



## MARCH 2015

### Welcome

Welcome to the March AIA 'Investor Update'. A really good selection this month. Jon Kalkman's article regarding negative gearing is well researched and will make us think. Some of us may be thinking about the issue of winding up our SMSF, and this article shows us how. Liz Moran's piece on bond risks is well worth considering.

### In this issue

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### Cuffelinks celebrates 100

The Cuffelinks newsletter recently celebrated its 100th edition, with articles from some of the most influential names in Australian investing, superannuation and regulations. Authors include Warwick McKibbin, former Reserve Bank Board member, Garry Weaven, Chair of IFM Investors, Phil Ruthven AM, Founder and Chairman of IBISWorld, Pauline Vamos CEO of the Association of Superannuation Funds of Australia, Peter Kell, ASIC Deputy Chairman, Jeremy Cooper, former Chairman of the Super System Review, and Noel Whittaker, leading author and columnist.

The Cuffelinks weekly newsletter consists of succinct articles written by financial industry experts, and provides topical and quality commentary and analysis to enable investors to better understand and manage their investments. AIA members may subscribe, for free, to Cuffelinks on their website <http://cuffelinks.com.au>

**Come and hear Graham Hand, Editor of Cuffelinks, speak at the AIA's Information Evening on 8th April in Chatswood, Sydney.**

### Upcoming Events

#### Kew VIC Discussion Group

25th March 2015 7.00pm

#### Melbourne Bayside Discussion Group

26th March 2015 4.00pm

#### Brisbane Special Event

**Lunch with Peter Thornhill**

28th March 2015 11.30pm

#### Greensborough Discussion Group

31st March 2015 7.15pm

#### Blackburn Discussion Group

1<sup>st</sup> April 2015 7.15pm

#### Hills District Discussion Group

1<sup>st</sup> April 2015 7.00pm

#### Brisbane Information Meeting

'The Outlook for the Australian Share Market. 1<sup>st</sup> April 2015 1.00pm

#### Perth Information Meeting

7<sup>th</sup> April 2015 7.30pm

#### Sydney North Shore Information Meeting

Portfolio Construction for SMSF's  
Graham Hand (Cuffelinks)

8<sup>th</sup> April 2015 7.30pm

## Details of AIA National Conference 2015 are now released



**The Conference brochure will be mailed to you next week**

## An AIA First! Create your own investment plan

Through a series of six modules, attendees will be guided through the process of creating their **personalised investment plan**.

Participants in the investment planning workshop will be sent a **workbook before the conference**, so that they can arrive prepared to define their investment goals, needs and strategies through a structured series of interactive presentations.



Full details, and bookings on the AIA Website  
[www.investors.asn.au](http://www.investors.asn.au)

## Negative Gearing

*Jon Kalkman*

Negative gearing is a form of financial leverage where an investor borrows money to purchase an asset but the income generated by the investment is less than the cost of the loan. The arrangement is called negative gearing because the income is negative and because it involves an investment loan it is gearing.

Under Australian tax law, that shortfall in investment income is allowed to be offset against personal income. In this way the net cost of the investment loan becomes a personal tax deduction, thereby reducing the personal tax payable. Under our progressive tax system, the largest tax refund goes to the person on the highest marginal tax.

The ability to offset the cost of an investment loan against personal income is also available to investors with loans to buy shares but the discussion about negative gearing is almost always about residential property, possibly because the amount of leverage available as bank are prepared to lend far more money on property than they are on shares.

For the landlord the arrangement looks particularly attractive because the loan typically requires only a small deposit of 20% or less, the rent collected helps to pay off the loan, any income shortfall becomes a personal tax deduction and any capital gain is concessional tax when the investment sold.

Investors often forget that to be successful investment, it does require a capital gain. Landlords are prepared to accept a negative return on the income from the investment in the hope of a sizeable capital gain. If there is no capital gain they still suffer the negative return on their investment income.

In this way the tax system is seen to encourage investment in residential property and therefore raises demand for houses and therefore prices. It is the high prices that are the most problematic for housing affordability thus constraining first-home buyers from entering the housing market although vendors of these investments seldom complain about high prices of residential property. With house prices at all-time highs, the focus often turns to negative gearing as the culprit.

Negative gearing is claimed to encourage speculation in residential property and destroys housing affordability for first-home-buyers. In their defence, investors in

residential property claim that they are providing shelter for rent to people who cannot afford to own their own home. Without negative gearing their costs would be higher and therefore rents would need to be higher thereby causing a different type of housing crisis. Indeed, when Paul Keating as treasurer tried to scrap negative gearing in the 1980's, rents, at least in Sydney, skyrocketed. The government quickly back tracked and reinstated negative gearing on residential property. Of course, if housing was more affordable and more home buyers could afford to buy rather than rent there would be less demand for rental accommodation.

So it very difficult to forecast what the likely effects would be of eliminating negative gearing. As so many taxpayers take advantage of negative gearing, it is regarded as suicidal for any politician to even debate prospective changes. The fact that a large number of politicians are themselves landlords probably distorts the debate.

Landlords and their agents also claim that investment in residential property is a business and like any other business they should be allowed to claim their legitimate business expenses as a tax deduction against their business income.

This claim is spurious.

Shareholders (the owners) of a company cannot claim any of the company's losses as a tax deduction against their own personal income tax. In all other businesses, the company's profits and losses are contained within the entity and the company can only pay a dividend when it makes a profit. Moreover the tax is paid on that company profit at a constant rate and is independent of the shareholder's personal marginal tax rate.

### **Suggested Solution**

We should start by recognizing that for some people, investment in residential property is a legitimate business with the intention of making investment profits and not just providing a tax deduction for high income earners. The same applies to people who invest in a portfolio of shares.

If net losses in investment income are to be regarded as business losses, we should insist that tax deductions for investment losses are only available to people who structure their affairs as legitimate businesses. That would mean:

- Establishing a company registered with ASIC with the appointment of Directors and shareholders
- The preparation of separate company financial accounts and separate tax returns

- The payment of 30% company tax rate on all business profits – including on capital gains
- The payment of dividends to shareholders only when the company pays a profit
- The allocation of imputation credits with those dividends which ensures that the shareholder only pays tax on those dividends at their marginal rate

### **Implications**

Such a residential property investment company would operate like any other company. It could be bought and sold as an operating entity. It could purchase and dispose of assets at its discretion. Its market price may be higher or lower than its underlying tangible asset value. It could borrow money to purchase more residential property. It could claim a tax deduction on all its legitimate business costs. It would pay tax as a separate entity. It could choose not to distribute a dividend to shareholders and reinvest the after-tax profits in the business.

At present, taxpayers on high personal marginal tax rates gain more from negative gearing than do those on lower personal marginal tax rates. Because a company would contain all the business profits and losses within the business entity, the suggested arrangement would ensure that this business activity did not "spill over" into the owner's personal marginal tax liabilities. That would ensure that all shareholders were treated equally and that, via the imputation system, all shareholders paid tax on their share of the company's profits at their marginal tax rate.

The decision to invest in residential property would then be driven by the business case and the potential to create business profits rather than the potential tax benefits to be derived by individual taxpayers on high marginal tax rates. However, people conducting legitimate businesses could still claim their business losses as tax deductions against their business income on their business tax return and so there would still be negative gearing for legitimate business activity.

Clearly there would need to be some transitional arrangements in place. People who currently hold property in their own name would need to transfer the title to their new residential property investment company and such a transfer would trigger a capital gains event. Any change to a new system would need to incorporate exemption for this.

But by insisting that investing in residential property was a legitimate business activity through a company and not just a means to personal tax minimization, we might

reduce the overall demand for residential property and thereby improve housing affordability.

*Jon Kalkman is a director of AIA*



## Winding Up Your SMSF

**SMSFs aren't for everybody, although many investors only realise that after they've got one. This is what to do if you want to kill your SMSF.**

*Richard Livingston, Liam Shorte*

### Key Points

- As you age, an SMSF may become too expensive or too much trouble
  - We run through process of winding up a fund
  - Doing it yourself can save you \$2,000 to \$5,000
- Every self-managed super fund has a use-by date. Some people decide early on that the running costs or commitment required simply aren't worth it. Others find the benefits of having an SMSF diminish as they age. A declining balance – courtesy of the forced minimum withdrawals – mean they're simply not worth the trouble.

But as you'd expect, winding up your SMSF can be as complex and expensive as starting one up and managing it. Let's try and simplify the process.

To wind up your SMSF you'll need to liquidate (sell) all the fund's assets and either transfer the balance to another super fund or distribute them to the SMSF members (or their beneficiaries).

Everything must be done by the book, carefully and methodically. If you overlook one particular asset and

your fund remains open, you'll be exposing yourself to additional costs for financial statements, audits and tax returns.

And if you're on the age pension, shutting down your current fund (and account based pension) will cost you the [grandfathering from the new deeming rules](#) (assuming it's done after 31 December this year). You should factor in any loss of age pension or Commonwealth Seniors Health Card if you're contemplating winding up your fund.

The trust deed

Start the wind up process by reviewing your trust deed. This will specify what needs to happen to wind up the fund, although in some cases it may be silent. If the deed contains winding up requirements you'll need to make sure you follow them (as well as all the legal requirements – see below). Good deeds will have simple requirements and allow the trustees maximum flexibility.

### Written agreement

The next step is to get the agreement of all parties, meaning the trustees (or, in the case of a corporate trustee, the directors) and each of the members. All should sign a resolution documenting the decision to close the fund with wording along the lines set out in Table 1.

'The trustee(s) and members(s) have decided to close the XYZ Superannuation Fund on 27th December 2015 for the following reason(s):

1. Low values mean the fund is not cost effective
2. In view of health issues it is more appropriate to transfer to a retail fund

The trustees and members having agreed to the above resolution will inform the accountant/administrator to process the winding up of the fund'

The trustees must also give notice to each contributing employer and member that the fund is to be wound up on the specified date.

### Sale of assets

Once it's been agreed to wind up the fund, the trustees can begin the process of selling any non-cash assets. The earlier you do this, the sooner you can complete your final tax return (more below). Note though, if you're transferring to another fund you'll have 100% cash exposure (assuming you have no investments outside of super) from when the assets are sold until the transfer to the new fund is complete.



We recommend seeking personal advice on strategies to mitigate this risk. For instance, you could buy exchange traded funds or use derivatives outside of super, or you could break the transfer into multiple units to ensure at least part of your overall super balance is invested in risk assets at all times.

If your fund isn't in pension mode and you have unrealised gains on your investments, note that the sale of assets may trigger a capital gains tax liability.

Finally, if you're paying benefits to members – or transferring to certain super funds – it's possible to do an [in-specie transfer](#) of the fund's assets. You will need to complete an 'off-market transfer form' if you're paying the benefit out to a member as a lump sum. If you're transferring to another fund that allows in-specie transfers, you'll need to follow their instructions. Specify where funds are to be paid

Each fund member also needs to tell the trustees (in writing) how and where they'd like their benefits paid. The member should specify whether they want their benefits rolled over to another fund – in which case they should identify the fund – or paid out as a lump sum.

Liam typically advises his clients to use the Tax Office's form [Rollover initiation request to transfer whole balance of superannuation benefits between funds \(NAT 71223\)](#) when benefits are being rolled over. But members can simply write a letter (using that form as a guide to the information to provide the fund) if they so choose.

If a member is requesting a lump sum, they should write a letter stating this and that the ['condition of release'](#) that has been met.

#### Prior year's compliance

Once the above paperwork is in place (and, if relevant, while assets are being sold) you should ensure that all of the prior year's financial statements, tax returns and any other compliance obligations have been completed.

Paying out the funds

Having completed those steps, you're ready to transfer the members' balances or pay out benefits, ensuring you comply with the fund's trust deed and the [SIS Act](#) in the process.

To pay out lump sum benefits to members, they must have met a [condition of release](#). If that's not the case the balance will need to be transferred (rolled over) to another complying super fund.

If you're rolling over benefits there are two ATO forms to complete:

1. [Rollover initiation request to transfer whole balance of superannuation benefits between funds \(NAT 71223\)](#). Fund members should use this to request the transfer of their super to another fund. It includes some compulsory information, which is why we suggest members use it to instruct the trustees.

2. [Rollover benefits statement \(NAT 70944\)](#).

Trustees should complete this form, sending the complete statement to the receiving fund within seven days of paying the rollover. They should also provide a copy of the statement to the member within 30 days of paying the rollover and keep a copy of the statement for a period of five years.

Where members have received a lump sum benefit payment, the trustees need to complete the form [ETP payment summary – superannuation fund \(NAT 70947\)](#). If a pension payment was made prior to closure and tax withheld, you'll also need to complete [PAYG payment summary – superannuation income stream \(NAT 70987\)](#).

Remember to retain enough cash in the fund to pay any outstanding and post-wind up expenses, including tax, professional fees and lodgement fees. Once the bills are paid, any remaining cash can be rolled over to the member's new accounts or paid out as a lump sum if a condition of release has been met.

#### Final audit and return

Okay, you're getting there; just a few more steps to go. To close the fund you'll need to arrange a final audit and lodge a final tax return, ensuring you complete the section that indicates that the fund is being wound up. At this time you should also pay any outstanding tax liabilities.

Assuming it's been done correctly, the Tax Office will send you a letter stating that they have cancelled your fund's ABN and closed its records on their system.

#### Closing the bank account

After (and only after) receiving the Tax Office confirmation letter, you should close your fund's bank account. In some cases, the SMSF will be due a refund after lodging the final tax return. If that's the case, leave the bank account open until the refund is received.

#### Post wind up expenses

Ideally, all bills will be paid before the date you want the fund wound up. But if you can't achieve that, it's possible to have some of the fund's money retained on trust by the former SMSF trustee(s) to discharge any

outstanding liabilities. We recommend getting personal advice on implementing and documenting this.

### Corporate trustee

If your fund has a corporate trustee and it's not needed for other purposes, it will also need to be closed down (deregistered). Failing to do this means it's still on the hook for annual fees and will need to keep on lodging annual documents.

The simplest approach is to apply to ASIC for a voluntary deregistration of the company. In order to do this:

- all members of the company need to agree to deregister
- the company can't be carrying on business
- there must be less than \$1,000 of assets in the company and no outstanding liabilities
- the company can't be party to any legal proceedings
- all fees and penalties payable under the Corporations Act 2001 must have been paid.

If these requirements are met, complete the [Application for voluntary deregistration of a company \(ASIC Form 6010\)](#) and pay the \$38 lodgement fee. ASIC will tell if your application is approved and then publish a notice of proposed deregistration in the *Government Gazette*. Two months after publication (assuming no-one requests a deferral or cancellation) the company will be deregistered.

Most people should be able to use this approach, but if not you'll need to do a members' voluntary winding up, in which case we suggest consulting your adviser, accountant or lawyer.

Closing a fund is a time consuming but relatively straightforward process. Most complications are likely to arise around the sale of assets, which is why you should seek personal advice on the tax and other aspects of the asset disposals.

If you don't want to run the process yourself, your administrator, or a good adviser or accountant should be able to do it for you. Unfortunately, it's not cheap because of the amount of paperwork involved. Expect to pay around \$2,000 to \$5,000, depending on the complexity of your fund and its arrangements.

More information on the winding up process can be found in the guide produced by the Tax Office.

*Richard Livingston and Liam Shorte are founders of Eviser.*

## The top 10 bond risks you need to know

*Elizabeth Moran*

*While bonds are lower risk than shares in the same company, they carry some of the same risks. They also have unique risks that can be used to your advantage under various economic conditions.*



In recent years, bond investors have been attracted to fixed rate bonds, in part because of their expectations that interest rates will fall leading to a capital gain if they sell prior to maturity. They have been rewarded with double digit returns, especially on long dated, low risk, fixed rate and inflation linked bonds.

A more recent strategy has been to invest in US dollar denominated bonds in the expectation that the US dollar would appreciate against the Australian dollar. This has generally been a rewarding trade for wholesale investors, but some investors in high risk companies have seen gains from the appreciation of the US dollar outweighed by falls in the price of the bond caused by an increase in perceived credit risk of the company.

Foreign currency bonds continue to be attractive to those investors who expect the US dollar to appreciate further against the Australian dollar.

Risk means different things to different investors. To some it means uncertainty or possible volatility in returns and to others the possibility or odds of losing money or the chance of unwinding a position at a loss.

There are many bond risks, the top 10 on my radar are:

1. **Credit or default risk** – this is the risk that the bond issuer may be unable to meet the interest and/or principal repayments when due, defaulting on the bond. Generally, the higher the credit risk of the issuer, the higher the credit margin that investors will expect in return.
2. **Interest rate risk** – the risk associated with an interest bearing asset, such as a loan or a bond, due to variability of interest rates. This mainly affects fixed rate bonds. When the expectation of interest rates is that they will rise, fixed rate bond prices will fall, and the reverse is also true. Expectations of lower interest rates will see fixed rate bond prices rise. This is also known as duration.

Floating rate bonds are more capital stable given interest is adjusted quarterly to reflect changes in the underlying benchmark rate.

3. **Call risk** – the risk faced by a holder of a callable bond that a bond issuer will or will not call the bond at the first opportunity.

Companies have the right to repay the bond before the final maturity date or leave it on issue on specific call dates. Companies will generally act in the best interests of the company. For example they would opt to extend maturity if it would cost them more to reissue a new bond or repay at first call if they could refinance at a lower interest rate. Financial institutions will also weigh up reputational consequences of calling early or extending and in the past have placed a very high reliance on reputation. However, regulatory changes since the GFC are changing that balance with regulators ensuring the decision is primarily based on the cost of funding.

If a company fails to call a bond and the maturity date is extended it is likely the value of the bond would fall on the secondary market.

4. **Early redemption risk** – the risk faced by a holder of a callable bond that a bond issuer will take advantage of the callable bond feature and redeem the issue prior to maturity. This means the bondholder will receive payment on the value of the bond (typically at par) even if the bond was trading at a premium (over its \$100 face value). In good economic times, there is also re-investment risk in that the investor may be reinvesting in a less favourable environment (one with a lower interest rate).

5. **Liquidity risk** – this is the risk that a security cannot be easily sold at, or close to, its market value.

During extreme events such as the GFC, illiquidity is heightened. Generally the lower the risk of the bond the easier it will be to sell at or close to its market value. Part of the premium for investing in higher risk bonds is to compensate for lower liquidity.

6. **Inflation risk** – mainly associated with fixed rate bonds where there is a set return that may not cover inflation if it starts to spiral. Inflation linked bonds directly hedge inflation risk while floating rate notes

would somewhat protect investors, with expectations of higher interest rates to combat inflation likely to increase the underlying benchmark interest rate, typically BBSW.

7. **Exchange or currency risk** – arises from moves in foreign currency rates. Can be divided into transaction risk where currency fluctuations impact the proceeds of specific transactions and translation risk which affects the value of assets and liabilities.

8. **Political or country risk** – the risk of loss when investing in a given country caused by changes in a country's political structure or policies, such as tax laws, tariffs, expropriation of assets, or restriction in repatriation of profits. Since the GFC, political and sovereign risks have been high. Sovereign risk is essentially the credit or default risk of a country but also results in heightened risk of political and regulatory changes.

9. **Regulatory risk** – the risk of regulation changes on a business or industry. This is particularly relevant for financial institutions such as banks and insurers as regulatory changes may have material changes on the value and call risk of regulatory capital securities such as subordinated bonds (or Tier 2) and hybrid (or Tier 1) securities. The non-viability clause required in any new subordinated and Tier 1 security issue is a good example of regulatory risk.

10. **Event risk** – risk due to unforeseen events, for example a company making a large acquisition.

It is important for investors to understand where their investments sit in the capital structure as this directly correlates to the risk involved (see *Just like property, location matters in bonds*). Investors should frequently reassess the return they are receiving and whether this is sufficient given ever-changing market expectations of credit risk, call risk and interest rates. Moreover, they should ensure that the additional return for moving down the capital structure compensates for any additional risk.

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