



# BLa BLa BLa

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## LIFE UNDER A

# *Labor Government*

After an election campaign that seemed to last forever, the Labor party returned to power under Prime Minister Kevin Rudd on 24 November. Labor has been in the political wilderness since 1996, so the obvious concern of our clients is whether we should be adopting a 'change of course' in line with the change in government.

In the past, Labor governments have tended to be big spending, social reforming governments, where fiscal responsibility took second place to other agendas. If this was true of the new Labor Government, one could expect inflationary forces and interest rates to be on the move upwards. This was, of course, the basis of the Coalition advertising campaign in the lead-up to the election – but will a change in government see the 'economic wheels fall off'?

During the election campaign, Kevin Rudd made his new government a very small target by announcing himself to be a "fiscal conservative" and holding very similar economic objectives to the Howard Government. Although this attracted cries of 'me-tooism', there's certainly no doubt that the 'if it ain't broke don't fix it' attitude was a refreshing aspect of the campaign. Undoubtedly, Rudd's positioning of himself as an economic conservative was received well by the public at large, and part of the logic behind the huge swing towards Labor.

Accordingly, the change in government has brought no negative reaction from financial markets, with the Australian share market actually rising some 220 points on the first trading day after the election. The Labor victory was hardly a last minute surprise, with the polls and the bookmakers having had Labor clearly in front for the entire campaign. On this basis, it would appear that both the electorate and the investment markets have seen Kevin Rudd's proposal to maintain fiscal responsibility as genuine.

One of Labor's 'core promises' was to maintain Budget surpluses at 1% of GDP. When the Howard Government took office in 1996, much was made of the 'black hole' that the Coalition inherited from the Keating Government, and after seeing consistent Budget surpluses under the Howard Government it was important that this policy be maintained.

In a booming economy such as ours, Budget surpluses tend to take care of themselves. In a strong economy, company and personal taxes are high, while social payments (such as unemployment benefits) are low. On the back of the resources boom, one does not have to be an economic genius to maintain a Budget surplus. The test of this comes in a less buoyant economy. When economic activity starts to fall, bringing government revenues with it, a Budget surplus can be maintained only by increasing tax rates (or starting new taxes), or reducing government spending.

It is well known that personal (PAYG) taxes are very difficult to move upwards. Only a very courageous government would increase PAYG tax as it is a very visible tax. The rate of PAYG tax payable has a direct correlation with the size of fortnightly pay packets, and an increase in PAYG tax is very noticeable with a reduction in take home pay. It is for this reason that changes to PAYG tax rates have only been one way (down) over the last 20 years.

When a government is looking to raise tax revenue, the common answer is a new tax. From 1983 to 2006 we saw both Labor and Coalition governments gorge themselves on new superannuation taxes. Superannuation tax is a far less visible tax than PAYG tax, as most individuals are unaware of the levels of tax being paid by their superannuation fund. If a future government were to (say) increase the tax rate on superannuation funds from 15% to 20%, there is



unlikely to be the same degree of public outrage as would accompany an increase in PAYG taxes by a third. As such, taxes such as those on superannuation have been a relatively soft target for governments over the past two and a half decades.

Of course, we are now in a position where many of these taxes have been abolished from 1 July 2007. With Labor having voted with the Coalition to remove these taxes, it remains highly unlikely in our view that we would see a re-introduction of these superannuation taxes, at least not in the short term. It may well be that a future Treasurer, in a less buoyant economy, will have no choice but to increase the level of superannuation taxes, as the pool of superannuation in Australia is growing at an almost exponential rate, and it is a relatively soft target. If this were to happen, it would be highly unlikely that any law changes would be retrospective, with those inside the superannuation system likely to be protected by transitional provisions. For the time being, however, we should probably look on the superannuation tax system as being as good as it gets.

One interesting issue arising from the election of the Federal Labor Government is that we now have wall to wall federal and state Labor governments. This undoubtedly represents a risk, as one of the classic checks and balances of our political system is no longer in place. But, on the other hand, it offers a tremendous opportunity for the Federal Government and state governments to work together on areas of overlap, such as health.

There is no doubt that one of the huge successes of the last Labor era (Hawke/Keating) was the deregulation of many aspects of the economy and the removal of many regulations that stifled competition. One can only hope that the legacy of the current wall to wall Labor governments will be greater cooperation and the removal of duplication in areas such as health.

One aspect that should not be forgotten about wall to wall federal and state Labor governments is the opportunity to raise tax revenues by increasing the GST. The current GST

legislation requires the agreement of all state governments and the Federal Government to change the 10% GST rate. Given that the states benefit from this 'federal' tax, they may well pressure the Federal Labor Government to increase the rate over time. Only time will tell.

Probably the largest 'watch this space' issue is how the Labor Government will handle Work Choices. There is no doubt that many Australians are comfortable with the new arrangements, and how far the new government will go in changing them is still largely unknown, particularly given that the Coalition will still control the Senate until next July.

One initiative announced by Labor in the lead up to the election was the establishment of the First Home Owners Savings Account (FHOSA) scheme. People aged 18 and over will be able to open a FHOSA (a separate superannuation-style account which will operate independently from their existing superannuation fund(s)) as long as they comply with the eligibility criteria for the First Home Owners Grant. Accounts will only be accessible four years after establishment and will only be released for an eligible first home purchase (exceptions apply). A \$10,000 (indexed) cap will apply to total contributions each year with a \$5,000 (indexed) cap applying to contributions made from pre-tax income each year. The remainder (\$5,000 indexed) may only be used for after-tax contributions from the individual or a third party.

It is proposed that these accounts will receive tax concessions, with withdrawals being tax free if they are used for an eligible first home purchase. Pre tax contributions will be taxed at 15%, as will the earnings within the fund.

Assuming that this proposal passes into law, we would expect to see the banking and finance sector establish a range of products for this market.

However, for the time being, financial markets do not seem spooked by the change in government and it would appear to be business as usual. Obviously, we will continue to keep clients abreast of any significant changes in tax law or policy.

# RISING INTEREST RATES AND *investment strategies*

The rapid growth in the Australian share market over the past 4 years has been underpinned by an extremely buoyant economy, particularly in the resource-rich states of Queensland and Western Australia. With an economy running at almost full capacity and unemployment at a 30-year low, it was inevitable that inflationary pressures would sneak back into the economy.

Since the 'recession we had to have', the Reserve Bank has been careful not to let inflation get out of the bag again. Former United States (US) President Ronald Reagan once said that inflation is 'as violent as a mugger, as frightening as an armed robber and as deadly as a hit man'. For those who lived through the 17% mortgage rates of the late 1980s, it is easy to understand why the Reserve Bank is acting so quickly on interest rates now, in an attempt to kill inflation before it gets a foothold. While the rising \$A has helped to keep the cost of imports down, increasing world oil prices (which flow through to all facets of production) have not helped in the fight against inflation.

The increase of 25 basis points on 7 November was the tenth increase of 25 basis points since the first one in May 2002. The official cash rate has increased from 4.25% in 2001–02 to the current level of 6.75%.

Compared with the 17% mortgage rates of the 1980s, a cash rate of 6.75% does not sound that bad. However, as mortgage rates fell through the 1990s, home buyers borrowed more. Spurred on by cheap credit and innovative lending products (such as lines of credit), Australians saw their homes as a pool of equity that could be drawn down on and repaid at a later date. The transition to the 'spend now, pay later' mindset is now pretty much complete in middle Australia, thanks to the cheap credit of the last 10 years. However, all good things must come to an end.

The increase in the cash rate from 4.25% to 6.75% is actually quite drastic, given the higher debt levels that borrowers now have. While an increase of 2.50% in the official rate may not sound like much, it is more than a 50% increase on the starting cash rate (of 4.25%). Since May 2002, the repayments on a \$250 000 loan (paid monthly and taken over

20 years) have increased by approximately \$350 a month.

It's not surprising that the media focuses on the pressure on borrowers, who must find the extra \$50 a month for the average mortgage. After all, pictures of banks repossessing homes and throwing defaulters onto the street sell papers. However, for those who are debt-free and have cash to invest, rising interest rates are a godsend.

Let's consider this in terms of the BL&A investment strategy, which is based on the consumption timeframe. According to this strategy, funds that are to be consumed within the next 3 years are considered to be 'first bucket' funds, and are placed into cash. The logic behind this is that a 3-year timeframe is quite short in terms of investment cycles, and money required in this timeframe needs to be removed from the volatility of the share market.

To a large degree, the funds placed in cash in the first bucket are somewhat of a sacrificial lamb. It is accepted that these funds will never provide a high rate of return, but their job is to provide stability for the short term, and let the second and third buckets 'put the runs on the board'. With the official cash rate on the increase, however, deposit rates being offered by all major institutions are also increasing. So having some of a portfolio in cash is not as detrimental as it used to be.

If an investor can safely get 6.5% to 7.5% on their cash deposits, they are in the position where the interest rate earned is exceeding the inflation rate (currently around 3–4%). Additionally, if they are drawing down an allocated pension, the minimum pension payments are only 4%, 5% or 6% a year until age 85. So even if a large portion of an allocated pension is in defensive assets, there is now a greater chance that the earnings will exceed drawings, allowing the allocated pension to grow.

The other consideration, however, is the impact the increase in the official cash rate will have on the other 'buckets' inside an investor's portfolio.

Rising cash rates are not just designed to slow consumers, but also to put a brake on production. Companies are like households, in that many already carry debt, and the cost



of additional borrowing is significant in deciding whether they expand operations. For those companies already carrying debt, rising interest rates will see a greater portion of their company earnings paid in interest, with profits to shareholders reduced accordingly. Rising interest rates could deter a company from borrowing additional funds to finance an expansion or develop a new business line.

Many BL&A investors are familiar with the concept of internal gearing. Under these arrangements, investments are enhanced by internal borrowing, with the fund manager borrowing an additional dollar for every dollar the client invests. The logic behind this 'third bucket' strategy is obvious, in that if the cost of borrowing is lower than the gains generated by the borrowed funds, the gearing will provide higher returns compared to a non-g geared investment. In recent years, on the back of rising share markets and low interest, these internally geared funds have experienced substantial returns and provided a significant reward to clients adopting this strategy.

The rise in interest rates is likely to affect the performance of these internally geared products in two ways. Firstly, funds will pay a higher rate of interest on their borrowings, so that even if the gross returns remain the same, investors will receive less as more of the returns must be dedicated to interest payments. Secondly, the companies themselves will be less profitable as their interest repayments bite into company profits.

The extent to which rising cash rates place a brake on the economy is yet to be seen. In the face of the never ending resources boom, small rises in the cash rate may not be sufficient to ease inflationary pressures – particularly on the back of personal tax cuts, which are likely to increase consumer spending.

While we have never predicted share markets, we believe that investors who know they have expenditure coming in the short term should look to take gains while they are on offer, and place them in a 'first bucket' investment. The fact that these first bucket funds can get a higher rate of return is

a greater incentive to take gains while they are on offer.

The market is suggesting that interest rates still have some way to go. If we consider the Member's Equity basic home loan, at the time of writing the current variable rate is 7.74%, while the 1-year fixed rate is 8.29%. The pricing of these loans would suggest that official cash rates could very quickly rise by another 0.5%.

This is also reflected in term deposit rates. At the time of writing, Macquarie Bank was giving 6.25% as their 'at call rate' but offering 7.7% for a 12-month term deposit.

It is probably true to say that no one really knows how many more interest rates rises are yet to come. The unfortunate aspect of the recent election campaign is that both political parties did their best to buy their way into office by throwing money at the electorate in the form of tax cuts and government spending. Both these actions will add considerable pressures to inflation. As mentioned at the outset, the Reserve Bank's first priority is to not let inflation get a foothold, and so we should probably expect a short sharp tightening of monetary policy in 2008.

One risk associated with this tightening of monetary policy is that domestic interest rates become considerably higher than overseas rates. This, in turn, places more pressure on the \$A, as offshore investors take advantage of our higher interest rates and the stable and secure Australian banking environment. This makes our exports more expensive and less attractive, as well as making imports cheaper. The last thing Australia really needs right now is cheaper imported plasma televisions, as the tax cuts tend to be consumed rather than saved. This would have been the perfect time to place the tax cuts into superannuation but, sadly, it is another opportunity lost.

For those with home loans, the obvious question is whether to lock in and, if so, for how long. We will only know the answer to this question in hindsight. However, if you find yourself with little room to move with your mortgage commitments, locking in for 12 months to 2 years will at least provide some certainty.

# UPDATE ON THE *sub-prime mortgage crisis*

During July and August we saw world share markets fall as the impacts of the sub-prime mortgage crisis in the US started to come to light. The Australian market largely shrugged off these impacts, except for stocks such as (the newly listed) RAMS and Macquarie Bank, which had direct exposure to these markets.

Our August edition of Bla Bla Bla detailed the problems associated with these NINJA loans (no income, no job & assets). Many of these loans were taken out when the US was experiencing record low interest rates but, not surprisingly, started to encounter difficulty when rates started rising. Many of the large US banks have had to write off billions of dollars in loans and restrict new credit. This 'credit squeeze' has been felt all around the world.

It is not surprising that Australian markets rebounded more strongly from this crisis compared to US markets. Australia really does not have a sub-prime market, with the closest thing being our 'low doc' loan system. However, even with the emergence of this market in Australia, our system is very different from that of the US.

	Australia	United States
Home ownership	75%	65%
Supply/demand	Under-supplied	Over-supplied
Construction	Rising	Falling
Vacancy	Low (1.4%)	High (9.5%)
Rents (year to June 2007)	Rising	Rising
Sub-prime mortgage lending rate	1%	15%
House prices	Rising	Falling
Mortgage rates	Rising (7.75%)	Falling (6%)
Mortgage delinquency (prime)	Rising (0.5%)	Rising (2.5%)
Average loan/value ratio	27%	54%
Affordability	Low	Low

The table paints an interesting picture of the differences in the two markets. The very high vacancy rates and over-supply in the US, coupled with a higher loan to value ratio and higher percentage of sub-prime lending, are clearly fuelling the sub-prime issues. With falling house prices, those who have borrowed heavily to purchase their properties are now finding themselves with negative equity in the property. In the absence of any 'hurt money', it can be simpler to merely walk away from the property and let the negative equity be the lender's problem. There is currently a delinquency rate of around 15% in all sub-prime lending, which is testimony to the lack of 'hurt money'.

But, in spite of this doom and gloom, it is important to put the issue into perspective.

In terms of global financial markets, the US sub-prime mortgage market is overwhelmingly small. The Bank of England has estimated that world securities markets have a value of some \$149.1 trillion. Of this, the sub-prime mortgage market is estimated to be \$0.7 trillion, or less than half a per cent of the world securities markets.

These figures emphasise how we should view this crisis. For those involved directly in the sub-prime market, there are huge implications associated with the high delinquency rate and low loan to value ratios. For those in the broader market, the small size of the sub-prime market (compared to global securities markets) means it is not a major concern. A delinquency rate of 15% affecting less than half a per cent of the world's global securities markets is unlikely to cause the worldwide credit squeeze some predict.



# Northern Rock

## – THE NEXT CONTAGION?

Readers of the financial press will be familiar with the problems facing the British Bank, Northern Rock. Britain's fifth largest mortgage lender was facing crowds of depositors wishing to withdraw their money, in light of fears generated by the sub-prime mortgage crisis in the US.

Such a 'run on the bank' is often a self-fulfilling prophecy. The funds deposited in banks such as Northern Rock do not merely sit in the vault waiting to be repaid, but are 'on loaned' to businesses and consumers for housing, commerce and all manner of things. When depositors suddenly want their money back, banks cannot call in their loans overnight. So banks must look for some other form of borrowings to hold their balance sheet. With the US sub-prime creating a credit squeeze, this was not the time for Northern Rock to be looking for additional finance to sure up their balance sheet.

Britain's Finance Minister Alistair Darling sought to reassure Northern Rock's 1.5 million depositors that their funds were safe, by reminding them that the Bank of England had agreed to emergency funding to Northern Rock. Clearly, the last thing any government wants is a run on the bank, as this can become a contagion, spreading from bank to bank. Further, it is not healthy for savings to be kept under the mattress in the bedroom. The savings of mums and dads form the backbone of the borrowings that are used to grow the economy.

As explained earlier, the problems with the sub-prime mortgage market really are a world away from Australia. Nonetheless, could a similar 'Northern Wreck' scenario occur here? Is it possible that we would have a run on the bank that spreads from institution to institution, drying up deposits and creating a credit squeeze? We all remember the Tricontinental and Pyramid disasters of the 1980s, so how exposed are we?

The good thing about being a relatively young nation is that our lawmakers were able to look at best case examples from around the world in establishing our laws. This is very true of the Australian banking industry.

The banking system in Australia is now under the prudential supervision of the Reserve Bank. Although most of the headlines concerning the Reserve Bank are to do with its role in setting monetary policy (interest rates), its major function is to ensure the stability of the banking industry through this prudential supervision. The prudential

guidelines developed by the Reserve Bank seek to constrain the commercial judgments banks make about the quantity and quality of assets they hold. The Reserve Bank's system of supervision is therefore fundamentally directed towards satisfying itself that the individual banks are following management practices that limit risks to prudent levels and that established prudential standards are being observed.

The prudential regulation of the Australian banking system covers many aspects of the day-to-day life of the banks, including:

- ownership and control of the banks
- capital adequacy
- prime asset ratios
- exposures
- associations with non-banks, and
- use of appropriate external auditors.

These controls underpin the safe operation of the banks. But, having said this, we know that in most cases a run on the bank is not generated by logic, but rather by fear and emotion. If such an 'illogical' event were to occur, would the prudential supervision be enough?

The Banking Act 1959 stipulates that each bank in Australia must hold assets in Australia of not less than the amount of its deposit liabilities in the country. Furthermore, the Act also states that if a bank cannot meet its obligations, or it suspends payment, its assets in Australia must be used to meet its deposit liabilities in Australia before any other liabilities are met.

In short, the prudential regulation of the Australian banking system seeks to ensure that banks behave responsibly in their role as custodian of depositors' funds. Of course, the only way to ever ensure that depositors are 100% covered against a run on the bank is for a bank to hold 100% of its deposits at call. But this totally undermines the whole concept of the banking sector.

It is safe to say that depositors in Australian banks have amongst the greatest levels of protection of any banking system in the world. This, coupled with our very low exposure to sub-prime lending practices, makes it highly unlikely that we would see the situation faced by Northern Rock occur here.

# The anti-laundering LEGISLATION

Legislation has recently been passed that places additional requirements on financial institutions and intermediaries handling investments.

In a sign of the times, the 99.99% of honest transactions will now be more cumbersome to process, in order to prevent the 0.01% of dishonest transactions which launder proceeds of crime through managed investments and superannuation. The new arrangements, which come into effect in December 2007, require fund managers and

financial advisers to hold proof of identification for clients when making transactions.

This identification requirement can be met by producing some form of photographic identification (drivers licence or passport) when opening an account or making a withdrawal. Fortunately, once we have a copy of this identification on our records, we will not require it again.

## IS IT TIME TO *take gains?*

As we approach the end of the 2007 calendar year, we once again ask ourselves 'Is it time to take gains?'

It is important to emphasise that the BL&A investment process will never attempt a 'tactical asset allocation' approach to investing, which would involve moving in and out of markets based on the assumption that they are about to rise or fall. All BL&A clients are familiar with our investment process – aptly termed 'Using the BL&A bucket approach to investing' and available on our website at [www.blapl.com.au](http://www.blapl.com.au). The basic philosophy behind the bucket approach in choosing an appropriate investment option is the consumption timeframe. The basis of this approach is to quarantine funds that are not required for at least 7 or more years from now and invest them in the share market, regardless of whether pundits or the general consensus is that the share market is too high, too low or fair in terms of relative valuation.

Despite the volatility experienced in the Australian and international share markets in 2007, the US Dow Jones Industrial Average Index has increased from 12 316 since 20 November 2006 to around 13 010 at 20 November 2007, an overall increase of 5.63%.

Over the same period, the ASX All Ordinaries Accumulation Index has increased from 5339 at 21 November 2006 to 6450 at 21 November 2007, an overall increase of 20.81%. Clearly, taking gains is something one contemplates only when gains are on offer

– and the domestic share market in particular has delivered good gains over the last 12 months.

The other important reason to consider taking gains is that the end of the year marks another 'rolling year' in the 'bucket cycle'. Under the bucket approach, with respect to an allocated pension investment we recommend clients quarantine their pension payment income and lump sum expenditure based on when the funds will be consumed. Generally, the first bucket should allow for 3 years' worth of pension payment income and lump sum needs within the next 1 to 3 years. The second bucket of investments should contain approximately 4 years' worth of pension payments and lump sum needs (4–7 years), with the balance to be allocated to bucket three (8 years plus).

If the buckets were set 12 months ago, the first bucket should now contain only enough pension payment income for the next 2 years. Under these circumstances, it is advisable to take the gains from buckets two and three to top up the first bucket, before the market has a chance to take the gains back.

Debbie-Jane Campbell and Sarah Hutchison are currently reviewing the 'bucket mix' of our clients. If you think your portfolio needs fine tuning in relation to the three bucket approach to investing, please contact us on (02) 6247 0099 or via email at [clients@blapl.com.au](mailto:clients@blapl.com.au)



# *Review your salary packaging arrangements*

## NOW

All BL&A clients need to review their current superannuation salary packaging arrangements to ensure they do not exceed the concessional contribution limits for the 2007–08 financial year.

From 1 July 2007, the government implemented a limit on concessional contributions of \$50 000 (indexed) per person per financial year. The limit applies to concessional (that is, deductible) contributions that may be made by or on behalf of a person. The \$50 000 concessional contribution limit will be indexed to average weekly ordinary time earnings, but will increase only once the increase in the indexed amount is more than \$5000 (to make it easier for people to track the amount of concessional contributions they can make each year). A transitional period allows people aged 50 and over to make up to \$100 000 of concessional contributions without breaching the concessional limit. The \$100 000 threshold is not indexed. This transitional concessional limit applies from 1 July 2007 to 30 June 2012. A person who turns 50 before the end of the financial year during this period will be able to take advantage of the transitional arrangements (that is, from the year of their 50th birthday).

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.

It is important to note that if you contribute to a ComSuper – Australian Reward Investment Alliance super scheme (that is, you are a CSS, PSS, PSSap, MSBS or DFRDB contributing member), your employer makes productivity contributions on your behalf. These

contributions are generally 2% to 3% of your gross salary and are classed as concessional contributions for tax purposes and included in the \$50 000 and \$100 000 limits. Actual employer productivity superannuation contributions are generally shown on your fortnightly payslip.

Contributions in excess of the concessional contribution limits (\$50 000 or \$100 000 limit) are referred to as excess concessional contributions. These contributions are subject to up to 15% tax by the superannuation fund, and individuals are liable to pay additional tax on the excess at the rate of 31.5% (giving an effective tax rate of 46.5%). Individuals can choose whether to withdraw the amount of their excess concessional contributions tax liability from their superannuation fund or pay it themselves. Importantly, excess concessional contributions will also count towards the non-concessional contribution limit of \$150 000 per person per financial year. In some circumstances, this may mean that the same contribution is effectively taxed more than once. For example, if the non-concessional limit of \$150 000 is exceeded, a further 46.5% tax can be imposed on the excess concessional contributions, resulting in an overall tax liability on the excess concessional contributions of 93% (15% contributions tax plus 31.5% excess concessional contributions tax plus 46.5% additional excess non-concessional tax).

All BL&A clients 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 limits for 2007–08.

# SHOULD YOU STOP YOUR *CSS contributions?*

The Superannuation Legislation Amendment Act 2007 received Royal Assent on 25 September 2007. This new legislation, effective from 1 July 2008, allows a CSS contributing member to elect not to contribute to the scheme.

If a contributing member of the CSS elects not to make member contributions (basic 5% or more of salary), the accrual rate of the defined benefit pension at age 55 (or above) will still accrue and is based on the member's age, final salary and length of membership.

However, where a CSS resignation benefit is a multiple of a member's contributions and interest (such as the resignation or 54/11 months benefit), the employer-financed benefit is currently 2.5 times a member's own basic 5% contributions plus earnings. For the period where the member makes no contributions, the employer-financed benefit will be 2.5 times the earnings only. Therefore, contributing members to the CSS who are under 55 should continue to contribute 5% of their superannuation salary into the scheme to maximise the potential 54/11 months employer-financed benefit.

Any CSS contributing members over 55 from 1 July 2008 should consider ceasing their after-tax contributions of 5% or more as the employer-financed indexed pension is not affected. As the member contributions provide a lump sum benefit funded by mainly post-tax member contributions and employer productivity contributions, a contributing member over 55 would be better off salary sacrificing the equivalent pre-tax amount into a superannuation fund of their choice.

The table below identifies the equivalent pre-tax amount (using the 2008–09 PAYG thresholds) a contributing CSS member could consider salary sacrificing compared to contributing 5% or more from after-tax dollars into the CSS.

<b>PAYG tax rates</b>	<b>2008–09 income thresholds</b>	<b>Equivalent pre-tax/salary sacrifice amount</b>
16.5%	\$6001 – \$30 000	6.00%
31.5%	\$30 001 – \$80 000	7.30%
41.5%	\$80 001 - \$180 000	8.55%
46.5%	\$180 001+	9.35%

As the above table highlights, a PAYG individual earning between \$30 001 and \$80 000 from 1 July 2008 will have a tax rate of 31.5%, which is equivalent to salary sacrificing 7.30%. A PAYG individual earning between \$80 000 to \$180 000 from 1 July 2008 could salary sacrifice 8.55% of their gross income, the equivalent of 5% of their after-tax CSS member contribution.

One word of warning with this strategy is that where an individual is made redundant after age 55, they are again offered the deferred pension option (which normally ceases at age 54/11). Hence, if it was known that an individual would be made redundant after age 55, and that they were better off under the deferred benefit arrangements, they would be wise to maintain their 5% CSS contribution level in spite of the above tax based argument.



## THE IMPORTANCE OF A

# *binding death benefit*

The importance of a binding death benefit nomination has recently been emphasised, with the unfortunate death of two BL&A clients who elected a non-binding death benefit nomination. In both cases, the superannuation member was in a second marriage, but had completed only a non-binding nomination that their current spouse be the beneficiary of their superannuation. Consequently, the matter dragged out for many months, causing enormous emotional grief, which could have easily been resolved if a valid binding death benefit nomination had been elected.

Changes to superannuation legislation over the last couple of years have allowed superannuation and allocated pension investors to elect a legally binding death benefit nomination in terms of who receives their benefits if they die, without any trustee discretion.

Effectively, most superannuation/allocated pension funds offer investors the opportunity to elect either a binding or non-binding death benefit nomination. The main difference between a binding and non-binding nomination is detailed below.

### NON-BINDING DEATH BENEFIT NOMINATION

Non-binding nominations, as the name implies, do not bind the trustee to pay the benefit in a certain way. If the member dies, the trustee will confirm that the nominated beneficiary:

- is a dependant under superannuation law at the time of death
- is able to be paid under the rules of the fund, and
- is the only potential beneficiary.

Where there are other beneficiaries, the trustee may either split the benefit between some or all of the beneficiaries or pay the whole amount to the member's estate for distribution. Where the trustee pays the benefit to a beneficiary, they usually give the beneficiary the option of taking the benefit as a lump sum or income stream.

In the recent cases of the death of two BL&A clients, the trustees took it upon themselves to investigate whether they should recognise the non-binding nomination. This involved us having to track down the former spouse of the deceased and the children from the first marriage, and ask them to make a statutory declaration that they were not interested in making a claim. In one case, there was considerable 'bad blood' with the former spouse, who saw this as an opportunity to make life difficult for the new spouse.

Clearly, the last thing anyone wants to see is their loved ones fighting over their superannuation/allocated pension monies. The difficulty with non-binding nominations is that the trustees of the fund want to completely rule out any chance that they will be sued, and hence seem to want everyone who has known the individual to 'sign off' that they do not want the superannuation, before releasing it to the nominated beneficiaries.

One could argue that this is a good thing, as many factors may have changed since the original non-binding nomination was made, and it is good to have the trustees investigate who should get your money. However, it is our experience that in 98% of cases this investigation is overkill, and all it does is needlessly delay payment of the benefit, bringing additional grief to loved ones. We are particularly concerned that the processes used by some trustees are overly cautious on matters that we would consider very straightforward.

This can all be circumvented by making a binding nomination. As stated earlier, when a binding nomination is made, the death benefit payment is made in a matter of weeks, rather than months.

### BINDING DEATH BENEFIT NOMINATION

Binding nominations bind the trustee to pay the benefit to the member's nominated beneficiaries. The difference with binding nominations is that they allow a member to nominate multiple beneficiaries.

# *nomination*

Provided the trust deed allows binding death benefit nominations and the regulations are complied with, a member's valid nomination legally binds the trustee to pay the superannuation/allocated pension monies to the nominated beneficiary – full stop.

Binding death benefit nomination notices must:

- be signed and dated by the member
- be witnessed appropriately by two individuals who are not nominated beneficiaries of the member
- specify the proportion of the benefit to be paid to each nominated beneficiary
- nominate only beneficiaries who are either dependant or the legal personal representative of the deceased member, and
- be sufficiently clear and unambiguous for the trustee to act on.

Other important issues involved with binding death benefit nominations are:

- the nominated beneficiaries must be a spouse, child, financial dependant, a person with whom the deceased member had an interdependency relationship, or their legal personal representative, and
- the maximum term an unchanged notice can remain in effect is 3 years. Subsequently, the trustee will contact a member every 3 years and ask them to renew their nomination.

Although binding death benefit nominations have been available for a number of years, some superannuation funds were reluctant to offer these nominations to their members until quite recently. Therefore, we strongly recommend that all BL&A clients ensure they have a binding death nomination for their current superannuation or allocated pension funds, to provide certainty and remove any doubt over who receives their superannuation monies when they die.

## REVERSIONARY PENSION NOMINATION

For those receiving an income stream such as an allocated pension, a reversionary beneficiary can be nominated when establishing the investment. A reversionary nomination binds the trustee to continue to pay the member's pension to their reversionary beneficiary on their death and there is no need to make a binding death benefit nomination. However, for the nomination to be valid, there can be only one reversionary beneficiary nominated, and they must have been a dependant at the time of death.

Reversionary nominations are advantageous where an individual has complex estate planning requirements and they want to ensure their income stream passes to one particular beneficiary. For an allocated pension, the beneficiary has the option of commuting the pension to a lump sum. However, for term allocated pensions, the reversionary beneficiary must continue to receive the pension for the remaining term.

Importantly, from 1 July 2007 the reversionary beneficiary must be a dependant of the deceased according to the Superannuation Industry (Supervision) Act (that is, a spouse, de facto, child aged under 18 or in an interdependency relationship, or a financially dependant child less than 25). Otherwise, the death benefit must be paid out as a lump sum and not as an ongoing income stream.

Although reversionary nominations allow estate planning certainty, they may not be as tax-effective as a binding nomination. This is particularly so if the member is under 60 as the trustee must calculate any deductible (tax-free) amount of the pension payment using the longer of either the member's or their reversionary beneficiary's life expectancy, which may reduce the annual deductible (tax-free) amount up until age 60.



## NEW PREMISES

After almost 7 years at Braddon, BL&A is moving to a permanent home in 2008. The first soils have been turned for our new, purpose-built premises. Pending rain, building strikes and other acts of God, we hope to be in our new premises before the end of financial year rush. Watch out for the April 2008 Bla Bla Bla for an update.

## CHRISTMAS AND NEW YEAR HOURS

**This year the BL&A office will close on Friday 21 December 2007 and reopen on Wednesday 2 January 2008.**

During this time an answering machine will take messages, and our email [clients@blapl.com.au](mailto:clients@blapl.com.au) will continue to operate. Both will be checked for any urgent matters over the break.

We wish all our valued clients a safe and prosperous festive season.  
*Chris, Deb, Doug, Fiona, Frances, Meg, Sarah, Scott, Stephen, Steve and Wendy*

### BARNETT LILLEY & ASSOCIATES PTY LTD

ABN 90 074 689 599

AFSL 237915

Address 27 Torrens Street, Braddon ACT 2612

Postal address PO Box 5095, Braddon ACT 2612

Phone (02) 6247 0099

Fax (02) 6247 0555

Email [clients@blapl.com.au](mailto:clients@blapl.com.au)

Website [www.blapl.com.au](http://www.blapl.com.au)

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