smart TALK

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FROM THE DESK OF PHILIP ENGER

Dear Reader,

The trouble with trying to provide a degree of certainty, or at least a little bit of reason to all matters financial, is that there are too many supposedly unrelated issues conspiring to upset the apple cart.

Here is a riddle for you to ponder. What is the link between an Icelandic volcano, the pension age of a Greek public servant, an explosion on an oil exploratory rig in the Bay of Mexico, a proposed super profit tax on miners in Australia and the rising unpopularity of the German Chancellor, Angela Merkal? Perhaps I should also add to this list the possible extinction of naked short selling on the German Bourse. You see what I mean?!

I think to provide some sense to our life; it is probably a good time to add a good dose of reality to our thinking. The reality is that to keep these events and shocking news headlines from overcoming our sense of foreboding, we need to remind ourselves that in the final analysis we need to stay calm; stick to the fundamentals of our life and above all, don't follow the herd.

Our business promise at Dollar Growth of providing Advice for Life is all about striving to ensure that financial stress does not unnecessarily impair our clients' ability to lead their life in relative security. We sincerely believe in this sentiment. We constantly grapple with this task.

VULNERABLE TO CHANGE

It may be shocking to confront the reality that we are all vulnerable to change in both our private and public circumstances and obligations, and our life can be seriously destabilized by extraneous events. The specifics of our personal circumstances and the turbulent nature of the economic landscape in which we have to live and eke a living, often conspire to expose the individual and families in general, to unanticipated financial pain. It is a simple fact that personal situations and arrangements are constantly unraveling and political decisions resulting in unanticipated impact on the livelihood of people regularly require the situation to be re-addressed.

For many people there is little slack in the household (or business) budget so any further loss of cash flow has the capacity to produce unwanted stress. The financial arrangements that people have in place and the contracts they have entered into have a tendency to become hostile to the current needs and circumstances of those they are meant to serve. Perfectly reasonable and appropriate commitments and arrangements can over time become toxic and burdensome.

Many people are oblivious to the inadequacies of their wills, non optimal superannuation arrangements, FBT payment practices, credit card punitive features, insurance premiums that rise and rise for no apparent reason, uneconomical and inappropriate contracts entered into with Telcos, the non-take up of government entitlements and local council exemptions (for lack of information), tax and depreciation one-off arrangement opportunities, salary splitting and strategic plans that need to be put in place as people transition to retirement, employer funded schemes, subsidised pharmaceutical entitlements, and a brochure full of Australian Government Payments. The list is seemingly endless.

Many of us live our lives oblivious to the changing nature of our circumstances and so fail to make appropriate strategic corrections. Take for example the following situations.

If you buy another house and are delayed before moving in be mindful of capital gains implications. The Australian Taxation Office is applying a strict interpretation to the rules that cover exemptions from capital gains tax for the principal residence. At the same time Land Tax implications are often over-looked.

As you may know, the principal place of residence is exempt from capital gains tax on the sale of the house. But, in many cases, home buyers rent out their properties before moving in – because of work commitments, retirement planning or financial need.

If the house is rented out, the exemption will not apply during rental periods. To qualify for the full exemption, the law says the taxpayer must take up residence as soon as practicable after purchase. That phrase, "as soon as practicable", has led to disputes between home owners and the Tax Office.

In a 2008 case, a home buyer agreed to a request by the sellers of the property that they be allowed to stay in the property and pay rent for six months while their new home was being built. In the end, the lease period was for two years. The taxpayer argued that the house should have been treated as his main residence for the two-year period because it was his intention to live in the house

The taxpayer lost the case and the AAT ruled that "mere intention to occupy a dwelling as a principal residence, but without actually doing so, is insufficient to obtain the exemption".

This may be a typical scenario. People might be approaching their retirement. They find a place to buy for their retirement but they might want to wait a year or two before moving in. If they sell the house some years down the track, they might have completely forgotten that they are affected by the partial-exemption rules.

The ATO calculated that in the case of a property in Northern NSW the total cost of purchase was $115,205 – the $105,000 purchase price plus $4813 of stamp duty, $4932 of renovations and $460 of legal fees on the sale.

Subtracting $115,205 from the sale price of $232,000, the ATO came up with a capital gain of $116,795. It applied the CGT discount of 50 per cent and applied a partial exemption for the number of days the owners had lived in the house. The CGT bill for each was a staggering $14,616. And, as it seems clear, the taxpayer gave no thought to tax-planning.

RESOURCE SUPER PROFITS TAX

Finally, it would be remiss of me not to provide a short rational insight into the controversial Resource Super Profits Tax (RSPT) proposed for the mining industry by the government, without in any way entering the political debate. With so much confusion and obfuscation in the media and so many wildly disparate figures being circulated by interested parties some clarity is needed, after all some Dollar Growth Financial Planning clients are directly effected by the share price movements of mining stock held in their portfolio.

Investment markets have a habit of capitulating when the level of uncertainty increases and the RSPT has done exactly that.

What are we to make of this confusing debate? The figures differ basically because they are based on differing definitions of 'tax' and 'profits'.

The point to note is that most of these figures add together two things under the heading of 'tax': the company tax the miners pay plus the royalties and other resource charges they pay.

All companies have to pay tax on their taxable income at the rate of 30 per cent. If the amount of company tax they pay comes to a smaller percentage of their published accounting profit – as it often does – the explanation is that the taxman is giving them more concessional tax deductions than they use when preparing their published accounts. (It shouldn't surprise you that many companies aim to minimise their taxable income while maximising their accounting profit.)

The miners' "effective" company tax rate will usually be a lot lower than 30 per cent - and a lot lower than paid by many other industries - because mining is so capital-intensive and because the government gives them generous rates of depreciation on their equipment and structures. So there are good reasons for miners' effective rates of company tax to be low. Is this relevant to the debate about the resource super-profits tax? Not really.

What is relevant is to understand that when you add company tax to royalties you're adding apples to oranges. Why? Quite simply, although royalty payments for the use of minerals are labelled as taxes, they're not really taxes.

A tax is a payment you make to government for which you get nothing specific in return. Mineral royalties are payments miners make to government for which they get the right to take the Crown's minerals out of the ground and sell them to their customers. Often, royalties are set at the rate of $X per tonne. The more tonnes you take, the more you pay. So royalties are a cost of production.

The rationale for the misleadingly named RSPT is that it will replace the present mineral royalties charged by state governments, which are both unfair and inefficient. They're unfair because the owners of the minerals – you and me – are getting a price for them that's now much lower than they're worth.

They're inefficient because they make no distinction between mines with high extraction costs and those with low costs, meaning they discourage mining activity that would otherwise occur.

The beauty of the new resource tax is that it charges miners for the minerals they use on the basis of the level of profit they're making. When world commodity prices are high the RSPT will increase; when world prices are low the RSPT will decrease.

So in demonstrating the case for a new way of charging for our minerals, it is relevant to look at how royalties have changed relative to profits since the start of the resources boom.

Figures prepared by Treasury show that over the five years to 2003-04, royalty payments averaged 32 per cent of profits. By 2008-09, however, this had slipped to 14 per cent. Using the source preferred by the Minerals Council, its figures imply the miners' royalty payments in 2007-08 were 13.5 per cent of profits – little different.

So, as world prices rose the increase in royalty payments fell far short of the increase in profits. The miners

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received a windfall, but this wasn't shared with the owners of the resources now so much more valuable. (The explanation of the various taxes paid by Miners is based on an article by Ross Gittins in the SMH, 29/05/10).

Briefly, the economic implications have not been adequately quantified by the government, based on the original form of the announced RSPT:

- Compared to other countries Australia becomes less competitive and employment numbers have reduced.
- There is clear evidence that mining projects have either been deferred or mothballed as the squeeze on Australia gathers momentum. The Eureka Report states that "270 major Aust. resource projects with a value of $320m are undergoing review".
- There is the likelihood of the RSPT increasing longer-term interest rates due to the domestic cost of capital rising as the squeeze on Australia gathers momentum due to higher global and domestic interest rates and downward revisions in certain the credit ratings of certain overseas countries.
- The RSPT is intended to redistribute wealth, a sound objective per se, but there has been little mention of the possible leakages which could distort the outcome.

From a Portfolio perspective lower (inflation adjusted) stock prices leads creates opportunities, but when markets become more volatile they are prudently postponed.

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