Switzer Super Report

Issue 365, 19 February, 2015

The only way is up

Charlie is very much enamoured with Telstra after it reported its half-year results last week. Today, he has a good look over the numbers, and given interest rates are still very low, he's upgraded his price forecast for the second time this year by 50 cents!

Also today in the *Switzer Super Report*, one of our newest subscribers has participated in our *My SMSF* article. He bought into the market – using the *Switzer Super Report* income portfolio as a guide – on 18 January and is now up 11.5%! I wish I had his timing!

We also have SEEK chief executive officer Andrew Bassat in *CEO Spotlight* and he answers some questions about the company's key strategies, and Tony Negline explains why you have to be very careful when it comes to claiming tax deductions for super contributions.

Sincerely,

Peter

Peter Switzer

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36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

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Applestra: upgrading price target again

by Charlie Aitken

Key points

- *Mobile revenue growth drove EBITDA 0.5% in the half, net profit after tax (NPAT) rose 21.7%, and the interim dividend was lifted from 14.5c to 15c fully franked.*
- *Return on equity (ROE) rose from 26.8% to 30.7%, while return on invested capital (ROIC) rose from 15.2% to 16.4%.*
- *With interest rates going lower, a 12 to 18 month share price target, based off a pre-tax yield three times the cash and fixed interest alternative of $7.50, is not out of the question.*

The great American activist investor Carl Icahn believes Apple is worth $US1trillion dollars. With a current market cap of $US744 billion and forward P/E of 14.9 times, it's hard to argue with Mr Icahn's view that APPL.NAS could rise another 34% and become the world's first trillion market cap company. For the record, Mr Icahn's listed vehicle, Icahn Enterprises, would be a top-20 stock in Australia.

One of the key reasons I have been bullish on telecommunications stocks for the last few years is what I call *"the Apple effect"*. Smartphones are driving *"mobile data addiction"* (MDA), which, in turn, is driving revenue growth for telcos with reliable 4G networks. It makes complete sense that the correlation below Apple and Telstra (TLS) is as strong as evidenced in the chart below.

Apple vs. Telstra: *Applestra*

Crunching the numbers

There was clear evidence of "the Apple effect" in Telstra's (TLS) record first-half FY15 earnings reported last week. What we can all observe in our daily life (1 million Australians now have two mobile devices) did translate to mobile driven earnings growth for Australia's dominant telecommunications company. To me, this is clear confirmation of our thesis on Telstra actually being a *"growth bond".*

Telstra's managing director David Thodey, who has done a terrific job running the company, made a few comments earlier this week that were very similar to what I think are the genuine structural growth drivers of TLS earnings.

To quote Thodey directly:

Telstra stands to benefit from our customers' love affair with high-tech gadgets.

We've got a long way to go in the mobile industry in terms of connectivity.

The use of tablets, the connectivity to machines, the opportunity to replace every PC, or augment every PC with a mobile device, you know cars will be connected etc.

Demand for mobile data was growing rapidly across industries as diverse as agriculture, mining and education.

It's a fundamental change in the way we behave.

We really just touched the top millimetre here.

I couldn't agree more with those comments, as I can see them in my own and my peer group's commercial behaviour. This is the start of a major structural change and to my way of thinking, telecommunications companies are the "railroads" of the next century.

An essential service

I've written before that the Australian economy simply can't open for business each day without Telstra's networks, and as each day passes, that becomes a more and more accurate statement.

Telstra should command the P/E of a monopoly critical infrastructure stock, such as Sydney Airport (SYD) or Transurban (TCL), and that's where I think Telstra's P/E is headed, as investors bid down its highly reliable fully franked (and growing) dividend yield.

Let's now look at some slides from the Telstra interim results pack.

Key Product Revenue

	1H15 $m	1H14 $m	Change %
Fixed	3,505	3,564	(1.7)
Mobile	5,327	4,861	9.6
Data and IP	1,458	1,498	(2.7)
NAS	1,007	853	18.1

Product Profitability EBITDA Margins[i]

	1H15	FY14	2H14	1H14
Mobile	40%	40%	41%	39%
Fixed voice[ii]	56%	59%	57%	61%
Fixed data[ii]	42%	41%	42%	39%
Data and IP	64%	65%	66%	65%
Telstra Group	42%	42%	42%[iii]	42%

Mobile revenues grew 9.6% in the half and mobile is now 42% of Telstra's revenue mix. The EBITDA margins on mobile remain a very healthy 40%.

Mobile revenue growth drove EBITDA 0.5% in the half, but as has been the recent trend in Telstra, analysts again underestimated the translation to strong NPAT and EPS growth in the half. NPAT rose 21.7%, EPS rose 23.4c, and the interim dividend was lifted from 14.5c to 15c fully franked. ROE rose from 26.8% to 30.7%, while ROIC rose from 15.2% to 16.4%. Gearing dropped from 51.4% to 49%. Capex dropped 4.7%.

All in

Telstra has been my single best large cap total return idea of the last five years. Ever since the note *"Telstra, a gift from the Nation"* when the Future Fund was dumping Telstra at $2.70, Telstra has been a high-conviction buy. Only for a very short period last year I downgraded Telstra to neutral at $5.75 then upgraded it again back to buy @$5.25 shortly after. The first note I wrote in 2015 was upgrading my Telstra price target from $6.45 to $7.00 when Telstra was $6.07.

Even though TLS has served me and readers of these notes very, very well, in all the time I have recommended Telstra, I have never seen the top down and bottom up drivers of growth being so strong, combined with macro factors, such as cash rates driving demand for stocks' income attributes. The natural contrarian in me gets a little concerned by that, but this is a classic example of letting a winner run and that is exactly what I intend to do with Telstra.

Ticking all the boxes

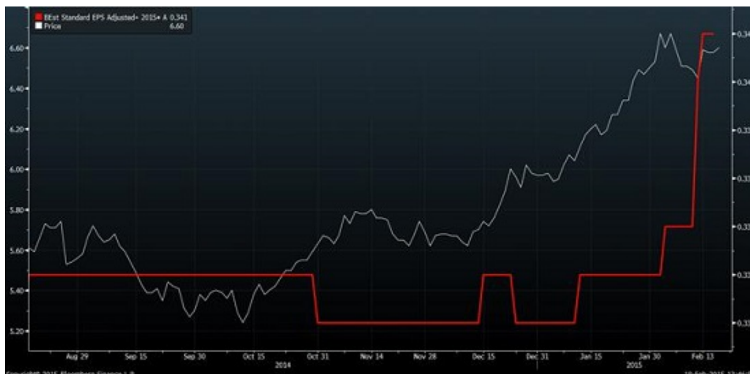
The industry has structural growth, the company is superbly positioned to capture a disproportionate percentage of that growth, the brand is getting stronger daily, and the company's products have effectively become an essential service.

If I then look at what Australian long bond yields are telling me about the medium-term interest rate and growth outlook in Australia. I see further growth in demand for large cap stocks that have Telstra's attributes. All the macro and micro ingredients are in place and this cake (share price) will rise.

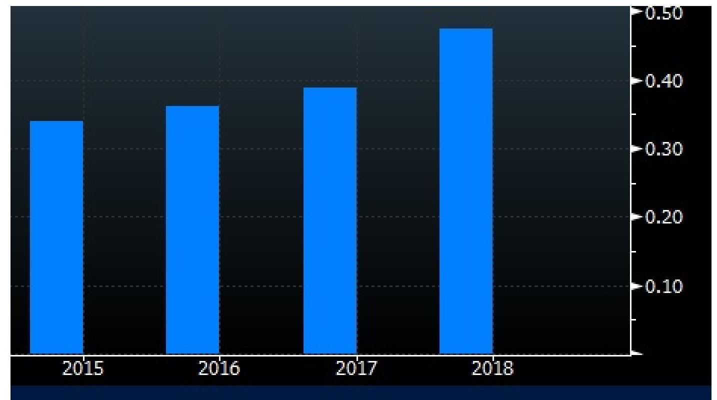
Interestingly, and one of the key reasons I am staying with Telstra, is the consensus analyst view remains sceptical. This has been the case the entire way up from $2.70 with analyst forecasts chasing the share price higher. Currently the buy/hold/sell ratio on Telstra is 5/12/4 and the median 12-month price target is $5.92. Good luck with that.

The chart below confirms Telstra analysts (yellow line) have been chasing the share price (white line) for the last two years. Their scepticism is again evident in this week's broker research on Telstra.

Below is Telstra's FY15 consensus EPS forecast versus the share price over the last six months. Telstra is in a structural earnings upgrade cycle. Note well the analysts only change their "forecasts" after results. I call that "back-casting".



16 of 21 Telstra analysts are "neutral" or "negative" but this is the EPS growth they forecast for the next four years.



My forecasts for FY15 for Telstra remain unchanged. I expect FY15 EPS of 35c and FY15 DPS's of 32c. That implies a 17c fully franked final dividend on top of the 15-cent interim.

The future still looks good

With Telstra cum the interim 15 cents fully-franked today and prospectively paying another 17 cents fully-franked in September, the seven-month yield is 4.96% fully-franked, assuming my final dividend forecast proves correct. 7.08% grossed up for seven months is highly attractive versus cash at 2.25%.

In my first note on TLS this year I said: *"There is simply no way that Telstra will continue to yield "grossed up" more than 3.5 times the equivalent 3-year government bond rate, or potentially more than three times the future RBA cash rate. Telstra yield will be bid down and inversely capital growth will be solid".*

Since I wrote that note, the RBA has cut cash rates to 2.25% and the interest rate futures market, post Tuesday's sloppy employment data, is pricing in a 60% chance of another 25 basis point rate cut in March and a 90% chance of a second 25 basis point rate cut in April. Australian 3-year government bond yields have dropped from 2.16% to 1.87% since early January.

It think it's very fair to assume the RBA cash rate will be 2.00% and the Australian Government Bond 3-year yield remain will below 2.00% for 2015. Both may well ended up even lower.

On that basis I am going to set a Telstra 12- to 18-month share price target based off a pre-tax yield three times the cash and fixed interest alternative. I am setting a grossed up yield target of 6.00%.

@$6.60

TLS div	Raw yield	Grossed up yield	6.00% grossed up yield share price target
31c	4.69%	6.70%	$7.38
32c	4.84%	6.92%	$7.61
33c	5.00%	7.14%	$7.85

The result is, for the second time this year I AM UPGRADING MY MEDIUM TERM Telstra PRICE TARGET.

Taking into account the interim result and movements in interest rates I am upgrading my TLS price target from $7.00 to…$7.50.

Telstra remains a core high-conviction buy and core portfolio overweight.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

With earnings season in full swing, there were a number of changes to broker ratings. Downgrades dominated, as many stocks are seen to be fully priced. While earnings are generally in line with expectations, there aren't too many companies reporting well ahead.

Challenger received two upgrades and one downgrade, while Macquarie saw two downgrades.

In the good books

Amcor (AMC) was upgraded to Neutral from Underperform by Credit Suisse. First half results were slightly below the broker's expectations. Credit Suisse observes, even after executing a US$500m share buy-back, Amcor will have US$1.3bn in acquisition capacity through debt. In the absence of acquisitions, further buy-backs appear to be a likely scenario and the broker believes another US$500m could be bought back in FY17 without exceeding 2.5 times net debt to earnings. Target is raised to $14.40. Market sentiment is now neutral at +0.0.

Cardno (CDD) was upgraded to Neutral from Underperform by Macquarie. Cardno's 17% profit decline from the previous first half was roughly in line and in accordance with the recent warning. Management expects improvement in the US, aided by the A$, but ongoing tough conditions locally. The broker believes the full impact of commodity price falls is yet to flow through to customer demand. However, Cardno's steep share price fall on the earlier profit warning puts the stock at a large discount to peers, hence an upgrade to Neutral. Target falls to $3.12 from $3.52. Market sentiment is now +0.3.

Challenger (CGF) was upgraded to Buy from Neutral by Citi, and to Neutral from Underweight by JP Morgan. According to Citi, Challenger's first-half result was broadly in line with expectations, guidance for retail liability book growth improving along with the dividend, but earnings falling just shy of the mark after a capital dilution. Guidance was revised slightly but overall, the broker says the removal of some uncertainty was the main theme of the result (although there is still enough uncertainty to keep the target price below spot valuation).

The broker notes margin compression in the Life business and weakness in Funds Management. While capital consumption was up, Citi sheets this back to one-offs and says a Tier-2 raising could fund strong growth if need be. The broker says Challenger offers value, has strong sales potential and the dividend in the second half will be 100% franked.

For JP Morgan, Challenger's first-half net profit fell a tad short due to margin pressure and capital surplus erosion. But JPMorgan notes strong annuity sales, a confidence-inspiring shift into less capital-intensive products, receding DSS risk and growth potential if the Murray recommendations are implemented. The broker expects margin pressure to continue but pricing pressure to wane, and says net book growth was strong in the first half. Rating upgraded to Neutral from Underweight.

With Deutsche going the other way (see in the not-so-good books below), market sentiment on Challenger is now +0.4.

GWA Group (GWA) was upgraded to Buy from Hold by Deutsche. First half results were in line with expectations. Deutsche Bank believes there is solid growth potential in FY16 because of volume and price growth, a capital return (potentially) and removal of the Wetherill Park inventory overhang. Accordingly, Deutsche Bank upgrades to Buy from Hold. Target is reduced to $2.61 from $2.69. With Citi going the other way (see below0, market sentiment is now +0.0.

Citi upgraded Paladin Energy (PDN) to Neutral from Sell. The new convertible note issue significantly reduces Paladin's refinance risk and leads the broker to upgrade to Neutral from Sell. Target rises to 40c from 35c. However while the broker is bullish on uranium, it does not believe prices will rise fast enough for Paladin to avoid additional debt or asset sales in order to repay the issue due on 2017. Market sentiment is now +0.4.

Credit Suisse upgraded Steadfast Group (SDF) to Outperform from Neutral. The interim report proved quite an event with Steadfast also announcing a number of acquisitions, plus an equity raising and an increase in debt. The interim results itself were weak, reflective of a turn in the insurance cycle, comment the analysts. CS is supportive of the acquisition strategy and sees potential from cost cutting too. On this basis the rating has been lifted to Outperform from Neutral. Target price lifts to $1.70 from $1.66 on slightly higher estimates. Market sentiment is now +1.0.

Citi upgraded Tatts Group (TTS) to Buy from Neutral. The stock has been viewed as a predictable defensive investment given stable lottery earnings but Citi believes the company has several strategic options, which could drive significant value. The broker incorporates a new risk-weighted methodology that better captures these options. Citi notes, following the successful legal claims in Victoria, the company has extra cash for licence renewals and acquisitions. Citi's target rises to $4.40. Market sentiment is now +0.1.

In the not-so-good books

ANZ was downgraded to Sell from Neutral by Citi. ANZ's first-quarter result fell shy of Citi's forecast as revenue flattened in global markets. Citi notes the bank's organic capital generation is struggling and the payout ratio is under threat. The broker says the bank is looking pricey and shaves 2% off earnings estimates. ANZ is downgraded to Sell from Neutral, joining its peers as Citi sours on the sector. Target price steady at $32. Market sentiment is now -0.3.

Aurizon Holdings (AZJ) was downgraded to Neutral from Buy by Citi. First half earnings were below the broker's forecasts. Management has identified additional savings and opportunities to increase efficiencies. Nevertheless, Citi considers pending industrial action and challenging markets in coal and iron ore make the drivers of a return to strong growth difficult to identify. The broker also believes the re-pricing of contracts is slowing. The target is reduced to $5.10 from $5.40. Market sentiment is now +0.6.

Bendigo and Adelaide Bank (BEN) was downgraded to Sell from Neutral by UBS. First half results were ahead of UBS but the composition of the result disappointed. UBS downgrades earnings forecasts by 4.0% for FY16. While further interest rate cuts may support the share price, UBS believes capitalising mark-to-market house price gains is dangerous and that the share price has rallied too far, too fast. Market sentiment is now -0.1.

Challenger (CGF) was downgraded to Sell from Hold by Deutsche. First half results were well below the broker's forecasts. The challenges of a lower interest rate backdrop for the life business are starting to show, in Deutsche Bank's view. While profit growth will remain supported by recent capital raisings, the broker believes new business margin pressure will emerge more clearly in FY16. Hence, while the company is upbeat on annuity growth prospects, lower margins/returns on equity reduce the appeal. Rating is downgraded to Sell from Hold and the target to $6.05 from $6.25. (see in the good books above).

Fortescue Metals (FMG) was downgraded to Sell from Neutral by Citi. Fortescue's interim slightly outpaced consensus and the broker on most metrics save net profit after tax, which fell 16% shy of the broker thanks to higher depreciation and amortisation and interest costs. Citi cuts its target price to $2.20 from $2.40 accordingly. The broker is bearish on iron-ore prices and, given the company's increase in net debt over the period, downgrades the stock to a Sell from Neutral. Market sentiment is now +0.3.

G8 Education (GEM) was downgraded to Neutral from Outperform by Macquarie. After a sustained period of acquisitions, and another 12 childcare centres added along with the result, G8?s revenue

and earnings missed the broker's forecast and guidance. The industry remains rife for consolidation but G8 is starting to pay full price, the broker notes. Further acquisitions may require additional capital, the broker warns, while competition is increasing and a Productivity Commission investigation into childcare promotes uncertainty. Target falls to $4.93 from $5.35. Market sentiment is now +0.4.

GWA was downgraded to Neutral from Buy by Citi. GWA Group's result failed to impress Citi. The broker says strategy execution has been underwhelming, that the Group has failed to stabilise Gliderol's profitability and that a recovery from Gainsborough will take longer than expected. The broker believes a shift to medium to high-density dwelling will also take its toll. There were plenty of positives, including the second-half capital raising, but the deciding factor was the high price earnings ratio, the stock trading 21% above its historical price-earnings multiple of 13.9x (despite yesterday's correction). Citi cut the target price to $2.67 from $3.30.

Iluka Resources (ILU) was downgraded to Hold from Buy by Deutsche. The 2014 loss was more than Deutsche Bank expected. The dividend improved with a 40% free cash flow payout, while net debt is at $59m. The focus has returned to a decision on replacement projects. The broker observes some encouraging early signs for zircon sales in 2015. Target is unchanged at $7.50 but the broker downgrades to Hold from Buy following the recent strong share price performance. Market sentiment is now +0.6.

Macquarie (MQG) was downgraded to Neutral from Buy by Citi, and to Hold from Add by Morgans. Citi says that it's all go at Macquarie, the group reporting in line with January guidance, and tipping earnings growth at the top end of its 10%-20% guidance. Citi notes the tax rate has peaked, operations are upbeat, and most businesses improved over the period. The broker bumps up the target price to $70 from $66 but downgrades the stock to Neutral from Buy given recent share price strength.

For Morgans, Macquarie's quarterly update highlighted ongoing momentum as capital markets benefit from improved trading conditions. Morgans envisages upside risks to FY15 growth guidance of 10-20%. The broker downgrades to a Hold rating from Add, given recent share price gains and believing the upside is largely priced in. Target is however raised to $73.50 from $62.00.

Despite these downgraded, market sentiment on Macquarie is still positive at +0.4.

Citi downgraded Sims Metal Management (SGM) to Sell from Neutral. The benefits of the review to focus on earnings per tonne were clearly evident in Sims' first half result but on the 11% share price rally, the broker has downgraded to Sell. The review has drawn focus away from the key driver of volume, the broker suggests. While the broker has lifted margin expectations, its earnings forecast rise modestly after lowering volume expectations in a deteriorating scrap market. Target falls to $10.40 from $10.50. Market sentiment is now 0.0.

Morgans downgraded Seymour Whyte (SWL) to Hold from Add. Morgans notes the good guidance for the results and believes, with the current order book, the company can achieve reasonable growth given its NSW exposure and Rob Carr business. That said, until the new government in Queensland unveils its infrastructure plans, the broker downgrades to Hold from Add. The company is still considered one of the better-placed infrastructure services businesses, with strong balance sheet and dividend support. Target is lowered to $1.50 from $2.03. Market sentiment is +0.5.

The above was compiled from reports on FNArena, which tabulates the views of eight major Australian and international stock brokers: BA-Merrill Lynch, CIMB, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie and UBS.

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CEO spotlight – SEEK's Andrew Bassat

by Andrew Bassat

Key points

- *SEEK is the number one brand when people think jobs, with 76% unprompted awareness compared to 38% of its nearest competitor.*
- *Focuses for this year will be the Placement Strategy, the Learning division and international operations.*

CEO

Andrew Bassat

Years in role

Co-founded the company in 1997

Interim earnings:

- Underling revenue up 17% on first half last year to $395.3 million.
- EBITDA up 18% to $168.5 million
- NPAT excluding significant items up 9% to $94.1 million.

What is the company's competitive advantage?

SEEK's competitive advantage lies in its ability to connect hirers and job seekers. SEEK has more unique and relevant job opportunities and the largest pool on candidates. It is the number one brand when people think jobs, with 76% unprompted awareness (versus. 38% of our nearest competitor). Through our Placement Strategy, we continue to evolve our product and service offerings to better facilitate the matching of jobseekers to hirers.

SEEK's international division offers significant competitive advantage as we operate market leading (number one or number two positions) organisations that collectively expose the Group to over 2.9 billion people and greater than 20 % Global GDP, providing a large platform for future growth.

What are the company's plans for the year ahead?

In November 2014, SEEK successfully completed the acquisition of JobStreet. We are now focused on the integration of this business with JobsDB, which will open up great opportunity for the Group across South East Asia.

Locally, we continue to reinvest into our Placement Strategy, which is building momentum in the market. We have grown candidate profiles 54% to circa 5 million and currently lead placements in Australia at circa 22%; the next nearest competitor is 1%. For us, placements are a critical measure of success as it demonstrates the value we're providing by connecting candidates to hirers and hirers to candidates.

We remain focused on continuing to support our international businesses in their operating models and deliver further value to market.

Our Learning division continues to perform well and we continue to explore growth opportunities, particularly offshore.

What is the company's growth strategy?

At a high level, SEEK always invests with a long-term outlook. At a divisional level, there are different growth strategies.

The Placement Strategy offers significant growth prospects for employment; opening up new product

and service offerings to the market and increased value to hirers and candidates.

In addition to this, the continual migration of job advertisements from print to online, along with the benefits of a cyclical uplift, represent strong growth opportunities.

Internationally, SEEK has a successful track record of investing in early stage markets with large growth potential. Zhaopin is a great example of how we've started small and worked closely with the local management teams to deliver on a solid growth strategy. We apply this approach across all our early stage markets and it continues to put us in a good position to realise opportunity into the medium to long term.

The education arm of SEEK offers growth opportunities through extending this offering into our international markets. We have early stage education businesses in Brazil and OCC, with Asia and China a key priority moving forward. Swinburne Online, which is a joint venture with Swinburne University, also has strong growth prospects through increased market penetration and the addition of new courses.

Do you have global growth plans?

Since our investment into China in 2007, SEEK has continuously looked globally for opportunities to add value and deliver shareholder return. SEEK now operates across 14 markets with exposure to over 2.9 billion people and greater than 20% global GDP.

We are focused on working closely with the management teams in the international businesses and sharing our intellectual property to support each business' growth. We are also exploring how to take our successful education model into overseas markets, particularly Asia.

What is your dividend strategy (payout ratio/franking etc.), and how much will you be returning to shareholders this year?

SEEK has a dividend payout policy of 40% to 70% of cash NPAT, and currently the payout ratio is 50% of cash NPAT.

SEEK's strong cash flows and balance sheet mean it's well positioned to either return or deploy capital to drive shareholder returns.

Seek (SEK)

Source: Yahoo!7 Finance, 19 February 2015

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My SMSF – perfect timing

by My SMSF

Name

Tom Woods

Age

59

Other members of the SMSF

Wife. I think it's best not to have any of our three children in the fund because of the four-member limit. How would you choose?

Where do you live?

Glen Waverley, Melbourne

What investments do you have outside of superannuation?

Family home, small share portfolio.

How long have you had your SMSF?

I started my own SMSF in 2011/12.

Why did you start it up?

The world is full of sharks and ticket clippers and everyone wants a piece of your hard-earned cash, so I was wary of getting involved with a lot of financial planners out there pushing product with high commissions and trailing fees.

I started my SMSF up to plan for my retirement and also because I was running a business from an industrial property and I knew I could take advantage of certain ATO small business concessions to move that property into the SMSF.

How big is it?

It's about $1.4 million.

Is it more or less difficult to manage than you thought it would be? Are you glad you have it?

Yes it is more difficult, but yes I am glad I have it.

Are you pleased with its performance?

Yes and no. A large part, 50%, is in the property and it has had a very good tenant there for five years but he is moving out. Hopefully a new tenant should move in soon.

All the rest of the money was in cash up until recently. I could see the way that interest rates were heading, but my wife was very risk adverse so I said let's try a little bit in the equity market first.

I followed Peter Switzer's formula for a high dividend portfolio exactly as published in the newsletter. It seems like the day I picked to do that (January 8) was the perfect day and I'm very happy with the way it's gone. It's up 12.5% ($14,000) since then, and I haven't even begun to collect my dividends!

I know your (*Switzer Super Report*) advice is to buy in the dips so I'm waiting for another dip to do that.

What is your asset allocation?

Currently it's property 50%, shares 10% and cash 40% so I may be looking at increasing the shares to somewhere about 25%. I think with the size of the fund that will give us a comfortable living. We don't have to chase high returns at high risk. And there will be a certain amount of capital growth on the factory

And this year I will be declaring I have retired from

full-time work so it will be in pension phase.

What are your favourite investments/stocks and why?

I'm a long time fan of BHP, but I don't even follow my advice. I've often said to people if you've put half your money in BHP and CBA you could just sit back and relax but I haven't done that. I was personally buying shares in BHP at $8, and $12 (but also at $36), however, overall, BHP has done well. I bought CBA in the original float and held on to them till I got to about $50 when I thought they had got a bit expensive.

Do you use an advisor or any kind of service provider?

I initially started my fund with an advisory firm but grew a bit disenchanted with them pushing a lot of in-house product. I just didn't like the way they did that. Their price for advice I thought was extravagant. They weren't much help with getting my property into the SMSF either. I used a solicitor who was familiar with all the aspects of that.

Why did I go with the *SSR*?

I was getting the free newsletter for a while begging me to join up, the advice just appeared to be solid and conservative and the suggested portfolios seemed to have a few runs on the board. I couldn't ask for a better way to start the year.

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Don't get your super tax deductions wrong!

by Tony Negline

Key points

- *You need to follow the rules to the letter including telling your super fund in writing that you intend to claim these contributions (and your super fund needs to acknowledge your correspondence in writing too).*
- *In a 2013 Super Complaints Tribunal case, a superannuant tried to argue that the super fund had not sent him the proforma letter in order to get out of back taxes.*
- *However, it was not the responsibility of the super fund to do so.*

Claiming personal super contributions as a tax deduction is an important tax benefit that many people access. However, the mechanics of this deduction aren't without some twists and turns. It's amazing how quickly the wheels can fall off, the concession lost and unexpected additional tax and penalty interest can be payable.

The six rules to claim a personal super tax deduction

1. You're not employed.
2. If you're employed then you satisfy the Maximum Earnings Test which stipulates that less than 10% of your assessable income for income tax purposes, reportable fringe benefits and salary sacrifice contributions has been paid by employers who should have made Super Guarantee contributions for you.
3. You have told your super fund in writing that you intend to claim these contributions as a tax deduction and they have acknowledged your correspondence in writing.
4. This documentary process must have been completed before the tax deduction is claimed and within some other specific time limits.
5. There are strict rules about if, and when, you might be able to change the information you have sent your super fund about claiming the deduction.
6. Your super contribution tax deduction can't create a tax loss.

A 2013 Super Complaints Tribunal case on how easily this concession can be lost

In June 2010, the Tax Office told a large super fund member that he wasn't allowed to claim a $100,000 contribution he had personally made to the fund in the 2007/08 financial year as a tax deduction. (In that financial year, taxpayers aged at least 50 had a concessional contribution cap of $100,000.)

When his tax return was adjusted, he was told he owed the Tax Office just over $50,000 in unpaid tax and penalty interest of $11,319. Ouch … to put it politely!

The ATO stated that the tax deduction wasn't allowed because the fund member hadn't told the super fund he was going to claim the contribution as a tax deduction. That is, point three above hadn't been completed.

The fund member complained to the super fund and said it hadn't sent him any documentation to enable him to claim the contributions as a tax deduction. He suggested that it should pay the amount now payable to the ATO.

The super fund refused to pay any compensation or acknowledge any failure on its part.

He'd been a member of the super fund since the

mid-1980s and for many years had been employed. He became self-employed in 2002 and began making personal contributions to the fund that he claimed as a tax deduction.

The fund member stated that in 2002 he visited the super fund's offices to make a personal contribution and to tell the fund he was now self-employed. The super fund had a record of the contribution but nothing showing that he had ceased employment and for that reason its computer system said he was employed.

As the Superannuation Complaints Tribunal (SCT) had no documentary evidence that the fund member had told his super fund his work arrangements had changed, it couldn't determine who was correct.

The SCT said a super fund isn't obligated to confirm the employment status of its members. One super law demands that super fund trustees chase up employers for unpaid super contributions. The SCT's written determination for this case doesn't say if the super fund at any time satisfied this obligation, as it hadn't received employer super contributions for this member since 2002.

As the super fund's systems recorded that he was employed it didn't send him any documentation about claiming his personal contributions as a tax deduction. In the fund's view, he was employed and therefore wasn't eligible for this deduction.

It's unknown if the super fund member exchanged this tax deduction paper work with the super fund at any stage after he became self-employed in previous financial years.

The super fund said that the responsibility to claim the tax deduction lay with the taxpayer. The SCT agreed with this view however it did acknowledge that many large super fund trustees do send pro-forma notices each year to their members so that the personal tax deduction can be claimed.

There are a few themes from this case that I think are important.

1. The initial correspondence about claiming a personal contribution tax deduction is sent by the taxpayer. There is no legal obligation on a super fund to send a pro-forma notice to their members. Many do it as a courtesy and as part of their soft marketing. But the responsibility for the completion of these documents lies with the taxpayer.

2. Clearly the taxpayer didn't understand the process and that it was his job to make sure paperwork was exchanged between himself and his super fund.

3. The super fund said it didn't send pro-forma personal super tax deduction notices to the fund member because it believed that he was employed when he had purportedly told them he was self-employed. No large super funds administration systems are fool proof and their data can easily become corrupted. Presumably, the super fund member believed that the fund's records had remained accurate for about five years. It was this belief that was his undoing. Unfortunately, you need to watch large organisations like a hawk and keep all documentation, as you never know when seemingly unimportant correspondence may become important.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Contraventions and the ATO – expect a call

by Penny Pryor

If your self-managed super fund isn't in ship-shape order, don't be too surprised if you get a call from the Australian Taxation Office this year. The ATO is taking a new approach to contraventions as part of its new penalty and compliance system.

All auditors still need to report contraventions to the ATO via an auditor's contravention report (ACR) but now the ATO is employing three options to deal with those breaches once it receives the ACR.

Director of SMSF income tax and regulatory programs, superannuation at the ATO, Nathan Burgess, said that in minor cases a warning letter urging the trustee not to make the same mistake again could be issued, but in many cases the ATO would be calling the trustee.

"We've decided to do a phone call to the trustee, or one of the trustees, and talk through the actual contravention to make sure they are aware of it and what steps they are doing to fix the contravention," Burgess said at the SMSF Association conference in Melbourne today.

"The phone calls are not 'got you' calls…The ATO wants to do this approach because it's not about penalties [it's about doing the right thing]," Burgess said.

It's very important that you are polite and responsive to the ATO if, and when, it does call. Burgess said that about one in 10 of the phone calls it makes needs to be escalated when, for example, the trustee might refuse to deal with the regulator. A contravention is almost always confirmed in this situation and followed up with a fine by the ATO, along with other possible penalties.

If the ATO can have a constructive conversation with the trustee over the phone, and if the trustee can explain what happened (particularly if it was an accident), the regulator may be able to avoid confirming a contravention, which would mean the fund can also avoid a penalty.

The ATO is also trying to expedite the whole process, which means you'll either get the letter or the phone call quite quickly after the ATO has received the contravention report from your auditor.

Under the new penalty regime, the ATO now has the powers to fine trustees up to $10,700 (60 penalty units) per trustee for common breaches such as borrowing from related parties.

And even if it is an old contravention, if it was still unrectified on 1 July 2014, it will fall under the new penalty regime.

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Investing offshore and CGT

by Questions of the Week

Question: If my super fund has US exposure via ETFs, will the growth in their value compensate for not having franking credits like we receive on Australian shares?

Answer (By Paul Rickard): Potentially, yes. One of the reasons you invest offshore is that the Australian share market will sometimes underperform overseas markets. For example, if you compare the period since the GFC (from 2009) to today, the US share market has materially outperformed the Australian market. Even when the benefit of franking credits is added back in, you would still have enjoyed a higher return if you had invested offshore.

Question 2: We have a house in our SMSF purchased in 2010. If we sell the house, should we have to pay any capital gains tax (CGT) on the capital gains?

Answer 2 (By Tony Negline): Your super fund will not pay CGT for any portion of the asset that is being used to pay a pension. If none of the house is used for pension purposes, then the profit will be taxed.

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Don't miss!

The market has been going gangbusters in 2015, so is it time to sell and take a bit of profit? My colleague Paul Rickard and I **share our game plan.**