Cuffelinks
Connecting investors with ideas

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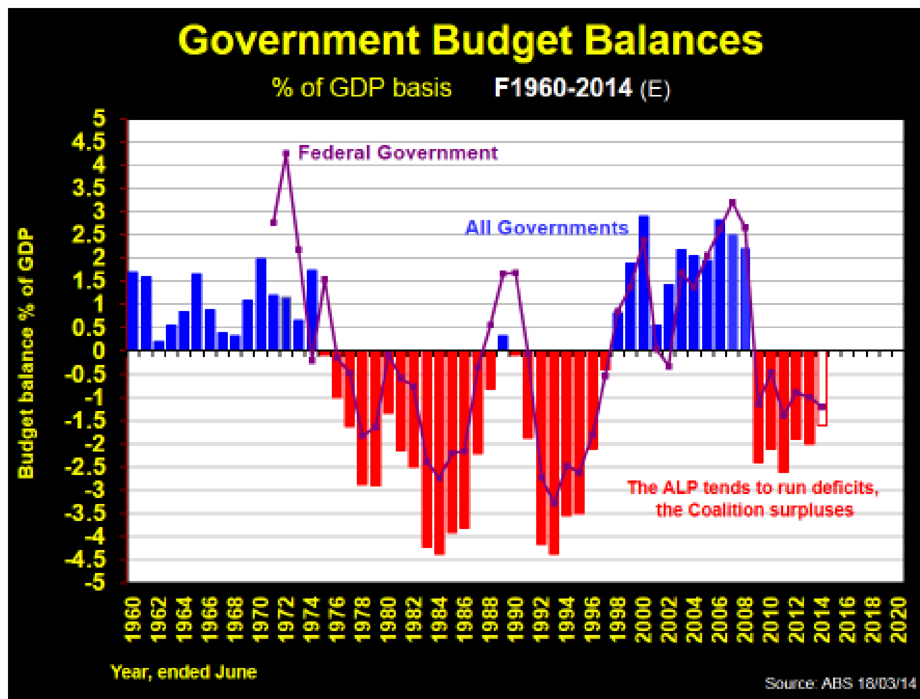
Living within one's means

Phil Ruthven

In the fiscal 2014 year, government at all three levels in Australia will spend around $520 billion, derived from taxes, income from government business enterprises (GBEs) and borrowings. Around $125 billion (24%) will go on social security and welfare, which is not excessive in relative terms when compared to virtually all other OECD nations. Indeed, it is the lowest as a share of GDP.

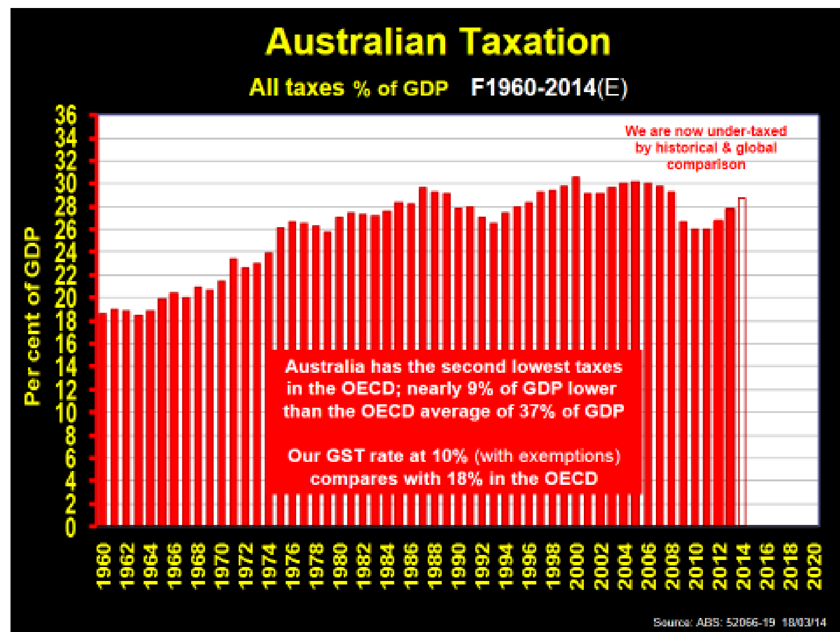
However, this year the nation will run yet another deficit, its sixth in a row, although not as deep as that of the Labor Governments in the 1980s and 1990s (Hawke/Keating Governments, and other Labor state governments). The only federal Coalition deficits over the past 60 years were under Malcolm Fraser, partly inherited from the Whitlam Labor Government. The first chart [next page] shows federal governments (purple line) and all governments (bars) surpluses and deficits since 1960.



So, should the Abbott Government and Coalition state governments cut deeply into spending in the 2015 financial year and later budgets to return us to surplus? To do this too harshly, whilst also introducing new welfare such as the proposed maternity allowance, seems unnecessary when we are already the lowest taxed nation in the OECD, smacking of ideology rather than common sense.

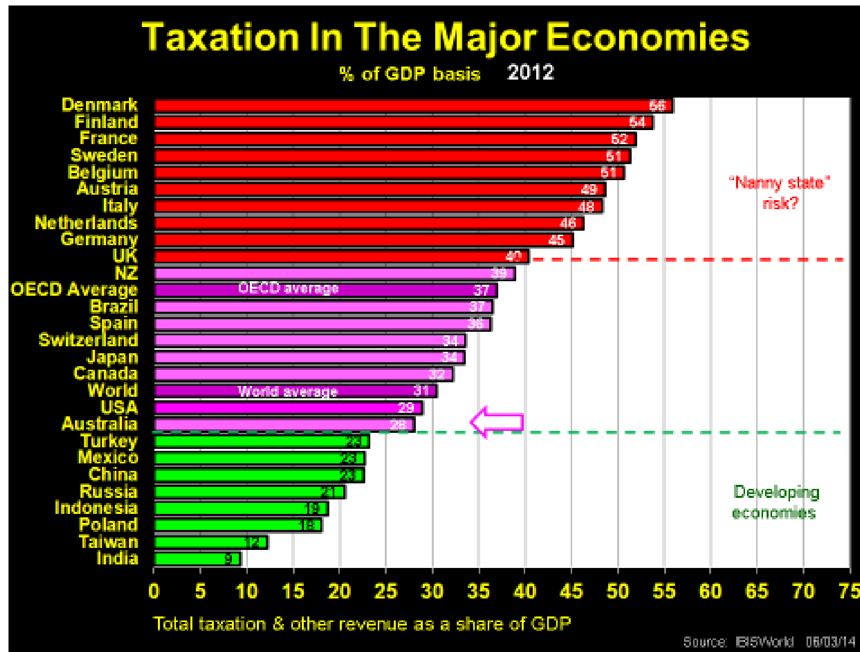
The debate about our taxes has been re-ignited often over the past several months, with a repeated denial by the Federal Government that there is any intention to raise our taxes, including the GST rate. However, taxes are currently 3% below where they were in 2007, then 31% of GDP, which was the last time we actually ran a surplus budget.

The second chart shows how taxation has fluctuated in recent years.



It may come as a surprise to taxpayers, be they personal or business, that Australia in 2014 is the lowest taxed nation in the developed world. At 28% of GDP in 2013, it is 9% below the OECD average of 37% of GDP, and exactly half the world's highest taxed nation (Denmark) at 56% of GDP.

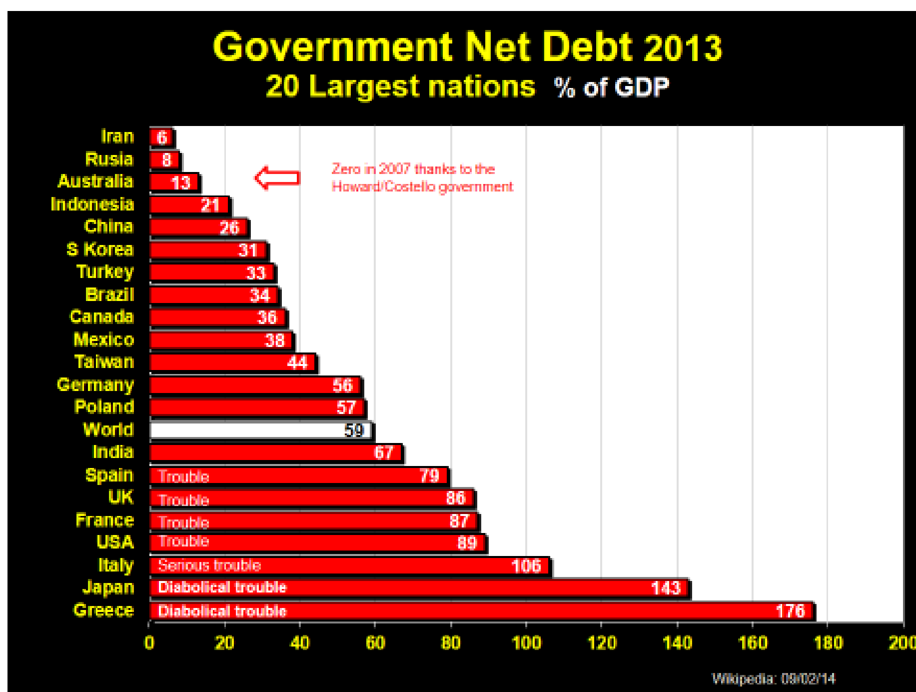
The third chart below shows that only developing economies, without the economic capacity to have higher taxes, sit below Australia's tax rate.



So, to suggest to the electorate that our tax level is high enough as it is, or indeed too high, is difficult to justify. To also promise, as the Government has done, that Australia can introduce more welfare without the funds to pay for it, is a fantasy, unless there is more than an equivalent reduction in other existing welfare. That sort of direction led to the debt problems that most EU nations and the USA now have.

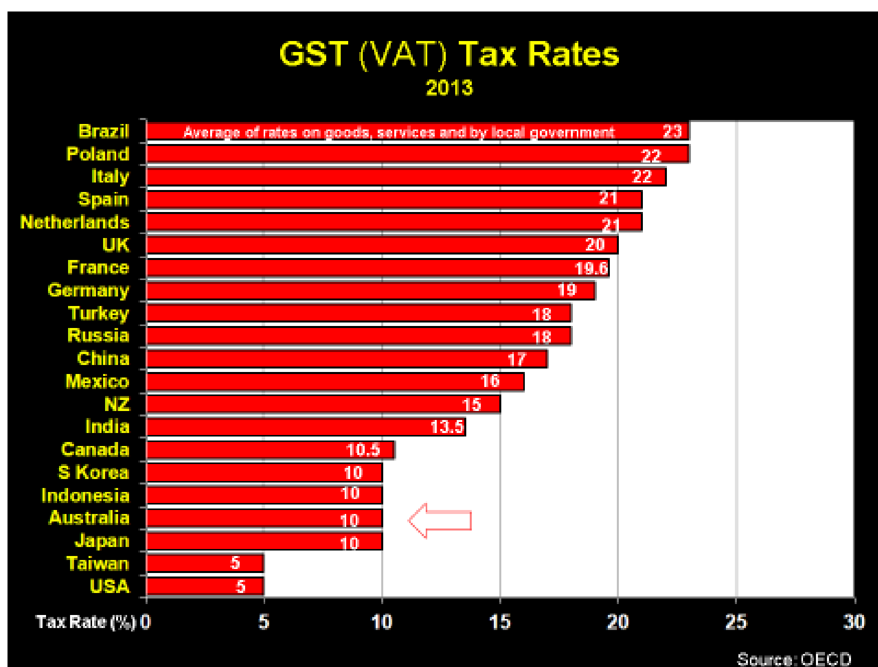
The reality is that the nation is lowly taxed, indeed under-taxed. Raising the GST to 12.5% and removing some of the exemptions would restore our virtuosity, and still make us one of the lower taxed nations. We are nowhere near the so-called 'nanny state' levels where taxes are well over 40% of GDP.

By world comparisons, Australia has the luxury of several years grace in becoming more serious about budget issues. We have a low government net debt - as the fourth chart shows - we are part of the biggest and fastest growing region in the world (the Asia Pacific), and we have relatively high consumer and business confidence. However, these attributes will not last forever in the absence of reforms.



Creating an Audit Committee with experienced captains of industry, and an Industrial Relations Review by the highly regarded Productivity Commission, are good initiatives. They will hopefully be heeded and have most recommendations implemented, unlike the previous government.

This brings the GST into the spotlight. As the final chart shows, Australia has one of the lower rates among the largest economies in the world, the 17th largest among 230 nations.



Our GST rate at 10% is nearly half the average (17-18%) and well below half of the five highest, all of whom have a rate over 20%. Yes, our personal income taxes sit higher than many in the OECD, but that advantage to individuals and households in those countries is offset by other taxes, including their higher GSTs.

Ken Henry, in his eponymous report on taxation in 2010, suggested a number of taxes should go in the interest of simplicity and streamlining business. They included payroll tax, insurance taxes, property transfer taxes, motor vehicle stamp duty, luxury car taxes and many others. These taxes would be replaced within the four pillars of personal income; business income; private consumption; and economic rents (natural resources and land). No argument from business on this goal.

Important points on taxation

Most importantly, the key messages on taxation are:

- we are lowly taxed
- we can and should raise them a little, preferably via the GST
- we can balance the Budget in the process
- yes, we should simplify and streamline the tax collecting regime.

We are living beyond our means, but we are not yet anywhere near a 'nanny state', and we do have some justifiable social security spending to maintain and expand (health services in an ageing society, support for maternity leave and some others). We can do all this while raising our taxes a little, and still remain close to the lowest taxed nation in the developed world.

Phil Ruthven AM is Founder and Chairman of IBISWorld.

Squiggly lines and lessons in market timing

David Bell

The ability to forecast market or stock returns is a holy grail in investment management. The search has captivated industry and academia. Many smart people have devoted their careers to the search, large teams of highly talented people have been assembled, and elaborate models have been developed. We have even seen examples of such work in Cuffelinks! Many of these endeavours have failed, sometimes spectacularly.

And yet so many are tempted to continue in their quest to develop a model or process for predicting market returns. It appears to me that the desire for precision, to be close to exact in one's forecasts, often contributes to the downfall of people taking on this quest.

If we step back to a higher, less specific view, take on board key messages (for example that markets appear cheap or expensive), diversify appropriately, and invest for the long term (with a matched frame of mind for assessing outcomes) then the world of managing a portfolio becomes a simpler and less high-stakes exercise.

Models and processes for forecasting markets generally fall into two broad categories:

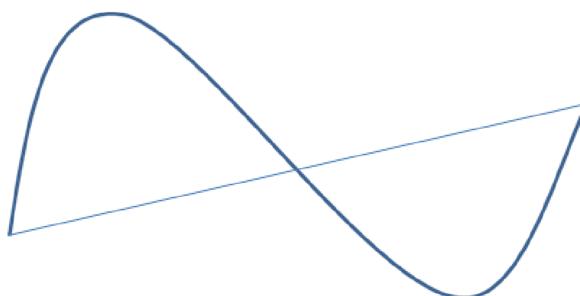
- fundamental – where one considers the economic (market) or financial (company) prospects and estimates the value of these prospects in the context of current market prices

- technical – where one solely looks at past price data in search of patterns that may repeat in the future. Common examples include trend following and mean reversion.

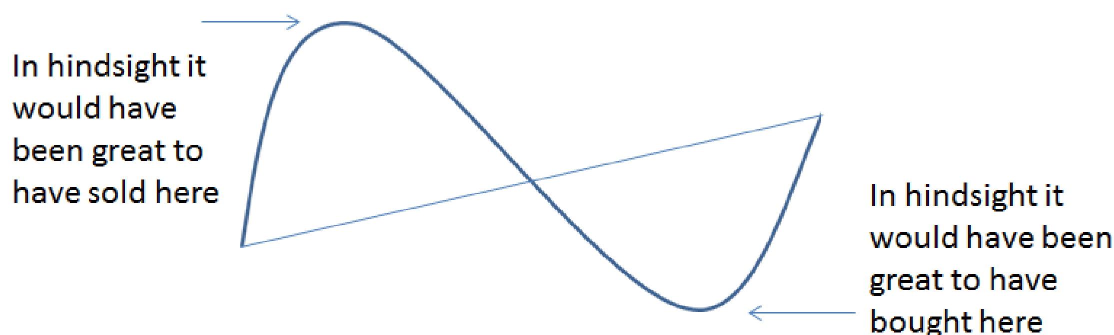
It is common to see both techniques used together. It doesn't matter whether the process is fundamental or technical; the same problems apply when we search for the exact model.

Here's where the squiggly lines come in. You can try this exercise yourself.

1. Draw a squiggly line which represents the movement of a stock price or market index through time. Connect the start and end points of the squiggle with a straight line.

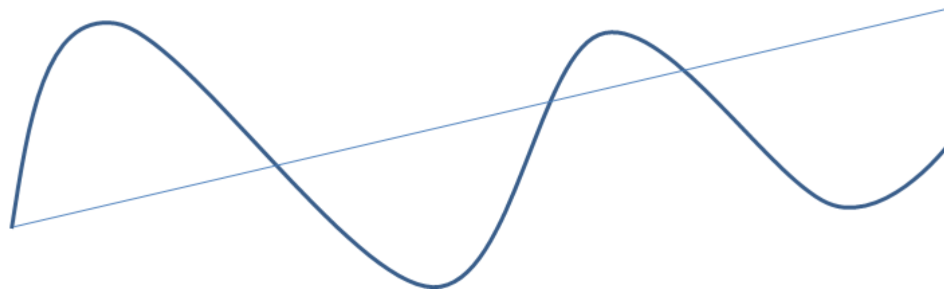


One might be tempted to look at the straight line and observe that it summarises the trend movement in the market. It might appear logical to say with hindsight, "there are clear buy and sell opportunities". It might lead to a trading rule: when the price is a long way above or below my trend line, I will sell or buy.

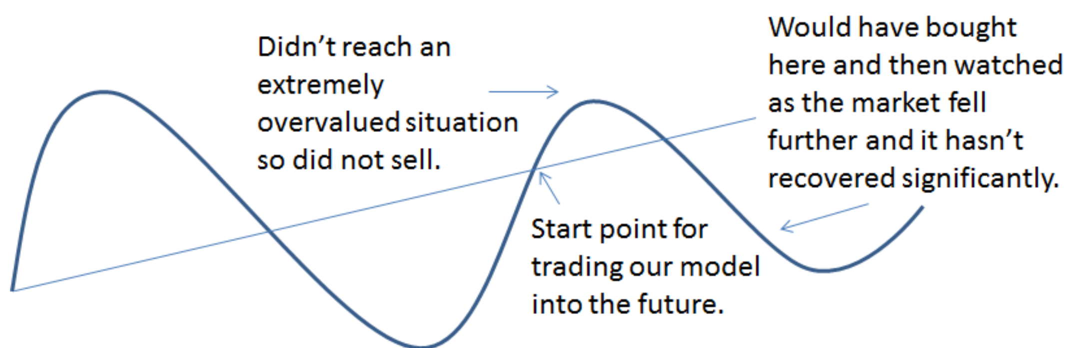


The example above could be something as simple as an expectation that equity returns will annualise 8% p.a. If they run too far ahead or behind this level then this is an opportunity to sell or buy.

2. Continue your squiggly line a little further into the future and extend the straight line derived in the previous example.



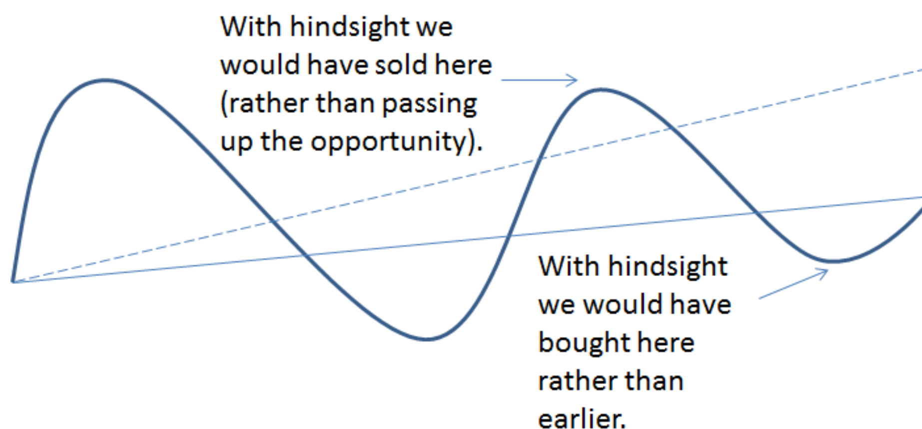
3. Let's assume we follow our little trading rule developed in step 1 into the future.



In the case of my diagrams above (yours would be different of course but you likely experienced less-than-perfect outcomes as well), it looks like our little timing model didn't work too well.

On reflection we may begin to realise that the opportunities identified in the second diagram are only available to people in possession of a time machine. It is only with hindsight that we can observe this historical relationship. The fallacy is to bet on this relationship continuing exactly in to the future.

4. Because we now have more market observations perhaps we should review our model. We find the slope of our line (which explains the relationship) has changed (become flatter in this case – the new line below is unbroken and the original line is dashed). With perfect hindsight we would have traded differently.



The fact that the slope changes as we progress through time is the downfall of this type of approach, and indeed any approach that looks backwards. It is easy to say "history doesn't repeat but it does rhyme" but simple analysis like this highlights that what we may have is an off rhyme.

Indeed it is risky to assume that there are any precise permanent relationships in finance. Even something like the equity risk premium has changed significantly through time and can be affected in uncertain ways by many externalities such as demographics, technology, politics and environment.

Technically the slope in our diagram is known as a parameter in a forecasting model. The fact that the slope can change through time and that we do not know the true value of the slope is called parameter uncertainty. Assuming a parameter or a relationship is stable when in fact it may evolve through time is dangerous. This uncertainty is everywhere but not really well considered when constructing diversified portfolios. For instance, is the equity risk premium 4%, 6% or 8%? Is it even appropriate to assume it is constant over the long term?

There has been much academic and industry research demonstrating that if we are uncertain of the true values of a parameter (the slope in this instance) we should allocate less to this investment opportunity ie. it is sensible to diversify.

It is possible to extend the findings of this example to more complex models in which multiple variables are used to describe market performance. A common example is the use of dividend yields to forecast market or individual stock returns. The more factors we have the greater the number of model parameters and the greater the number of sources of parameter uncertainty.

So what lessons should we pull out from this collection of squiggly lines?

1. History is just that and could be far from an accurate forecast of the future.

2. There are however valuable observations and lessons to be drawn from history.

3. Any model based on an historical relationship would have worked perfectly in hindsight. But we don't have a time machine and we are not bestowed with perfect foresight.

4. Once we acknowledge the uncertainties introduced in forecasting markets it is easy to understand why it remains sensible to diversify and take a long-term outlook.

No one knows precisely which way markets or individual stocks will perform. The best we can do is to research deeply and tilt the odds in our favour, especially over the longer term. In searching for precision we may actually construct portfolios which subsequently disappoint. These are valuable lessons for selecting managed funds and constructing portfolios.

David Bell's independent advisory business is St Davids Rd Advisory. In July 2014, David will cease consulting and become the Chief Investment Officer at AUSCOAL Super. He is also working towards a PhD at University of NSW.

Disability advice: the niche that's gone mainstream

Graham Hand

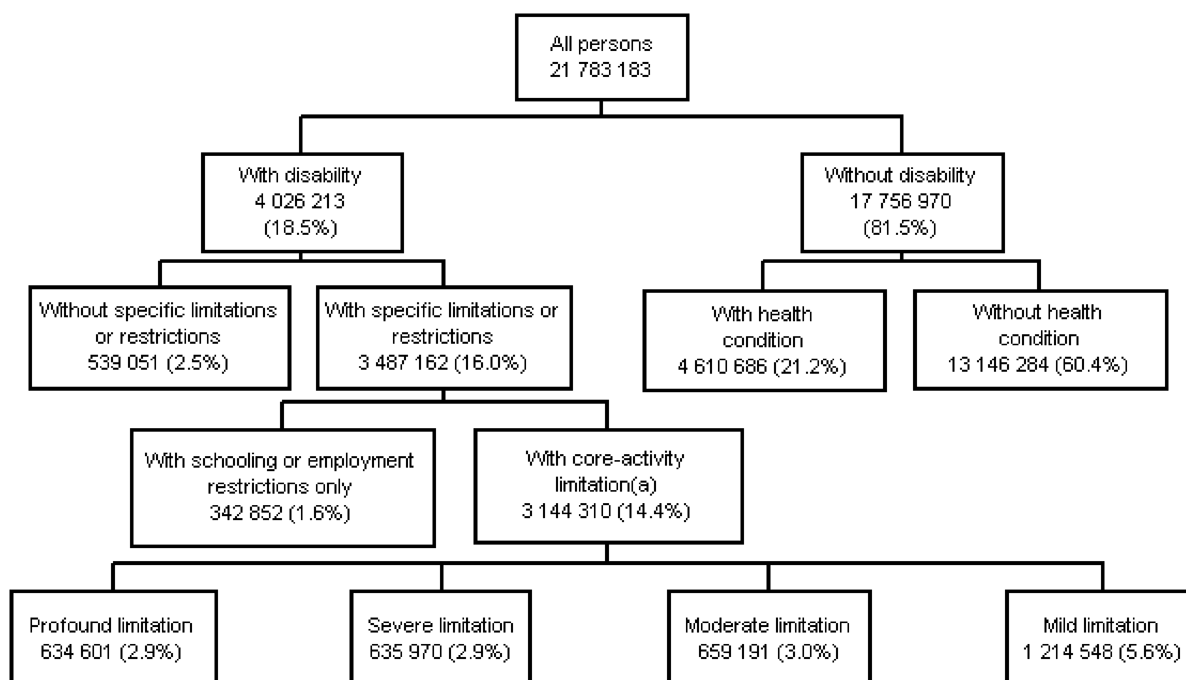
When is a niche not really a niche? How about when it's almost 20% of the population, and most of the elderly. The Australian Bureau of Statistics (ABS) states, "Four million people in Australia (18.5%) reported having a disability in 2009, according to the results of the Survey of Disability, Ageing and Carers … The rate of disability increased with age. Almost nine in ten people aged 90 and over (88%) had a disability, compared with 3.4% of those aged four years and under."

Many people hope disability is an inconvenience that happens to other people, but of course it can hit anyone at any age. In particular, we have an ageing population where most people can expect to live to

90 years of age or longer. So 88% of us can expect to live with our own disability, and add to that our ageing parents and the reality of this issue will confront nearly everyone at some time in their lives.

That's certainly not a niche. It should be considered as part of every financial plan.

Disability is not easy to define. The four million number includes problems such as loss of sight that is not corrected by glasses, arthritis which causes difficulty dressing, and advanced dementia that requires constant help and supervision. A stricter definition, being people who require assistance with core daily activities because of severe or profound restrictions, gives about 1.2 million. They are supported by an estimated 2.6 million carers. The number of Australians 65 and over with a severe or profound disability is expected to grow to 1.5 million in 2031.



Source: ABS 4430.0 - Disability, Ageing and Carers, Australia: Summary of Findings.

Special legislation relating to people with a disability

The regulations designed to assist people with a disability and their families should be better known by advisers and their clients. It would be unacceptable for any financial adviser to overlook the basic rules of a financial topic like superannuation. It is part of the required knowledge set which influences every Statement of Advice. It is equally unacceptable that there is not widespread understanding of special regulations applying to people with a disability of all ages, including the very young. While there are issues of eligibility and definition, there are significant opportunities to improve the financial outcomes of a large proportion of the population.

Some important regulatory issues relating to disability include:

1. Ability to access superannuation at an early age

The Australian Taxation Office provides conditions of early release of super under the Superannuation Industry Supervision Act 1993 for a person with a 'permanent incapacity'. This is called a 'disability super benefit'. The superannuation trustee must be reasonably satisfied that the person is unlikely to engage again in gainful employment for which they are reasonably qualified by education, training or experience. At least two medical practitioners must certify this, and there is no limit on the amount that can be released where the person is permanently incapacitated.

Clearly, such a release may alter the traditional planning horizons. Early access means the money may run out quicker. Traditional thinking around retirement ages of 60 or 65 may not apply, and a release may affect other support payments. It's certainly a step which should only be taken after considering many options.

2. Excepted person for tax purposes

Disabled children may be taxed as adults and have access to adult tax-free thresholds and tax scales. Parents of children with disabilities may be able to reduce their tax payments by saving money or earning income in the name of the child without the usual low tax thresholds applying to children. Financial planners often warn people not to invest in their children's names, but this advice may need modifying for a family supporting a child with a disability.

Generally, a minor is an excepted person if they are:

- disabled and likely to suffer from that disability permanently or for an extended period
- working full-time, or had worked full-time for three months or more in a year (full-time work that was followed by full-time study)
- entitled to a disability support pension or rehabilitation allowance, or someone was entitled to a carer allowance to care for them
- entitled to a double orphan pension and received little or no financial support from relatives, or
- unable to work full-time because of a permanent mental or physical disability and received little or no financial support from relatives.

3. Special Disability Trusts

Special Disability Trusts (SDT) carry exemptions from gifting and assets test rules under social security legislation, and certain expenses relating to care can be charged to the SDT. These rules encourage people to set up trusts for the future care needs of children with disabilities. The Department of Social Security answers more questions on the operation of SDTs here.

People with disabilities and their financial advisers should consider these rules in the design of a financial plan for the client, their carers and their family.

Benefits include a gifting concession of up to $500,000 combined for one or more eligible family members. There is also an assets test assessment exemption of up to $609,500 (as at 1 July 2013 indexed annually) for the beneficiary, which might assist retention of other entitlements. Plus all trust income is excluded from the income test assessment of the beneficiary.

The beneficiary must be deemed as severely disabled and the Trust Deed, Contributor and beneficiary must comply with certain conditions. A particularly restrictive rule is that the beneficiary can only work up to seven hours per week. While the SDT is primarily required to spend its earnings on the care and accommodation needs of the beneficiary, up to $10,750 per year (indexed) can be spent on other items.

Eligibility is not straightforward, and a Centrelink Special Disability Trust team will assess the beneficiary against the legislated criteria for medical impairment, care needs and work capacity.

4. Disability support pensions

These pensions provide support for people with a disability that either prevents them from working, or earning above a minimum threshold. Eligibility includes:

- aged 16 years or more and under age pension age
- permanently blind or have been assessed as having a physical, intellectual, or psychiatric impairment
- unable to work, or to be retrained for work, for 15 hours or more per week at or above the relevant minimum wage within the next two years because of the impairment

More details are available on the Department of Human Services website. The pension is means tested on income and assets. There may also be eligibility for a pension supplement and a mobility allowance.

For anyone thinking disabled people do not have much money because of their difficult employment circumstances, there's a large group of litigation lawyers, insurance assessors and medical practitioners who know one large subset needing top quality financial advice.

Planning for disability support

People with a disability have complex financial needs, especially after a care giver can no longer provide support. These needs are not addressed simply by buying a large life insurance policy for the primary care giver and hoping money lasts through the life of the person with a disability. They often require lifelong guardianship and financial assistance. Protecting government benefits while still assuring financial support are paramount.

These issues are heightened by longer life expectancy and longer term dependence on expensive medical care. Caring for older people with disabilities will present challenges for families, friends, volunteers and paid service providers. There will be insufficient paid carers, residential aged-care facilities and community services as government departments will be slow to recognise the demographic changes. The prevalence of profound disability which results in a need for residential care increases from about 5% at age 70 years to 50% at age 90 years. In other countries with rapidly ageing populations (for example, Germany and Japan), the response has been to introduce insurance for long-term care. In Australia, we are having our own debate about products such as deferred annuities. Such approaches need to be considered. The best solution, if it can be afforded, is to build enough financial resources to withstand the cost (if not the emotional turmoil) of whatever life throws at you.

(And there's an entire article on disability services without even touching on the National Disability Insurance Scheme. That's for another day).

This information is general in nature and only summarises some of the relevant legislation. It takes no account of personal circumstances and financial advice should be sought before taking any action.

Make sure going overseas does not spoil your SMSF

Monica Rule

There have been many articles written about how an SMSF can maintain its residency status when the members of the SMSF go overseas. However, perhaps not many SMSF trustees are aware of the tax implications of going overseas for a period and then returning to Australia. For an SMSF to maintain its complying status and receive concessional tax treatment, the SMSF must be a resident regulated superannuation fund **at all times** throughout the financial year.

The three tests that must be met for an SMSF to maintain its residency status are:

Test 1: The SMSF must be established in Australia or have any of its assets situated in Australia. This test is easy to meet if the initial contribution was received in the SMSF's bank account in Australia or if at least one of the assets of the SMSF is in Australia in the financial year the residency status is tested.

Test 2: The central management and control of the SMSF must ordinarily be in Australia. If the person who makes the high level decisions for the SMSF is overseas, as long as the period of absence is temporary, the SMSF will satisfy this test. If this person goes overseas for an indefinite period, then the SMSF will fail this test. Take care with this test as many people believe there is a two year threshold. To be 'ordinarily' in Australia whilst being overseas will depend on the trustee's intent; the substance of their absence; and whether the duration is 'temporary'. The decision surrounding what is temporary involves consideration of the circumstances of each particular situation.

Test 3: The SMSF does not have any 'active members', or if it does have active members, then at least 50% of the superannuation account balance in the SMSF belongs to 'resident active members'. An active member is one who contributes to their SMSF or has contributions made for them on their behalf (e.g. an employer). So if SMSF members go overseas, it is best they do not make any contributions. If they do, then they need to make sure that their total superannuation balance in the SMSF is not more than 50% of the total superannuation balance of all active members in the SMSF.

SMSF trustees often get this test wrong by measuring the balance in the SMSF of resident members against the balance of non-resident members. It is not the balance of all members, it is the balance of all **active** members that is measured for this test. To ensure that at least 50% of superannuation balance belongs to resident active members, it will be necessary for each resident member to be classified as an active member by having contributions made for them. If the superannuation balance of resident active members is less than 50% of the total balance of all active members, or resident members with at least 50% of the total balance fail to make a contribution while a non-resident does, the active member test would not be satisfied.

Failing the residency test

Once an SMSF fails the residency test it becomes a non-complying superannuation fund. Then, all of its assets accumulated over the years of its existence, *less* any member contributions (where no tax deduction has been claimed) *plus* earnings on investments received in the financial year that the SMSF becomes non-compliant, are taxed at a flat rate of 45%. Each year the SMSF remains a non-resident (non-complying) fund, the income will also be taxed at a flat 45%.

Another thing that people may not be aware of is what happens when the SMSF members return to Australia, and their SMSF changes its status from a non-resident SMSF back to a resident SMSF. In such case, the above formula takes effect again and all of the fund's assets, *less* any members' contributions to the non-resident SMSF, are included in the assessable income of the SMSF in the year it becomes a resident SMSF. The SMSF is taxed at either 45% (if the SMSF members return to Australia during the financial year) or 15% (if they return to Australia for the full financial year). Each year the SMSF remains a resident (complying) SMSF it will continue to receive the concessional tax treatment of 15%.

If you don't seek advice on your SMSF before you depart it can be quite detrimental to your life savings if you go overseas and later return to Australia. You could end up paying 45% tax on your SMSF's accumulated assets twice!

Monica Rule has worked for the Australian Taxation Office for 28 years and is the author of The Self Managed Super Handbook – Superannuation Law for Self Managed Superannuation Fund in plain English.

Consider a Debt Agreement before you resort to bankruptcy

Terry Morgan

There are circumstances where a person is able to propose a 'Debt Agreement', which is a relatively low cost alternative to bankruptcy.

In the financial year ended 30 June 2013, just under 10,000 people filed Debt Agreements. That figure was up nearly 8% on the number in the previous financial year.

Debt Agreements enable creditors to receive a return which they may not otherwise receive in the event of a bankruptcy. A debtor can offer assets to creditors, such as funds from family members or other assets. It means that creditors can receive a higher dividend while the debtor avoids entering into bankruptcy.

Prior to 1996, there were few alternatives available to a person who was unable to pay their debts when they fell due, which resulted in insolvency. Whilst voluntary bankruptcy was available, it was often considered an undesirable outcome. Many would have preferred to enter into an agreement with their creditors. Fortunately, in 1996 some alternatives became available, including a Debt Agreement.

Four alternatives for creditors

As it stands today, if an individual is unable to pay creditors, four alternatives may be considered:

1. reach a private arrangement with all creditors
2. enter into voluntary bankruptcy
3. enter into a Personal Insolvency Agreement
4. enter into a Debt Agreement – the focus of this article.

A Debt Agreement is processed through Insolvency Trustee Service Australia's Debt Agreement Service (DAS). It receives Debt Agreement proposals, conducts a voting of creditors and maintains records.

There are some situations when a Debt Agreement is not available, such as:

- where a person's unsecured debts exceed $100,664.20
- if a person's after-tax income for the last financial year exceeds $75,498.15 (amount indexed twice annually)
- if a person is not insolvent.

A debtor who proposes a Debt Agreement must provide the Official Receiver with a written proposal, which must be in an approved form and:

- properly identify the debtors to be dealt with under the Agreement
- specify how the identified property is to be dealt with
- authorise a nominated person to deal with the identified property in accordance with the terms of the proposal.

A person cannot propose a Debt Agreement if at any time during the past ten years, they have been bankrupt or been a party to another Debt Agreement. Any person who proposes a Debt Agreement must accept that the proposing of the Debt Agreement constitutes an act of Bankruptcy pursuant to the *Bankruptcy Act*.

Once a Debt Agreement is accepted for processing, the Official Receiver must provide a copy of the proposal to each creditor.

A Debt Agreement must be accepted by the majority of creditors (by value) within the 'applicable deadline'. Following acceptance, a creditor cannot apply for alternative enforcement of the Debt. Further, a Sheriff must not take any action or further action to execute or sell property under any process issued by a Court, or to enforce the payment of any debt which is the subject of a Debt Agreement.

Once a Debt Agreement is in place, Section 185(N) of the *Bankruptcy Act* releases the debtor from all provable debts upon the completion of the Agreement. Completion usually occurs once the debtor has fulfilled the promise made in the Debt Agreement.

A person proposing a Debt Agreement must accept that if there is any property which is otherwise secured to a creditor, then the secured creditor is still able to deal with that property, irrespective of whether or not a Debt Agreement is approved.

Here's the catch

There are provisions within the *Bankruptcy Act* which enable a Court, in certain circumstances, to declare a Debt Agreement void.

The principal advantage of a Debt Agreement is that a debtor is not required to declare bankruptcy. However, as the Debt Agreement is an act of bankruptcy, if the Debt Agreement is not accepted by the

creditors, then any individual creditor is able to rely on the proposal of a Debt Agreement, as an act of bankruptcy for the purpose of applying to a Court to make the debtor bankrupt.

Terry Morgan is a Partner of Baker Love Lawyers.

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