9% by retail property. These property holdings are spread across all states and territories, thereby reducing the geographic risk of having all mortgages tied to one state, where economic conditions may fall behind.

A fund such as this is likely to offer a rate of return of around 7%, which is lower than the 8.5% to 9.85% offered by ACR. However, for the small difference in return, the investment strategies are worlds apart. It has become public knowledge that most of ACR's problems stem from late payments from one developer, who was the fund's major borrower. When his property development did not sell according to plan, ACR's problems soon followed. In a mortgage trust like Howard, it would take 2902 mortgagors to simultaneously fall on

hard times, **as well** as all the value of their properties simultaneously falling by more than 42%, for there to be one dollar of risk to clients' funds.

The recent instability in the US share market is attributable to poor credit and overzealous lending practices in the sub-prime mortgage market. In the US, the sub-prime home loan market lends money to people who are looking to borrow money for a property but have what is loosely termed an *impaired* credit history.

In reality the American banks have been falling over themselves to make what the lenders in the US call 'Ninja' loans. . . Ninja - No Income, No Job, No Assets. It is estimated that about 25% of US mortgage debt (approximately US\$25 trillion) was outstanding as at February 1 this year. Of that, about US\$1.4 trillion was likely to default and about US\$458 billion would almost certainly default.

In the US sub-prime fund market, loan valuation ratios (LVR) are running at about 87% and that as much as one third of the sub-prime lending book is at 100% LVR - this in a market where the hot property markets - California, New York etc. - have fallen by as much as 10% over the past year and with economists predicting that there is another 10% to come off the market before it starts to recover

It can only be hoped that Australian banks are paying attention to the difficulties of the US sub-prime market. Over the last couple of years we have seen an emergence of the 100% home loan, offered by reputable organisations such as RAMS and St George. This is a dangerous practice in a time of rising interest rates. Not only is there an increased possibility of default, but with rising interest rates falling house prices are a distinct possibility, leaving the banks with negative equity in the first mortgage security. To date Australia has avoided most of the sub-prime problems, however the spectacular collapse of these mezzanine finance companies shows that this is a very slippery slope.

WILL THE NEW SUPER LAW BE CHANGED

in the future?

The new 1 July superannuation arrangements are a godsend to retirees. It's true to say that there is something for everyone in the new superannuation laws, from the 10% tax offset for Commonwealth Superannuation Scheme (CSS) pensions through to removal of reasonable benefit limits (RBLs). These changes effectively take us back to the way superannuation law operated in 1988, removing many of the taxes that have been introduced since then.

As there is an election due over the coming months, many of our clients have viewed these changes as a stunt to win support for the present government and increase their re-election prospects. Further, many have raised concerns that if there is a change in government this year, the first act of a new Labor Government would be to unwind the tax concessions and re-introduce taxes on superannuation.

We view this as being very unlikely. Labor and the minority parties supported the latest range of superannuation changes, and it would be 'courageous' to change their position so quickly. After all, the ageing of the population means that the voting population is also getting older.

The more probable concern is that it will be a future government, 5 to 10 years down the track, that will bring in new taxes on superannuation. This could arise from the pressures of an ageing population paying little or no tax, with an increasing tax burden being passed onto generations X, Y and Z. It may well be that to not re-introduce taxes on superannuation at some point would be fiscally irresponsible.

This is, of course, purely speculation. However, if history is any guide, future changes will not be retrospective, and there will be transitional provisions to ensure that those who are close to retirement are not adversely affected by the changes.

This has been a fundamental part of superannuation and tax since the first changes to superannuation started in 1983. Quite simply, it is very bad politics to pull the financial rug from under someone's feet when they have made retirement plans based on the law as it stands. The further you are away from retirement age, the less likely you are to be protected, as you have time to adjust your position.

This is best demonstrated by considering the changes to

superannuation law over the last 20 years, and seeing how they were 'grandfathered' in.

In July 1990 we effectively saw the introduction of RBLs, an upper limit on how much superannuation a person could take over their lifetime. Once a person reached their RBL, the amount in excess of the RBL was taxed at the top marginal rate.

For those who were approaching retirement age and had already established considerable superannuation assets, transitional provisions ensured that this sudden capping of superannuation entitlements did not inconvenience them. For those aged 50 or more, with a large amount in superannuation already, their RBL would either be the standard RBL or the balance of their super fund, whichever was the higher. This transition was further enhanced to allow the balance of the super fund to include future earnings. In this way, a person's RBL would always be equal to the balance of their super fund.

For those aged under 50, their RBL was still the higher of the standard RBL or the balance of their super fund. But for these people it was the frozen balance of the fund in 1990, not the future earnings as well. This established a very clear two-tier level of transition. Those closest to retirement (50 or above) were completely protected, while those further from retirement (below 50) were partially protected.

In 1992 the government changed the preservation age, the age at which an individual can access their superannuation, from 55 to 60.

Clearly there would have been a march on Parliament House if the government told 54-year-olds that they should stop planning for age 55 retirement and start thinking about retiring at age 60. In order to avoid such unrest, the new arrangements applied to anyone born after June 1960. By doing this, the government upset no one, because for the average 30-year-old long-term planning was more likely to be about what they were doing next weekend. Hence they were an easy target to shift the retirement age.

In 1996 the government introduced the superannuation surcharge. This was an additional entry tax on the superannuation contributions and support of high-income earners. It effectively meant that someone on a high



income would pay 30% tax at the point of entry into superannuation, rather than the 15% where contributions tax alone is payable.

This tax was not retrospective – it applied only on contributions being made from that time. This simply meant that if the new tax made superannuation less attractive for someone, they could choose to avoid it as a remuneration strategy and get fringe benefits or income instead. The transitional provisions effectively quarantined this to only ‘new money’.

In all three cases, the rules on superannuation were made less attractive for the person investing in superannuation. However, in all cases the transitional provisions effectively quarantined any superannuation already accrued from the effects of the new laws.

We believe that at some time, in a less prosperous economy, a future Treasurer will find themselves with little choice other than to start milking the growing superannuation pot for a bit more tax. This may be in 5 years, or maybe 10. However, one thing we remain confident of is that any future tax will not be retrospective, and there will be sufficient transitional provisions to protect those who are close to retirement from any adverse impacts.

The question is then, what do we mean by ‘close to retirement’? In the past, transitional provisions have generally provided the best protection for those aged 50 or more when the new legislation comes into play. As much as the past can be a guide, we can only assume that a future Treasurer would also recognise the political ramifications of not protecting the rights of those who have made retirement plans under current laws and concepts.

This should also send a warning to younger people to not believe that the laws will necessarily be as they are now when they retire. For a start, a future government may decide that 60 is too early for our generations X, Y and Z to retire, and impose a new retirement age of 65 for those currently aged under 45. In that time, the laws concerning the tax payable on their end benefit could change 100 times, and if they are not close to retirement, they will not necessarily be protected by transitional provisions.

Tax Office

TARGETS

The Tax Office has warned that it is scrutinising the following areas in 2007 tax returns.

RENTAL PROPERTY DEDUCTIONS

The Tax Office says that over 1.4 million people claimed more than \$21 billion in rental deductions in their tax returns for the 2006 tax year, with almost 200 000 people claiming deductions for the first time.

To help minimise errors, the Tax Office has outlined the following common mistakes made by both first-time and other rental owners.

- Incorrectly claiming the cost of structural improvements as repairs when they are capital works deductions (for example, remodelling bathrooms and kitchens, or constructing a deck or pergola).
- Overclaiming deductions for the interest on loans taken out to purchase, renovate or maintain a rental property. Where a loan is taken for both income-producing and private purposes, such as to buy a car or go on an overseas holiday, the interest on the private portion of the loan is not tax deductible.
- Incorrectly claiming the full cost of an inspection visit when it is combined with a private purpose, such as a holiday. Only the portion of the travel directly related to the property inspection can be claimed as a deduction.
- Claiming deductions for rental properties not genuinely available for rent.
- Incorrectly claiming deductions for properties available for rent for only part of the year. If a holiday home or unit is used by a taxpayer, their friends or relatives free of charge for part of the year, the taxpayer is not entitled to a deduction for costs incurred during those periods.
- Incorrectly claiming the cost of land as a capital works deduction. The cost of land forms part of the cost base when calculating capital gains tax (CGT) on the sale of a property.

RENTAL PROPERTY, WORK DEDUCTIONS AND CGT

- Incorrectly claiming deductions for depreciating assets that are actually capital works deductions. The Tax Office's Rental properties booklet contains a comprehensive list of more than 230 residential property items and sets out whether items are depreciating assets eligible for a decline in value deduction, or assets eligible for a capital works deduction. The booklet is available from the Tax Office website.

The Tax Office also notes that renovation costs and costs to repair damage, defects or deterioration existing when a property is purchased cannot be claimed as an immediate deduction. These costs are capital expenditure, depending on what is repaired or improved, and must be claimed as either decline in value deductions over the asset's effective life, or as capital works deductions over 40 years.

WORK-RELATED EXPENSES

The Tax Office says that over 7 million people claimed more than \$12 billion in deductions for work-related expenses last year. For 2007 tax returns, the Tax Office says it will review a range of deduction claims, including expenses for motor vehicles, self-education, home office and travel.

Each year the Tax Office selects a number of occupations for specific attention because they have above-average work-related expense claims, a high number of work-related expense claimants, or because the ratio of work-related expense claims to salary and wages is high. For 2007 tax returns the Tax Office will focus on:

- tourism, travel consultants and guides
- fitness and sporting industry employees
- construction trades people who are employees
- guards and security employees, and
- mining site employees.

CGT ISSUES

The Tax Office is continuing to focus on people who do not report capital gains made when they sell or dispose of shares, properties and other assets. It matches data from state and territory revenue offices, managed funds, the Australian Stock Exchange and share registries against tax return information to identify share and property sales that involve capital gains. It reminds taxpayers of the following points about CGT.

- Taxpayers who sold assets to take advantage of the opportunity to invest in superannuation before 30 June 2007 may have made a capital gain, which may be subject to CGT. The Tax Office warns that it is important for taxpayers to set aside funds to meet any tax liability (including CGT) resulting from selling or transferring assets into superannuation.
- Taxpayers who purchase or inherit an asset, or receive an asset as part of a divorce settlement or as a gift, may be liable for CGT when they sell or otherwise dispose of it.
- Capital losses from collectables can be offset only against capital gains from collectables, not against capital gains made on other assets.
- Taxpayers must keep records of the purchase or acquisition and the sale or disposal of any asset that may attract CGT.



2007 Federal Budget

REDUCTION IN PERSONAL TAX RATES FOR 2007 AND 2008

The 2007 Federal Budget is estimated to provide an underlying cash surplus of \$10.6 billion, the government's tenth surplus. The Budget delivered a range of tax and related changes, including a fifth consecutive year of personal tax cuts.

As announced, the government will provide tax cuts worth \$31.5 billion (including the reduction in the fringe benefits tax rate) over four years. These cuts are in addition to the \$36.7 billion worth of tax cuts provided in last year's Budget.

Changes to the thresholds are as follows:

- from 1 July 2007 the income threshold for the 30% tax bracket increases from \$25 001 to \$30 001
- from 1 July 2008 the income threshold for the 40% tax bracket increases from \$75 001 to \$80 001.

New tax thresholds from 1 July 2007 Income range (\$)	Tax rate (%)	New tax thresholds from 1 July 2008 Income range (\$)	Tax rate (%)
0 – 6000	0	0 – 6000	0
6001 – 30 000	15	6001 – 30 000	15
30 001 – 75 000	30	30 001 – 80 000	30
75 001 – 150 000	40	80 001 – 180 000	40
150 001 +	45	180 001 +	45

The increase in the threshold for individuals earning more than \$30 000 a year provides a maximum tax saving of \$750 a year. Individuals earning between \$80 000 and \$150 000 will receive a further \$500 tax saving in 2008–09, while those earning \$150 000 or more will gain a maximum tax saving of \$1500 once they reach a salary of \$180 000.

The announced change to the 30% tax threshold to \$30 000 is a trigger to review your existing salary sacrifice and/or transition to retirement strategies. You should ensure that your annual taxable income is no more than \$30 000 as

this is a benchmark to salary sacrifice by keeping the tax rate the same as in superannuation from 1 July 2007. The changes from 1 July 2008 will have a bigger impact for those in the two top marginal tax rates, particularly with regard to negative gearing and overall tax minimisation strategies, including salary sacrifice arrangements.

MEDICARE LEVY THRESHOLD

From 1 July 2007 the Medicare levy low-income threshold increases to \$16 740 (from \$16 284) for individuals and \$28 247 (from \$27 478) for families. The additional amount of threshold for each dependent child or student increases from \$2523 to \$2594.

The Medicare levy low-income threshold for pensioners below age pension age rises from \$19 583 to \$21 637 from 1 July 2007.

TAX OFFSETS

From 1 July 2007 the low-income tax offset has been increased from \$600 to \$750. Those eligible for the full tax offset will not pay tax until their annual income exceeds \$11 000 (up from \$10 000). The low-income tax offset payable is shown in the following table.

Taxable income	Tax offset
< \$30 000	\$750
\$48 750 & over	Nil

Senior Australians eligible for the senior Australians tax offset and the low-income tax offset currently do not pay tax until they reach an annual income of \$24 867 for singles and \$41 360 for couples (depending on the income received by each member of the couple). The tax cuts lift these income levels to \$25 867 for singles and \$43 360 for couples.

The dependent spouse rebate will be increased to \$2100 (up from \$1655) for the 2007–08 and later income years. This increase will benefit taxpayers with a dependent spouse who do not have a dependent child.

COMMONWEALTH PUBLIC SERVICE SUPER REFORMS

The government announced the following reforms to the Commonwealth Superannuation Scheme (CSS) and the Public Sector Superannuation Scheme (PSS).

- From 1 January 2008 maximum benefit limits in the PSS will be \$500 000 (indexed) where the final average salary is \$50 000 or less. Where the final average salary is more than \$50 000, the maximum benefit limit will be 10 times the final average salary.

Importantly, the accrual rates don't change and are intended to stop contributing members reaching their maximum benefit too early.

*There are many BL&A clients who have been told to slow down their PSS contributions because they would reach their maximum benefit limit too quickly. With the increase in the maximum benefit limit, **this strategy needs to be urgently reviewed.***

- On 1 July 2008 compulsory member contributions will be scrapped for contributions to the CSS and the PSS. However, as these are defined benefit schemes where the benefit accrual has been linked to member contributions, the following adjustments will be made:
 - for the PSS, if a member ceases to make personal contributions the employer accrual will be 11% of salary
 - for the CSS pension, the accrual rate of the defined benefit pension will not change (as member contributions provide a lump sum benefit). However, for the CSS resignation benefit (the 54/11 months benefit), the employer-financed benefit is currently 2.5 times a member's own contributions (5% salary) plus earnings. For the period the employee chooses not to make personal contributions, the employer-financed benefit will be 2.5 times the earnings only.

- Choice of superannuation fund will extend to the PSS but not the CSS from 1 July 2008. Contributions will have to be made to the PSS Accumulation Plan before a member can elect to choose another fund. Public sector employers who don't contribute to this plan can have an arrangement with employees to contribute elsewhere.

GOVERNMENT SUPER CO-CONTRIBUTIONS TOP UP

The government will provide a one-off extra co-contribution for individuals who made undeducted (after-tax) personal superannuation contributions in 2005–06 by doubling the co-contribution payable in that year. Most individuals have already received the co-contribution related to personal contributions made during 2005–06, and should have received the second one-off co-contribution in June 2007.



New salary sacrifice limits

FROM 1 JULY 2007

From 1 July 2007, concessional contributions made to superannuation are subject to an annual cap of \$50,000. Concessional contributions include employer contributions (including contributions made under a salary sacrifice arrangement) and personal contributions claimed as a tax deduction by a self-employed person. The age-based limits on deductions for these contributions no longer apply.

Individuals will be taxed at 31.5% on concessional contributions over the \$50,000 cap. This is on top of the 15% tax paid by the fund. Those who exceed the \$50,000 cap may request their super fund to release money via a 'release form' to pay this excess contributions tax.

Between 1 July 2007 and 30 June 2012 a transitional concessional contributions cap will apply. During this time, the annual cap is \$100,000 for people aged 50 or over.

It is important to note that if you contribute to ComSuper – Australian Reward Investment Alliance (that is, you are a CSS, PSS, MSBS or DFRDB member), your employer makes productivity contributions on your behalf. These contributions are classed as concessional contributions for tax purposes and are included in the \$50,000 and \$100,000 caps.

So anyone salary sacrificing into super should review their current salary sacrifice arrangements immediately and contact their salary packaging administrator to ensure they fall within the above concessional contribution caps for 2007–08.

Example 1

Jessica (aged 45) salary sacrifices \$50,000 into her personal super fund (not the PSS) and her employer contributes 3% of her superannuation salary (\$65,000) each fortnight (or \$1,950 a year) to her PSS in the same financial year. So Jessica receives \$51,950 in concessional contributions for the year, which is \$1,950 above the \$50,000 cap. This means that \$1,950 is taxed at 15% initially, plus an additional 31.5% representing the top marginal tax rate of 46.5%. The excess contributions also count towards Jessica's non-concessional cap.

Example 2

Hannah (aged 51) is a contributing member of the CSS and salary sacrifices \$100,000 into her personal super fund. Her annual CSS superannuation salary is \$150,000. Based on the 2007–08 productivity contribution rates, from 1 July 2007 her employer is required to contribute 2% (or \$3,000) of her superannuation salary into the CSS. So Hannah's combined concessional contributions are \$103,000, which exceed her concessional contributions cap of \$100,000 by \$3,000. Again, the excess funds of \$3,000 will be subject to 46.5% (or \$1,395) in excess concessional contributions tax, and will also count towards Hannah's non-concessional cap.

To avoid exceeding the concessional contributions cap, Hannah simply needs to reduce her salary sacrifice arrangements with her employer or salary packaging administrator to a maximum of \$97,000 a year, given that her employer is contributing 2% of her superannuation salary as a productivity contribution. Hannah will also need to review her salary packaging arrangements at least yearly, given her CSS superannuation salary will increase on her birthday each year in line with any applicable salary increases.

The table at the bottom of the page shows the employer productivity superannuation contribution rates apply for all CSS and PSS contributing members from the first pay period of 2007–08.

Applicable fortnightly rate of salary for superannuation	Fortnightly employer productivity superannuation contribution
Less than \$1591.33	\$47.74
\$1591.33 to less than \$2564	3% of a member's fortnightly superannuation salary
\$2564 to less than \$3846	\$76.92
\$3846 or more	2% of a member's fortnightly superannuation salary

Actual employer productivity superannuation contributions are generally shown on an individual's fortnightly payslip.

Ethical Investment

IN AUSTRALIA

Ethical investment in Australia has been gathering momentum over the last decade, led particularly by the institutional market. Both in Australia and overseas, large investors have started taking into account environmental, social and governance factors and whether they cause risks or present opportunities for companies.

Recent large corporate collapses such as Fincorp, Westpoint, Australian Capital Reserve and HIH have focused attention on governance and international accounting standards. Serious ethical issues in the case of James Hardie and the Australian Wheat Board have also raised questions about the way businesses operate.

Couple this with greater public awareness of environmental and social issues – particularly relating to climate change and, in Australia, the availability of water. As this awareness has been converted into a need for action, investment markets and financial service providers have responded to an increased demand for investment options that meet investors' requirements for products aligned with their beliefs, ethics and values.

SIZE OF THE MARKET

According to the Ethical Investment Association Benchmarking Study, conducted in June 2006 by Ethical Investor magazine, social responsible investment (SRI) managed portfolios in Australia were worth \$11.98 billion, up 56% on the previous year. This represents growth of around three times that of the managed investments industry overall. However, despite this growth, the SRI sector still constitutes only about 1% of total managed investments in Australia.

ETHICAL INVESTMENT OPTIONS

There are a large range of SRI funds now available for investment, with around 20 fund managers, 15 of which offer screened Australian share funds. Recently, Colonial First State announced it had signed an exclusive retail distribution agreement with long-term and sustainable investment specialists Generation Investment Management.

Generation was co-founded in 2004 by former US Vice-President Al Gore and David Blood, former CEO of Goldman Sachs Asset Management. Under the terms of the alliance, Colonial FirstChoice account holders will have exclusive access to the Generation Global Sustainability Fund from September 2007.

Other more established SRI Australian fund managers include Hunter Hall Investment Management and Australian Ethical Investment.

METHODOLOGIES FOR ETHICAL INVESTMENT

Ethical investment, in its broadest form, involves investing money in line with an investor's values. It may exclude companies involved in products or activities the investor has ethical concerns about, such as tobacco, gambling, armaments or alcohol.

The terms 'ethical investing' and 'social responsible investing' are often used interchangeably. But there are arguments that SRI represents a more positive approach to ethical investing, by actively seeking out companies that may invest in energy-efficient technologies, for instance, or perform well on environmental or social factors.

A more all-encompassing term used for these types of investment could be 'responsible investment', which can encompass environmental, social and governance factors.

NEGATIVE SCREENING

The method initially used in ethical investment was negative screening, whereby companies involved in products or activities such as tobacco, alcohol, gambling, weapons and uranium mining were excluded from the investment universe.

POSITIVE SCREENING

Positive screening, as the term suggests, involves tilting the portfolio towards stocks that perform well on selected criteria. For instance, a charity that helps unemployed people get back into the workforce may want to invest



in companies that perform well in terms of the way they treat their human capital. Other investors may want to skew their investments towards companies that have good corporate governance, or towards the alternative energy sector, with investment in gas companies and wind farms, for example.

BEST OF CLASS OR BEST OF SECTOR

Because using positive or negative screening can produce an unbalanced portfolio, another approach to ethical investment was introduced – best of class or best of sector. This approach is geared to obtaining the same sector exposure as you might to an index such as the Australian Stock Exchange top 300 companies, while choosing stocks in each sector that are the highest performers on a range of environmental, social or governance criteria. This means, for instance, that while mining companies may be excluded in an investment approach that uses a purely negative screen for companies involved in mining or resources, a best of class or best of sector approach could identify the mining company with the best environmental and community engagement record for investment.

The result of this approach is a portfolio that usually resembles the index fairly closely, but is weighted towards more sustainable companies.

INTEGRATION

The integration approach reflects the greater importance being placed on environmental, social and governance factors. Rather than using positive or negative screening, mainstream managers incorporate the individual environmental, social and governance factors into their fundamental or quantitative stock analysis and valuation.

SHADES OF GREEN

The ethical investment world sometimes talks about SRI funds being various shades of ‘green’. In this context, a ‘light green’ fund would rely only on negative screens; a

‘mid green’ fund would include negative screens plus a positive bias towards socially responsible companies; while a ‘dark green’ fund would include a more comprehensive set of negative screens, including other aspects such as the use of animal testing or operating in countries with human rights issues. This would be coupled with a stricter positive policy, including orienting the portfolio towards areas such as renewable energy, biotechnology, and human service companies such as aged care and private hospitals.

Obviously, as funds move up the spectrum from light to dark green, the available universe of companies to invest in becomes smaller. This is evident in the Australian share exposure of the Hunter Hall Investment Management Australian Value Trust and Australian Ethical Investment Ltd Equities Trust shown in the following table.

Hunter Hall Australian Value Trust at 30 June 2007	Australian Ethical Equities Trust at 31 May 2007
Structural Systems	Arrow Energy
Ausdrill	Australian Pipeline Trust
RCR Tomlinson	Babcock and Brown Wind Partner
Hansen Technologies	Brambles Limited
Paladio Group Ltd	Cochlear Ltd
Lighting Corporation	Energy Developments Ltd
Telstra Corporation	Envestra Ltd
Legend Corporation	Geodynamics
Sirtex Medical	Hastings Fund Management
National Can	Macquarie Communications Infrastructure Group
	Origin Energy Ltd
	ResMed Inc
	Sigma Company Ltd
	Sonic Healthcare Limited
Total percentage of fund – 57.50%	Total percentage of fund – 52.27%

Limits

ON NON-CONCESSIONAL (AFTER-TAX) CONTRIBUTIONS TO SUPER

From 1 July 2007, non-concessional contributions to superannuation are subject to an annual cap of \$150 000. Non-concessional contributions include personal contributions that are not claimed as an income tax deduction.

There is a bring-forward option available, which means that people aged under 65 can make non-concessional contributions of up to \$450 000 over a three-year period.

For those aged over 65 and under 75, the maximum non-concessional contribution is limited to \$150 000, subject to meeting a work test of at least 40 hours of paid employment within a 30-day period during the financial year the contribution is made.

Individuals will be taxed on non-concessional contributions over the cap at the rate of 46.5%. They will be required to ask their super fund to release an amount equal to the tax liability.

SUPER CO-CONTRIBUTIONS

Super co-contributions are not included in either of the new concessional or non-concessional caps.

FOR THE SELF-EMPLOYED

Self-employed individuals can now claim a full 100% tax deduction for superannuation contributions, subject to the concessional contribution limits.

Importantly, self-employed individuals are also eligible for the super co-contribution on contributions they don't claim a deduction for.

RISK AND RETURN

As illustrated in the previous table, the top 10 holdings in the Hunter Hall Australian Value Trust represent 57.50% of the entire value of the portfolio, while the Australian Ethical Equities Trust has exposure to 14 companies, which represent 52.27% of the entire portfolio.

Ethical or responsible investment is sometimes regarded as more risky because of investment capability and a smaller accessible investment universe. The smaller investment universe increases risks on a sliding scale, according to the number of objections or exclusions the fund manager elects. The 'greener' the SRI fund, the more it will limit the availability of suitable investment options because more companies are excluded and there could be more of a desire to buy certain emerging areas of the economy, which would be more growth-oriented. These factors could increase volatility significantly in the short term.

With financial markets becoming more attuned to some of the broader social and environmental issues such as climate change, the options for investment along SRI or ethical principles are increasing. One of the potential problems with ethical investment is that there is a very wide range of ethical or SRI funds, with a wide variance in screening approaches and methodologies, but there is not necessarily an understanding of this complexity. It would be easy to simply lump all ethical funds into the one bucket, or make assumptions based on the name of the fund about what the manager is looking to achieve.

For this reason, we believe it is important to look beneath the surface and educate our clients on what they are actually investing in and, importantly, understand the risk and return trade-off.



Should you

PURCHASE A TERM ALLOCATED PENSION BEFORE 20 SEPTEMBER 2007?

From 20 September 2007, complying income streams such as term allocated pensions (TAPs) will no longer qualify for a social security assets test exemption, and will effectively become obsolete. Existing TAP investors will retain their income streams, but with limited opportunity to roll over (commute) the pension to another provider.

Complying income streams such as TAPs were traditionally purchased to:

1. access pension RBLs by placing at least 50% of superannuation benefits in a complying income stream. Individuals with higher accumulated superannuation benefits could access the higher pension RBL of \$1 356 291 (compared to the lump sum RBL of \$678 149), or
2. maximise age pension entitlements, as TAPs purchased from 20 September 2004 to 20 September 2007 attract a 50% exemption from the age pension assets test.

Importantly, the downside of purchasing a TAP is that an investor cannot access their capital, and is restricted to receiving the funds in a series of income or pension payments.

The abolition of RBLs from 1 July 2007 effectively removes any benefit derived from purchasing a TAP under the first reason mentioned above.

Secondly, from 20 September 2007, the age pension assets test taper rate will reduce from \$3 to \$1.50 for every \$1000 above the lower rate threshold. This will increase the level of assessable assets a homeowner couple can hold before losing their age pension, from \$531 000 to \$825 500 (based on current rates effective 1 July 2007).

The following table contains more detail.

	Current cut-off threshold (\$3 taper)	Cut-off threshold from 20 September 2007 (\$1.50 taper)
Single homeowner	\$343 750	\$520 750
Single non-homeowner	\$464 750	\$641 750
Couple homeowner	\$531 000	\$825 500
Couple non-homeowner	\$652 000	\$946 500

The information in the above table raises the following questions:

1. Should you consider purchasing a TAP and obtaining a 50% assets test exemption before 20 September 2007?
2. With the relaxation of the assets test, is there any benefit to be gained from locking away funds in a TAP income stream?

Whether there is any benefit in purchasing a TAP will depend on your individual circumstances and objectives. To illustrate this, let's look at a case study.

CASE STUDY

Ernie and his wife Betty are a homeowner couple aged 66 and 64 respectively. They have \$400 000 in assessable assets and currently receive an age pension of \$10 200 a year. If they were to do nothing, from 20 September 2007 when Centrelink's assets test changes, their benefits will automatically increase to \$16 576 a year – an annual increase of \$6 376 in their overall situation.

Ernie and Betty's situation could be improved if they invest \$100 000 of their assets into a complying TAP before 20 September 2007. Only 50% of the amount invested in the TAP will contribute to the assets test, along with the remainder of their assets of \$300 000. This gives them total assessable assets of \$350 000, which means

Benefits

OF AN ALLOCATED PENSION FOR THOSE OVER 60

they would receive an age pension of \$14 100 a year. From 20 September 2007, when the assets test changes, their estimated age pension entitlements would increase to \$18 526 a year.

By purchasing a TAP, Ernie and Betty will increase their annual income in the short term by \$3900 and then, from 20 September 2007, it will increase a further \$4426 a year – a total annual increase of \$8326.

Ernie and Betty need to consider whether the greater short-term benefits and less significant longer-term gains are offset by the loss of access to capital and flexibility. Once they invest in a TAP, they must take a certain amount each year as a pension payment (which can vary 10% up or down each year), but they cannot switch to the new-look allocated pensions.

Importantly, those receiving a CSS (ARIA) indexed pension could be assessed under the income test rather than the assets test, thereby eliminating the advantages of purchasing a TAP in the first place. In addition, if the underlying TAP pension investments have performed well over time, the higher return will eventually have to be taken as income by the TAP owner and this income will be assessed under the income test.

An allocated pension is a superannuation account that will provide you with a regular income stream from your superannuation savings. The income stream will generally be available to you once you've retired from the workforce. Alternatively, if you are working you can access a pre-retirement allocated pension.

From 1 July 2007, an investor in an allocated pension must elect to receive a minimum pension payment of 4% a year to age 65. One of the best things about an allocated pension is that it is generally much more tax-effective than taking your super as a lump sum.

TAX BENEFITS OF AN ALLOCATED PENSION

Allocated pensions provide significant benefits.

- You don't pay any tax on any returns earned by the investments in your account. These tax-free earnings remain in your account to increase the value of your investment, so you can potentially receive more income or increase the life of your pension fund.
- Payments from an allocated pension account are completely tax-exempt for anyone aged over 60.
- Centrelink treats only part of the income received from an allocated pension as income, so you may still be eligible for an age pension, depending on your individual circumstances.
- Any unrealised capital gains in your superannuation account can be rolled into an allocated pension account. No tax is payable on rolling over and, best of all, the investments can later be sold tax-free.

Table 1 on the following page illustrates the tax advantages of an allocated pension tax structure compared to a superannuation tax structure. It is important to understand that the investment earnings in a super fund and allocated pension fund are taxed inside the fund at concessional rates.



Benefits

OF AN ALLOCATED PENSION FOR THOSE OVER 60

Table 1

Type of payment	Allocated pension	Super fund
Franked income	(-42.8%) ¹	(-21.4)%
Unfranked income	0%	15%
Capital gains	0%	15%
Discounted capital gains ²	0%	10%

Footnotes

1 Allocated pensions and super funds can both claim unused imputation credits on shares. The fact that their tax rate is lower than the rate of the imputation credit means that they get back more tax than they paid. This effectively becomes a negative rate of tax.

2 When an asset is held for at least 12 months, it becomes a discounted capital gain.

The table shows the rate of tax payable inside an allocated pension fund compared to a super fund. Clearly, the super fund must pay up to 15% tax on any investment income, compared to no tax on earnings in an allocated pension fund. While both tax structures are eligible for a refund of unused imputation credits, the allocated pension receives a higher tax credit (refund) of 42.8%, compared to 21.4% in a super fund.

It is important to understand that an allocated pension fund is merely a tax structure – it does not, in itself, determine performance. It is what you ‘put inside’ the allocated pension fund that determines this. Generally, you can invest in the same investment options or maintain the same asset allocation you currently have in your super fund.

Another benefit of an allocated pension fund is the ability to vary the amount of income you receive and the frequency and timing of each payment, depending on your changing needs. This is especially useful if you’re balancing your allocated pension income against other income sources such as a CSS pension or Centrelink age pension. If you have previously retired, you can also draw a tax-free lump sum at any time, say, for a holiday or emergency. Basically, you can access your money if and whenever you need it.

An allocated pension can run for your own lifetime (assuming the money doesn’t run out!) or transfer to a beneficiary (generally your spouse) after your death. Allocated pensions are also a good way to secure an income stream for your spouse, giving you peace of mind knowing that you can provide for your family in the future.

CASE STUDY

Let’s say George, aged 66, is retired and has \$400 000 in super. Instead of drawing down lump sum amounts as required from his current super portfolio, he decides to roll over his lump sum into an allocated pension. Under the new levels set by legislation, George must draw a minimum pension of 5% (or \$20 000) in the first year.

Let’s assume George already receives a CSS indexed pension of \$50 000 gross a year and at this stage doesn’t need any additional income. He decides to reinvest the first year’s pension payment of \$20 000 (tax-free) into a managed investment generating 5% a year fully franked income (that is, \$1000 investment income).

Table 2 illustrates the cash flow benefit to George of reinvesting the allocated pension payment into a managed investment generating a fully franked income of 5% a year. Based on a taxable income of \$51 000, George’s pay as you go tax rate is 31.5% and any franked income is subject to only 2.14% tax due to the imputation credit/refund from receiving fully franked income. This reduces George’s ultimate tax liability (ignoring other rebates) to \$10 371, some \$21 more than maintaining his existing super portfolio. From a cash flow point of view, George’s net (after-tax) income has automatically increased from \$44 650 to \$65 629, which is \$20 979 or approximately 47% more a year.

Table 2

Cash flow position	Maintain super fund	Proposed allocated pension fund
Gross CSS indexed pension	\$50 000	\$50 000
Plus investment income (fully franked) from reinvesting allocated pension payment	N/A	\$1 000
Plus allocated pension (5% minimum – tax-exempt)	N/A	\$20 000
Taxable income	\$50 000	\$51 000
Less tax (after imputation credits)	(\$10 350)	(\$10 371)
Plus 10% rebate on CSS pension	\$5 000	\$5 000
Total net combined income	\$44 650	\$65 629

In addition to the cash flow benefits of commencing an allocated pension, there is also the potential for George's superannuation account balance to grow because there is no tax on investment earnings and a higher level of imputation credits/refund from any franked income received. Let's assume the \$400 000 is invested in the same investment options in both a superannuation and allocated pension structure generating 8.24% a year after fees, but before taxes. Let's also assume half of these earnings (4.12% a year) are derived in the form of fully franked income and the remaining half is unfranked income. This means that if George maintains his existing super fund, his actual after-tax return will increase to 8.5% after the imputation credit of 21.4% is refunded (see table 1).

If the same gross return of 8.24% a year is generated within the proposed allocated pension tax structure, the actual after-tax return will be 10% a year because of the 42.8% tax credit/refund on half of the gross annual return. Therefore, the allocated pension fund is increasing

by approximately 1.5% a year due to the benefit of paying no tax on the investment earnings and a generous 42.8% tax credit/refund on any fully franked investment income received. Table 3 below shows the benefit of George investing his super into an allocated pension, despite having to draw down a minimum of 5% each year.

Table 3

Type of income	Maintain super fund	Proposed allocated pension fund
Initial account balance	\$400 000	\$400 000
Plus fully franked income (4.12%)	\$16 480	\$16 480
Plus unfranked income (4.12%)	\$16 480	\$16 480
Plus imputation credit from fully franked income	\$3 527	\$7 053
Less 15% tax on unfranked income	(\$2 472)	N/A
Less minimum allocated pension payment	N/A	(\$20 000)
Account balance after investment income and taxes	\$434 015	\$420 013
Assume allocated pension payment reinvested into a managed fund/direct share portfolio	N/A	\$20 000
Combined total	\$434 015	\$440 013

At the end of the first year the allocated pension fund has increased by an additional \$5998, assuming the annual pension payment is reinvested rather than consumed.

Therefore any BL&A clients who are over 60 and have funds invested in superannuation need to contact us to consider the benefits of an allocated pension fund over maintaining funds in superannuation. The tax advantages of increasing your superannuation assets far outweigh the required minimum pension payments that must be drawn down at least yearly.



WANT TO KNOW WHO WILL WIN *the election?*

With politicians kissing babies in shopping centres, there must be an election coming. At the time of writing, the polls have the Labor party a clear favourite, and even the bookies (who are far more reliable than the polls) showing Labor as the favourites, at \$1.60 compared to the Coalition's \$2.30. Is there anyone out there who thinks the coalition can come from behind and win this one?

The answer is yes. A BL&A client currently residing in the Czech Republic sent this email through to us a week ago.

"There is a small size Gypsy community that live in Brno, which by the way is the second largest city in the Czech Republic after Prague. They are renowned for their fabulous style of music and fortune telling. I took a Czech interpreter with me, a friend of ours. I took with me the pictures of Howard, Costello, Brendan Nelson, Turnbull, Downer and Julie Bishop. Also I took pictures of Rudd, Gillard, Bill Shortten, Greg Combet and Maxine McKew.

This shabby looking woman does not know any of these people and has never seen or heard of them, looked at the pictures for a while and with the help of her crystal ball she predicted the following.

Howard's party will win the election by only one or two seats. Howard will lose his seat to Maxine McKew. He will be a very disappointed and broken man. There will be turmoil within Howard's party. Costello will become leader but with great difficulty. Nelson and Turnbull will offer stiff opposition. Again with the Deputy leadership there will be stiff competition between Julie Bishop and Downer. Bishop will just get in.

On the Labor front, Kevin Rudd will be forced to resign. Gillard will be too anxious to take over. She will not find it easy as Combet and Bill Shortten will throw their hat in the ring. In the months to come Australia will not be governable."

Obviously by the time our next edition of Bla Bla Bla hits the street, we will know whether the gypsy woman knew her stuff. If so, we will be offering her selections for shares to watch and the powerball numbers. We will also try and attempt the world's largest teleconference between Canberra, the Czech Republic and Elvis.

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