

BLa BLa BLa

BL&A SEMINAR

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IS THAT A LIGHT AT THE END OF THE TUNNEL, OR A TRAIN COMING?

What does one make of the current investment climate? European debt, the stalling US economy, the downgrade of the US credit rating, the high A\$, the two-speed Australian economy, and the possibility of a carbon tax.

Is there any good news out there?

BL&A clients are invited to hear the opinions of two top economists as they discuss these issues.

The seminar will be held at 6.30 pm on 29th September in Building 14 at the
University of Canberra.

RSVPs are imperative as places are limited. The session will be recorded
(and available on our website) for interstate clients and those unable to attend the seminar.

Refreshments will be served afterwards.

Please contact Frances on (02) 6225 8200 or
email her at clients@blapl.com.au to reserve your place.

BOND CREDIT RATINGS

Late July and early August 2011 was an interesting period for the United States (US) 'debt crisis'.

Opposing parties were engaged in a game of chicken with each other, both holding out to get their reform package through and score the maximum political points. Although a compromise was reached at the eleventh hour, the public and the world in general remained far from amused at the shenanigans.

Hanging like the sword of Damocles over the debt debate was the possibility of the US being downgraded from its AAA credit rating. After a compromise was reached, one of the three major ratings agencies did remove the US AAA rating, meaning that it was the first time that this rating did not apply to the US Government as an issuer of debt since 1917. The other two ratings agencies maintained the AAA rating, but changed their outlook on the US to 'negative'.

The downgrade announcement set off a roller coaster week on world share markets as analysts, investors and the finance sector tried to work out the implications of something that has not occurred in their lifetime. On Monday August 8, the first US trading day after the downgrade was announced, the US Dow fell some 5.5%. As Australian markets opened a few hours later, the ASX All Ordinaries fell nearly 5% in the first few hours of trade, to then rally and finish up 2.7% by the end of the day.

There has been a considerable amount of economic commentary as to what happens from here. Some have argued that the downgrade should not have occurred as the US can always 'print more money'. Additionally, it is pointed out that the US spends some 1.9% of GDP on debt maintenance, compared to other AAA rated sovereigns such as the United Kingdom (2.6%).

Obviously this is another part of the jigsaw puzzle with investments.

The long term implications of this, for the US and world economies, will be discussed at our upcoming seminar. It is however interesting to appreciate the background to these credit ratings as they are referred to on an increasingly common basis in the press.

Rating agencies date back to the 19th century and the heady early days of the US railways. In the rush to lay track and build railway stations across the American continent, investors craved information to help them profit without losing their shirts. Many railway companies went bankrupt, with some businessmen (among whom were those later dubbed 'robber barons') using borderline-illegal tactics to cripple their rivals.

Henry Varnum Poor (one of the 'fathers' of Standard & Poor's (S&P) credit-rating agencies) was one of the first analysts to tackle the railway tycoons. He collected and published analyses of the financial health of the various railroad companies that sprang up across the country. John Moody launched a similar venture, called Analyses of Railroad Investments, in the early 20th century.

In the 21st century, a credit rating still evaluates the credit worthiness of an issuer of various types of debt, specifically, debt issued by a business enterprise such as a corporation or a government. It is an evaluation made by a credit rating agency of the debt issuer's likelihood of default. Credit ratings are determined by credit rating agencies. The credit rating represents the credit rating agency's evaluation of qualitative and quantitative information for a company or government, including non-public information obtained by the credit rating agency's analysts. Credit ratings are not based on mathematical formulas. Instead, credit rating agencies use their judgment and experience to determine what public and private information should be considered in rating a particular company or government. The credit rating is used by individuals and entities that purchase the bonds issued by companies and governments to determine the likelihood that the issuers will pay their bond obligations.

A poor credit rating indicates a credit rating agency's opinion that a company or government has a high risk of defaulting, based on the agency's analysis of the entity's history and analysis of long-term economic prospects.

The big three credit rating agencies are Standard & Poor's (S&P), Moody's Investor Service, and Fitch Ratings. Moody's and S&P each control about 40% of the market. Third-ranked Fitch Ratings, which has about a 14% market share, is sometimes used as an alternative to one of the other majors.



Differences in the credit rating between agencies

| Moody's | Standard & Poor's | Fitch | Credit worthiness |
|---------|-------------------|-------|--|
| Aaa | AAA | AAA | An obligor has EXTREMELY STRONG capacity to meet its financial commitments. |
| Aa1 | AA+ | AA+ | An obligor has VERY STRONG capacity to meet its financial commitments. It differs from the highest rated obligors only in small degree. |
| Aa2 | AA | AA | |
| Aa3 | AA- | AA- | |
| A1 | A+ | A+ | An obligor has STRONG capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher rated categories. |
| A2 | A | A | |
| A3 | A- | A- | |
| Baa1 | BBB+ | BBB+ | An obligor has ADEQUATE capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments. |
| Baa2 | BBB | BBB | |
| Baa3 | BBB- | BBB- | |
| Ba1 | BB+ | BB+ | An obligor is LESS VULNERABLE in the near term than other lower rated obligors. However, it faces major ongoing uncertainties and exposure to adverse business, financial or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitments. |
| Ba2 | BB | BB | |
| Ba3 | BB- | BB- | |
| B1 | B+ | B+ | An obligor is MORE VULNERABLE than the obligors rated 'BB', but the obligor currently has the capacity to meet its financial commitments. Adverse business, financial or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments. |
| B2 | B | B | |
| B3 | B- | B- | |
| Caa | CCC | CCC | An obligor is CURRENTLY VULNERABLE, and is dependent upon favourable business, financial and economic conditions to meet its financial commitments. |
| Ca | CC | CC | An obligor is CURRENTLY HIGHLY VULNERABLE. |
| | C | C | The obligor is CURRENTLY HIGHLY VULNERABLE to non-payment. May be used where a bankruptcy petition has been filed. |
| C | D | D | An obligor has failed to pay one or more of its financial obligations (rated or unrated) when it became due. |

A bond is considered investment grade if its credit is rated BBB– or higher by S&P or Baa3 or higher by Moody's or BBB (low). Generally, they are bonds that are judged by the rating agency as likely enough to meet payment obligations (that banks are allowed to invest in them).

Ratings play a critical role in determining how much companies and other entities that issue debt, including sovereign governments; have to pay to access credit markets, that is, the amount of interest they pay on their issued debt. The threshold between investment-grade and speculative-grade ratings has important market implications for issuers' borrowing costs.

Bonds that are not rated as investment-grade bonds are known as high-yield bonds or, more derisively, as junk bonds.

The risks associated with investment-grade bonds (or investment-grade corporate debt) are considered noticeably higher than in the case of first-class government bonds. The difference between rates for first-class government bonds and investment-grade bonds is called investment-grade spread. It is an indicator of the market's belief in the stability of the economy. The higher these investment-grade spreads (or risk premiums) are, the weaker the economy is considered.

What is special about the AAA rating?

The AAA rating is the highest possible rating that can be given to a company or government. S&P says that it awards AAA only when there is an 'extremely strong capacity to meet financial commitments'. This gold standard means an AAA-rated borrower can usually secure a loan at lower interest rates as there is much less risk that the money will not be repaid.

Is a AAA rating a guarantee that a borrower will not default?

No. The rating agencies are careful to point out that their opinions exist 'within a universe of credit risk'. So, while there is less chance of a AAA bond defaulting than a BBB one, there is still some danger.

How many countries have a AAA rating?

Because the ratings agencies use slightly different methodologies, there is no single list of AAA-rated

sovereign debt. As an example, S&P have assigned the AAA rating to Australia, Austria, Canada, Denmark, Finland, France, Germany, Liechtenstein, Luxembourg, the Netherlands, Norway, Singapore, Sweden, Switzerland and the United Kingdom. Territories that are not sovereign are also included – Guernsey, Hong Kong and the Isle of Man.

Why don't China or Japan make the cut?

Japan lost its AAA rating in 2001, when S&P warned that its weak economic growth and large deficit made it more of a credit risk. It is now rated only AA–, the fourth-highest rating, by S&P. It is ironic that the world's biggest net creditor has a lower credit rating than the world's biggest net debtor (the US).

In practice, the lower rating has little impact, as much of Japan's government debt is bought by its own citizens or corporations.

Despite its strong economic growth, China does not qualify for the AAA rating either. S&P says that 'contingent liabilities' (that is, unknown but possible future debts) in the Chinese banking system could knock its growth off course, and assigns it an AA– rating.

Does one cut lead to another?

Once a country is downgraded, it can quickly see its rating deteriorate. This happened to Greece, which was cut from A to A– in January 2009, and was recently downgraded three levels in one move by Moody's. This is the lowest rating, only above C.

From a rating agency perspective, the first cut is the hardest. Once that initial downgrade has been made, others often follow.

Once a AAA rating is lost, is it gone for ever?

No, it is possible to regain the faith of the rating agencies. In 1994 Moody's stripped Canada of its 'Aaa' rating, citing concern over its rising debts. Seven years later, after a strict austerity program helped to rebuild the nation's finances, it was upgraded to Aaa.



OILS AIN'T OILS

Following the 'All that glitters' article in the April edition of *BLa BLa BLa* discussing gold prices, another commodity attracting a lot of interest in recent times is oil prices.

There are many factors that affect oil prices in the world market – the oil demands of different countries, supply issues, market speculation and other factors.

As a result, focusing on the longer term price trends in the relevant regional market for specific products is important to understand what is driving movements in the prices of specific fuels here in Australia. Table 1 outlines some of the fundamental market drivers and other influences affecting regional and global market prices, and thereby Australian prices, over time.

One of the major factors affecting oil prices is the volume of oil demands of different countries. In recent years, countries that are in the process of economic expansion have demonstrated increased demand for different petroleum products. The increased demand ultimately translates to increased oil prices in the world market.

Clearly, if there is an increased demand for a certain good at a prevailing price, it will tend to push the price up. Since there is a shortage in the supply of oil in the world market, for various reasons, different countries bid the price up and, consequently, the oil price rises.

The world consumes just under 90 million barrels of oil a day. About a third of that is consumed in the US and Europe, although consumption has eased somewhat in recent times. New demand growth is coming from China (which is responsible for about 10% of world consumption) and other developing countries.

Speculations about the petroleum futures volume can also contribute to an increase in oil prices. Speculators influence prices by taking larger positions in crude oil futures.

Since oil prices tend to be unstable, variables other than supply and demand and speculation influence the oil price in the world market. As we have recently seen, socio-economic and political crises may affect oil prices, although some may have only a temporary impact.

Table 1

Key factors influencing international crude oil prices

- changes in regional and global supply balances in both the short and longer term
- major supply disruptions resulting from natural disasters, war, civil unrest and strikes
- seasonal demand and demand spikes
- inventory management
- shipping availability and freight rates
- market trading activities and strategies
- short-term decisions of oil producing countries, national oil companies and nations holding strategic reserves
- alternative fuel developments
- changes in economic conditions or sentiment in both the short and longer term
- new oil discoveries
- investment in new oil production or refining capacity
- future global demand and supply balances
- global economic growth and conditions
- costs of oil production and refining
- technological progress
- long-term policies of national oil companies and oil producing nations
- population growth
- regulation and government policy.

All of the factors mentioned in Table 1 can have an influence in determining the final price to fuel consumers, and the role that each of these factors plays can change over time or, indeed, can offset each other. As an illustration of these factors, Graph 1 (page 6) highlights specific international events that have affected the price of crude oil in recent years.

Graph 1 shows that the steep increase in the crude oil price in 2008 reflected a broader trend in the price of global energy commodities prior to the global financial crisis. The increase reflected market fundamentals, specifically, the significant increase in global demand from economic growth in China and India, and supply not keeping pace with this demand. As a result, crude and fuel prices, as well as other commodity prices, increased in the Asia-Pacific region and globally.

Graph 1: Major events affecting crude oil prices Tapis Crude Oil: Cents Per Litre

Source: Australian Institute of Petroleum



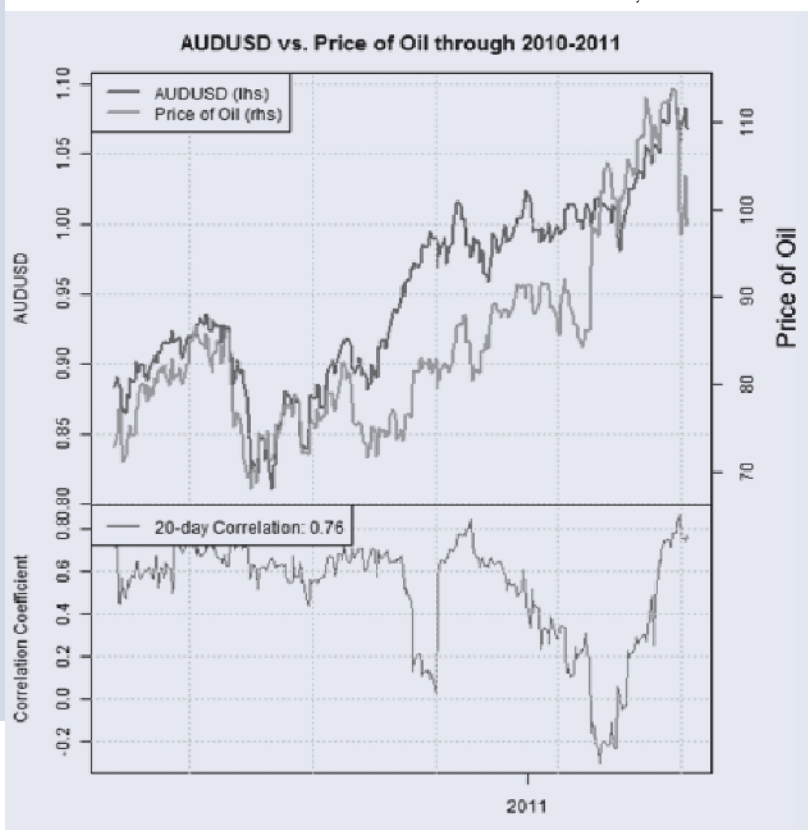
Key crude oil pricing benchmarks for the Asia-Pacific market, including Australia, are Tapis, Dated Brent and Dubai. The Singapore benchmark prices of unleaded petrol and diesel are the key petrol and diesel price markers for Australia. As the Singapore benchmark prices for fuel are quoted in US\$ per barrel terms, their price in A\$ terms reflects movements in both the US\$ benchmark price for fuel as well as movements in the US\$/A\$ exchange rate. This means that exchange rate movements can offset or

magnify changes in Singapore fuel prices. Fluctuations in the exchange rate can also independently affect the market prices for shipping and fuel quality premiums, which are also quoted in US\$ terms.

As Graph 2 highlights, the A\$'s strong correlation to crude oil prices has never been stronger than during 2010-11, generating a correlation coefficient of 0.76 (a correlation coefficient of +1 indicates perfect positive correlation) over a 20-day rolling period.

Graph 2: A\$/US\$ and NYMEX West Texas Intermediate Crude Oil Prices

Source: www.dailyfx.com



The A\$ 'Commodity Block' currency (currency of a country whose economy is strongly correlated with the price fluctuations of a certain commodity) previously hit fresh record highs amidst impressive strength in raw material prices. Though gold is typically the more traditional commodity link to the A\$, its short-term correlation is actually equal to that of crude oil. A resumption of US\$ rallies would keep this correlation quite strong. In fact, the additional benefit of high interest rates is what makes oil a favorite among speculators bullish of commodity markets.

Economic uncertainty and oil prices more often than not affect share markets. Studies have shown the correlations between changes in oil prices and share market prices, revealing that a rise in oil prices suggests a lower share market and a drop in oil prices a rise in share prices.

Despite the positive correlation between the US\$/A\$ exchange rate and oil prices, it is important not to use this relationship as a benchmark for trying to predict the direction of oil prices or, more importantly, share markets in the short term.

DEATH AND TAXES

As Benjamin Franklin famously stated: 'In this world nothing can be said to be certain, except death and taxes'.

It is somewhat ironic that these two go hand-in-hand so often. Over the past few months the complexity of taxes at death has arisen on a number of fronts. Recent rulings and high-profile cases should prove the catalyst for clients to re-examine their death benefit arrangements.

In the first instance, all adults should have a legal will. Where an individual dies without a legal will, they are deemed to be intestate. Over the years there have been some significantly high-profile cases of intestacy.

1. Howard Hughes, the eccentric billionaire who founded Pan American Airlines, died in 1976 at the age of 70. His will was discovered at the headquarters of the Mormon Church in Salt Lake City. However, it was proved a forgery and his estate was shared among his 22 cousins.
2. Pablo Picasso died in 1973 at the age of 91. He left a fortune in assets, including artwork, properties, cash, gold and bonds. Because Picasso didn't make a will, it took six years to settle his estate at a cost of US\$30 million. His assets were eventually divided up among six heirs.
3. Stieg Larsson, who wrote *The Girl with the Dragon Tattoo*, among other titles, died in 2004. He too died without a will. Swedish law dictated that his estate be divided between his father and brother. His lifelong partner of 32 years, Eva Gabriellson, received nothing. However, the family did grant her ownership of the couple's apartment.
4. Jimi Hendrix died in 1970. He didn't leave a will regarding the distribution of his estate. The battle over his estate raged on for more than 30 years for one simple reason; his estate continued to generate money long after his death.
5. Heath Ledger died in 2008. He had a will which left everything to his parents. The problem is, since he made that will in 2003, Heath had a child, Matilda. By not updating his will to accommodate his new

circumstances, Matilda got nothing in the will.

Fortunately, Heath's parents made sure she was looked after, but without the aid of any tax protection like a testamentary trust.

We are often asked for assistance in preparing a will. Given how varied individual circumstances can be, there is certainly no easy guide to will preparation. There are, however, a number of key points that individuals may wish to consider.

1. Who makes the best executor?

The best executors are those people inheriting the estate. This usually means the spouse in the first instance and then all the children once both parents die. The logic for this is that they have a strong self-interest to ensure that the estate is administered quickly and efficiently.

Many people forget that naming a person as an executor is simply an invitation. It is not a mandatory appointment. If a person named as an executor is unable or unwilling to act, they can renounce (give up) the position.

The executor clause in your will could be improved if:

- it does not appoint the surviving spouse at first instance
- it appoints only one child as executor once the parents die – it is appropriate to appoint all of the children as executors.

2. What happens with your family home?

In many cases the family home will not form part of an estate. For example, if Steve and Helen are joint owners of the family home, upon Steve's death the house will automatically become the property of Helen, the other joint owner. If Steve and Helen were tenants in common, then Steve's portion of the property would be directed to the beneficiaries named in his will.

It is quite possible that an estate is not required upon the death of an individual. If all assets are jointly owned (bank accounts, property etc), then they will all revert to the joint holder without the need to go through the estate.

A common situation on the death of an individual is that they wish to allow someone to reside in the family home,

but not own it. This can be done in one of two ways; Life Estates and Rights to Reside.

Life Estates and Rights to Reside can have adverse tax consequences – they generally mean that the principal place of residence capital gains tax exemption no longer applies.

3. Is superannuation an ‘estate asset’?

Superannuation is not automatically part of the estate. It often passes outside of the will.

Defined benefit schemes (such as CSS and PSS) normally define who the beneficiaries are in the legislation or trust deed of the scheme. In the case of Steve and Helen, Helen would be deemed to be Steve’s beneficiary if she is married to him or living with him in a bona fide domestic relationship. This also applies to same-sex couples. Under these circumstances, the surviving spouse would automatically receive an ongoing pension entitlement following the death of the primary pension holder.

Private superannuation (such as allocated pensions and accumulation funds) will seek beneficiary details from its members when the account is established. Assuming that a beneficiary nomination is valid at the time of death, the superannuation or allocated pension will pass directly to the nominated beneficiaries, without going through the estate. It is possible, however, to establish your estate or legal personal representative as the beneficiary of your private superannuation, which means that the superannuation balance will go to the estate to be distributed through the will.

4 Is tax planning really important at death?

Capital gains tax, income tax and transfer duty are the stealthy de facto death duties.

Under certain circumstances, your will can benefit from a testamentary trust, as follows:

- A testamentary trust is designed to minimise tax, that is, it is designed to allow the beneficiaries to wash out the de facto death duties

- One of the advantages of a testamentary trust is that the tax payable on the income earned on the estate or capital gains tax payable is paid to family members on low tax rates.
- Each primary beneficiary controls their own trust by becoming the trustee of their own trust. For tax purposes, they control the assets. They do not own the assets.
- The primary beneficiary is often the person in complete control of the estate assets in their own testamentary trust.

Testamentary trusts are extremely useful tools when the beneficiaries are minors (children, grandchildren), spendthrifts, bankrupts or in relationships that may not be stable. Effectively, they are a tax-advantaged means of retaining control of assets, yet allowing beneficiaries partial access to income or the assets themselves.

5. Protecting beneficiaries

Simple wills do not protect bankrupt beneficiaries. That means your hard-earned money goes directly to the beneficiaries’ trustee in bankruptcy. You might as well just pay the debts yourself. In the meantime, the beneficiary is left with nothing from your estate.

Protective trusts keep the wealth in the family. A protective trust is an instruction to the executor not to distribute to a beneficiary if they:

- are bankrupt
- lack mental capacity, or
- are under age.

The protective trust is designed to preserve the estate until the beneficiary qualifies for the gift, that is, once they are out of bankruptcy they have a nice boost to get them back on their feet.

6. Can my estate end up like that of Lang Hancock?

For every will there is a potential challenger. There is a strong blood line relationship which defines who can make



an application to the Supreme Court to challenge a will.

The class of people who can challenge your will include your:

- parents
- spouses – including de factos, mistresses and gay partners
- biological and adopted children (but not stepchildren)
- biological and adopted grandchildren
- anyone you financially maintain (but not in all states).

A considered person clause can be used to mitigate the risk of people challenging your will. A considered person clause names those people who you don't wish to make provision for beyond what is stated in the will. There's no need for details in the will – when you die, your will becomes a public document so it's best not to feed the rumour mill and embarrass your family. A considered person clause does not prohibit a person challenging the will but it does make it harder for them to be successful.

What should you do now?

Many individuals are put off updating or making death benefit arrangements for a number of emotional reasons. However, over the years we have had to deal with the consequences of 'sloppy estates' and can assure all of our clients that the pain of a sloppy estate is magnified many times compared with an efficient one.

A will is not something that should be prepared once and put in a drawer for 20 years. As your circumstances, assets and relationships change, so too should your death benefit arrangements.

We highly recommend that you choose a 'significant day' every year to reconsider the arrangements in place and see if they need tweaking. In the many households, the first day of daylight savings each year is the day when outdoor furniture is varnished or oiled and the household insurance is updated to take into account any purchases over the previous 12 months. This could also be a good day to

ensure that death benefit arrangements remain valid.

Some key questions that you should be asking yourself **right now**.

1. Do you have a will, and how valid is it?

Without wishing to profit the legal fraternity, we have seen enormous problems with 'newsagent wills', or wills drafted by individuals. No one likes paying lawyers, but this is an area that has to be 100% right. If you do not have a will, get one done. If the will is old, get it updated. Remember, in the ACT intestacy law says that if you die without a will, the ACT Government could ultimately end up being the beneficiary.

2. Consider your executors and ask them if they are prepared to do the job.

It is not uncommon to find that in an old will the nominated executor has already died. This means that their executor (probably someone you don't know) will now be your executor. We also see situations where a nominated executor may have been appropriate 20 years ago (such as a brother-in-law at the time), but due to divorce or other circumstances is no longer appropriate. Above all, be sure that the person you are nominating as executor knows that they are being nominated and agrees to do the job. Obviously, this person should be given a copy of the will and kept up to date with all major assets (such as life policies).

3. If your will contains bequests, ensure that these are up to date.

It is common for a will to leave a list of bequests, to either individuals or charitable organisations. Generally speaking, a bequest is a distribution of a specific asset or amount of benefit before the remaining pool is divided.

In a recent case concerning the death of a client, two bequests (each of a valuable piece of artwork) had been made in a very dated will. In the case of the first bequest, the specific artwork no longer existed, having been lost

in the 2003 Canberra bushfires. In the second case, the artwork was still in the possession of the deceased but the individual nominated to receive the bequest had died several years ago.

4. Consider ownership structures

As mentioned previously, joint assets and assets in superannuation can bypass the whole estate process if need be. We had a recent case where the husband died prematurely and all assets were in superannuation or jointly owed, or so we thought! It turned out that the husband had a bank account with some \$50 000 in it from a posting that he did a couple of years back. As this was in his name only, an estate had to be created solely to deal with this asset. As Murphy's law would dictate, this individual was in a second marriage, with a high degree of animosity between his first family and his new wife. Not surprisingly, the estate was challenged by the first family and the vast majority of the \$50 000 was eroded in legal fees. Had these funds been in a joint account, none of these problems would have arisen.

5. Are your reversionary and beneficiary nominations up to date in your private superannuation?

Beneficiary law has changed considerably for private superannuation funds over recent years. There are now a number of categories of nominated beneficiaries, as follows:

- **Reversionary beneficiary** – used in allocated pensions and annuities. Basically, the person nominated takes over the pension or annuity on the death of the primary holder. This is particularly useful where the beneficiary is aged over 65 and would therefore be unable to recontribute any lump sum back into the pension environment.
- **Non-binding nominations** – a non-binding nomination is a request, rather than a direction, as to who gets your benefit upon your death. The trustee of the fund can choose to go along with your request, but has the right to pay another if they think it appropriate. This could be the estate, meaning that an estate may

need to be created and could then be challenged.

- **Binding nomination** – compels the trustee to give the benefit to the nominated beneficiaries.
- **Lapsing binding nomination** – as above (in terms of binding on the trustee), however, the nomination lapses after three years and a new nomination is then required.
- **Non-lapsing binding nominations** – as above (in terms of binding on the trustee), however, this nomination does not lapse.

Obviously, we can help you ensure that your nomination is up to date and the correct one for your circumstances.

6. If you hold a defined benefit pension with in-built reversionary components (such as CSS, PSS, DFRDB, MSBS, UniSuper), does your trustee know who your spouse is?

It may sound like an odd comment, but if you retired 10 years ago and have re-partnered since then, the trustees of your scheme probably still believe that your former spouse is your legal beneficiary. To remove any confusion, people in this situation should write to the scheme trustees and provide them with this updated information.

Additional considerations for self-managed superannuation funds

The Tax Office recently issued Taxation Ruling TR 2011/D3 on the tax-free status of pension funds. The ruling, designed to provide clarity to tax and superannuation practitioners, covers when a self-managed superannuation fund (SMSF) member dies while their account is in pension phase. The issue is whether anything has really changed, or whether some practitioners misinterpreted the law from the outset.

The ruling discusses three key issues for superannuation fund pensions:

1. When a superannuation income stream, or pension, starts.
2. When a superannuation income stream, or pension, ceases.



3. What happens to any residual benefit of a superannuation income stream, or pension, when a member dies.

When does a pension start?

The pension starts on the first day of the period that you get your first pension payment. The Tax Office says the start day is also subject to the rules of the superannuation fund. Importantly, the start day cannot be before the date the member applies to the trustee to start the pension.

When does a superannuation income stream, or pension, cease?

The ruling identifies that a superannuation income stream or pension ceases on the date that there is no longer:

1. a member of the superannuation fund, or
2. a 'dependant' beneficiary of a member

who is entitled to receive the pension.

The SIS Regulations 1994 state that a pension must meet the requirements of sub-regulations 1.06(2), (9A) or (9B). If the pension fails to meet any of those criteria at any point in time, the pension ceases on that date.

Other ways a pension ceases are by:

1. the exhaustion of the capital that supports the pension
2. the member commuting the pension to receive a lump sum benefit.

Commuting a pension causes it to cease because it no longer meets the criteria of sub-regulation 1.06(2). In particular, there is no longer a regular payment that is paid at least annually.

What happens to your pension account after you die?

The ruling states that the rules of the SMSF 'must ensure that the pension is transferable to another person only upon the death of a member'. It goes on to say that where the SMSF rules do not comply, the pension ceases at the

date of death of the member.

The ruling states that the concessional tax treatment of pensions is lost immediately upon the pension ceasing.

Take, for example, an SMSF whose major asset is a commercial property, purchased in 2005 for \$1 million. The primary pension holder (Patrick) establishes a reversionary entitlement for his wife (Frances). In 2010 the property is worth \$1.2 million, when Patrick dies.

At this point there are no tax consequences, as the fund is still in pension mode, with the reversionary pension being paid to Frances.

In 2015 Frances dies, with the property now worth \$1.5 million. The SMSF sells the property and the fund is wound up.

The \$500 000 capital gain on the property is now subject to tax, as the fund is no longer in pension phase. The sale is a discount capital gain, with a tax rate of 10% applying on the \$500 000 gain, or tax of \$50 000. Had the fund sold the property the day before Frances died, there would have been no tax as the capital gain was realised while the fund was in pension mode.

The difficulty with this case is that the central asset of the fund is large and relatively inflexible. If the fund (instead) contained a large number of (say) BHP shares, then these shares could be sold and repurchased during the lifetime of the pensioner or reversionary pensioner. As these sales are taking place while a pension is being paid, the SMSF is deemed to be in pension phase and therefore not subject to capital gains tax. This continued 'washing' of unrealised capital gains throughout the life of the pension would ensure that there is minimal capital gains tax payable when the music stops.

VICTIMS OF TRIO CAPITAL GROUP FRAUD

In late 2009 Trio Capital Group collapsed. In the wash-up of the collapse, it was revealed that the group had an intricate network of overseas companies and offshore bank accounts. In essence, the responsible trustees were involved in a long-standing fraud operation, where some \$118 million of investors' money had simply disappeared.

Individuals could invest directly with Trio Capital through one of four superannuation funds under the trusteeship of Trio. Alternatively, individuals with an SMSF could invest directly with Trio.

The Trio superannuation funds were regulated by the Australian Prudential Regulation Authority (APRA). APRA supervises and regulates public offer funds in Australia, trying to ensure that fraud of this nature does not occur.

Trio claimed positive returns in almost every month of 2008 and 2009 – a period otherwise known as the global financial meltdown – as everyone else watched their portfolio values collapse. The line was swallowed – by ratings groups such as Morningstar, which rated Trio's funds as four and five star and authorities such as APRA, but more importantly, the auditors.

There were two sets of auditors. WHK was the main accounting group (on its website it boasts that it provides 'total financial solutions') while big-four group KPMG was supposed to be overseeing compliance.

The members of the Trio superannuation funds (Astarra Superannuation Plan, Astarra Personal Pension Plan, My Retirement Plan and the Employers Federation of NSW Superannuation Plan) will recover 100% of their losses (approximately \$55 million) from a levy imposed on all other APRA-regulated funds.

A levy raised across all APRA-regulated funds at a rate of 1.5 – 2 cents per \$100 will pay for the compensation. APRA-regulated superannuation funds will pay a maximum \$750 000 under the compensation levy.

The impact of the levy on a member of an average sized fund with an account of \$33 000 is expected to be less than \$4.50.

However, those who invested with Trio directly through an SMSF will not be eligible for any compensation for the scheme. As an SMSF does not have to comply with the same regulations as an APRA fund, it does not receive the same protection. One report suggests that the losses of SMSFs have been up to \$700 000 per fund.

There are several lessons that come out of this exercise.

The first is that if someone is particularly good at committing fraud, it may well take a while for people (such as regulators and rating agencies) to catch on. By this time it is usually too late, with the money long gone.

Secondly, good ratings from rating agencies are not a guarantee. We know that these same rating agencies were giving the thumbs up to the Lehman Brothers consolidated debt packages just days before the bank collapsed.

Finally, there is safety in size. We would be horrified if any of the APRA-regulated funds we use committed a similar fraud activity. However, we take great consolation from knowing that if one of these funds does 'fall through the regulator's gap', our clients would recover their losses through the compensation fund.



PROPOSED CARBON POLLUTION HOUSEHOLD ASSISTANCE MEASURES ANNOUNCED

On Sunday 9 July the Australian Government announced the detail of its proposal to put a price on carbon pollution. It also announced a range of household assistance measures designed to help offset the price impact of the changes. The measures are all proposed tax cuts and increases in pensions, allowances and family payments, and will take effect only if legislated.

Proposed tax cuts and tax reform

The government has announced that the household assistance package will include both tax cuts and a number of tax reform measures to simplify the tax system and improve incentives to work.

From 1 July 2012 the government proposes to triple the tax-free threshold and to increase the 15% and 30% marginal tax rates to 19% and 32.5% respectively.

From 1 July 2015 the tax-free threshold and the 32.5% tax rate would be further increased to \$19 401 and 33% respectively. Table 2 summarises the current and proposed marginal tax rates.

The government also announced that it proposes to roll the low income tax offset into the increased tax-free threshold. As a result, the low income tax offset will be reduced from its current level of \$1500 to \$445 from 1 July 2012, and then to \$300 from 1 July 2015. The combined effect of the above changes will be an increase in the effective tax-free threshold from \$16 000 in 2011–12 to \$20 542 from 2012–13, and \$20 979 from 2015–16.

| Year | Effective tax-free threshold (\$) |
|--------------|-----------------------------------|
| In 2011–12 | 16 000 |
| From 2012–13 | 20 542 |
| From 2015–16 | 20 979 |

The government has indicated that these changes will also simplify the tax system for part-time and low income workers earning less than the tax-free threshold, as they will not have any tax deducted from their salary or wages. The government also states that these changes will mean that over a million taxpayers will no longer need to lodge a tax return.

Small business tax announcements

The government has announced a proposal to increase the small business instant asset write-off threshold for businesses with an aggregated turnover of less than \$2 million a year from \$5000 to \$6500 for depreciable assets from 1 July 2012.

For more information on the proposed tax changes please visit www.treasurer.gov.au

Social security/family assistance changes

As part of the household assistance measures, the government also announced that it proposes to increase pensions, allowances and family payments. The detail of these announcements are summarised on the following page.

Table 2

| Tax scale | Current | | From 1 July 2012 | | From 1 July 2015 | |
|-----------|----------------|--------------|------------------|--------------|------------------|--------------|
| | Threshold (\$) | Tax rate (%) | Threshold (\$) | Tax rate (%) | Threshold (\$) | Tax rate (%) |
| 1st rate | 6 000 | 15 | 18 201 | 19 | 19 401 | 19 |
| 2nd rate | 37 001 | 30 | 37 001 | 32.5 | 37 001 | 33 |
| 3rd rate | 80 001 | 37 | 80 001 | 37 | 80 001 | 37 |
| 4th rate | 180 001 | 45 | 180 001 | 45 | 180 001 | 45 |

Pensioners/allowees

A clean energy supplement is proposed from 1 July 2012. This supplement will be equivalent to 1.7% of the maximum rate of a person's pension or allowance, and will be paid as follows:

- In May/June 2012, an advance payment will be made to cover the period to 20 March 2013.
- From 20 March 2013, the clean energy supplement will then be paid as a fortnightly amount.

The maximum clean energy supplement will be \$338 a year for singles and \$510 a year for couples combined.

Self-funded retirees

The clean energy supplement is also proposed for those eligible for the Commonwealth Seniors Health Card. As with pensioners and allowees, the maximum supplement will be \$338 a year for singles and \$510 a year for couples combined. The advance payment in May/June 2012 will also apply.

Family tax benefit recipients

A lump sum advance is proposed to be paid to family tax benefit recipients in May/June 2012 to cover the period to 30 June 2013. During this time, family tax benefit payment amounts will remain unchanged.

From 1 July 2013 a fortnightly tax-exempt clean energy supplement is proposed.

The initial lump sum advance and the future fortnightly supplement will be equivalent to a 1.7% increase in the maximum annual rate of the relevant family tax benefit payment.

Low income supplement and single income family supplement

From 1 July 2012 it is proposed that single income families may be eligible for a single income family supplement of up to \$300 a year. This measure recognises that single income families may not benefit from proposed changes to the income tax system by as much as dual income families in a comparable financial position.

A low income supplement is also proposed for low income households who can demonstrate that the income tax and social security assistance will not fully compensate them against the expected cost impacts of a carbon price.

Clients using essential medical equipment at home

For those using a dialysis machine or other life-support equipment at home, an annual cash payment of \$140 is proposed in addition to any other assistance.

For more information on the proposed social security and family assistance changes, please visit www.jennymacklin.fahcsia.gov.au.



REFORMS TO CAR FRINGE BENEFIT RULES

As advised in our BL&A May 2011 Budget analysis, the Gillard Government has changed the fringe benefit treatment of cars to remove the unintended incentive for people to drive their vehicle further than they need to in order to obtain a larger tax concession.

The government's decision to progressively change the current statutory percentage for calculating fringe benefits tax (FBT) from a tiered rate to a flat rate of 20%, regardless of the kilometres travelled, came into effect for all new leases commencing after 7.30pm (AEST) on Tuesday 10 May 2011.

Under the statutory formula method, a person's car fringe benefit or employee contribution is determined by multiplying the relevant statutory rate by the cost of the car. Previously, the sliding scale of rates provided an increased tax concession for salary-sacrificed or employer-provided vehicles that are driven further.

To manage an FBT liability, individuals can elect to use a special method called the employee contribution method. This method involves collecting the car's lease and running costs from a mix of pre- and post-tax salary deductions. Under the existing pre-10 May 2011 lease contracts, the more an individual drove, the more they could pay with pre-tax dollars and the more they would save. This method maximises the tax savings regardless of what pay as you go

tax rate the individual pays.

The statutory rate for each year is detailed in the table below.

- For drivers travelling 25 000 km and over during the FBT year, the new statutory rates will be modified each year within the term of the lease over the next four years. For example a customer driving more than 25 000 km who entered a novated lease after 7.30pm (AEST) on 10 May 2011 will have a rate at the start of their lease, which will be revised each year until 1 April 2014 when a 20% standard rate is achieved.
- Those travelling less than 25 000 km will now be on a flat statutory rate of 20% for the term of the lease.
- The budget changes will see all leases, regardless of kilometres travelled, have a standard statutory percentage of 20% applied by 1 April 2014.
- There is no change to customers who commenced a novated lease arrangement prior to 7.30pm (AEST) on 10 May 2011.
- People who use their vehicle for a significant amount of work-related travel will still be able to use the operating cost (or log book) method to ensure their car fringe benefit excludes any business use of the vehicle.

Fringe benefits tax rates

| Distance travelled during the FBT year (1 April – 31 March) | Statutory rate (multiplied by the cost of the car to determine a person's car fringe benefit or employee contribution) | | | | |
|---|--|---|-------------------|-------------------|-------------------|
| | Existing contracts | New contracts entered into after 7:30pm (AEST) on 10 May 2011 | | | |
| | | From 10 May 2011 | From 1 April 2012 | From 1 April 2013 | From 1 April 2014 |
| 0 – 15 000 km | 0.26 | 0.20 | 0.20 | 0.20 | 0.20 |
| 15 000 – 25 000 km | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 |
| 25 000 – 40 000 km | 0.11 | 0.14 | 0.17 | 0.20 | 0.20 |
| More than 40 000 km | 0.07 | 0.10 | 0.13 | 0.17 | 0.20 |

The key points from the perspective of employers and employees are as follows:

- **The new rules do not apply to existing novated leases prior to 10 May 2011.** All current packaging arrangements remain unchanged.
- **New leases will, from 10 May 2011, use a transitional set of statutory rates that will gradually phase out the 7% and 11% valuation options over the next four years.** This means that the savings achievable for employees driving more than 25 000 kilometres a year will be lower and that, at least for the time being, some employees will still need to meet kilometre targets in order to get the most out of their packaging arrangements (refer to table on page 15).
- **The new rules will now open up novated car leasing to employees currently not packaging a vehicle and driving less than 15 000 km a year.** Previously, employees driving less than 15 000 km were required to value their cars for tax purposes using the 26% rate, but now the 20% rate is immediately available. Since the average Australian car travels less than 15 000 km a year, it's likely that a number of employees who previously couldn't achieve good savings will now benefit from a salary-packaged car.

Example

If the base value of a motor vehicle is \$25 000 and the individual estimates they will travel 14 000 km in the 2012–13 FBT year, the employee contribution or post-tax amount required is:

$$\$25\,000 \times 20\% = \$5000$$

This means that \$5000 is deducted from post-tax salary to partially fund lease and running costs each FBT year.

Using the same example, if an existing pre-10 May 2011 lease was in place and the individual elected to travel less than 15 000 km per FBT year, the employee contribution or post-tax amount required is:

$$\$25\,000 \times 26\% = \$6250$$

Therefore, in this example, the pre-10 May 2011 arrangement results in an additional \$1250 per FBT year (\$6250 – \$5000) compared to the government's new FBT statutory rates based on travelling less than 15 000 km.



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