

SELF MANAGED SUPER FUNDS

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Introduction

By Pauline Hammer

Welcome to our August edition of the Self Managed Superannuation Funds Bulletin and a happy new financial year to all. The 2009 financial year was as challenging as 2008 but we look forward to what should be a less tumultuous 2010 financial year with financial markets commencing to reflect stability and less uncertainty.

This month, Dan Butler and Bryce Figot shed light and clarification on the issue of the use of Powers of Attorney within self managed superannuation. This is an area which trustees and members should seek professional advice to ensure the implementation of a Power of Attorney for their fund in the event of travel or incapacity due to ill health.

Dan Butler and Claire Malone bring us up to date with the ATO's draft ruling which addresses the use of a guarantee if borrowing to purchase an asset within the superannuation fund.

We thank AIA member, John McLauchlan for his article - Treatment of SMSFs and Non-residents. We have included an article which provides further information and answers frequently asked questions relating to this topic. Please note that the ATO tax ruling on residency rules has much information in it – refer to TR 2008/09.

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Important Clarification for SMSFs – Enduring Power of Attorney

By Bryce Figot and Daniel Butler

The Commissioner has released SMSFR 2009/D1. This draft ruling has important implications for SMSF trustees who are not SMSF members but hold enduring powers of attorney.

Background

One of the key elements of being an SMSF is that the relevant superannuation fund is truly *self managed*. The legislation seeks to ensure this occurs by requiring all members to be involved in the superannuation fund's management. Accordingly, all members are required to be trustees or directors of the corporate trustee of the fund.

However, there are a number of exceptions to this rule. One exception is that a member of an SMSF need not be a trustee or director provided that the member's legal personal representative is a trustee or director. For the purposes of the superannuation legislation, a member's legal personal representative includes someone who holds an enduring power of attorney in respect of the member.

A person who executes an enduring power of attorney is called the donor because that person is giving (or 'donating') their legal powers. The person who holds an enduring power of attorney in respect of the donor is called the attorney.

When is the 'enduring power of attorney exception' most often used?

The 'enduring power of attorney exception' is most often used where SMSF members travel overseas for prolonged periods.

In order to ensure that a superannuation fund receives concessional tax treatment, it must meet the definition of 'Australian superannuation fund' in the income tax legislation. This definition has several elements. One is that the superannuation fund must be ordinarily centrally managed and controlled in Australia. Whether this test is met depends on a range of facts and can be subjective and grey. Accordingly, one popular strategy to ensure that this test is clearly met is as follows:

- the SMSF member executes an enduring power of attorney appointing a trusted person who will remain in Australia to be his or her attorney;
- the attorney is appointed as a trustee/director pursuant to the relevant governing rules;
- the donor resigns as a trustee/director before leaving Australia; and
- the attorney commences making the strategic and high level decisions in respect of the SMSF's management (eg reviewing the SMSF's investment strategy and amending if necessary).

Accordingly, this draft ruling is of particular importance for SMSFs with overseas members. It makes the following key points:

Limited enduring power of attorney should be sufficient

Naturally, granting an enduring power of attorney can have far reaching consequences. The attorney legally steps into the shoes of the donor and can typically do anything the donor could do (eg sell the donor's home). Accordingly, some SMSF members who are going overseas have sought to appoint donors pursuant to *limited* enduring powers of attorney. These enduring powers of attorney are limited in the sense that the powers that the donors give to the attorneys are limited to those necessary to manage the SMSF and no more. Other powers (eg the power to sell the donor's home) are not given.

However, there has been some debate as to whether such an emasculated enduring power of attorney would constitute an enduring power of attorney for the purposes of the superannuation

legislation. Although the Commissioner has not expressly answered this debate with a yes, he has made the following comments which suggests that a limited enduring power of attorney should be sufficient:

the Commissioner considers that ... the authority conferred by the enduring power of attorney must include an authority to act in relation to the donor's financial, business and property affairs or an authority to act in relation to the donor's superannuation affairs. Conversely, the authority cannot have an exception relating to superannuation or financial affairs.

Accordingly, consider a trustee/director who holds an enduring power of attorney that is limited to only making decisions relating to the SMSF's management. This superannuation fund should still be an SMSF.

Attorneys must be properly appointed as trustee/director

The legal position is quite clear that merely executing a normal enduring power of attorney does not appoint attorneys to be a trustee or director where the donor is a trustee or director. (However, special trustee or director powers of attorney do exist for this purpose.)

The Commissioner makes it clear that he agrees with this position.

In order to be appointed as a trustee or director, the attorney must be appointed pursuant to the governing rules of the SMSF or trustee company. In the case of individual trustees, typically this means the SMSF's members or principal employer elect the attorney to be a trustee. In the case of corporate trustees, typically this means the company's shareholders elect the attorney to be a director. Naturally, the terms of the specific SMSF's trust deed or company's constitution should be checked. The 2008 Victorian Supreme Court decision of *Hayne v Moss Super Pty Ltd* illustrated that failure to strictly follow this procedure can result in a purported appointment of an SMSF trustee being invalid.

Must be an ENDURING power of attorney

A power of attorney is an *enduring* power of attorney if the powers given under it continue even if the donor loses legal capacity (eg goes into a coma). There are other types of powers of attorney where the powers given cease if the donor loses legal capacity. These are not enduring powers of attorney.

The Commissioner makes it clear that if a superannuation fund trustee/director holds a non-enduring power of attorney, the exception will not apply and the fund may not be an SMSF.

Only one attorney to represent a member

It is possible to simultaneously appoint more than one attorney. The Commissioner expressly states that in order for the exception to apply, only one attorney can be appointed as a trustee or a director of the corporate trustee of the SMSF, in respect of each member.

For example, Joe has executed an enduring power of attorney appointing his son Sonny and his daughter Mary as his attorneys jointly and severally. Joe is the sole member of his SMSF and the sole director of its corporate trustee. If both Sonny and Mary are appointed as directors and Joe resigns, the Commissioner would probably consider that the fund would cease being an SMSF. However, if only one of Sonny or Mary is appointed, the fund would continue to meet the definition of an SMSF. Serious consideration should be given as to which of Sonny or Mary should be selected as whoever is selected would wield significant control over the SMSF assets.

There is some disagreement in the legal community as to whether this aspect of the draft ruling is correct. This aspect might change when the ruling is finalised. However, for practical reasons, it is currently prudent to treat it as being correct.

Practical implications

As a result of SMSF 2009/D1, anyone seeking to rely on the 'enduring power of attorney exception' should confirm that the following is met:

- the attorney has been properly appointed as a trustee or director pursuant to the terms of the SMSF's specific governing rules or corporate trustee's constitution;
- the power of attorney is an enduring power of attorney; and
- only one attorney represents an SMSF member.

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Note: DBA Butler, Lawyers, will be presenting at an SMSF seminar, at venues all around Australia in August and November 2009. For more details or to register, visit www.dbabutler.com.au/index.php?p=DNW or call Marie on 03 9682 0903.

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SMSF – Key Rulings on Guarantees and Contributions

Prepared by Daniel Butler and Claire Malone

The recently released draft taxation ruling TR 2009/D3 outlines the Australian Tax Office's (ATO) view on a range of situations in which a 'contribution' is made to a super fund. The draft ruling touches on borrowings under section 67(4A) of the *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA'), also known as 'instalment warrant'-style borrowings, where the borrowing is supported by a guarantee.

The relevance of this draft ruling is that it is now clear that the ATO might consider payments made pursuant to a guarantee to be a contribution to the superannuation fund. This is the first substantial comment by the ATO on this topic since it first raised concerns about guarantees in April 2008.

Background

Trustees of regulated superannuation funds have been permitted to undertake 'instalment warrant'-style borrowings since 24 September 2007. Broadly speaking, a trustee is permitted to borrow if the borrowed funds are used to acquire an asset the fund would ordinarily be permitted to invest in, subject to several other strict requirements that must be met.

One notable requirement is that the loan must be what is commonly referred to as a 'limited recourse' loan. Sub-section 67(4A)(d) specifically provides that:

"the rights of the lender against the regulated superannuation fund trustee for default on the borrowing, or on the sum of the borrowing and charges related to the borrowing, are limited to rights relating to the original asset or the replacement".

In other words, it is clear that fund's trustee cannot offer security beyond the asset being purchased. However, this does not expressly preclude the lender from obtaining security against a third party. For this reason some lenders, including some of the major banks offering SMSF loans, have been requesting a guarantee from members.

The ATO's initial response

The ATO first expressed a general concern about the use of guarantees to support loans to super funds in April 2008 via Taxpayer Alert 2008/5. It expressed the view that if a guarantee is enforced against a super fund trustee, this could result in recourse being made against the assets of the fund, other than the asset being purchased. The ATO was therefore concerned that this could breach the limited recourse requirement in s 67(4A).

Many have argued that this concern could be unfounded because a guarantor's rights might not extend beyond the rights of the creditor. (That is, a guarantor 'stands in the shoes' of the lender. In the case of a limited recourse loan to an SMSF, a guarantor who has been called upon to meet an outstanding amount can only take action against the fund to recover the asset that was acquired and therefore no other assets are exposed). However, this will depend on the precise terms of the

guarantee and/or right of indemnity, which could extend the guarantor's rights to any asset of the debtor.

Deemed contributions

More recently, the ATO has focused on the potential benefit derived by a fund where its borrowing is supported by a third party guarantee. It states in the recent draft ruling TR 2009/D3 that if a payment is made under a guarantee (for example, if the fund defaults and the guarantor is called upon to pay an outstanding amount), this will constitute a contribution to the fund if the guarantor has no right of indemnity against the fund. This is on the basis that the fund effectively derives a benefit (ie, by not having to meet the liability it has incurred).

According to the ATO, a contribution is also made if the guarantor has paid out to a financier under a guarantee and subsequently forgoes their right of indemnity (eg, via deed of release) or is prevented from enforcing it (for example, under the statute of limitations).

While this draft ruling sheds some light on the possible consequences of relying on guarantees, several questions remain unanswered:

- Although the ATO states that a contribution is only made when the guarantor takes 'formal' steps to forgo their right of indemnity (eg, via deed of release) or if the right of indemnity expires, the ATO has not explained how it would treat a situation where a person sleeps on their rights (eg, where a member guarantor makes a payment to a lender under a guarantee and has a right of indemnity, but simply takes no action to enforce it). In this case, the statute of limitations will not apply for several years and it is unclear how the ATO would approach this in this intervening period.
- It is also unclear how the ATO's recent analysis of guarantees sits with its general position that any expense or liability of a super fund paid for by another entity may count as a contribution to the fund if the fund does not reimburse the payer. This was stated in an earlier Taxpayer Alert (TA 2008/12) and also in this recent draft ruling.
- The draft ruling appears to accept that, in practice, guarantees are being given for super fund loans. However, the ATO has not expressly clarified whether they consider that guarantees comply with the s 67(4A) borrowing law, given their earlier comments in TA 2008/5 that a guarantee could breach the limited recourse requirement. The ATO will hopefully withdraw or amend TA 2008/5 on finalisation of the draft ruling.

It is also important to remember that this is only a draft ruling and in any event, taxation rulings are not law. However, the ATO has made it clear that payments made pursuant to a guarantee could have consequences for members' contributions caps (and possibly excess contributions taxes).

What if I am asked to give a guarantee?

Given the potential for a significant 'contribution' to be made where a related guarantor is called upon, SMSF trustees should closely examine their ability to repay a loan before borrowing. Trustees should take into account a range of factors such as the expected yield of the asset, the ability of the members to make future contributions and other liabilities of the fund, such as any annual minimum pension payments that will need to be met. Above all, a borrowing must be consistent with the fund's investment strategy.

If a lender requires that a guarantee be given by the members, trustees should ensure that they understand the risks related to guarantees before proceeding with the loan. Some alternatives might be available, such as sourcing finance from a lender that does not require a guarantee (including a related party lender), seeking advice about an alternative non-g geared unit trust structure instead of a SMSF borrowing (which could allow the trustee to make incremental acquisitions of units from a related entity who has borrowed to purchase their units) or, if possible, simply maximising contributions to the fund to allow it to purchase the asset outright.

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Treatment of SMSF for Non-Residents

Prepared by John McLauchlan

For many non residents the rules governing compliance of Self Managed Superannuation Funds are not very clear and there is a very real danger that the fund may become non-compliant unless it is carefully restructured by its members.

Non compliance is extremely punitive and will result in the fund being taxed at the highest individual rates of tax ad infinitum.

Most accountants and financial advisers have knowledge of the rules where the individual members (who may also be the trustees) of a SMSF are resident in Australia. However there is not only a lack of knowledge by advisers but also the likelihood of incorrect or sub optimal advice which could be costly or even impossible to reverse should the member return to Australia as a resident again.

My wife and I formed a SMSF in 1992 when we owned a business. The SMSF become our main savings vehicle. It doubled in value from 2003 to 2007 but has now reduced back to 2003 levels following the credit crunch.

After selling the business in 2006 we both left to take up employment in the Middle East. We were both under 55 and are currently both under 60.

At the time, the ruling was that we needed only to return to Australia for 28 consecutive days in every two years and the fund would automatically remain compliant for a further period of two years.

The rules changed on 1 July 2007. From that date the management of the fund needed to be separated from membership. A member could not actively manage the fund any longer. This did not mean inability to make contributions as a non resident (this provision always existed) but active involvement in the management of the fund by making decisions on investment strategy.

We sought advice from our financial adviser as to how we might maintain the fund in its current form but also ensure future compliance because we wanted to continue using the SMSF structure when we returned to Australia.

He had no idea, nor did our accountant. We were therefore forced to do our own research because an inadvertent mistake could have resulted in the fund becoming non compliant.

The first issue we faced was whether we were non-resident for tax purposes. We had been out of the country less than 12 months when the rules changed. We found out that non-resident status is a matter of intent rather than any hard and fast rules. We knew we wanted to remain overseas for at least two years and that would break most of our ties with Australia in doing this. The exception was that we rented out our main residence through a real estate agent and kept active bank accounts. We also continued to complete and lodge individual tax returns with the ATO.

Just getting correct information from our accountant on this was difficult and we ended up doing our own research again mainly using the ATO web site: which we found very difficult to use but it does contain useful definitions on residence.

We were fairly certain that we would be classified as non-resident even if we had been made redundant and had to return to Australia within two years of leaving. This was because: accommodation, was provided by my employer, and I had a specific employment contract which was for three years; plus a residence visa for the UAE. This is an area which anyone wanting to keep their SMSF active whilst becoming a non resident for tax purposes needs to research.

With regard to the treatment of the SMSF We found that there were three options available to us. These were:

- 1) Convert the SMSF into a Small APRA fund.

- 2) Appoint an independent Power of Attorney who would make all investment decisions for the fund and effectively administer it.
- 3) Sell down the assets into a Public Offer Fund.

The option to replace the SMSF with a small APRA fund was quite attractive but the options we found were administratively expensive. In addition; we were told that there could be significant difficulties where the SMSF holds real property comprising up to 80% of the fund value. Although quite acceptable within the investment strategy of the fund the small APRA trustees would almost certainly have insisted that it be reduced to around 20%.

The option of a Public Offer Fund was ruled out as selling the assets in the fund would have crystallised a CGT liability (mid 2007) and we were not sure how we could reverse this back to a SMSF on our permanent return to Australia. If we had been over 55 the CGT issue could have been overcome if we had commenced a transition to retirement pension thus making the realised capital gains tax free.

If this applies to you, care should be taken here unless the pension is taken for the whole financial year as the gains may be prorated if your member account is in accumulation mode for part of the year.

We eventually decided to appoint a very good friend of ours as our Power of Attorney. To many people this is a very high risk strategy but to us this kept our costs down and retained the SMSF in its current form. We had to resign as directors of the corporate trustee and appoint the POA as a Director to ensure that we had no management control over the fund.

If we had not done this we would have transferred the assets into a small APRA fund.

Currently we have a financial adviser; use a separate wrap account for fund administration and a specialist superannuation accountant. All investment decisions are made by our financial adviser in conjunction with our POA. This is expensive but ensures compliance.

As non-resident members we have no active involvement in the fund. We make no contributions and take no part in investment decisions or administration of the fund.

My advice to anyone who has a SMSF who is a non-resident is to research this area very carefully particularly if you plan to return to Australia in future and want to retain the SMSF in its original form. Control of the fund is the big issue with the possibility of the fund becoming non compliant through ignorance of the rules the greatest risk. If you have relatives or children they can become additional members of your SMSF so long as at least 50% of the trustees are resident in Australia. A two member fund can appoint a further two members.

Active control must rest with the residents so this may preclude a non-resident couple including two of their resident children in the fund with only token balances. At the time of writing my wife and I are both under 60.

We understand that if we are still non-resident at 60 we can move to the pension stage without a problem as long as active member accounts are not greater than 50% of the fund for non residents.

If you need additional information on this area then I would suggest you contact one of the specialist accountants or superannuation administrators; and possibly the ATO as well. It is unlikely a normal accountant or financial adviser will have a detailed knowledge of both non residency rules and SMSF compliance requirements. The AIA can assist you with contacts I am sure.

John McLauchlan is a member of the AIA.

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Answers to Frequently Asked Questions – Residence and Self Managed Superannuation Funds

Provided by Smart Super Pty Ltd

Tax concessions

Tax concessions for superannuation are generally only available to Australian resident funds and Australian resident individuals, so when looking at whether you can live in the Greek Islands but still make contributions or retain superannuation in Australia you must look at the residence of both the fund and the individual. One of the consequences of a fund becoming non-resident is that the income tax rate increases from 15% to 45%. Residence is therefore a critical issue.

Residence of a super fund

SIS legislation uses the definition of residence in Section 6E of the Income Tax Assessment Act 1936 (please refer to the Act for the full definition). To be resident the fund must satisfy **all** the following tests:

1. Qualify to be a fund (under SIS)
2. Either have been established in Australia *or* have assets in Australia
3. Either have its central management and control ordinarily in Australia *or* satisfy an alternative control test (see below)
4. If there is an active member at least 50% of the accumulated assets of the fund held for active members must be held for resident active members

Central management and control

Whether a fund has its central, management and control in Australia can be difficult to determine. One relevant factor will be where the trustees are located. For instance, if a majority of the trustees (or directors of the corporate trustee) are located outside Australia then it is possible that the central management and control will also be outside Australia. Conversely, if a majority of the trustees (or directors of the corporate trustee) are located in Australia then it is possible that the central management and control will also be in Australia.

Alternative control test

If the central management and control test can't be met then it may be possible to satisfy the alternative control test. This test will be met if the following conditions can be met:

1. One or more of the trustees (or directors of the corporate trustee) are temporarily absent from Australia.
2. The central management and control of the fund would be in Australia if the trustee(s) or director(s) were in Australia.
3. The trustee(s) or director(s) have not been continuously outside Australia for more than two years. There are no exceptions to the "no more than 2 year" rule. If the trustees are overseas for more than two years the fund will be treated as non-resident and will hence lose its concessional tax status.

Active membership test

The last test in determining the residence of a fund only applies if there are active members. Where the test applies the fund must show that 50% of the funds held for active members are held for resident active members. Active members do not include members who have ceased being resident in Australia, if no contributions have been made by the member, or on behalf of the member, since the member ceased being resident in Australia. Given the unfavourable tax treatment afforded to contributions made by, or on behalf of, non-resident members (see below), it

is unlikely that a fund would have any non-resident active members. As such, it is considered most funds would satisfy this requirement.

Residence and contributions

Taxation concessions for contributions made to super funds are only available if made by, or on behalf of, Australian residents. You must therefore be careful that your fund only accepts contributions from or on behalf of members while they are residents or from periods when they were residents eg if a rollover is made to the fund after they become non-resident but that rollover was created from contributions that were made while the member was a resident.

Residence of the trustee company

Under the Corporations Act, trustee companies must have at least one director that “ordinarily resides” in Australia, and if it has a secretary/secretaries, at least one secretary who “ordinarily reside” in Australia. Unfortunately, there is no definition in the Corporations Act of the term “ordinarily resides”. The term therefore takes its ordinary meaning.

There is a substantial amount of case law on when a person is ordinarily resident in a particular place. Without going into details, it is possible that a director(s) of a trustee company is not ordinarily resident in Australia (even though the fund may be resident through satisfying the alternative control test referred to above). In such a case, it might be appropriate to admit a resident member to the fund and appoint that member a director and secretary of the corporate trustee in order to comply with the Corporations Act.

What if I’m going to be overseas indefinitely (or at least for more than 2 years)?

To maintain the resident status of the fund you must ensure that you return to Australia within the two year period. If you cannot do this you should either:

1. Appoint an Approved Trustee (ie convert your fund to a Small APRA Fund) as they are certainly resident in Australia and have their central management and control in Australia; or
2. Appoint individuals with enduring powers of attorney for the members to act as trustees.

While appointing individuals with enduring powers of attorney (option 2) as trustees is acceptable under the SIS act, you need to be able to demonstrate that central management and control still resides in Australia for purposes of the Tax Act, ie those persons are controlling the direction of the fund and not just acting on the instructions of nonresidents.

To be safe it is probably best to appoint a corporate trustee with at least one resident director. If you have a company as trustee we recommend that you appoint or maintain at least one member/director who “ordinarily resides” in Australia before you are overseas for more than 183 days to be on the safe side as far as ASIC is concerned. Appointing a director(s) with enduring power(s) of attorney could satisfy this requirement as well.

If less than 50% of the members/trustees are living overseas and have less than 50% of the fund assets you could probably argue that the fund was resident even if the particular members/trustees do not return to Australia as the central management and control would still be in Australia thereby satisfying the first part of test three in the fund residency section above.

Conclusion

The whole area of residence as far as a super fund is concerned is critical as any mistakes can render the fund non-complying which means it will be taxed at penalty rates instead of the 15% concessional rate. Because of this we recommend you seek professional advice before traveling overseas for any substantial length of time.

The information contained in this document is of a general nature only and is not intended to be personal or legal advice. No person should act solely on the basis of the information contained herein but only after discussing their individual circumstances with their Financial and Legal Advisers.

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