

Instalment Warrant Amendments: Implications for SMSF 'Develop and Hold' Strategies



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Real estate investments are generally capital-intensive and often require a mixture of debt and equity to undertake. Traditionally, superannuation funds were prohibited from borrowing thus preventing many SMSFs from participating in the real property market, at least directly.¹ Whilst this general prohibition remains, there are limited exceptions including, as of 24 September 2007, limited recourse borrowings under instalment warrant arrangements.²

Instalment warrants facilitated geared investments by SMSFs in real property, including development activities as part of a 'develop and hold' strategy. However, on 26 May 2010, the *Superannuation Industry (Supervision) Amendment Bill 2010* ("Bill") was introduced into parliament proposing to amend the *Superannuation Industry (Supervision) Act 1993* ("SIS Act") in order to reduce perceived prudential risks relating to the use instalment warrant arrangements. If passed in its current form, the Bill will have major implications for instalment warrant arrangements and geared self-managed superannuation fund ("SMSF") investments in real property specifically.

WHAT IS AN INSTALMENT WARRANT?

As the Commissioner of Taxation ("Commissioner") notes:³

"Instalment warrants are a form of derivative or financial product that entails borrowing to invest in an asset, such as a share or real property (the underlying asset), with limited risk to the investor . . . the underlying asset is held on trust during the life of the loan to provide limited security for the lender."

Essentially, a trustee ("Custodian") holds legal title to an asset under a bare trust arrangement with the beneficial title to the underlying asset held by the SMSF. Upon payment of all instalments, the trustee transfers the underlying asset to the SMSF.

In the event of default, the Custodian is able to sell the underlying asset to recoup the outstanding instalments and other relevant expenses. However, the extent of the SMSFs indebtedness is limited to the underlying asset such that any deficiency following the exercise of the Custodian's power of sale is borne by the lender, with no recourse to the other assets of the SMSF.

CONDITIONS FOR INSTALMENT WARRANT BORROWINGS BY SMSFS

Under the current provisions⁴, the following conditions must be met in order to come within the instalment warrant exception to the general borrowing prohibition:

1. the borrowed funds are used to acquire an asset which the fund is not otherwise prohibited from acquiring;
2. the asset acquired (or a replacement asset) is held on trust (the holding trust) so that the fund receives a beneficial interest in the asset;
3. the SMSF has the right to acquire legal ownership of the asset (or the replacement asset) by making one or more payments after acquiring the beneficial interest;
4. any recourse that the lender has under the arrangement against the SMSF trustee is limited to rights relating to the asset acquired (or the replacement asset).

Under the current legislation, although some debate exists as to whether the requirement to use the borrowed funds to acquire 'an asset' extends to the payment of expenses for capital improvements to real property, which would generally involve a contract for the provision of goods and services, the Commissioner expressly approves of such use:⁵

"Improving real property involves changing the property into a more desirable or valuable form – for example, by extending the property's income-producing ability, or enhancing its saleability or market value. When improvements materially alter the character of the original asset, they create a replacement asset for the purposes of subsection 67(4A) of the SISA. Under subsection 67(4A), the replacement asset is not limited to any particular type of asset but must be an asset that the SMSF trustee is not prohibited from acquiring. Assuming that the original property was an asset that the SMSF trustee was permitted to acquire, the improved property will be a replacement asset."

The term 'replacement asset' is not defined under the current legislation and again there is considerable debate as to its scope. In fact, prior to the introduction of the Bill, the only guidance as to its meaning was that outlined by the National Taxation Liaison Group Superannuation Technical Sub-Group,⁶ which did no more than highlight the term's capacity for multiple interpretations. The merits of a broad view (supported by the professional bodies) versus a narrow view (supported by the Australian Taxation Office and the Australian Securities and Investment Commission) were scantily addressed but ultimately there was no conclusion either way.

Further, the Commissioner expressly approved the acquisition of multiple assets (including real property acquisitions) under a single instalment warrant arrangement.⁷

Often, particularly in the context of instalment warrant arrangements involving real property, financiers require the provision of additional security outside the instalment warrant arrangement to supplement its limited recourse to the underlying asset and therefore reduce its overall lending risk. For example, the lender may require a personal guarantee by a SMSF member secured by mortgage over that member's family home or an investment property. Again, the Commissioner expressly approves of such arrangements under the current legislation.⁸

THE PROPOSED AMENDMENTS

The Bill proposes to amend the SIS Act so that, among other things:

1. instalment warrant arrangements may only be entered into in relation to the acquisition of a single asset or a collection of identical assets with the same market value;
2. SMSF trustees cannot borrow to make capital improvements to real property;
3. the relevant asset can only be replaced in very limited circumstances; and
4. the rights of any person against the SMSF trustee in relation to a default under the instalment warrant arrangement is limited to rights relating to the underlying asset.

Acquirable assets

The Bill introduces the concept of a single 'acquirable asset' which is defined as a singular asset with the exception of limited collections of identical assets. The Explanatory Memorandum to the Bill ("EM") gives the following examples of a collection of assets that can be treated a single 'acquirable asset' under the proposed amendments:

1. a collection of shares of the same type in a single company;
2. a collection of units in a unit trust that have the same fixed rights attached to them; and
3. a collection of economically equal and identical commodities.

Conversely, the EM gives various examples of a collection of assets that would not be permissible under the Bill including:

1. a collection of shares in different entities; and
2. a collection of buildings each under a separate strata title, irrespective of whether the buildings are substantially the same at the time of acquisition.

This means that an instalment warrant arrangement can only be used to acquire a single asset, other than as outlined above. That is, a single instalment warrant arrangement cannot be used to fund the acquisition of two separate properties or even a parcel of ordinary shares in a range of blue-chip companies.

Capital improvements

The EM clarifies that borrowed funds under an instalment warrant arrangement may be used for the acquisition, maintenance and repair of an acquirable asset in order to ensure its functional value is not diminished. However, the EM continues to state that the borrowed funds cannot be used to:

"improve the asset, as this would fundamentally change the nature of the asset used as security by the lender, potentially increasing the risk to the fund."

This view presents particular difficulties with regard to renovation plays in which a run-down property is purchased for renovation prior to letting. If a single acquirable asset is purchased in such a state as to require repairs so as to return its functional value lost over a period of time prior to the Custodian's ownership, is this considered an improvement? If so, it may be appropriate to purchase the acquirable asset with borrowed funds and use the equity of the SMSF to meet the renovation expenses, however, at which point the repairs become an improvement in any event so

as become a replacement asset is not known. Although the common law surrounding the distinction between repairs versus improvements in the context of the deductibility of the outgoings generally may provide some guidance in this regard,⁹ these issues will take on increased prominence in this context.

Replacement assets

The EM notes that the current regime creates uncertainty over what constitutes a replacement asset and that this gives rise to arrangements that could place funds at risk. In addition, the EM offers the following examples of circumstances not permitting a replacement asset, including:

1. securities liquidated or traded or both for different assets only as a consequence of implementing an investment strategy;
2. money or cash is not eligible as a replacement asset under any circumstances;
3. the replacement of an asset arising from an insurance claim covering loss of an original asset;
4. the replacement by way of improvement of real property; and
5. a series of titles over land replacing a single title over land that has been subdivided.

Therefore, to return to the example above with regard to the renovation play, even if equity of the SMSF is used to avoid the use of borrowed funds to carry out capital improvements, such improvements will render the property something different to the asset originally acquired and as the property would fall outside the permissible replacement assets under the Bill, will not be permitted.

Extension of limited recourse requirements

As outlined above, under the current legislation, a personal guarantee may be provided to the lender in addition to the limited recourse security provided by the Custodian.

At law, when a guarantee is called upon by a lender following default by the borrower, the guarantor (who provided the guarantee) has a right to recover the amount paid to the lender from the defaulting party, that is, the guarantor has a right to indemnity against the borrower. Presently, the guarantor is not required to waive their right to indemnity against the SMSF borrower in the event that the lender calls upon the guarantee. The Commissioner has previously identified his concern that in the event of default, although the lender’s recourse may be limited to the underlying asset of the Custodian, the guarantor’s right of indemnity may not be so limited thus putting the assets of the SMSF at risk.¹⁰

The Bill seeks to restrict the rights of not only the lender but also any other person (including a guarantor) in relation to any default under an instalment warrant arrangement. The EM notes:

“[the proposed amendments] seek to protect fund assets from such claims by limiting the rights of the lender or any other person . . . for or in connection with or as a result (direct or indirect) of a default on a borrowing or charges related to the borrowing, to rights relating to the acquirable asset. In this way, a guarantor’s rights . . . are limited as the rights of the lender are limited, so that no claim . . . should arise which could give rise to a claim for indemnity from fund assets. That is, a charge may be given over an asset that is acquired through a borrowing arrangement in order to secure that borrowing, but no other charge is permitted.”

RE-DEVELOPMENT STRATEGIES

A popular investment strategy involves the purchase of a block of land or a run-down house for re-development such as a known-down rebuild. The aim is to achieve an equity gain in the form of increased capital value over the cost to buy and build which also pushes up yield relative to paying market value for the end product. Consider the following:

Example 1 – Duplex re-development

The trustee of an SMSF wishes to purchase a large block with an old weatherboard house on it suitable for re-development as a duplex. The total cost will be as follows:

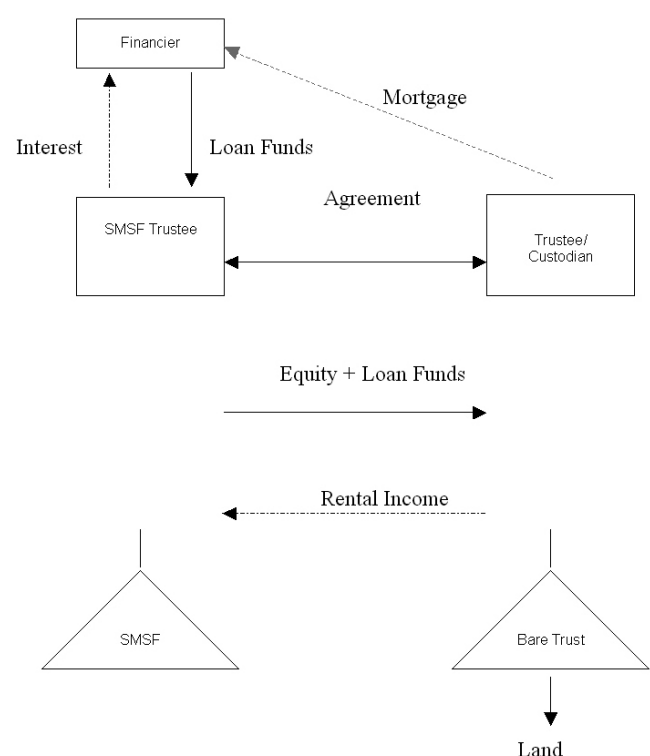
Land	\$450,000
Stamp Duty	\$ 15,000
Demolition	\$ 10,000
Construction	\$350,000
Subdivision	\$ 15,000
Other	\$ 10,000
Total	\$950,000

After conducting the necessary research, the end-value based on comparable properties for both dwellings will be approximately \$1,200,000 (a potential equity gain of \$250,000).

The SMSF has \$500,000 in available funds and the trustee, in accordance with the fund’s investment strategy,¹¹ will allocate \$400,000 to real property. Therefore, there is a difference between available equity and the cost of the re-development which may be met by entering into an instalment warrant arrangement in the amount of \$550,000 to fill the funding gap.

This arrangement may be depicted in Figure 1.

Figure 1. Instalment warrant arrangement to fill a funding gap



Under the current legislation:

1. the Commissioner accepts that borrowed funds under the instalment warrant arrangement may be used to undertake capital improvements to the land;
2. the term, 'replacement asset' is capable of broad interpretation and arguably covers each of the newly subdivided dwellings (each one with their own separate title) following completion of construction; and
3. the Commissioner accepts that a single instalment warrant arrangement can be used to acquire more than one asset.

If the proposed amendments are introduced in their current form, where the same strategy is adopted:

1. paragraph 67A(1)(a) of the SIS Act will apply to prevent the SMSF trustee from accessing the exception to the general prohibition against borrowing as the funds have been used, at least in part, to meet expenses related to capital improvements which fall outside the definition of a single acquirable asset; and
2. even if paragraph 67A(1)(a) of the SIS Act did not apply, the newly subdivided blocks do not fall within limited definition of a replacement asset in section 67B of the SIS Act and once again the exception to the general borrowing prohibition cannot apply.

Example 2 – Single dwelling re-development

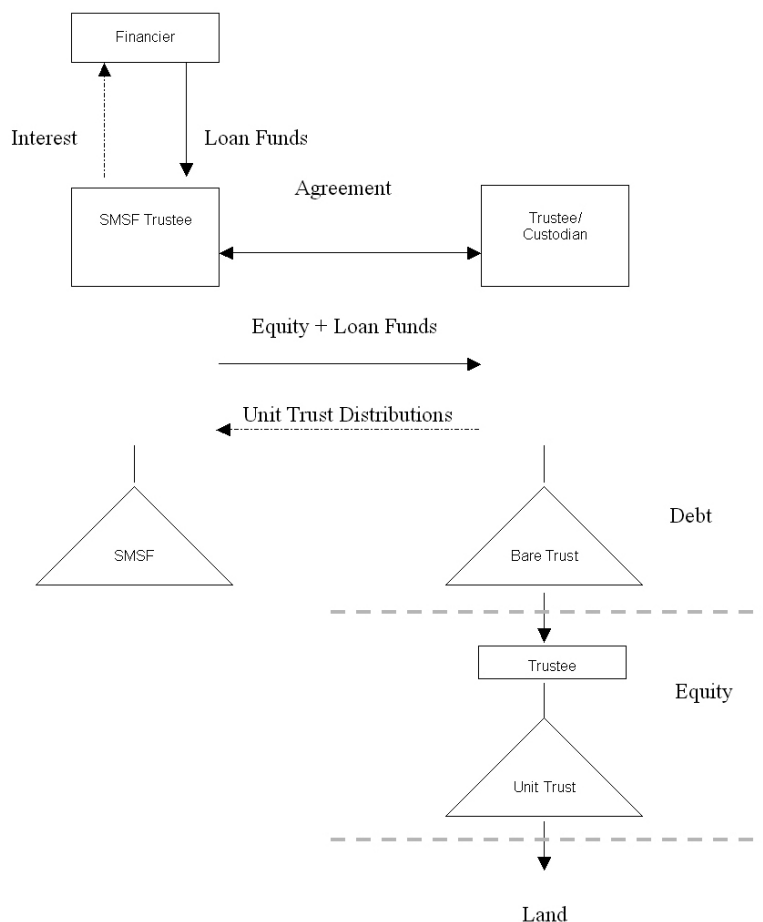
Assume the same facts as above except the proposal relates to the development of a single dwelling only (and thus there are no subdivision costs). Under the current legislation:

1. the Commissioner accepts that borrowed funds under the instalment warrant arrangement may be used to undertake capital improvements to the land; and
2. even though capital improvements in the context of re-development are likely to be considered to have materially altered the original asset so as to become a replacement asset, it is a permitted replacement asset by virtue of the above.

If the proposed amendments are introduced in their current form:

1. the initial purchase of the property will fall within the definition of a single acquirable asset, however;
2. paragraph 67A(1)(a) of the SIS Act will apply to prevent the SMSF trustee from accessing the exception to the general prohibition against borrowing as the funds have been used, at least in part, to meet expenses related to capital improvements which fall outside the definition of a single acquirable asset; and
3. even if paragraph 67A(1)(a) of the SIS Act did not apply, the new dwelling will not fall within limited definition of a replacement asset in section 67B of the SIS Act and once again the exception to the general borrowing prohibition cannot apply.

Figure 2. Instalment warrant arrangement to subscribe for units in a unit trust



WHAT ARE THE OPTIONS GOING FORWARD?

Based on the above, if the Bill is introduced in its current form, it will no longer be possible for SMSFs to gear directly into re-development strategies.

For smaller SMSFs without the necessary capital to undertake such investments, trustees will be faced with the prospect of forgoing participation in these arrangements or either:

1. gearing into a unit trust which in turn carries out the re-development activities; or
3. utilising the un-related trust exception to the in-house asset rules.

The rules regulating these arrangements are well known, however, they are likely to take on renewed significance following the passage of the Bill into legislation.

The un-gearred unit trust exception

Assume the same facts as in Example 1 above, however, instead of gearing into the re-development directly, the SMSF enters into an instalment warrant arrangement to subscribe for units in a unit trust.

This arrangement may be depicted in Figure 2.

Generally, the unit trust will be an in-house asset of the SMSF as it will be a related trust. A related trust includes a trust that a member of a fund controls within the meaning in section 70E of the SIS Act.¹³

A member of an SMSF controls a trust if:¹⁴

1. a member or a group in relation to the member has a fixed entitlement to more than 50 per cent of the capital or income of the trust;
2. the trustee of the trust, or a majority of the trustees of the trust, is accustomed to or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of a member of a group in relation to the member; or
3. a member or a group in relation to the member is able to remove or appoint the trustee, or a majority of the trustees, of the trust.

In turn, a 'group' for present purposes means:¹⁵

1. an entity acting alone;
2. a Part 8 associate of the entity acting alone;
3. the entity and one or more Part 8 associates of the entity acting together; or
4. 2 or more Part 8 associates acting together.

A Part 8 associate of an individual member includes:¹⁶

1. a relative of the primary entity (the member);
2. if the primary entity is a member of a superannuation fund with fewer than 5 members (generally SMSFs):
 - (a) each other member of the fund; and
 - (b) if the fund is a single-member SMSF whose trustee is a company – each director of that company; and
 - (c) if the fund is a single member SMSF whose trustees are individuals – those individuals.

3. a partner of the primary entity or a partnership in which the primary entity is a partner;
4. if a partner of the primary entity is an individual – the spouse or a child of that individual;
5. the trustee of a trust (in the capacity as trustee of that trust), where the primary entity controls the trust;
6. a company that is sufficiently influenced by, or in which a majority voting interest is held by:
 - (a) the primary entity;
 - (b) another entity that is a Part 8 associate of the primary entity because of any of the above; or
 - (c) two or more entities covered by the above.

Note, a relative is broadly defined to include ancestors, siblings, descendants and spouses of thereof.¹⁷

Therefore, as the SMSF member will likely act as the trustee of the unit trust or a director of the corporate trustee, either alone or together with relatives, the unit trust will be a related trust of the SMSF and therefore fall within the general definition of an in-house asset.

However, a unit trust that is a related trust is specifically excluded from the definition of an in-house asset of an SMSF where it is of the kind referred to in the *Superannuation Industry (Supervision) Regulations* ("SIS Regs") as so excluded.¹⁸

The SIS Regs state that a related trust will not be an in-house asset where it satisfies the following criteria:¹⁹

1. the trustee of the trust has not leased trust property to a related party (with the exception of business real property);
2. the trust does not have any borrowings;
3. the assets of the trust do not include:
 - (a) an interest in another entity;
 - (b) a loan to another entity;
 - (c) an asset over which, or in relation to which, there is a charge;
 - (d) an asset that was acquired from a related party of the SMSF after 11 August 1999 (except business real property acquired for market value);
 - (e) an asset that had been owned by a related party of the SMSF at any time in the previous three years (except business real property acquired for market value);
4. the trust does not carry on a business; and
5. the trust conducts all transactions on an arm's length basis.

Therefore, it will be possible following the introduction of the proposed amendments to gear into a unit trust which in turn carries out the re-development without offending the borrowing prohibition. In this way, the borrowings are at the SMSF level used to acquire units in a unit trust which, provided the units are fixed and carry uniform rights will fall within the definition of a single acquirable asset. The Unit Trust on other hand is fully capitalised and has no borrowings.

One practical consideration, however, is that third party financiers may be un-willing to lend on the security of the units alone and require personal guarantees on behalf of the SMSF members secured by assets outside the SMSF. Remember, in

order to maintain the exception to the in-house assets rules, any such security must not only be outside the SMSF, but also outside the Unit Trust. In this regard, the Commissioner has acknowledged that it is permissible to borrow from related parties under an instalment warrant arrangement.²⁰ However, considerable care must be taken so as to ensure that the loan approximates commercial terms so as to avoid breaching prudential standards under the SIS Act, including:

1. the prohibition against the provision of financial benefits or financial assistance to a member or relative of a member;²¹ and
2. the sole purpose test.²²

In addition, if in the event that a third party lender requires a personal guarantee from a member of the SMSF, it will be necessary to consider the Commissioner's views in Taxation Ruling TR 2010/1. Here, the Commissioner argued that rights of the guarantor against the SMSF must be limited to the underlying asset of the Custodian, meaning that any guarantee should include an express limitation or waiver of any right of indemnity such that the guarantor has no recourse to other assets of the SMSF. However, the Commissioner also notes in TR 2010/1:

"a guarantor who satisfies a loan obligation of a superannuation provider may be taken to benefit the fund members in circumstances where the guarantor has no, or forgoes their right of, redemption against the superannuation provider. There may be a commercial reason for providing the guarantee (for example, the loan would not have been made to the superannuation provider without the guarantee) or indeed for satisfying the liability of the fund (the contractual requirements of the guarantee itself). However, the failure to deal with superannuation provider on a similar commercial basis in satisfying the fund's obligation means that it may be reasonably inferred that the guarantor's purpose is to provide benefits for the members of the fund."

Further, the Commissioner considers that a contribution by way of debt forgiveness will be taken to occur when the lender executes a deed of release that relieves the trustee of an SMSF from the obligation to repay a loan to the lender.²³ In terms of the timing of such contributions, the Commissioner adds:²⁴

"If a guarantor makes a contribution by paying a debt of a superannuation provider, when the contribution is made will be determined by whether or not the guarantor has a right to be indemnified by the superannuation provider. If the guarantor has no right of indemnity, the contribution is made when the superannuation provider's liability is satisfied. If the guarantor has a right of indemnity, a contribution is only made when the right of indemnity expires, for example, because of the operation of the statute of limitations of actions or when the guarantor takes formal steps to forgo that right, for example, by executing a deed of release."

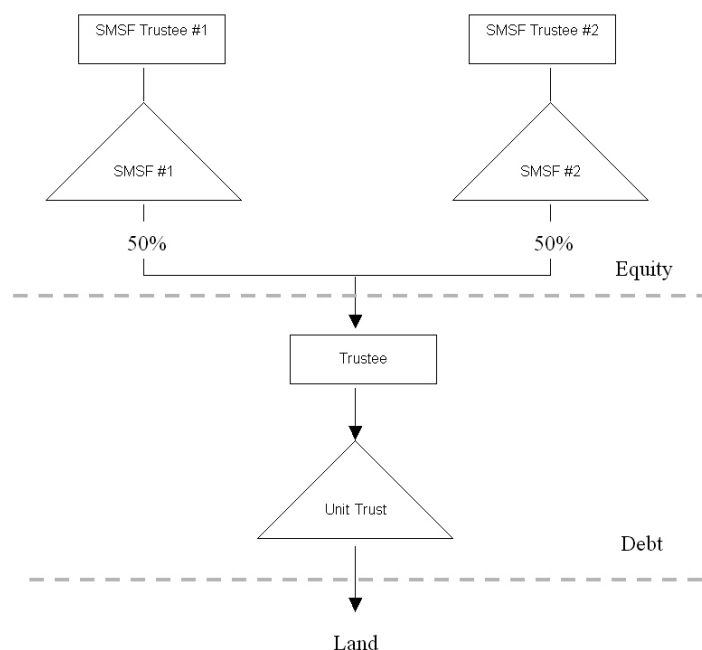
The Commissioner's views have major implications with regard to contributions tax and beneficiaries' contributions caps. As such, personal guarantees may become less popular going forward with lenders compensated for increased lending risk by, for example, lower loan-to-valuation ratios, increased interest rates, or both.

The un-related trust method

In circumstances where an opportunity arises that a single SMSF is unable to take advantage of, either using its own equity or with the use of borrowed funds, two or more un-related parties, for example, two life-long friends, may seek to establish a unit trust via their respective SMSFs in equal shares and take advantage of the fact that the unit trust will not be a related trust of either.

As the respective SMSF trustees will not be seeking to rely on the un-gearing trust exception, each SMSF may subscribe for units of a nominal value, for example, 10 \$1 units each, and have the trustee of the unit trust enter into a full recourse loan with a

Figure 3. The unrelated trust method



third party financier. Even if personal guarantees are required by members of the SMSFs secured by assets other than SMSF assets and even if they are called upon to meet any deficiency in the event of default, the Commissioner's views in TR 2010/1 are irrelevant as there is no obligation on behalf of the respective SMSF trustees.

This arrangement may be depicted in Figure 3:

Based on the above, despite the extensive definition of a Part 8 associate, which feeds into the definition of a group tracing back to the issue of control in determining whether a trust is a related trust of an SMSF, it is clear that two unrelated friends (who are not otherwise partners in a partnership) do not fall within the definition. As such, even though the members' respective SMSFs are each entitled to 50 per cent of the income and capital of the unit trust, neither member will be taken to have a fixed entitlement to *more than 50 per cent* of the income and capital of the unit trust as the definition requires and therefore, the Unit Trust will not be a related trust (and therefore an in-house asset) of either SMSF.

Of course, falling outside the definition of a related trust is also predicated on the trustee of Unit Trust not being accustomed, or under an obligation or reasonably expected to act in accordance with either member's wishes or where only one member acts as appointor of the Unit Trust and thus able to control the trust via the removal and appointment of the trustee.

OTHER CONSIDERATIONS

Although the public trading trust provisions may potentially apply to tax a unit trust as a company in circumstances where 20 per cent or more of the units are held by a superannuation fund,²⁵ it is strongly arguable in these circumstances that the development activity falls outside the definition of a 'trading business' as the purpose of the development activity is to derive passive rental income and long-term capital growth.

Further, it is critical to ensure that all relevant dealings are on arm's length terms. There are four types of 'special income' of an

SMSF that will be assessed at the top marginal tax rate (currently 45 per cent):²⁶

1. private company dividends;
2. non-arm's length income derived from a scheme where the parties were not dealing at arm's length;
3. distributions from a discretionary trust; and
4. non-arm's length income derived in the capacity of a beneficiary holding a fixed entitlement where that entitlement was derived under a scheme, the parties to which were not dealing at arm's length.

Therefore, in order to avoid the punitive tax rates that apply to non-arm's length income, it is important for related parties (who prima facie are not considered to be at arm's length) to ensure that they actually deal at arm's length. That is, to ensure that any dealing approximates that which may have been struck with an arm's length third party in the market.

CONCLUSION

If introduced in its current form, the Bill will result in major changes to the instalment warrant landscape, especially with regard to direct gearing into development activity as part of a 'develop and hold' strategy.

However, alternative structuring options will remain so as to enable SMSF trustees to participate in such investments. Although care must be taken in the establishment and operation of such arrangements in order to avoid the prudential pitfalls of the SIS Act, SMSF members will not be forced to forgo participation in such potentially lucrative investments as part of the fund's overall investment strategy. Like any other SMSF asset, real property may be used to support pension payments so as quarantine unrealised capital gains from tax as well as provide a tax-free income stream (subject to various conditions). This can considerably boost retirement incomes and it is therefore incumbent on SMSF trustees and their advisors to be aware of alternative methods of achieving optimal retirement outcomes. ●

NOTES

- 1 *Superannuation Industry (Supervision) Act 1993*, section 67
- 2 *Superannuation Industry (Supervision) Act 1993*, subsection 67(4A)
- 3 'Limited recourse borrowing arrangements by self-managed super funds – questions and answers' (available at <http://www.ato.gov.au/print.asp?doc=/content/00132054.htm>)
- 4 Note 2
- 5 Note 3
- 6 NTLG Superannuation Technical Sub-Group Minutes – 16 June 2008
- 7 Note 3
- 8 Note 3
- 9 See *Law Shipping Co Ltd v Inland Revenue Commissioners* (1923) 12 TC 621; *W Thomas & Co Pty Ltd v FCT* (1966) 115 CLR 58; *FCT v Western Suburbs Cinemas Ltd* (1952) 88 CLR 10 and the Commissioner's views in Taxation Ruling TR 97/23
- 10 Taxpayer Alert 2008/5
- 11 *Superannuation Industry (Supervision) Act 1993*, paragraph 52(2)(f)

- 12 *Superannuation Industry (Supervision) Act 1993*, subsection 66(1)
- 13 *Superannuation Industry (Supervision) Act 1993*, subsection 10(1)
- 14 *Superannuation Industry (Supervision) Act 1993*, section 70E
- 15 *Superannuation Industry (Supervision) Act 1993*, subsection 70E(3)
- 16 *Superannuation Industry (Supervision) Act 1993*, subsection 70B
- 17 *Superannuation Industry (Supervision) Act 1993*, subsection 10(1)
- 18 *Superannuation Industry (Supervision) Act 1993*, sub-paragraph 71(1)(j)(ii)
- 19 *Superannuation Industry (Supervision) Regulations*, reg 13.22C
- 20 Note 3
- 21 *Superannuation Industry (Supervision) Act 1993*, section 65
- 22 *Superannuation Industry (Supervision) Act 1993*, section 62
- 23 Taxation Ruling TR2010/1 at para 209
- 24 Note 23 at para 210
- 25 *Income Tax Assessment Act 1936*, Division 6C
- 26 *Income Tax Assessment Act 1997*, section 295-550

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