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Money News

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Inside this issue:

Super-leveraged property investment has arrived in Australia.

Superannuation funds can now borrow money to purchase real estate. An investor can have just as much choice and control over investment properties inside as outside a superannuation fund.

Many Australians have significant money in superannuation, and more are establishing their own self managed super funds (SMSFs). Many people would like to be able to include direct investments in real estate in their super fund's investment portfolio.

SMSF's want to gear their real estate investments in order to diversify risk, increase the yield on the investment, and because many funds do not have sufficient money to purchase real estate outright.

Until recently, this has not been possible for most SMSF's because of restrictions on superannuation funds borrowing and charging their assets. However, the Superannuation Industry Supervision Act (SIS ACT) was amended in September 2007 to allow super funds to borrow and charge their assets so long as a special structure is used.

Features of the Structure.

- Choose any kind of property including residential, commercial, retail, and holiday units.
- A super fund can purchase real estate let for business purposes from a member or a related entity (i.e. this does not breach the "in house asset" rule under the SIS Act). Investments in property other than "business real property" are permitted provided the purchase is from an arms-length vendor.
- The legal owner of the real estate will be the Property Trustee.
- The beneficial owner of the real estate will be the SMSF.
- The lender has no recourse to the other assets of the SMSF, providing the SMSF with absolute protection for its other assets.
- The loans are personally guaranteed by the member/s of the SMSF (subject to credit approval).
- SMSFs can deal with the property however and whenever they like, in the same way as investors can deal with "normal" investment properties (eg: lease, renovate, repair, or sell), subject to the terms of the relevant loan and mortgage).
- All rents are paid direct to the SMSF. Loan repayments are made in the ordinary way from the SMSF.
- The SMSF can pay out or reduce the mortgage at any time (subject to the terms of the relevant loan).
- When the mortgage is paid out in full, title to the property can be transferred to the SMSF of the Property Trustee can continue as registered proprietor.
- Source: Seiza Mortgages, 2008.

No need to Panic.

Well, 2008 has certainly been a wild ride. Now that the market has fallen 20 per cent from its early-November high, we are technically in a bear market– but perhaps a more apt description is a "bucking bronco" market. From one day to the next, it jumps around erratically.

So how can you ride out the ups and downs and cling on for investment success? By going back to the fundamental principles of investing; there are tenants that, in the raging bull market of the previous five years, were sometimes forgotten.

First, markets move in cycles and it is impossible to predict the end of one cycle and the beginning of the next. That is why it is often said that time in the market is better than timing the market. Indeed, Morningstar research shows that if you has missed 10 best trading days since 1983 by getting in and out, your returns would be 36 per cent lower than if you had simply been invested the whole time. If you bale out, you could miss the recovery.

The second tenant is to stick to your strategy. If an investment was sound when you made it, it is likely to be sound now. The only caveat in the current environment is where you have brought shares in companies that are highly leveraged, which are the ones coming unstuck in the sub-prime fallout. These might require a rethink.

The third, and probably most important axiom, is diversification. How you fare in market routs will be directly related to the size and spread of your investment positions. The best protection is a portfolio diversified by specific holding, sector, asset and location.

Source: Financial Review Smart Investor, March 2008.

Hit the Spot.

While everyone was distracted by shares, in many areas property quietly returned to boom conditions. *AFR Smart Investor* has scoured the country to reveal the top 16 investment prospects, Penny Pryor reports.

Volatile times on the share market mean property is starting to look a little more attractive-even after the run of interest rate rises we've had over the past two years. Developers and valuers say those rate hikes are yet to seriously dent investor sentiment but these days you need to be even more careful when deciding where to invest your property dollars. It goes without saying that you should invest or buy within your means and leave some leeway for at least one or two further interest rate hikes, but there will always be locations with good appeal that offer value.

With that in mind, we asked Australian Property Monitors to screen its nationwide database and pinpoint 16 areas that show both strong capital growth and solid rental yields. We then applied a further screen-fundamentals supportive of investment success. Our selection process has revealed many inner-city areas likely to provide strong returns- through both capital growth and yield– for many years to come. In part that's because the affordability crisis and demographic change mean younger people are renting for longer. The properties they're renting are generally chosen to match their lifestyles, being located in the trendy parts of Australia's cities. Suburbs such as Fortitude Valley in Queensland, Newtown in NSW and North Hobart in Tasmania all fit this bill. Larger regional arrears with strong economies and proximity to cities– such as North Cairns in Queensland and Traralgon in Victoria– also hold opportunities.

Source: Financial Review Smart Investor, March 2008.

Tax Tips.

Income Tax under the Rudd Labor Government.

As expected from July 1 2007, average wage earners will receive their $20 a week tax cut as promised by both Labor and the coalition but high income earners will have to wait at least three years for an extra $75 a week under the new Labor government.

In the election campaign both sides of politics were willing to take the risk that injecting #34 billion into the economy as a result of tax cuts would win them government without pushing up interest rates.

The Rudd government will be depending on the continued strength of the economy to ensure its ambitious six year tax reform program is completed.

While both sides steered clear of detailed tax reform in the election campaign, key Labor commitments include:

- From 1 July 2008, halving the withholding tax on distributions from Australian managed funds to foreign investors from 30% to 15%.
- The low– income tax offset will increase in three stages from $750 to $1,500 by 1 July 2010, providing an effective tax-free threshold for low income earners of $16,000 compared with the current $11,000.
- The 30% threshold is to increase in stages from the current $30,000 to $34,000, from 1 July 2008, to $35,000 from July 2009 and then $37,000 from July 2010.
- Wage earners receiving between $35,000 and $38,000 a year will receive a total tax cut ranging from $28.85 to $34.62a week from 1 July 2010.
- From 1 July 2009, the second highest marginal tax rate will fall from 40% to 38%, affecting taxpayers earning between $80,000 and $180,000 a year.
- The following year from 1/07/2010, this second highest marginal rate falls to 37% providing a $116 tax cut for those with a taxable income of $180,000 a year.

These deferred tax cuts for high income earners are in contrast to the immediate tax cuts offered by the coalition and will be used by the Rudd government to fund reduced elective surgery waiting lists and subsidises education costs for low income families.

Labor proposes an even bigger tax cut for high income earners by 1 July 2013, when they propose to simplify the tax system by reducing the number of marginal tax rates from four to three with tax scales of 15, 30 and 40 per cent. Only people with taxable incomes in excess of $180,000 will pay the top marginal rate of 40% (currently 45%).

At this time, the 30% bracket will apply to income earned between $37,000 and $180,000.

Labor also intends to adopt the coalition's long term plan to increase the low income tax offset to $2,100 by 2012/13.

Superannuation Funds Installment Warrants.

An installment warrant is an agreement that enables you to purchase an asset over time. Under such an agreement, you make an initial part-payment and then pay the remaining installment (s) plus interest and the cost of settling up the loan to fund the asset.

At any time, you can default and forfeit the:

- Asset you are purchasing under the agreement, and
- And payment (s) you have already made.

When you have paid all the installments under the warrant, the asset is transferred.

Borrowing Conditions.

You are allowed to borrow as long as you meet the following conditions:

- You have a right but not an obligation to purchase an asset under an installment warrant by paying installments.
- If you default on a loan payment or decide to walk away from the loan, the lender can only recover an outstanding amount via that particular asset (or any replacement). For example, they might repossess or dispose of the asset. The lender can not recover money through the fund's other assets.
- The fund would normally be able to invest in the asset (or any replacement). Existing investment restrictions, such as those on in-house assets and acquiring certain assets from a related party of the fund still apply.

If you invest in an installment warrant, it is not automatically counted against the in-house asset limit. However, if holding the asset directly would breach the in-house asset rule, you must not invest in an installment warrant for that asset.

Self managed Super Funds (SMSFs)

If you are a trustee or director of a SMSF and you invested in an installment warrant before 24 September 2007 that the new law allows, the ATO will not issue a notice starting your fund is a non-complying fund solely on the basis of this investment.

However, if you invested in an installment warrant product before 24 September 2007 that breaches the new law, the ATO will decide on a case-by-case basis what you must do to become compliant. For example, the ATO may impose a penalty, or where possible, require you to rectify the contravention.

Examples of products that may not comply with the law are those where:

- There is a charge over a fund's existing asset– for example, you cannot take a loan against an asset your fund already owns, or
- Investment restrictions mean you could not normally have acquired the asset– for example, non-business real property a member owns.

A number of fund managers have made a geared property investment strategy available to it SMSF clients. Typically this involves finding up to 70% of the purchase of a commercial property. The SMSF subscribes for a property note which represents the balance of the purchase. There are variations on this model.

Source: The Taxation Examiner's Bi-Monthly Newsletter, Jan/Feb, 2008.

Things You Must do Before You Die.

It may sound funny to say life is short, when really there isn't anything you do that lasts longer.

Nevertheless, it's a good excuse to try something wild or self-indulgent– like bungee jumping, going on a safari or visiting the Taj Mahal.

But after compiling a list of worthwhile experiences to make the most of your life, its vital to also consider strategies to make the most of the wealth you have worked your life for.

After all, if you don't put the right plans in place, you'll only serve to reinforce that other truism: that there are two certainties in life– death and taxes.

If you fail to fix your final finances, you will die and then your money could be largely eaten up by taxes.

So, what can you do about it?

Something as simple as making a legal will ensures that you decide where your assets go when you fall of the peg.

There are also more complex structures you can implement to give you power over what happens after you've departed– and, importantly, to stop the taxman taking a big chunk of your estate.

We've spoken to some of the best and brightest in the industry to come up with a list of the top ways to safeguard your wealth– and your family's future– once you're gone.

Get Some Will Power.

A will can ensure that your assets will be distributed as you'd like. If you don't have kids, cousins or a dog to leave the money to, you can bequeath it to an organization or charity. Perhaps even to the Church of Scientology, if you're Tom Cruise.

However, if you die without a will– or interstate– state and public trustees will administer your estate. This can result in litigation, further delays and hardship for your immediate family. Most importantly, money may not reach the people who matter.

Racing legend Peter Brock, for instance, had more than one will when he died, which made it difficult to decide how to divide his assets. Ultimately, it was ruled that the king of the mountain died interstate, which meant his assets could not be distributed according to his wishes. If you don't want people fighting over your money in court, you can buy a will kit for less than $100, or you can consult a solicitor. The cost of having a solicitor draft your will can be as low as $250.

You must sign the will with two witnesses present– it’s best that they’re not beneficiaries, as that could lead to disputes down the track. And make sure you update the will as your circumstances change.

Married people should have a separate will to that of their spouse. You can have the same clauses and terms, just in reverse, in what are known as mirror wills. Because the details are the same, you can get a second will drawn up usually for a lower cost.

You may think making a will is something you do when you get old, but trustee company Australia Executor Trustees suggest that anyone over 18 should have one.

Choose Your Favourites.

Nominating beneficiaries for your super can ensure the money is paid to the right people, rather than the government.

Martin Murden of Partners Superannuation Services says making a binding nomination is most appropriate when there’s a blended family or a chance of friction between the children.

However, binding nominations are current for three years only and not every fund allows them, Some funds only permit non-binding nominations, so that the final decision on who receives your benefit lies with the trustees.

Members of self– managed funds can sign a non-lapsing nomination, which lasts into perpetuity. Update these as your circumstances change.

Even if you make a binding nomination, if the nominees aren't dependants under the super rules, the fund trustees may not be able to pay them.

Allowable dependants include your spouse, children or other people financially dependant upon you or in an interdependency relationship with you.

A “non-tax dependant” (such as an adult child) cannot receive a benefit as a pension– it must be paid as a lump sum. So a binding nomination that stipulates the death benefit is to be paid as a pension to a non-tax dependant is technically void.

Bentleys Advantage principal adviser James Carson says there may be many people with such nominations in place as the law came into effect only on July 1 last year. These need to be reviewed.

Don’t assume super is part of your estate. Carson says it’s a common misconception that this is automatic, but your super will only be paid to your estate if you have instructed your fund to do so in a binding nomination. Otherwise, it will be paid to the relevant beneficiaries, which could mean a higher tax liability for those individuals.

Update The Rules.

If you're one of the hundreds of thousands of people who have their own super fund, you'll know there's a set of rules under which your fund must operate.

Although superannuation laws outline who can be dependant, sometimes trust deed rules have stricter definitions. Members should check their fund’s deed to see what happens to benefits upon death, to ensure their beneficiaries won’t be cut off.

In addition, it’s important that members who are trustees are aware of what’s required of them if another member should die.

Appoint an Executor.

No you’re not hiring a hit man. But like a Mafia godfather, you're arranging for someone to do your bidding. In this case, the executor– usually a solicitor or legal representative– takes care of things after your death, for instance, by lodging your final tax return.

Going a step further, another tip is to have a specific provision allowing your executor to distribute income and capital gains while the estate is still being administered. Sometimes an estate will be executed and assets distributed quite promptly, but often there are delays because of the need to identify, collect or sell assets.

For the first three years after the death, an estate is a separate taxable entity that is subject to income and capital gains tax. Usually there are benefits spreading tax liabilities among other individuals and minors.

Source: Financial Review, Smart Investor, March 2008.

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