Switzer Super Report

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Oh what a night!

Positive sentiment has been snowballing in recent weeks, but tonight will be important in deciding whether that snowball keeps rolling or turns to powder. We're waiting to hear what the US Federal Reserve decides on whether it is going to give the US, and the world's markets, another stimulus hit. I tell you why this is so important in today's note.

Also in the Switzer Super Report, Charlie Aitken names two stocks to buy and one to sell. Plus, we look at the dos and don'ts of putting property in your self-managed super fund as well as a special exemption for personal injury payments when it comes to the contributions cap. Plus, our auditor, Jo Heighway, answers your SMSF questions. Enjoy!

Sincerely,

Peter Switzer

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Oh what a night!

by Peter Switzer

“Oh what a night!” September 14, 2012 could go down as a crucial time in the post-global financial crisis era. I know there will be many who think I’m being a tad dramatic, but they are those who underestimate the importance of what Keynes called “animal spirits”.

In fact, this is what he said in his famous book, ‘The General Theory of Employment, Interest and Money’:

“Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.”

Animal spirits

Animal spirits are effectively measured by confidence – consumer, business and investor – and this why the US Federal Reserve’s Ben Bernanke has to make tonight an oh-what-a-night event, because it can make or break what I have called a snowball of improving confidence.

This has been the missing ingredient since the GFC hit in late 2007, becoming worse when Lehman Brothers failed and then even more dramatically threatening by inept, stupid and pathetic politicians who mishandled the repair job process, especially in Europe.

Last year it was the Europeans, helped by the morons in the US Congress, that got in the way of the improvement process for the global economy and stock markets worldwide.

However, Europe has lifted its game and it has helped the snowball of confidence to get rolling. It started with Draghi and his “whatever it takes” pledge, then Angela Merkel showed some German compromise and the Chinese said they would stimulate their economy. The European Central Bank then delivered a plan to buy bonds and lower borrowing costs and the German Court gave the bailout fund a tick. And so now the US needs a QE3 shot in the arm – that is, a third quantitative easing stimulus package.

Now, sure the doubters who hate Obama and Bernanke say the first two lots of QEs haven’t worked – that’s crap! Jobs have come but not enough, however the Dow is at highs not seen since December 2007 and the all-time high of 14,164.53 is not too far away.

If Europe had played its part, China wouldn’t have slowed by so much and the US would be growing at a faster clip and the Dow would be higher. Consumer, business and investor confidence would have been higher and the more aggressive animal spirits would have pushed both economic growth worldwide and stocks higher.

So how are my spirits?

By the way last night European Commission President, Jose Manuel Barroso, “called for a full fiscal union and criticised EU nations that don’t fully support measures taken to combat the debt crisis,” CNBC reported.

That’s great progress!

Ahead, my animal spirits are a bit restrained because I fear the upcoming US election and what that might mean for the so-called 'fiscal cliff'. An obstructionist Congress could hamper US economic growth by failing to agree to tax and spending changes.

My gut feelings tell me that the Yanks won't be dopes, but they have been before. Once this is beaten and China is growing with Europe showing some positive signs of economic growth, stocks could really spike and that will be because animal spirits will have been let loose.

I look forward to that time, but for now we need Ben Bernanke to be pro-animal tonight!

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Two stocks to buy and one to sell

by Charlie Aitken

Emeco Holdings (EHL) – Buy

Concerns over a slowdown in mine investment and the impact on capital intensive exposures has seen Emeco sell-off sharply, despite recently delivering a full-year 2012 result above expectations. Investors' concerns appear focused on the Australian fleet and both the relatively low level of current utilisation (about 76%) and contract renewals in the fleet exposed to thermal coal (about 10% of the domestic fleet). Utilisation should approach 80% by November with recent renewals and we see the current share price as implying that none of the thermal contracts due in December are renewed.

Emeco's business is substantially different from the one that endured the global financial crisis with an exit from North America, Europe and the Victorian Civil business. In excess of 90% of revenues today are production-based and with Emeco trading at a 5% discount to net tangible assets (NTA) and 3-times its estimated full-year 2013 earnings before interest, tax, depreciation and amortisation (EBITDA), we retain our Buy rating with a target price of $1.09 per share. The presence of a 5% buyback is likely to provide a floor to the stock price.

- Recommendation: Buy (unchanged)
- Price: $0.71
- Target (12 months): $1.09 (previously $1.25)
- Expected capital growth: 54.3%
- Expected dividend yield: 9.0%
- Total expected return: 63.5%

Virgin Australia (VAH) – Buy (accumulate)

Virgin Australia's trading volumes have returned to more normalised levels over recent days as the short-term stimulant provided by the Etihad Airways demand has now been removed. We expect the focus to turn to the earnings outlook with particular attention on capacity and yield growth for Virgin's domestic business. The year-to-date operating statistics in August contained no material surprises from our perspective with group passengers number up 2.4% with a revenue load factor of 77.3%. Domestic capacity growth for the first two months of fiscal 2013 increased 9.3% in-line with management's guidance of 8% to 9% for the first half of this financial year.

Our valuation for Virgin Australia remains unchanged at $0.52 based on a one-year forward Price-to-Book multiple of 1.13-times and we have upgraded our rating from Accumulate to Buy. Our earnings per share (EPS) estimates remain unchanged as the July/August operating statistics were in-line with our expectations. We think the stock represents value after the recent share price decline and the company is well positioned to deliver earnings improvement over the short to medium-term driven by a change in the revenue mix and a lower cost base relative to Qantas.

- Recommendation: Buy (Accumulate)
- Price: $0.42
- Target (12 months): $0.52 (unchanged)
- Expected capital growth: 23.8%
- Expected dividend yield: 0.0%
- Total expected return 23.8%

GrainCorp Ltd (GNC) – Sell

The latest government crop report continues to suggest a significant correction in the east-coast winter crop. The report expects a 12% reduction in the three major winter crops – wheat, barley and canola – in 2012-13, down almost 30% from the record 2010-11 harvest that has underwritten the last two years of earnings for GNC.

We see the merit in GNC's strategy to pursue vertical integration into grain and oilseed processing. However, we also see the share price as reflecting the benefit of back-to-back record crops.

We continue to see the estimated earnings base from full-year 2012 as inflated and at least 30% above what could be achieved under more normalised crop conditions. We retain our Sell rating and target price of $7.35 per share.

- Recommendation: Sell (unchanged)
- Price: $9.29
- Target (12 months): $7.35 (unchanged)
- Expected capital growth: (20.8%)
- Expected dividend yield: 6.5%
- Total expected return: (14.4%)

The rules of SMSF property investing

by Chris Gray

Property investing within your self-managed super fund is a highly regulated affair and playing by the rules is essential if you are to avoid the perils and pitfalls of the property game. Follow these guidelines though, and you'll discover that property investing in your SMSF can yield financial rewards.

Can I live in the property I buy with my SMSF?

When it comes to purchasing residential property inside your SMSF, one of the tightest rulings by the ATO is that the investment must be kept at "arms length", restricting you from directly benefiting from the asset until retirement. (This is the same ruling that forces us to keep our artwork in storage until we retire, lest we gain pleasure from its aesthetics).

This means you can't use your SMSF to purchase the home you live in, nor can you use it to purchase an investment for your family or lease it to anyone other than an unrelated third party.

Unfortunately, investing in a holiday home for yourself is also out, even if you only plan on staying there for one evening of the year.

What about commercial property? Can I invest my super in a business premises?

Yes you can. In fact, the ATO treats commercial property quite differently to residential investments, allowing you to indirectly benefit from the use of the property via your own business. For example, your super fund could potentially purchase the premises your business currently leases, allowing you to pay rent directly to your SMSF.

Many business owners have seen real benefit in acquiring a commercial property under this scheme as it essentially allows them to become their own long-term, blue-chip tenants.

What if I don't have enough super to invest in property safely?

In my last article I talked about the ability to lend funds to your SMSF from an outside source, such as personal equity, in much the same way a bank lends money to its clients. The SMSF would then repay the loan back to you over an agreed time and at an agreed rate.

Alternatively, because an SMSF allows up to four members to act as trustees to the fund, you can effectively pool your assets with other parties to raise the monies required.

If my property increases in value, can I use the additional equity to buy more property?

The government has restricted the ability of SMSF's to redraw on any additional equity gain that their investments may experience. This is one of the biggest considerations when it comes to investing in property as your equity gains are effectively "locked inside" the fund and can't be leveraged in the same way as investments outside the fund.

Can I renovate to increase the properties value?

The ATO has been slowly relaxing its policies on SMSF property improvements over the last couple of years and it's now possible to repair and even renovate and improve the property to add value. The difference lies in how the building works are financed and it is important to understand the difference between "repair" and "improve" if you are to avoid any liability.

According to the ATO, "'maintaining' ordinarily means work done to prevent defects, damage or deterioration of an asset, or in anticipation of future defects, damage or deterioration, provided that the work merely ensures the continued functioning of the asset in its present state. The term ‘repairing’ ordinarily means remedying or making good defects in, damage to, or deterioration of an asset and contemplates the continued existence of the asset.”

This can be surmised as general wear and tear on the building. For this work, the SMSF can use its own funds or it can borrow the required funds to get the work done.

“In contrast to repair, an asset is improved if the state or function of the asset is significantly altered for the better, through substantial alterations, or the addition of further substantial features or rights, to the asset.”

This might include adding a pool or a granny flat or upgrading the kitchen.

In these cases, the SMSF can ONLY use existing funds – not borrowed – or funds from external sources to finance the improvements.

Can I develop the property I have purchased with my SMSF?

Each case would need to be evaluated on its own merits, however as an over-arching rule the SMSF property must remain the “same asset”. This means you can’t buy a vacant block of land then put a house on it, you can’t convert a house to a restaurant, and you can’t pull a house down and build three townhouses in its place.

Also, the property must only be purchased with a single title. You can’t purchase two properties in a single sale if they are on separate titles.

As you can see, purchasing property with your SMSF does have some restrictions and it’s essential that you understand these limitations as penalties can be fierce. Legislation is often changing to accommodate this growing investment strategy and there are always areas open for interpretation, so make sure you obtain timely advice that is specific to your situation if you intend to invest in property with your SMSF.

Injured? You may be eligible for an exemption

by Andrew Bloore

If you've ever been seriously injured, or in the very unfortunate event that you are, you may be interested to know there's a special exemption that allows you to put any personal injury payments into your superannuation without the risk of breaking your contributions cap.

Personal injury payments are generally excluded from the non-concessional (after tax) contributions cap of $150,000. There is no limit to the amount that can be contributed under this exclusion, however in order for it to apply, there are certain conditions that must be met.

Personal injury payment requirements

The payment type must be paid as a result of one of the following categories:

1. The payment is for the settlement of a claim for compensation or damages for, or in respect of, personal injury suffered by the member, and the claim is based on the commission of a wrong, or on a right created by a statute. Further, the settlement must be a written agreement between the parties whether or not the agreement is approved or endorsed by a court.
2. The payment is for the settlement of a claim for, or in respect of, personal injury suffered by the member under Commonwealth or State law in relation to workers compensation.
3. The payment is made following a court order for compensation or damages for personal injury suffered by the client and the claim is based on the commission of a wrong, or on a right created by a statute. The order can't be one approving or endorsing an agreement as in the first point above.

If the payment is a combination of compensation for personal injury as well as compensation for something else – such as medical expenses or property damage – only the amount relating to personal injury will be exempt from the super contributions caps. This is illustrated in the following example.

Example

As a result of a car accident, Bruce is awarded $1.25 million from insurers of which $1 million is for personal injury. The remaining $250,000 is compensation for medical costs. He contributes the full $1.25 million to his self-managed super fund within 90 days of receiving the payment. Only the $1 million can be contributed as a personal injury payment and excluded from the cap. The remaining $250,000 will be counted towards the $150,000 non-concessional cap.

Contribution requirements

Two legally qualified medical practitioners must have certified that the member is not expected to ever work again in a role in line with their education, training or experience.

The member must make the contribution within 90 days from whichever of the following events occurs last:

- the day the member received the personal injury payment;
- the day an agreement for settlement of personal injury payment was entered into; or
- the day on which a court order for the personal injury payment was made.

The receipt of the payment is dated from when the person 'receives' the payment, whether it is paid directly to them or to their legal personal representative. This point is important, as you can see from this example:

In 2002, a child taxpayer was awarded damages pursuant to a court order and these were paid to the Public Trustee. When the taxpayer turned 18, they received the money that was held in trust and proposed to contribute it to their super fund within 90 days of receipt of the trust funds. The ATO determined that the 90-day period started when the payment was made to the Public Trustee and not when the taxpayer took over their finances. So the amount couldn't be contributed to super under the personal injury exclusion and would be counted in the non-concessional cap.

Advising the super fund

Members must advise their fund that they are claiming the exclusion either before or at the time of the contribution. If they don't, the fund is required to report these amounts as personal contributions, which count towards the non-concessional contributions cap. The ATO provides a form for this purpose called the 'Contributions for personal injury form', however it is not mandatory to use this as long the fund is provided with all the required information.

Age restrictions

The same age contribution restrictions that apply to normal contributions also apply to personal injury payments. Members below age 65 can contribute the personal injury payments without limitations. Members aged 65 but less than 75 will need to meet the work test, being gainfully employed for at least 40 hours in a period of not more than 30 consecutive days in the financial year. No contributions can be accepted if the individual is aged 75 and above.

Don't forget the caps

If the contribution doesn't meet the exact requirements of a personal injury payment, or is contributed after the 90-day period, it won't be classified as a personal injury payment and therefore can't be excluded from the cap.

The payment will then be a non-concessional contribution. The amount of the payment may be substantial, so watch out that it does not breach $150,000, or inadvertently trigger the bring forward rule for members under 65. This will require careful management of any contributions going forward.

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Ask the auditor: caps and valuations

by Jo Heighway

Q: How should an SMSF starting an account-based pension value cash deposits or fixed deposits?

A: Cash and fixed term deposits are typically valued at their face value (principal amount) when an SMSF is starting an account-based pension.

Interest income is taxable when it is received (i.e., on a cash basis), so SMSFs tend to recognise interest income on a cash basis.

Q: Are share transfers counted in my $150,000 non-concessional cap?

We want to transfer shares my wife and I hold outside the super to our SMSF. We understand this is called an "in specie" transfer and we have until the end of this financial year to do so.

Will the value of the shares transferred be counted as part of the non-concessional cap?

We hold shares in a stock that were accumulated over12 years and that stock price has risen. Would this trigger capital gains tax (CGT) on transfer?

A: An "in-specie" contribution is effectively just making a superannuation contribution in the form of assets rather than cash. The changes to the rules haven't actually become law yet – they may ban listed shares from being transferred via "off market transfer", but at this stage completing an off market transfer form to move listed shares into your SMSF is still allowed.

The market value of the shares at the date of transfer will be counted towards your non concessional caps unless you are able to claim a tax deduction for personal super contributions.

Transferring shares to your SMSF does trigger a CGT event for you personally. Remember to claim the 50% CGT discount to reduce the gain as you've held the shares for more than 12mths. It may be possible for you to consider claiming a deduction for part of your in specie contribution to offset the expected capital gain and save some tax that way, but I recommend seeking further advice about this.

Q: Can a temporary resident run an SMSF?

My wife and I are expats of four years and our super is in a generic scheme. We would like to open up an SMSF, but our accountants keep telling us that we can't because it contravenes being an expat and may have tax implications. We have no immediate plans to return overseas. All we wish to do is manage our own investments. Can I set up an SMSF?

A: To open up an SMSF which qualifies as a complying fund from day one, you need to make sure your SMSF can meet the following tests:

1. the fund is established in Australia or any asset of the fund is situated in Australia
2. the central management and control of the fund is ordinarily in Australia; AND
3. either the fund had no active member (which means a member making contributions), OR at least 50% of the total market value of the fund's assets is attributable to superannuation interests held by active members who are Australian residents.

A fund that fails to satisfy any one of these tests at a particular time is not an Australian superannuation fund at that time, even if the other tests are met.

You might like to take a look at Tax Ruling TR 2008/9 which contains some very valuable guidance and case studies as to what will and won't cause residency problems for an SMSF. If you set-up an SMSF and transfer all your super into it, but then fail the above definition of an Australian fund, unfortunately the ATO will hit the fund with a tax rate of 45% on income and assets. So getting it right is extremely important.

Q: Do contributions made to an overseas retirement fund count towards contributions caps?

No, only contributions made to an Australian regulated superannuation fund count towards contributions caps. So contributions to an overseas retirement fund do not count for the purposes of contribution caps.

On the other hand, generally, if you transfer overseas super and pension money to an Australian super fund, the transfer amount will be counted as a non-concessional (after tax) contribution.

Have you got a question for Jo? Ask it here.

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Don't miss this!

The US Federal Reserve's decision on whether we get third quantitative easing package (QE3) to stimulate the economy. Read my note in today's report for why this is so important.

Did you know?

In a landmark ruling last night, Germany's Constitutional Court overturned a raft of legal challenges aimed at preventing President Joachim Gauck from signing the European Stability Mechanism (ESM) and fiscal pact that will act as a debt brake for Europe. This was a major win for the stability of the eurozone.

With the 500 billion euros ($A619.92 billion) ESM in place and a beefed-up European Central Bank ready to intervene massively on the markets, the EU's crisis fighting machinery is taking shape, and it has elicited a positive response on the markets where borrowing costs for weaker eurozone states continued to fall.