Cuffelinks
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Bring back indexation to replace big CGT discount

Chris Cuffe

"The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state." Adam Smith, *The Wealth of Nations*, 1776

Everyone has a different idea of which taxes are fair. The 'father of modern economics', Adam Smith, thought tax should be paid according to what a taxpayer could afford. Without wading through an ethical debate, let's focus mainly on one way Australia raises money to finance the operation of government: the Capital Gains Tax (CGT) on investments.

A realised gain on investments, which is what a CGT taxes, should fall within a comprehensive definition of income.

So what is the logic of giving a generous 50% discount on CGT for assets held greater than 12 months, when other income is taxed at marginal personal rates? This has the knock-on effect of encouraging people to arrange their affairs to generate a CGT rather than income.

The current favourable treatment of CGT has become sacred ground, defended again recently by Prime Minister Malcolm Turnbull, as if it were a basic and long-standing tenet of our budget system.

The large discounts of today were only introduced in 1999, when market circumstances were different. It's time to recognise that after 18 glorious years of CGT heaven, it is no longer appropriate.

Look what's happening in the current residential market?

In a comprehensive study of CGT (in Economic Roundup, Issue 2, 2014), John Clark of the Tax Analysis Division of the Australian Treasury, wrote:

"The concessionary treatment of capital gains income is arguably the primary motivation for financial investment in negatively geared real estate, which aims to shift all of the investment return into the capital gain on the eventual sale of the asset."

Only the hard-hearted would feel no sympathy for young families struggling for the first step into their own home. A home is usually more than an investment. It represents a more secure future and roots into a community and lifestyle. Home ownership is part of our culture. Australia's short-term rental leases make a precarious existence for tenants who are often uprooted with a few weeks' notice. With both Sydney and Melbourne experiencing auction clearance rates over 80%, and last month CoreLogic claiming Sydney house prices hit an annual growth of 18.4%, frustration levels show no sign of easing.

What pushes the disappointment to anger for first home buyers is knowing they were beaten at auction by a property investor at a different stage of life, probably buying a second or third property, with confidence buoyed by tax breaks.

(Victoria has announced a range of measures to help first home buyers, such as a waiving of stamp duty and a Vancouver-style tax on empty properties at 1% of the capital value. The fear is that these will merely stimulate demand further in the residential market, while doing little to curb the enthusiasm of investors).

Briefly, what are the tax breaks?

Without going into great detail, the two main tax breaks that fuel investor property appetite are:

1. Capital Gains Tax discount

Assets acquired since 20 September 1985 are subject to CGT unless specifically excluded, such as personal assets. A capital gain is the difference between the cost of the asset and the amount received on disposal. The realised gain forms part of taxable income in the year of sale. A loss can't be claimed against other income but it can offset a capital gain and can be carried forward.

For assets held for 12 months or longer before the CGT event, there is a 50% discount for individuals and trusts, and a 33 1/3% discount for complying super funds. There is no CGT payable on a person's main residence upon sale.

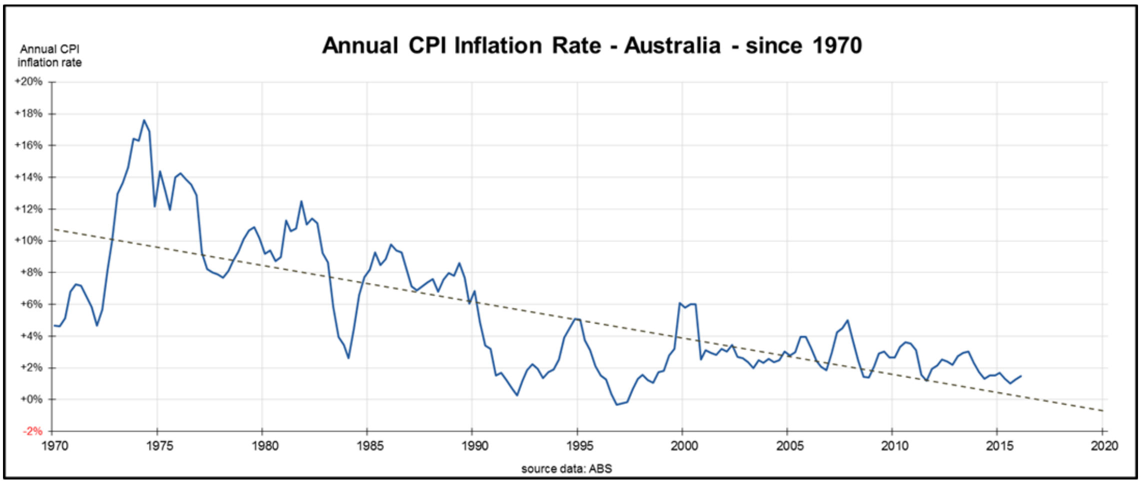
2. Negative gearing

Where the rental income on a property is less than the interest and other expenses, the loss can reduce the investor's taxable income (of course, the same applies in other investments including shares). Many people seem to believe that anything that reduces their tax bill is good. They talk about negative gearing as if it is an end in itself, when all it does is reduce the size of the loss. It's still a loss.

An owner occupier who buys a family home does not have negative gearing, and mortgage payments are not tax deductible.

Why did we introduce such a generous CGT discount?

When the Hawke Keating Government introduced CGT in 1985, the rules allowed for the cost base of assets held for one year or more to be indexed by inflation when working out the gain. That is, the part of the realised gain due to the consumer price index (CPI) rises was not taxed. The 50% discount was introduced in 1999 by the Howard Costello Government. Let's consider Australia's inflation since 1970, as shown below.



For much of the late 1980s, inflation was around 8%, and then in 'the recession we had to have' in 1991, it fell significantly and then rose again.

According to John Clark of Treasury (referenced above), *"Somewhat surprisingly, the 50% CGT discount was introduced with little in the way of empirical evidence or modelling of the possible revenue effects."* One stated rationale for change was the old indexation method was too complicated to calculate, adding uncertainty and inefficiency to the tax system.

The rationale for returning to indexing

Economists like to measure purchasing power in 'real' terms, adjusted for inflation. GDP, for example, is best judged as 'real GDP' to determine actual economic growth. Realised capital gains should be considered in real terms, allowing for inflation over the holding period.

With inflation closer to 2%, and likely to stay low for many years, the 50% discount is extremely generous for assets realised after a relatively short period. The 50% discount is inherently arbitrary – what does 50% signify other than half? It does not appeal to the basic tenet of adjusting gains for inflation, it simply applies a number with no relationship to real returns or the length of time an asset is held (beyond the one year).

The CGT discount offends the principles of both vertical and horizontal equity, the very reasons to have a CGT in the first place. For example, a person in the top marginal tax bracket with a $1 million realised property gain will lose less than a quarter of the proceeds in tax, but would lose half in tax on other income. This breaks the principle of horizontal equity between gains. Also, as capital gains accrue to the highest income earners, it offends principles of vertical equity and the ability to pay according to our means in our progressive system. The CGT discount effectively lowers the marginal tax rate for high income earners.

Furthermore, the CGT discount pushes investment towards shares and property and away from regular income streams, such as from bonds.

As for the complexity identified in 1999, our improved accounting systems and ability to make adjustments ensure indexation is a straightforward calculation based on published statistics.

When CGT indexing was introduced, inflation was high at around 8%, and an asset held for say six years would have a 50% 'discount'. Now inflation is around 2%, the 50% discount is inequitable.

Unlike some schemes designed to improve home ownership which simply act to increase the amount a first home buyer can afford to pay and therefore bid up prices, this CGT change would reduce investor demand and remove a speculative element from the market.

Although at high rates of inflation, it's possible that an indexation system would be more favourable than the 50% tax break, this is highly unlikely for many years.

Let's remove this investor tax break and give our children a chance

There is no justification that someone can flip a property after a year and be taxed on only half the realised capital gain.

It's also likely that knowing gains will be halved drives investor confidence, far more than the uncertain principle of 'adjusted for inflation'. Most people will know that inflation over say five years is likely to be only about 10%, leaving 90% of the realised gain to be added to taxable income.

The capital gain discount regime which replaced the previous inflation indexed method is inherently arbitrary and has differing consequences depending on the rate of inflation and the length of time for which an asset subject to CGT is held. Let's fix the calculations and level the playing field a little more!

Chris Cuffe is co-founder of Cuffelinks; Portfolio Manager of the charitable trust Third Link Growth Fund; Chairman of UniSuper; and Chairman of Australian Philanthropic Services. The views expressed are his own.

History repeats on housing, but how long will this last?

Ashley Owen

In 2011, the Reserve Bank of Australia set out to create a policy-induced housing construction boom to fill the hole being left by the collapse of the 2003-2011 mining construction boom. It cut interest rates 12 times between November 2011 and August 2016 to levels never before seen in Australia, to lift house prices and lower borrowing costs to encourage development.

House prices are important for Australian investors for several reasons. The local economy and stock market are heavily reliant on the local banks remaining solvent and lending. Our big banks make up one third of the local stock market value and they pay one half of all dividends.

The vulnerability of banks

The problem with the banks has four main elements:

1) they are extremely highly leveraged (at around 20:1, for every $1 of debt there is 5 cents of equity capital)

2) they are highly exposed to the local housing and housing construction industries

3) they are heavily reliant for funding on fickle foreign markets, as Australia's conduits for foreign debt, and

4) mortgage interest rates are extraordinarily low and rising rates will put pressure on highly geared borrowers.

The pattern of mining booms switching to housing construction and lending booms that collapse in bank bad debt crashes and economic recessions is not new. The 1870s-80s mining boom (which gave birth to BHP, Rio and many others) turned into the 1880s housing construction and lending boom which collapsed in the bank bad debt crash in the early 1890s, triggering a deep economic depression. The 1960s mining boom turned into the early 1970s housing construction and lending boom which collapsed in the property finance crash in 1973-1974, triggering the deep 1974-1976 recession. The early 1980s 'mini-resources boom' expanded into the mid-1980s 'entrepreneurial boom' which after the 1987 crash turned into the late 1980s construction and lending boom which collapsed in the bank bad debt crisis in the 'recession we had to have' in 1990-1991.

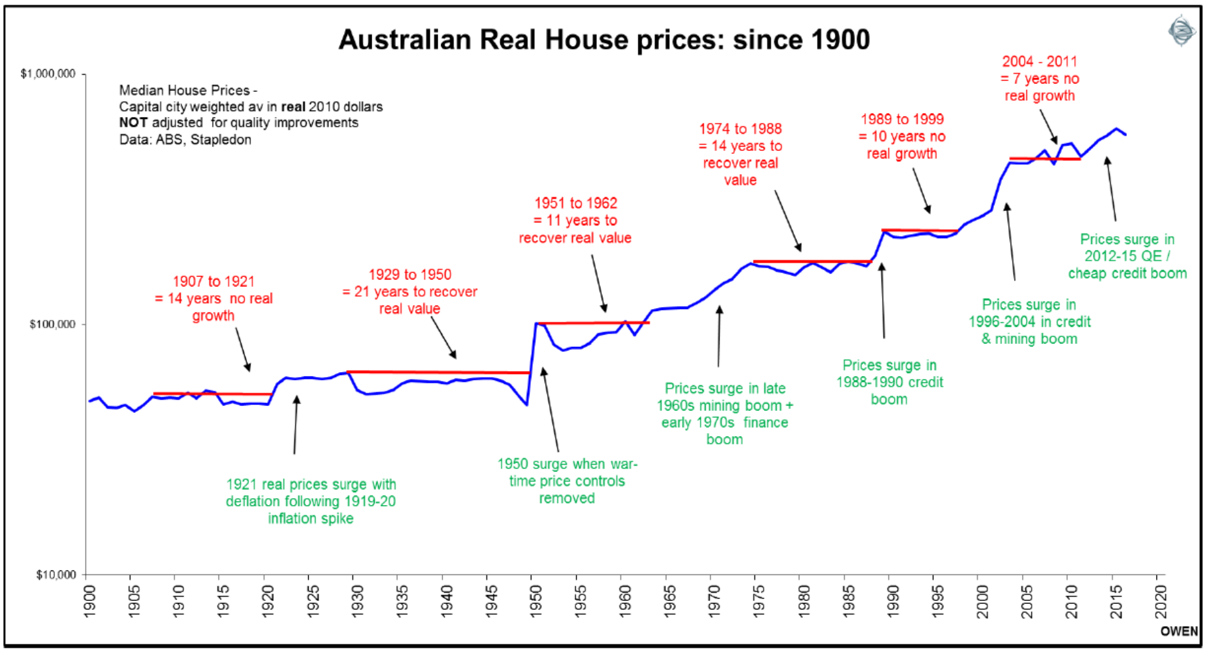
Problems looming in apartments but not houses

In each of these cycles, Melbourne saw the worst of the excesses in construction and lending and suffered worst in the crashes, in terms of price falls, vacancies, bad debts, business failures and unemployment. In the current cycle Melbourne is once again leading the charge (along with Brisbane), while the excesses are less severe in Sydney and other cities.

The main problem is not in the broader suburban housing market but in high-rise construction. As in all previous cycles, the current over-construction will result in high vacancy rates, boarded up building sites, properties lying empty for years, falling rents, falling prices, bankrupt developers and bankrupt over-extended buyers. As in past cycles the problem for the banks will mainly be property developers, not just the highly-leveraged buyers.

This has happened several times before and it will happen again. The risk for investors is that the collapse in the high-rise market will probably also infect the broader economy and the broader housing market as well.

Our broad housing market has not suffered big crashes as it has in most other countries. Our high rates of immigration and population growth and extreme concentration of population in a few large diversified cities ensure broad house prices have tended to rise rapidly for a few years every decade or so, and then go sideways in real terms for several years.



There are regular price falls of 10% to 15% or so but no major broad-based collapses like in the US and many other markets.

While the Melbourne and Brisbane high-rise markets are probably heading for another sizable collapse similar to past boom-bust cycles, the most likely outlook for the broad housing market is for modest price falls in housing and then many years of no real growth, rather than a sudden major crash.

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The evolution of our cities

Stephen Hayes

In 2008, a major milestone in mankind's co-habitation occurred. For the first time in human history, there were more humans living in cities than in rural areas. Our cities have been evolving for centuries. Today, the world has 28 mega cities each containing more than 10 million inhabitants, and a total global urban population of 3.9 billion. Tokyo is the largest city by built-up area, with 38 million people. Current estimates predict that the total global urban population will grow to 5 billion by 2030, containing 41 mega cities and a total land area of 1.2 million sq km.

Urban and technological growth presents new challenges

Our cities now contain 54% of the world's population. Urbanisation is having a profound effect on our societies, with growing populations require more civic infrastructure. As cities expand this becomes more challenging, and as land scarcity increases it becomes much more expensive and more logistically difficult to build out civil amenity. This places a greater social responsibility on commercial landlords and pushes up the value of their land significantly.

Technological advances and labour specialisation continue to develop at a rapid pace, while old-world industry and traditional manufacturing centres are becoming much less labour intensive. As this well-defined trend progresses, traditional businesses are giving way to service, leisure and technology industries, which require greater levels of human engagement. The long-term trend following jobs and wealth is likely to become more pronounced in the future as technology rapidly advances.

However, as computing technology and the internet evolve, and hand-held devices become increasingly common, our cities' infrastructure is failing to keep pace. The way we spend our leisure time, the way we shop, how we are treated when we're ill, the way we commute, the way we are educated and way we use space will all be different in the future.

Shopping habits reveal technology's impact

What does the future look like for our cities? Technological advances are impacting city dwellers in all facets of life, such as our changing shopping habits. As global consumers, many channels are now available to purchase goods and services, from the ancient market place concept to the internet. The internet's ability to compare the pricing and availability of goods and services has led to increased transparency and a more efficient market place. It's a major windfall for the consumer. Efficient pricing has had a deflationary effect (this concept is lost on central banks) with increased productivity (acquiring the good and/or service in less time for less effort) freeing up more time for work and leisure.

It is estimated that there are now 3.4 billion internet users globally from a total world population of 7.4 billion, with approximately 2 billion smart phone accounts. Etailing, the purchasing of goods and services over the internet, is now a global phenomenon, and continues to grow at a remarkable rate. According to research firm eMarketer, total global retail sales for 2016 are estimated to be US$22 trillion. eCommerce sales estimates for 2016 are projected at US$1.915 trillion, a year on year (YOY) increase of +23.7% and an 8.7% share of the total. These estimates include Consumer to Consumer (C2C) purchases but exclude services such as travel and restaurants.

Resolving the 'last mile' dilemma

As younger generations come through, we will eventually reach the point where most goods and services purchases are made through the internet. This trend faces some major challenges. For example, the logistics of the 'last mile' are labour-intensive, inefficient, environmentally unfriendly and costly. The best we have is daytime delivery, with a man and his van ferrying goods from remotely located sorting centres, delivering non-standardised, non-modulated goods via disembarking and walking to the final drop off point.

The rule of thumb is that the 'last mile' represents 35% of the total delivery cost. Amazon and Alibaba have toyed with the idea of using drones as a part-solution. Uber is currently trialling the driverless car in the US city of Pittsburgh. Cloud-based total logistics solutions, where the consumer picks up the purchased goods from elockers, will become more common.

Today, omni-channel retailers have a distinct advantage over the pure etailers. With their physical store foot prints, they have existing infrastructure in place which directly interfaces with the consumer. This tactile experience builds brand recognition and offers the added benefit of in-store pick-up. The option of 'ship from store' also goes part of the way to solving the 'last mile' challenge. While still inefficient, it is a little less costly.

Land redevelopment could increase efficiency

As our cities have evolved, little thought has been given to future technologies, population growth or social change. This puts urban commercial landlords in a position where they control a valuable and scarce resource: strategic land parcels located within densely populated cities. Through redevelopment, they are in the lucrative position of being able to innovate as part of the future logistics solution.

Today, it is estimated that 95% of developed city populations reside within five miles of a shopping centre. As cities densify, land parcels currently being used as shopping centres are well placed to be transformed into hybrid retail shopping and sorting centres. This would eliminate the need for separate sorting centres, materially increasing efficiency. Goods going both to homes and showrooms could then be shipped straight from distribution warehouses to hybrid retail shopping and sorting centres.

The redevelopment and expansion of existing shopping centres is an ongoing activity, as professional landlords adapt their assets. A recent example is an Australian publicly-traded landlord's redevelopment of the Warriewood shopping centre on Sydney's northern beaches. The sub-regional shopping centre caters to a primary catchment area of 75,000 people. The centre's recently completed redevelopment added 9,000 sqm of net lettable area taking the centre size to 29,700 sqm. Major tenants introduced to the centre included Aldi, Kmart, and Cotton On Mega. Decked car parking was also added taking the total to 1,450 spaces. The centre now contains three supermarkets, a discount department store and totals 89 specialty tenants. The specialty tenant sales productivity is expected to be more than $10,000/sqm. The development cost was $87 million generating a day one 7.3% income return on capital deployed with an IRR of +11.0%. The centre valuation increased to $275 million.

An example of the current logistical inefficiencies would be the Woolworths supermarket. The major Woolworths distribution centre is 66 kms away. The next iteration for the centre should include sorting facilities to also provide the logistical infrastructure for the 75,000 local inhabitants that wish to purchase goods via the internet.

Landlords a driving force in wealth creation

Publicly-traded real estate securities are the world's largest landlords. They are the dominant landlords in our major cities and have a good understanding of land values and its best usage. The amalgamation of sites in urban infill locations is a patient game, but the rewards can be very high. As a finite resource, our cities' land is already valuable, and it will become increasingly so. This increase in wealth comes with great social responsibility and with innovation, expertise, vision, patience and access to capital, our landlords will be a major driving force in the future evolution of cities. Whatever the future has in store, publicly traded urban landlords are in an enviable position to create true long-term wealth, through their control of a valuable and scarce resource.

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How does CGT relief work for SMSFs and TTR pensions?

Mark Ellem

Much has been written about capital gains tax (CGT) relief, and it's worth understanding how it works. Transitional CGT relief is available for SMSFs affected by the new $1.6m transfer balance cap, or for SMSFs paying a transition to retirement income stream (TRIS).

With relief available, important decisions need to be made as we head towards 30 June 2017. These choices will have a direct effect on the amount of SMSF income tax paid in future years.

What is CGT relief in a nutshell?

The new CGT relief rule, which applies in particular circumstances, enables the cost base of fund assets to be reset to market value.

The intent of the new rule is to provide CGT relief on gains made before 1 July 2017, so as not to disadvantage fund members who are required to commute a pension due to the new transfer balance cap, or the TRIS tax changes.

Whilst the focus has been on relief for retirement phase pension funds, relief also applies for funds paying transition to retirement (TTR) pensions.

Even though there'll be no requirement to commute from a TTR pension to comply with the transfer balance cap (TTR pensions don't count towards the cap), the introduction of the new TTR pension integrity measures will result in:

- assets being transferred from the segregated current pension asset pool to the segregated non-current asset pool, for a fund using the segregated method to claim Exempt Current Pension Income (ECPI), or
- a change in the proportion of total fund assets used to discharge pension liabilities, for funds using the unsegregated method.

What's the process and which SMSFs should be looked at?

In essence, the process is the same as a fund with members who are required to comply with the transfer balance cap (see our CGT Relief explained article), except there'll be no pension commutation. As there is no reference to the $1.6 million transfer balance cap, when reviewing which SMSFs will be eligible for CGT relief, this is not restricted to SMSFs who have members with pension accounts in excess of $1.6 million.

Fund with TTR members under $1.6 million eligible for CGT relief

Let's consider an SMSF with two members and total assets of $700,000. At first glance, this SMSF would not be eligible for CGT relief, however, one member has a TTR pension with a balance of $500,000. Assuming the SMSF is using the unsegregated method to claim ECPI in 2016/17, you would expect an ECPI% of around 70%. From 1 July 2017, the new TTR pension integrity measures will mean that the level of ECPI claimed will be nil. This will have an effect on the amount of tax the fund pays when an asset is sold as any gain accrued since acquisition date to 30 June 2017 will be fully assessable (subject to CGT discount rules) when sold after 1 July 2017.

Consequently, this SMSF is eligible to apply the CGT relief rules. As the SMSF is using the unsegregated method to claim ECPI in 2016/17, all of the assets are eligible for CGT relief.

Let's assume the SMSF has the following assets (all held for at least 12 months):

Asset	30 June 2017 market value	Cost base
Direct property	$600,000	$400,000
Listed shares (one company)	$55,000	$42,000
Bank account	$45,000	N/A

The SMSF then has the choice to either include the assessable gain for each of the assets, or defer until the asset is sold. The election to defer is made on an asset-by-asset basis and is also an irrevocable election to be made on the approved ATO form.

Asset	Cost	MV	Gain	CG Discount (33%)	Net gain	ECPI (70%)	Assessable gain in 2016/17
Property	$400,000	$600,00	$200,000	$66,667	$133,333	$93,333	$40,000
Shares	$42,000	$55,000	$13,000	$4,333	$8,667	$6,067	$2,600

When the asset is sold after 30 June 2017, the assessable capital gain will be calculated based on a cost base of the respective 30 June market value and using a purchase date, for CG discount purposes, on 30 June 2017. The deferred assessable gain will also need to be included in the income year the asset is sold. For example, let's say the listed shares were sold in 2019/20 for $60,000 and the notional gain in 2016/17 was deferred, the total assessable amount from this disposal will be calculated as follows:

Consideration	$60,000
Cost base	$55,000
Gross gain	$5,000
Apply CG discount (33%)	$1,667
Assessable gain	$3,333
Add deferred assessable gain from 2016/17	$2,600
Total assessable	$5,933

In this example, by applying the CGT relief and deferring the notional assessable gain in 2016/17, the SMSF saved $919 in fund income tax for this asset.

Is the SMSF a 100% TTR pension fund? Watch out for the trap!

For SMSFs wholly consisting of TTR pensions, there is a trap that can prevent the fund from applying the CGT relief rules.

Such funds are by default segregated funds. For the CGT relief rules to apply the fund must either transfer assets from the segregated current pension asset pool to the segregated non-current asset pool or change to the unsegregated method, on or before 30 June 2017. In practical terms, this would require the SMSF to have at least one member accumulation account on or before 30 June 2017. This could be achieved by either a member or their employer, making a contribution or a member effecting a partial or full commutation of a pension, with the commuted amount being retained in their accumulation account.

However, be mindful of the ATO's comments in relation to application of Part IVA to schemes or arrangements designed to trigger access to the CGT relief rules. For example, a member making a $1 contribution would warrant ATO scrutiny as opposed to a fund that received an SG contribution from a member's employer or where the member partially or fully commuted a pension.

Mark Ellem is Executive Manager, SMSF Technical Services, at SuperConcepts. This article is for general information only and does not consider the circumstances of any individual.

Governments fund more research than we realise

David Bell

[Editor's Note: For background, CEPAR is the ARC Centre of Excellence in Population and Ageing Research. ARC stands for Australian Research Council, an Australian Government entity whose mission is to deliver policy and programmes that advance Australian research and innovation globally and benefit the community].

Understanding the changes in our population and its demographics are vital inputs when planning our retirement systems. On 8 September 2016, ARC awarded CEPAR $27.25 million in funding to finance a second research term of seven years. This is a significant achievement and the many people involved, notably Professor John Piggott (Centre Director) and Marc de Cure (Chair of CEPAR's Advisory Board), deserve congratulations.

To put this win into context, consider the other eight winners of ARC funding:

- ARC Centre of Excellence for All Sky Astrophysics in 3 Dimensions
- ARC Centre of Excellence of Australian Biodiversity and Heritage
- ARC Centre of Excellence for Climate Extremes
- ARC Centre of Excellence for Engineered Quantum Systems
- ARC Centre of Excellence for Gravitational Wave Discovery
- ARC Centre of Excellence in Exciton Science
- ARC Centre of Excellence in Future Low Energy Electronics Technologies
- ARC Centre of Excellence for Quantum Computation and Communication Technology

Reactions may include awe at the complexity of some of the topics and the breadth of research areas supported by government funding. A large number of top quality applications were unsuccessful, and I agree wholeheartedly with Piggott's comment that *"population ageing is an issue of paramount importance to all; this is truly the ageing century"*.

CEPAR is a good example of collaboration:

- From a research perspective, while based at UNSW Australia, it applies a best practice model and has research members from the Australian National University, the University of Sydney, the University of Melbourne, the University of Western Australia, the University of Manchester, the University of Pennsylvania and the Wharton School.
- CEPAR has a collaborative funding model, receiving additional funding from industry and government partners including the major Commonwealth policy departments, large corporates, and the NSW Government. CEPAR also has strong support and engagement with the World Bank, OECD and COTA.

CEPAR's multidisciplinary approach draws on expertise in actuarial studies, demography, economics, epidemiology, organisational behaviour, psychology and sociology. Piggott explains, *"CEPAR's research programmes are assembled into four interconnected streams, that cover demographic modelling; decision* *making, expectations and cognitive ageing; work design and successful ageing in the workforce; and sustainable wellbeing in later life. The latter including not only physical but financial wellbeing as well."*

Sometimes it may be difficult to identify the output of a research body. Some of CEPAR's statistics shed light on the breadth and quantity of output (for the period 2011 to 2015):

Total research outputs	1540
Research outputs in refereed journals	515
Average % in A* and A rated journals each year	49.8%
Invited talks/papers/keynotes at major international meetings	119
Articles	378
Postgraduate completions	24
International visitors and visiting fellows	152
National and international workshops held/organised by the Centre	34
Visits to overseas laboratories and facilities	180
Government, industry and community briefings	253
Public talks given by Centre staff	85
Public conferences	13
Government and industry briefings	253

Why does this matter for industry and individuals?

People will ask questions such as *"How does this all flow down to the real world?"* or *"How does society benefit from academic research?"* The table above demonstrates how research centres are increasingly focusing on more than publication in academic journals (though that will always be important). Modern day research in practice recognises engagement and collaboration are drivers of success.

If research groups engage well, then their research is better positioned and reaches a larger audience. By engaging and collaborating, academic researchers are better informed of research needs and barriers to implementation.

The first draft of this article received strong editorial feedback. It was going to finish with the following paragraph.

Perhaps it is important for industry to ask themselves *"Are we sufficiently engaging with the research community?"* If you haven't heard of CEPAR or aren't aware of the work CEPAR is doing, then it is worth learning more about, especially if you are affected by population ageing (in my case, for instance, superannuation).

However, the alternative paragraph is just as thought-provoking.

How many people in industry have heard of CEPAR? Are the metrics tabled above ones which best measure effective engagement? How highly does CEPAR value the benefits of engagement with industry; is it core to their culture and philosophy? And how can we more clearly see how the work benefits the ageing public who pay for their work?

Personally, I feel there will always be the potential for greater levels of collaboration between industry and researchers such as CEPAR. All parties are stepping in the right direction, but hopefully there is more to come. In CEPAR's case, at least seven years and hopefully a lot more.

David Bell is Chief Investment Officer at Mine Wealth + Wellbeing. He is working towards a PhD at University of New South Wales.

The gift of education and the costs of funding it

Neil Rogan

Benjamin Franklin said that "an investment in knowledge pays the best interest", but given the rates of interest on offer at the moment and the spiralling costs of education, saving enough to fund your kids' or grandkids' education can be a real challenge.

Wouldn't it be great to know that school fees were covered? One less big ticket item to worry about, and the confidence of knowing that you are in a position to make the best educational choice for your child, without being unduly influenced by the price tag.

Education, particularly private education, can be monumentally expensive. For the vast majority of Australians, unless they win the lottery, they will be paying for education as they go, and feeling the pressure. As returns on savings attract tax, attempts to save consistently for a long-term goal can feel like one step forward and two steps back. Super is great from a tax perspective, but it's not much help if your children will be starting school before you're 65.

The true cost of education can be surprisingly high

Costs vary enormously depending on the choices you make, but you can be sure of one thing – education is expensive. According to recent research, parents of a child born today, who has a fully government funded (public) education, including university, will spend in the order of $200,000 on education. A fully private education, on the other hand, comes in at nearly $700,000. And a mix of the two will be somewhere in between (based on the Australian Scholarships Group calculator). It's a lot of money to save, and if you have more than one child, it's daunting.

Education is more than simply tuition, and the desire of parents to give children a well-rounded education has added to the total cost. An increasing number of parents are concerned that an intense focus on academic excellence in some schools is overshadowing the social and emotional growth of their children, and that children should be more engaged in activities other than academic studies.

This means extra-curricular activities, which many parents see as crucial to a well-rounded education, but which incur additional costs.

A realistic estimate of education costs should include extras such as books, uniforms, and stationery, but also the costs of extra-curricular activities such as sport, music and dance.

Start as soon as you can in a tax-effective structure

An investment bond is an insurance policy, with a life insured and a beneficiary but, in practice it operates like a tax-paid managed fund. As with a managed fund, you choose from a broad range of underlying investment portfolios which can range from growth-oriented to defensive assets.

An investment bond has several features:

- **Tax effectiveness**

Returns from investment bonds are taxed at the company rate of 30% within the bond structure and are then re-invested. They are not distributed to you as income. This means you do not need to include them in your annual tax return, and if you hold the bond for 10 years, all funds are distributed entirely tax-free.

In addition, depending on the underlying investment portfolio, dividend imputation credits and other credits may apply, making the effective tax rate less than 30%. This compares very favourably with the top marginal tax rate of up to 49%.

- **Affordability**

There is no limit to how much you can invest in an investment bond. You can start with as little at $500 and make additional contributions every year, up to 125% of the previous year's contribution.

- **Flexibility**

Investment bonds are most tax-effective when held for 10 years or more, but the funds can be withdrawn at any time if needed. If the money saved is not in fact needed for education, it can be used for any other purpose.

- **Ownership and transfer**

If you are saving for a child's education, you can choose to invest in the name of a child over the age of 10, but this means the child will gain full control to decide how to spend the money once he or she reaches age 16. The preferred option in most cases is to hold the bond in the name of a parent or grandparent. This avoids penalty tax rates for children under 18 if they make withdrawals in the first 10 years, the adult stays in control, and the bond can be started for a child younger than age 10.

This is an option preferred by many grandparents putting money aside for a grandchild's education.

Saving for your child or grandchild's education may be one of the most important challenges in your financial life. The key to success will be keeping three things in mind: Start as early as possible, be realistic about the costs and choose a structure that allows you, and not the taxman, to keep as much of your savings as possible.

Neil Rogan is Head of Investment Bonds for Centuria. Centuria is a sponsor of Cuffelinks. This article is for general information only and does not consider the circumstances of any individual.

Why LICs differ in dividend sustainability

Peter Rae

With company reporting season now behind us, we take a look at how the listed investment company (LIC) sector fared. The majority of LICs reported lower earnings for the six months to 31 December 2016, mainly due to lower dividend income. Some LICs, mainly those with a small cap-focus, experienced lower capital appreciation from their investment portfolios. The potential for lower earnings had been well-flagged by many LICs given the lower dividends from the mining, energy and retail sectors and ANZ bank.

Dividends flat despite lower LIC profits

Despite lower reported earnings, most LICs reported good portfolio returns (pre-tax-NTA plus dividends) for the period with the S&P/ASX 200 Accumulation index up 10.6% for the six months to 31 December 2016. The average portfolio return for the large-cap focused LICs under our coverage was 7.8% while the mid/small-cap focused LICs produced an average portfolio return of 3.7%.

The apparent disconnect between the good portfolio returns from the large-cap focused LICs and the lower reported earnings reflects the fact that most, particularly the larger, long established LICs report only dividend income and realised profits in the income statement. These LICs are long-term investors, so unrealised portfolio revaluations are not recognised in the income statement. Many of the newer LICs, particularly a number of the small-cap focused LICs, tend to hold investments for shorter periods and their reported earnings rely more on capital appreciation, with both realised and unrealised gains and losses reported through the income statement.

Given the trend of lower reported earnings, it was not surprising to see few increases in interim dividends. As shown in the table, all of the large cap focused LICs in our coverage held dividends flat, except CBG Capital (ASX:CBC) which reduced its dividend. A number of the mid/small-cap focused LICs announced modest increases in dividends. Amongst the LICs with an international focus, Cadence Capital (ASX:CDM) reduced its dividend, not surprising given relatively low profit reserves, while Hunter Hall Global Value (ASX:HHV), which has a high level of profit reserves, increased its dividend despite reporting a lower profit.

Table: LIC Dividends and Coverage

Australian Shares - Large Caps					Australian Shares - Mid/Small Cap					Austr/International Blended & International Shares				
Company	Interim Div. cps	Change cps	Div. Yield	Reserves Cover (x)	Company	Interim Div. cps	Change cps	Div. Yield	Reserves Cover (x)	Company	Interim Div. cps	Change cps	Div. Yield	Reserves Cover (x)
AFI	10.00	0.00	4.1%	3.9	WAM	7.50	+0.25	6.1%	1.7	CDM	4.0	-1.00	6.7%	0.9
ARG	15.00	0.00	4.0%	4.0	MIR	3.50	0.00	5.4%	2.8	HHV	3.5	+0.50	5.4%	6.3
MLT	8.70	0.00	4.2%	2.1	WAX	4.50	+0.25	5.5%	4.2	FGG	0.0	0.0	0.9%	0.6
DJW	10.00	0.00	6.4%	0.9	FGX	2.00	+0.10	3.5%	1.1	AUF	1.1	0.0	1.8%	10.8
AUI	15.50	0.00	4.4%	3.3	CTN	2.70	+0.10	5.8%	2.3					
DUI	6.50	0.00	4.0%	2.1	WIC	3.00	0.00	5.7%	3.4					
WLE#	1.00	n.a.	n.a.	n.a.	CIE	3.00	0.00	6.8%	1.0					
WHF	8.50	0.00	3.9%	9.4	WAA	2.75	+0.25	4.3%	1.6					
AMH	0.00	0.00	3.7%	2.7	GC1	1.00	+0.25	4.0%	1.9					
ALR*	2.00	0.00	4.5%	1.9	BST	1.00	0.00	2.9%	3.0					
FSI	3.50	0.00	4.6%	0.8	8EC#	1.00	n.a.	n.a.						
CBC	1.00	-0.60	3.3%	1.2										

Source: IIR Estimates/Company Accounts
#WLE and 8EC announced maiden dividends in February 2017
*Sum of last 2 quarterly dividends

Update on dividend sustainability

In our August 2016 LMI Update, we discussed dividend sustainability and how this is a critical issue when choosing LICs. We mentioned that LICs that rely largely on dividend income for earnings are less likely to report losses during periods of market downturns, and therefore the dividends they pay to their own shareholders are likely to be more sustainable. However, if the companies they invest in are forced to lower dividends due to reduced earnings, then, depending on their own payout ratios, the LICs may also be forced to reduce dividends, or at best hold them at current levels. We have seen this occur in the recent reporting season, with the lower dividend income from portfolios resulting in flat dividend payments by the large-cap focused LICs. In our report we also noted that LICs with a greater reliance on capital appreciation were more likely to be forced to reduce or even stop payment of dividends in a sustained market downturn. However, with positive market returns this has not been the case over the past six months. Portfolio gains and reasonable profit reserves have allowed some of the mid/small-cap focused LICs to slightly increase dividends.

Whilst LICs need to generate profits in order to pay dividends, it is possible for them to pay out more than they generate in profits in a given year by dipping into retained profit or dividend reserves from prior years. So it is possible for LICs to smooth dividend payments to their shareholders by retaining profits rather than simply paying out 100% of earnings each year. The table above shows our estimates (based on the latest published accounts) of the number of years each LIC under our coverage (excluding those that don't pay dividends) could retain current dividend payments without generating any additional profits. This is a good indicator of dividend sustainability when markets turn down. Coverage of one means that a LIC could maintain its current dividend payout for one year without generating any profit in the current year. There a number of LICs with dividend coverage of more than two years which means they are reasonably well placed in the event of a sustained market downturn.

Attractive yields remain but watch profit reserves

Despite the flat, or modest increase in dividends, the LIC sector still offers attractive yields for investors. We calculate an average dividend yield of 4% across the Australian share focused LICs with most LICs paying fully franked dividends. We think it likely that the LICs will experience stability in their dividend income over the next six months and do not expect to see many reductions in dividends from the sector. It is possible we may see modest dividend increases from some LICs.

It is important to watch management commentary for any indications of potential changes to dividend payments. We note that Djerriwarrh Investments (DJW), one the highest yielding LICs currently, has already said it expects to cut its dividend from 24 cents per share to 20 cents per share in 2017. Also, keep an eye on those LICs that have low levels of profit reserves as this could also be an indicator of a potential dividend reduction.

Peter Rae is Supervisory Analyst at Independent Investment Research. Extracted from IIR's February 2017 LMI Monthly Update.