AUSTRALIAN INVESTORS ASSOCIATION

Investor Update

Monthly updates on investment issues for AIA members

SEPTEMBER 2012

AIA 'Investor Update'

Its time for another 'Investor Update'. This month we announce the AIA 2012 Managed Investments Report, which is an extremely comprehensive report of great value to anyone using managed funds in their portfolio. We have an SMSF article about related party lending, a commentary on the recent RBA minutes, and a link to a video of a talk by Jonathan Pain about Africa.

Note that the September edition of **Investors Voice** has been mailed to members. You should receive your copy soon.

In this issue

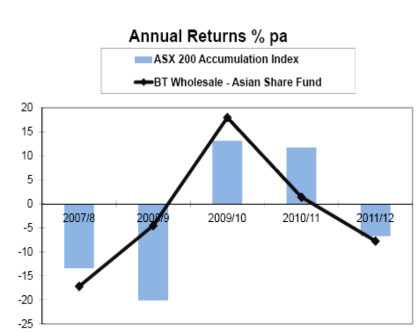
2012 Managed Investments Report

The 2012 Managed Investments Report is now available. This year, the structure and content of the report has been extensively revised to increase its usefulness to AIA Members.

A new section describes the three most popular types of managed investments:

Managed Funds, Licensed Investment Companies (LICs), Exchange Traded Funds (ETFs) - and the strengths and weaknesses of each.

The usual list of "well performed" managed investments has been extended to include LICs in addition to Managed Funds.



Upcoming Events

Kew Discussion Group
The Phyllis Room, Kew Library, Kew VIC, 26th September 2012 7.00pm

Bayside Discussion Group
Hampton Community Centre, Willis Street, Hampton VIC, 27th September 2012 4.00pm

Canberra Information Meeting
Reporting Season Wrap Southern Cross Club, 1st October 2012 7.30pm

South Sydney Discussion Group
Miranda Community Centre, Miranda,NSW, 2nd October 2012 7.00pm

Perth Equities Discussion Group
Wembley Downs Tennis Club, 2nd October 2012 7.30pm

Adelaide Information Meeting
Getting a sustainable income from equities The German Club, 223 Flinders St, Adelaide SA, 2nd October 2012 7.00pm

Brisbane Information Meeting
Getting a sustainable income from equities Broncos Leagues Club, 223 Flinders St, Adelaide SA, 3rd October 2012 1.30pm.

Melbourne Trading & Investment Expo Melbourne Convention & Exhibition Centre, 5-6th October 2012

This is an extremely valuable report. For anyone investing via managed funds, it is essential reading. The The full report (39 pages) may be downloaded free for AIA members, or you may purchase a printed copy at a cost of $20 plus postage.,. Also available are 'dashboards' with the results and graphs for each investment.

The AIA would like to thank members of the Brisbane Managed Investment Group for producing this report for the benefit of AIA Members.

Related party lending and SMSFs — has the ATO really given a 'carte blanche'?

By Bryce Figot (bfigot@dbalawyers.com.au), Principal, and Daniel Butler (dbutler@dbalawyers.com.au), Principal, DBA Lawyers

Introduction

Comments by the ATO in the June NTLG Superannuation Technical Sub-group suggest that below market value interest rates do not constitute a contribution. This has caused much 'interest' (pun intended) in the SMSF community. This article explores what constraints still exist when setting the terms of a related party SMSF loan.

The exact comments

The ATO was posed the question:
If a related party lender offers a discounted rate of interest to an SMSF under a section 67A borrowing arrangement, would the discount be considered a contribution received by the SMSF?

The ATO responded:
No. The absence of a requirement to pay interest on money loaned to the trustee does not increase the capital of the fund.
A further question was posed:
Can an SMSF enter into a borrowing arrangement with a related party if a zero rate of interest is charged by the related party lender and only principal repayments, with no imputed interest, are made throughout the loan term in accordance with the loan agreement?

The ATO responded:
Yes. A lower than market interest rate or the absence of a requirement to pay interest on money loaned to the trustee by a related party will not prevent the arrangement from being a borrowing. (Naturally, the above are only extracts and are no substitute for reading the full comments, which are available on the ATO website.)

Not binding

Firstly, remember that the NTLG Superannuation Technical Sub-group minutes are not binding on the ATO. They reflect the position at the date of release and that position may subsequently change.

Accordingly, the comments should be taken with a 'grain of salt'.

Arm's length requirements in the SISA

In ATO ID 2010/162, the ATO considered the question:

Does a [SMSF] trustee contravene section 109 of the [SISA] if it borrows money from a related party of the SMSF under a limited recourse borrowing arrangement on terms favourable to the SMSF?

The ATO in turn respond:
No. The terms cannot be more favourable to the related party than would have been the case had the parties been dealing at arm's length, but there is no contravention of section 109 of the SISA if the terms are more favourable to the SMSF.

Accordingly, it appears that the ATO only views the SISA arm's length requirements as contravened if the loan terms favour the lender. If the loan terms favour the SMSF, ATO ID 2010/162 suggests that there is no contravention of s 109.

Division 7A

Naturally, div 7A of the *Income Tax Assessment Act 1936* (Cth) should be considered. If the lender is a company (or even a trust in certain circumstances), unless the loan meets strict criteria, it could be treated like a dividend. If div 7A were to be enlivened, the tax consequences could be significant.

Non-arm's length income provisions

On its face, the non-arm's length income of the *Income Tax Assessment Act 1997* (Cth) do not apply. However, upon closer investigation, they are probably the key constraint to be considered when setting the terms of the loan.

A superannuation fund's non-arm's length income is taxed at the highest marginal tax rate, regardless of whether the fund is in pension mode. Income — both ordinary and statutory — can constitute non-arm's

length income in a variety of ways. The key way in this context is if the following two limbs are both met:

- Limb A — the income is derived from a scheme the parties to which were not dealing with each other at arm's length in relation to the scheme.

- Limb B — the income is more than the amount that the fund might have been expected to derive if those parties had been dealing with each other at arm's length

In light of the above, consider the following.

Errol's SMSF has $450,000 cash and wants to borrow $300,000 so that it can acquire a $750,000 residential property. Banks are offering Errol's SMSF an interest rate of 7%. However, by drawing down on his home loan, Errol personally can borrow at 5.9%.

Accordingly, Errol personally draws down $300,000 then on lends to his SMSF at 5.9%. The property acquired is then leased to an unrelated party for an arm's length amount. Assume that the arm's length amount of rent is 3% of the property's value (ie, rent of $22,500 pa).

This situation does not enliven the non-arm's length income provisions. This is because limb B is not met. Limb B is not met because the income (ie, the *gross* income of $22,500) is not greater than what the fund would have earned if the parties were dealing at arm's length (ie, $22,500).

However, a closer investigation is warranted.
Firstly, in the example above, there is an interest saving of $3,300 pa (ie, 1.1% x $300,000). If the parties were dealing at arm's length, the fund would not have this extra $3,300. Assume the $3,300 was placed in a term deposit earning 5.5% pa. The $3,300 will earn $181.50 (ie, $3,300 x 5.5%) of interest pa. Had the parties been dealing at arm's length, this extra $181.50 would not have arisen. Accordingly, this $181.50 amount might be sought by the ATO to be non-arm's length income. At first glance, most would dismiss this based on a *de minimis* approach. However, the $181.50 amount arises using reasonably modest figures. If the interest rate at which Errol lends is very low (eg, 1% or 2%) and the amount of the loan is very large (eg, $5 million), the non-arm's length income amount might become quite sizable.

Secondly, consider an SMSF where a related party lends 100% of the value of real estate. The loan might be $2 million. If the real estate is commercial it might yield rent of 8% (ie, $160,000) on an arm's length basis. The ATO may well say that no arm's length lender would lend $2 million to an SMSF on a 100% loan-to-value ratio and accordingly every dollar of rent is higher than it would be if the parties were dealing at arm's length. If such a view is correct, all of the $160,000 — plus any net capital gain arising from any subsequent sale of the real estate — would be non-arm's length income and taxed at the highest marginal tax rate (subject to any relevant deductions). Naturally, if the ATO adopted this view, the taxpayer could seek to counter it by adducing evidencing that the terms were the same that arm's length parties would adopt. However, if a bank is not willing to lend on such terms, the taxpayer could find itself in a difficult situation.

Tax profile

Advisers should ensure they cover off risks before recommending a low or no interest loan. It is best this is in a written record provided to the client to confirm the advice. Naturally, the implications of pt IVA and similar provisions should also be considered.

Conclusion

The ATO comments in the June NTLG Superannuation Technical Sub-group do suggest that related party loans will not give rise to excess contributions tax concerns. However, other concerns still remain, of which the non-arm's length income concern is key. Accordingly, when setting the terms of a related party loan, parties should be able to demonstrate that the income that the fund will generate is the same than if dealing at arm's length.

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 holds 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.

Melbourne Trading & Investment Expo

If you live in Melbourne, put 5-6th October in your diary. Get your free tickets at http://www.tradingandinvestingexpo.com.au/special-offers/australian-investors-association/

Recordings of Sessions from the 2012 Conference

Here is your chance to get some great tools to help you learn and plan for this coming year.

If you missed the latest information from your industry leaders that was shared at the recent AIA Conference, EverTechnology Meeting Services is now giving you the chance to purchase either individual sessions or the complete set of presentations.

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If you would like further information, you are welcome to contact Ed Van Maanen at EverTechnology, phone (07) 3893 1500 or email ed@evertechnology.com

Africa, the New Old Continent

Jonathan Pain, The Pain Report
Presented by PortfolioConstruction Forum (Featuring a special introduction from Archbishop Desmond Tutu)

In his closing keynote at the 2012 PortfolioConstruction Forum Conference, Jonathan spoke about Africa, the continent where he was born and grew up and about which he remains very passionate. Africa's economies are amongst the fastest growing in the world, with technological change sweeping across the continent. Is Africa the next China?
View the video of Jonathan's presentation http://portfolioconstruction.com.au/perspectives/Pain-Report-video-presentations

RBA Minutes – Now more open to rate cut

By Dr Stephen J Nash - FIIG Securities Limited

In September, the RBA chose to do what the market expected once more, it left rates unchanged, and continued to identify that the stimulus for further easing was probably going to come, if at all, from offshore. However, in the minutes issued yesterday, on 18 September (the Minutes) for the 4 September meeting, the RBA shifted away from the more hawkish tone in August, as initially sketched on 3 July and 7 August.

While markets want more easing, the RBA is still not so sure, but is now much more neutral on the subject, when compared to August minutes.

Once again, the order of topics suggests that the RBA continues to be somewhat relaxed, since it has reverted to the usual ordering of topics, with global developments being dealt with first, unlike the June minutes, where developments in financial markets were dealt with first.

This note provides a summary and comments on considerations for monetary policy and finally, some brief conclusions. The pertinent details from each section of the minutes are provided below.

Global assessment

While expansion in growth was apparent in the United States, European growth "remained weak". Of most interest, however were the RBA comments on regional growth, especially Chinese growth. Here, the RBA acknowledged that activity in China as a "little softer overall", and the comments on the impact of the weakening on commodity prices was most interesting.

Members observed that spot prices for iron ore and coking coal had fallen sharply of late, largely reflecting weakness in China's steel market as well as an easing in a range of factors that had temporarily disrupted the supply of coking coal. Since mid June, iron ore spot prices had fallen by a little over 35 per cent and coking coal prices had fallen by almost 25 per cent. Members noted that these price falls were likely to be reflected relatively quickly in export prices, as an increasing share of iron ore was traded in the spot market and on short-term contracts over recent years

Overall, other commodity prices had been relatively flat over the past few months. The RBA index of commodity prices had declined by 7 per cent over the previous month (on the basis of spot price movements).

Domestic assessment

Significantly, the RBA emphasised the current low level of observed inflation, and indicated that it does not think that there has been much upward influence on the CPI from the Carbon price, even though wages were a little elevated in the June quarter. As the RBA indicate,

Liaison suggested that the introduction of the carbon price had not yet had a significant effect on downstream price pressures, with only isolated examples of suppliers attributing price increases to the carbon price.

However, two main problems exist for those wanting rates lower, as they did in August. First, unemployment remains very low by historic standards, although leading indicators pointed to a softening in the labour market. Second, interest rates remain a little below average. In other words, the ability of the economy to withstand any increase in growth remains limited. Yet, the point, in these minutes, is that acceleration of growth remains unlikely with the moderation in commodity prices, as the RBA indicates

If the fall in the iron ore and coking coal prices were to be sustained, it could lead to somewhat lower mining investment, but given the large LNG and other mining investment projects already under way, the staff still expected there to be a substantial increase in resource investment over the next year or so.

Financial markets

Even though the RBA minutes pre-date the ECB announcements, the RBA note the improvement in expectations in the lead up to the recent announcement by the ECB. While equity prices had lifted in most markets, the RBA noted that this was not the case with a large trader partner, China, where the equity market was "at its lowest level in more than three years". Since the currency remains a drag on growth, the comments by the RBA, especially about the possible over-valuation of the currency were of great interest.

Activity in foreign exchange markets was also subdued in August, with the euro appreciating modestly. While the Australian dollar depreciated slightly over the past month, it remained near its recent highs, despite significant falls in some commodity prices and a weaker outlook for the global economy. Members noted that most model-based estimates of the currency generally placed a large weight on the terms of trade. With the terms of trade still high by historical standards, these models suggested that the Australian dollar may have been somewhat overvalued, but not substantially so, although members also noted the significant uncertainty that surrounded this assessment.

While these models may have been relevant in the past, two main recent developments are keeping the AUD at elevated levels: (a) the relative yield of the AUD, relative to the developed world, (b) the relative credit quality of the Australian government, to the rest of the developed world. Also, improvements in AUD liquidity support and amplify these two recent developments.

Financial stability

Here the RBA emphasised how risks to global financial stability remain significant, while Australian banks remained strong enough to weather potential volatility,
In general, the Australian banking system remained well placed to service the needs of the Australian economy. Members noted that pressures in wholesale funding markets had eased since late last year and the large banks had further reduced their use of offshore wholesale funding as growth in deposits continued to outpace growth in credit. While the Australian banks remained exposed to swings in global financial market sentiment associated with the problems in Europe, the changes in their funding, liquidity and capital positions over recent years suggested their resilience to these swings had improved.

Considerations for monetary policy

Generally, the RBA indicated that the Australian economy was recording a trend level of growth, while global economies continued to pose serious risks to achieving that expected level of growth. However, the RBA did what the market thought that it might do last month; it acknowledged the recent declines in bulk commodity prices. As the RBA indicates.

Developments since the previous Board meeting suggested that the global economy remained subject to significant downside risks. Of particular note this month was the recent sharp decline in some bulk commodity prices. At the same time, though, the domestic economy appeared to be growing at around trend pace and there were signs that the effects of earlier reductions in the cash rate were still working their way through the domestic economy.

Apart from the dramatic downside movements in commodity prices, the high Australian currency was also recognized by the RBA, as "weighing more heavily on the economy than might be expected". Hence, the decline in commodities, when combined with the high currency are acting together to drag growth, possibly lower than trend, over the medium term.

Conclusion

Financial market commentators are quick to overstate changes in RBA rhetoric; they have a habit of "jumping at shadows". An unbiased reading of the minutes, however, does indicate a new opening up of the possibility of a rate cut, in the absence of a problem CPI reading on 24 October.

A November easing now remains a possibility, yet developments in many variables will need careful monitoring before that would occur. Specifically, while Europe remains the key risk for RBA expectations of growth, the high currency and the fall in commodity prices are shifting RBA thinking. While rates were not going anywhere in August, given borrowing rates are lower than average and low unemployment, recent developments are changing RBA assessments of domestic growth. While domestic considerations do not, on balance, require additional easing, the RBA has just lowered the bar with regard to what is needed for an easing of monetary policy. However, improvements in bank funding, where the five year senior bank funding spread had fallen more than 50 bps since January, may allow competitive pressures to create an easing in mortgage rates, without the RBA lifting a finger.

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