



JULY 2012

AIA 'Investor Update'

Its time for another 'Investor Update'. This month we have an article on "When is a grandchild financially dependent on a grandparent", which will be of interest to all of those grandparents wishing to pay death benefits to a grandchild. We have an article by Thierry Malleret of Donnelly Wealth Management about the shenanigans of private banks; an economic update; and a useful article for our property investing members about death during a tenancy. Note that it is still not too late to come to our conference – we would love to see you there.

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When is a grandchild financially dependent on a grandparent?

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On the death of a grandparent, in order to be able to pay a super death benefit to a grandchild, and for the grandchild to receive it tax free, the most common test to satisfy is financial dependency on the grandparent. Unlike an interdependency relationship, financial dependency does not require the two to live together.

Financial dependency of a grandchild on a grandparent will also open up the possibility of the very tax efficient scenario

Upcoming Events



AIA Annual Investors Conference

Kew Discussion Group (Vic)
Key Library, 25th July 2012 7.30pm

Bayside Discussion Group (Vic)
Hampton Community Centre, Willis Street, Hampton, 26th July 2012 4.00pm

Blackburn Discussion Group (Vic)
Naturalist Club of Vic, 1 Gardenia St
Blackburn, 1st August 2012 7.15pm

Canberra Information Meeting
Southern Cross Club, 92-96 Corinna St
Woden, 6th August 2012 7.30pm

South Sydney Discussion Group
Miranda Community Centre, Miranda
7th August 2012 7.00pm

where the grandparent died aged 60 or over, with the super death benefit being paid by way of pension to the grandchild. The tax efficiency of this position arises because, at the SMSF level, income generated by pension assets is broadly income tax free, and at the recipient (grandchild) level, pension income received is income tax free.

The meaning of financial dependency

The above discussion begs the question: what is financial dependency? Case law tells us that financial dependency is a question of fact, and does not require that the other person had an obligation to support the first person. Additionally, the fact that one person has income or separate wealth of their own will not necessarily mean they are not financially dependent on another. Whether somebody is financially dependent on another is a question of whether there was actual 'maintenance and support'. This article discusses the ATO view, which will be the first hurdle if one claims a grandchild to be a dependant of their grandparent. It should be noted, however, that the Commissioner of Taxation's view does not necessarily reflect the law.

The Commissioner has not expressed a detailed view on financial dependency in a public ruling. However, a number of private binding rulings ('PBRs') show the use of the following test: 'financial dependence occurs where a person is wholly or substantially maintained financially by another person'. It appears from this that being 'substantially' maintained financially will be enough. However, these rulings appear to go further, stating the test is also as follows:

If the financial support received by a person were withdrawn would the person be able to survive on a day-to-day basis. If the financial support provided merely supplements the person's income and represents 'quality of life' payments, then it would not be considered a substantial support. What needs to be determined is whether or not the person would be able to meet the person's daily needs and basic necessities without the additional financial support.

It appears that after some elaboration in the rulings, a strict approach is taken. But what has the outcome of the rulings told us? This article sets out where one should stand in the ATO's view.

Only the necessities of life are relevant

It was explicitly stated in PBR 18688 that 'issues of 'quality of life' in terms of 'enjoying a reasonable standard of living' cannot be taken into account and are

irrelevant for the purpose of determining whether the trustee can be treated a dependant.'

Another PBR (64085) has shown that paying for social outings, medication, pocket money, chocolate, music CDs and 'costs for football' will not count.

A further example is PBR 40376, where amounts spent 'tended to be on luxury items such as entertainment, rather than the child's day to day living expenses'. Financial dependence was not made out. The ruling went on to state: 'the person was not so much maintaining the child's standard of living, but rather improving it, hoping to give the child the best chance of a happy and successful life...'

Expenditure relating to school

Expenditure relating to schooling is naturally of interest in the question of a grandchild being dependent on their grandparent. Again in 64085, the deceased's contribution in paying for school books, school lunches and school uniforms did not matter. However, in 52530, payment of school fees was relevant in finding financial dependency, along with paying for necessary food, shelter and clothing expenses. It remains to be seen whether paying private school fees alone, being significantly higher than government school fees, can go toward financial dependency in the ATO's view. It seems a fair inference that the Commissioner would not count this, as it is not strictly necessary for a child to attend a private school.

Proportion is crucial

It has been reiterated in many PBRs that the financial support must be substantial. This has in fact been applied in a literal and numerical way. For example, contributions toward a person have been described as not 'significant' where they represented only a 'factually small percentage of the value of the total annual income of the household during this period'. Other instances where financial dependency was not made out were where the 'bulk' of the money for the rulee's living expenses came from welfare benefits.

In addition, if a grandchild lives in a dwelling along with others, any contributions made by a grandparent towards the associated expenses of the dwelling have to be prorated for the others living there before they can count towards support of the grandchild (PBR 57857).

Regularity and continuity is important

From all the rulings discussed, the ATO have required one to show reliance on regular and continuous contributions. Therefore, a grandparent should be able

to show that they financially met or substantially helped to meet the basic needs of the grandchild regularly and over a period.



Lack of evidence — the classic pitfall

Retaining evidence of a grandparent's expenditure on a grandchild will be critical to proving financial dependency. Additionally, the rulings indicate that where expenditure is asserted but not itemised, it will be difficult to convince the Commissioner that payments went toward the daily essential needs of the grandchild.

A more generous case law position?

Certain tribunal decisions and case law suggests that at least partial financial dependency can arise where financial contributions were made that assisted a person to maintain their normal standard of living, even if that standard was above the necessities of life (*Malek and Commissioner of Taxation* (1999) 42 ATR 1203), and even if the person could have paid the expenses themselves (*Bovaird v Frost* [2009] NSWSC 337). On its face, this is a different position to that expressed in PBRs. Expert advice should therefore be sought where one's particular facts do not produce a clear result.

Naturally, seeking to rely on a legal analysis and case law that conflicts with the ATO's view may result in scrutiny and a potential dispute. A conservative approach would be to seek a PBR, but it is likely the Commissioner would apply the above tests. Upon a negative result of a PBR, an objection is possible. If the result of this is also negative, one could appeal to the Administrative Appeals Tribunal or Federal Court of Australia. Naturally, the review and appeal process could be a costly and time-consuming path.

Conclusion

The position on financial dependency taken by the ATO is quite strict. Unfortunately for well-meaning grandparents, contributions that merely improve the quality of a grandchild's life may not be enough. The Commissioner's view indicates that for a grandchild to be dependent on their grandparent, the grandparent must, over a period, regularly contribute at least half of the cost of the grandchild's daily necessities of food, shelter, clothing and (to take a conservative position)

government school fees. They must also be able to produce evidence of this. While PBRs do not bind the Commissioner in future, he is likely to continue to apply the same test.

This article is for general information only and should not be relied upon without first seeking advice from an appropriately qualified professional.

Note: DBA Lawyers hold SMSF CPD training at venues all around Australia and online. For more details or to register, visit www.dbanetwork.com.au or call Marie on 03 9092 9400.

Lean and clear vs. mean and murky!

By **Thierry Malleret** (PhD and MPhil in economics and MA in international relations)

Thierry Malleret is a member of the Donnelly Wealth Management (DWM) Advisory Committee. DWM is guided by four key principles: providing objective and tailored advice; committing personally; living our values of discretion, integrity, transparency and continuity; and applying intellectual rigour. Such principles seem at odds with the mainstream financial services industry, which has showed signs of focusing on profits rather than client objectives. Thierry is a passionate advocate of individual investors and believes the following information is important for all to consider when obtaining financial advice.

"Honesty and transparency make you vulnerable. Be honest and transparent anyway."

Mother Teresa

On the 14th of March 2012, the New York Times published an op-ed which immediately captured the headlines of all financial media, and attracted considerable attention elsewhere. The piece, entitled "Why I am leaving Goldman Sachs" was authored by Greg Smith - a mid-level executive who, after almost 12 years with Goldman Sachs and having worked his way up from being a summer intern to providing advice to truly significant clients, decided that he no longer could live with being part of "the toxic and destructive environment where the interest of clients continue to be side lined", which is what, according to Mr Smith, Goldman Sachs had become.

The op-ed provided insight to matters on which most people already knew yet few have yet to act upon. These include matters such as:

- how banks, private banks and bank-like institutions (for the purpose of this paper I will call them Private Banks ("PB")) put their own interest before their clients';
- the highly conflicted, and for clients, toxic environment that exists within the PBs;

- a corporate culture driven by personal greed rather than a deep and passionate desire for clients to succeed;
- the inability for clients of PBs to have any meaningful level of transparency to detect when PBs are investing opposite to the very investments they are touting to clients; and
- the lack of governance that enables PBs to influence markets and to get confused between use of their client's money and their own.

The op-ed went immediately viral, being viewed by more than three million people in less than a day. This sudden excitement is symptomatic of two things: the public's profound dissatisfaction with PBs, and the speed at which the wind may be changing in the financial industry.

Nowadays, the general public is upset with PBs. After all, it is not so long ago that Goldman, which is not an exception in the industry, paid a fine amounting to half a billion USD to settle charges that it had cheated its US clients ("Muppets" in Goldman Sachs jargon). So it should come as no surprise that clients of PBs, people with money who generally are seeking advice and people of high net worth (for the purpose of this paper I will group these and simply call them "Clients") that are serviced by PBs are profoundly dissatisfied because, rather than their wealth serving as a protection against predatory behaviour from the PBs, their wealth stimulate the predators and is often perceived by PBs as an even greater incentive to milk the Clients.

The bottom-line is this: PBs are primarily concerned with maximising their own income, not on achieving their Clients' objectives. This is why trust in PBs is now at an all-time low. In the words of Daniel McFadden (an economist who won the Nobel-Prize in 2000) "what's been lost is the idea that a banker has some responsibility to protect the client's interest".

Is this a new phenomenon?

It all started in the 1990s, with the globalisation and liberalisation of financial services that provided an environment in which financial institutions, and in particular PBs, pursued aggressive strategies to develop as global businesses. This new obsession with growth, coupled with an excessive complexity of the financial instruments they were developing, led PBs to engage massively in the practice of providing selective and asymmetric information, whilst charging hefty fees for the privilege.

Over the last two decades this trend has grown far worse, both in terms of scope and scale. Not only does the PBs charge hefty fees, they often charge additional hidden fees as well. Conflicts of interest permeate the entire global industry to an extent that regulators appear unable to keep up with. PBs have become too powerful for their own good and it's amazing they can get away with it. Many would agree with Simon Johnson, the former chief economist of the International Monetary Fund, when he says that "the underlying cause of this crisis (i.e. the Great Recession) is the economic supersizing of finance, as manifest particularly in the rise of big banks to positions of extraordinarily political and cultural power." Robert Reich, a former minister of labour in the Clinton administration, put it differently: "bankers make huge, risky bets with other people's money".

The financial institutions that played a huge role in driving the global economy into the mess that has led to the current Great Recession were labelled "too big to fail" by global leaders who vowed to eliminate any such institutions ever again holding such powerful positions. The sad reality is that the opposite has occurred. Five years prior to the Global Financial Crisis erupting, five large US banks (JP Morgan Chase, Bank of America, Citigroup, Wells Fargo and Goldman Sachs) held assets equivalent to 43% of US economic output. At the end of 2011, assets held by the same five banks had grown to 56% of US economic output.

In other words, it's hard to refute the idea that the financial moguls have hijacked the political establishment. How does that translate in terms of policies and attitudes vis-à-vis Clients? Simply! The PBs' primary concern has moved from: "What investment strategy would best serve my client?" in the early 1990s, to today's: "How many basis points per managed asset is the client worth to me?". Sadly, the natural tendency of financial innovation is towards complexity, exploitation and crisis.

Today's world, the financial system and wealth

Today, four intertwined forces are shaping the world, re-shaping the financial system in the process and contributing to making the global environment a much "tougher" place to navigate for people with capital to invest.

- **Increasing interdependence:** this is a by-product of globalisation and technological progress. It is a defining feature of the 21st century where we live in a world of systemic connectivity:

everything is linked and can affect everything else.

- **Increasing complexity:** our globalised world is an ecosystem of multifaceted microcosms that interact in an ever changing and convoluted way. Complex systems or situations are often characterised by an absence of visible causal links between their elements, which makes them virtually impossible to predict.
- **Increasing velocity:** we now live in a world in which everything goes much faster than it used to, because technology has created a culture of immediacy (the “flash crash” that occurred 6th May, 2010 where the Dow Jones Index tumbled 650 points and recovered in half an hour, is an illustrative example).
- **Evaporation of privacy:** Governments across the globe are adopting a “Big Brother”¹ like approach which decries individuality and confidentiality of peoples’ private affairs through increasing government surveillance which is changing societies by profoundly modifying or making extinct things that were once taken for granted.

One might ask: how does this all relate to issues of private wealth?

What is interesting about complexity in human systems is that it can be tweaked in order to gain a competitive advantage, which is where the “perverse” or pernicious relationship between complexity and wealth unfortunately has become apparent between PBs and Clients.

Complexity ceases to be an exogenous variable and becomes something that can be deliberately engineered by those who hope to profit from it (i.e. the PBs). The example of financial engineering comes to mind: exceedingly complex financial instruments were and still are sometimes created with no other purpose than to abuse gullible Clients who innocently thought they could trust the PB and safely buy something they did not understand (a classic problem of asymmetric information where the seller knows more than the buyer).

In other words, the lack of care and transparency towards Clients is near complete within PBs. Mean and murky is what most Clients have become accustomed to expect!

There are four major “flaws” that affect the way in which PBs service their Clients:

- The first of the flaws has to do with PBs a) general unpreparedness to invest the time required to truly understanding their Client’s situation; and b) inability to understand the real risks of the various products they are selling to Clients. The wealthier the Client, the more the Client is encouraged to invest in obscure funds or instruments with a total lack of transparency (see below).
- The second flaw is the general opacity in terms of how PBs operate and charge the Clients. Paradoxically in an increasingly transparent world, PBs tend to be non-transparent in the way they invest their Clients’ money, non-transparent in the way they charge their Clients and non-transparent in the details of the remuneration of their management.
- The third flaw has to do with the lack of alignment of interest that characterises the PBs. Very seldom do the PBs owners (and even less so the PBs advisors or relationship managers) invest their own money in the same way as they ask their Clients to invest.
- The fourth and final flaw is the PBs’ reluctance (or inability?) to help clients make sense of the world in a holistic and independent manner. As the world is getting increasingly complex and difficult to “read”, it is critically important that Clients can connect many different dots, ranging from macro advice to everything that has to do with the use of their money (wealth planning, succession issues, taxation optimisation, philanthropy, art, knowledge, education, and so on).

Each of these flaws calls for a simple response. A response which I believe realistically can only be provided by a wealth management advisory firm where the firm knows and understands each of its Clients personality and personal affairs in detail; and where the firm has sufficient resources and a global reach that enables it to form its own opinion.

- **Risks.** It is paramount to help Client understand risk and ensure that they only take risks that are fully understood. This presupposes a “holistic” approach to risk and the decision not to rely too much on “off the shelf”, mechanistic risk models. It is also important to go beyond the realm of traditional risk analysis (market risk, currency risk, interest rate risk and so forth) and

encompass risks that matter increasingly, but are not properly understood by a majority of advisors and Clients alike, such as: societal, geopolitical or environmental risks. As the world is radically changing, risks (probabilistic) mutate into uncertainties (non-probabilistic), making the pricing of risk increasingly problematic.

- **Transparency.** Transparency, and often the simplicity that goes with it, are the best responses to complexity, which - as we've shown above - often entails opacity and various phenomena of asymmetric information. The recipe in terms of delivering transparency couldn't be simpler: "tell the client what you do, and do what you tell the client", open the books, make the remuneration of the leadership visible to the client, and so on.
- **Alignment of interest.** Again: this is easy to implement in a "smallish", independent, structure. If the owners have their money invested in the company, they'll be super-careful about avoiding the downside risks to which the employee of a PB may be indifferent (or worse still: the PB employee may have an incentive to engage in risky investments due to the inter-temporal disconnect between reward (i.e. the bonus) and long-term profitability of the PB).
- **Holistic approach to wealth.** In our world of ever-increasing complexity, much of our thinking on issues that matter to our personal life and decisions is based upon "pancake knowledge": knowledge that is spread wide and thin, but which often lacks real substance and is conflicted. To remedy this situation, independent structures can offer unbiased advice to their clients by relying on networks. Efficient networks are based on what social scientists call "*the strength of weak ties*". "Weak ties" are your connections to people who don't know each other and who do know other people you don't know. Weak ties are the channels through which ideas, influences or information socially distant from someone may reach him or her. Weak network ties very often shape fresh insights and perspectives and ultimately lead to the creation of new ideas.

The bottom line is: The "rules of engagement" between Clients and the financial services industry will evolve dramatically in the coming years. They will favour structures and firms that are (1) independent, (2) transparent, (3) lean and (4) networked. The world is changing, and the wealth management industry must

change with it, and only those firms who accept and embrace the vulnerability that honesty and transparency bring will survive.

To read more thoughts from Thierry Malleret visit <http://unconventional-wisdom.com.au>.

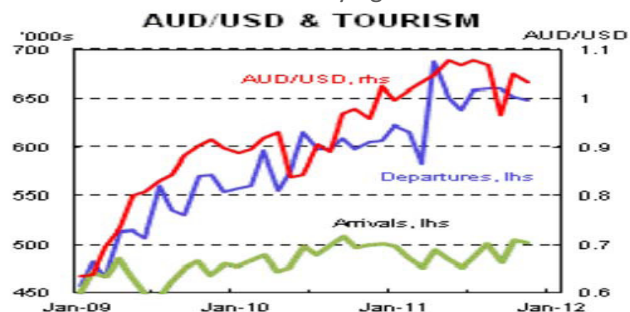
Economic Update

Low consumer confidence despite economic growth

A key index of consumer confidence rose only marginally in May. This is despite the large rate cuts and financial data indicating that the Australian economy is currently growing at its fastest rate in the last five years. Economists indicate that the media coverage of the European debt issues are a key issue impacting on consumer confidence in Australia.

High Australian dollar has negative impacts

The high Australian dollar has had some major ramifications for some industries in Australia. Whilst some industry sectors are enjoying the high AUD (such as importers), other industries are suffering. One of the biggest impacts has been to local tourism which due to the high AUD, has seen a marked reduction in the number of overseas visitors, and an increase in Australians holidaying overseas.

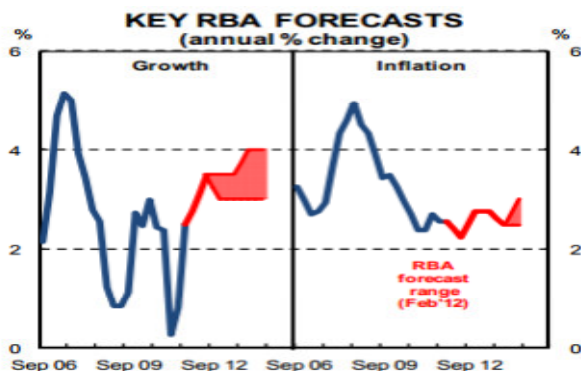


Boost to consumer spending expected

Consumer spending is expected to receive a boost in the coming months with some \$2.3 billion in payments arriving in the bank accounts of almost 8 million Australian households. These payments will be concentrated towards lower-middle income households who typically have a higher propensity for consumer spending. Economists are predicting that around 90% (approximately \$2 billion) is likely to be spent. This is likely to provide a much-needed boost to the retail sector.

Cash rate cut to 3.50%

The Reserve Bank of Australia cut the cash rate by 0.25% to 3.5% after its June board meeting. This cut followed a 0.5% reduction in the official interest rate in early May, the largest rate cut since February 2009. Rates have been cut by 1.25% since October 2011.



Source: Commonwealth Research, Australian Economic Perspective

Death during a tenancy

Not something we hope to ever experience but what does happen if your tenant passes away? Landlords there are rules when it comes to handling the rental bond. A representative of the deceased tenant needs to provide the Rental Bond Authority applicable to your state with written proof showing their authority to act for the person who has died.

There are 3 ways proof of authority can be provided:

1. An executor of the will can provide a copy of a Grant of Probate, which is an official court document that names the executor and states that the will is legally valid.
2. When there is no will, a court may issue a Letter of Administration which appoints an administrator to look after the estate of the deceased person.
3. If there is no Grant of Probate or Letter of Administration the third option is for the deceased person's representative to complete a Statutory Declaration and Information Sheet. These forms can be requested from the RTA.

The deceased tenant's estate is entitled to claim for their bond contributions, in a sole tenancy. When a sole tenant dies, the tenancy ends two weeks after any person involved in the tenancy gives notice of the death. Alternatively, the deceased tenant's estate and the Landlord can agree on an end date, or if an application is made to the Tribunal, the tribunal can set an end date. If no notice is given and no application to the Tribunal is made, the tenancy ends one month after the tenant's death.

In a co-tenancy, when any of the tenants dies their interest in the tenancy ends. Contact your Bond Authority for information on how to manage bond arrangements in this situation.

In the event a Landlord dies, the tenancy continues and the landlord's legal representative acts as the new lessor. The Bond Authority must be informed of the change of lessor using the relevant form (below) and providing the same types of proof of authority documents.

NSW – Change of managing agent / owner

(http://www.fairtrading.nsw.gov.au/pdfs/About_us/Forms/change_managing_agent_owner.pdf)

ACT – Change of Lessor or managing Agent

(http://www.ors.act.gov.au/resources/attachments/Change_of_Lessor_or_Managing_Agent.pdf)

QLD – Change of Lessor or Lessor Agent

(http://www.rta.qld.gov.au/zone_files/forms/05_form5.pdf)

WA – Variation of Security Bond

(<http://bonds.commerce.wa.gov.au/bonds/pages/external/public/variation/index.jsp>)

SA – Change of Ownership or Agent

(http://www.sa.gov.au/upload/franchise/Housing,%20property%20and%20land/OCBA/change_of_ownership_or_agent.pdf)

NT – The Landlord holds the security deposit in trust for the tenant and must be handed to the new owner.

TAS – Property Owner / Agent Transfer Form

(http://www.consumer.tas.gov.au/fair_trading2/forms/Property_Owner_Transfer_Form.pdf)

VIC - Agent/Landlord Transfer forms can be generated from the [Residential Tenancies Bond Authority \(RTBA\) Online website](#). Forms are also available by sending an email to rtba@justice.vic.gov.au or by calling 1300 137 164.

Any further information visit

www.landlordspecialists.com.au

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