



Entrusting the trustees: the regulation of self-managed superannuation funds in Australia

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Declaration of Originality

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Abstract

Self-managed superannuation funds (SMSFs) are a uniquely Australian retirement savings vehicle which are constituted as trusts with one to four members, each of which must be a trustee of the fund unless under a legal disability. SMSFs have become so popular in recent years that as a sector they are now the largest in terms of number of funds and assets under management, yet very little academic study has been directed at this important sector to date.

The intent of this thesis is to evaluate the regulation - both statutory and supervisory - of the SMSF sector, which has, since 1999, been subject to the supervisory regulation of the Australian Taxation Office. As a starting point, the regulation of SMSFs can be characterised as extremely difficult because of their private nature and sheer numbers.

An examination of the demographic characteristics and motivations of the SMSF trustees forms part of this evaluation, as does an international comparison with selected western countries where self-directed superannuation is permitted. What is apparent is that the Australian SMSF enjoys a freedom unparalleled elsewhere and under that regime appears to be performing very well in enhancing its members' retirement savings.

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CHAPTER 1

INTRODUCTION

1.1. Background to the study

1.1.1. The importance of superannuation

Concern for the present and future problems associated with ageing populations in developed societies is neither new nor peculiar to countries such as Australia. It is now commonly referred to as a 'demographic time bomb'.¹ However, an ageing population is merely one of the symptoms underlying social disequilibrium.² It is often accompanied by a decreasing birth rate, limited tax revenue and longstanding disagreements over raising taxes.

The third intergenerational report released by the Australian Treasurer in February 2010³ highlighted the burden of an ageing population on health, aged care and welfare expenditure, a burden borne on the shoulders of a shrinking number of taxpayers. If retirees are not supporting themselves financially, they will be depending on a shrinking proportion of younger people in the workforce who must pay an increasing percentage of their incomes in taxes to the government to be spent on feeding, housing and providing medical treatment for those retirees. In addition, an increasing percentage of the working population will be engaged in providing such services to the elderly.

¹ Ross Gittins, 'Australia's demographic time bomb', *The Age* (Melbourne), 21 September 2005, 2; Tania Branigan, 'China faces 'timebomb' of ageing population' (20 March 2012) *The Guardian* <<http://www.guardian.co.uk/world/2012/mar/20/china-next-generation-ageing-population>>

² According to Functionalists, society is a complex system whose parts work together to promote solidarity and stability. In the most basic terms, it simply emphasizes "the effort to impute, as rigorously as possible, to each feature, custom, or practice, its effect on the functioning of a supposedly stable, cohesive system. (John J Macionis and Linda M Gerber, *Sociology* (7th ed, 2010), 14).

³ Australian Treasury, 'Intergenerational Report ' (2010).

Longevity risk (the risk that an individual will outlive his/her retirement savings), caused by increasing life expectancy⁴ creates a projected retirement savings gap of some \$836 billion or \$79,200 per person,⁵ - being the value for the working population of the shortfall they will have in building an adequate or reasonable retirement benefit. Success of government retirement income policy and consequent enhancement of individual savings can be measured through a reduction in the gap over time. Retirement was once a luxury enjoyed only by few; in modern Australian society it is an expectation for practically all.⁶ And for most people the time will come when their health and strength declines to the point where they cannot work to support themselves and must therefore rely on either their own savings or the public purse.

The Australian government has, since July 1909, provided some form of Age Pension,⁷ which is today an integral part of the retirement income of more than 66% of Australians.⁸ Since 1912 means testing of Age Pension eligibility has been imposed, however because of the ageing of the population and recognising the extent of longevity risk and savings gap facing the population, (then) Federal Treasurer Paul Keating became the original architect of Australia's modern superannuation system,⁹ and the Keating Labor government introduced compulsory employer-sponsored superannuation in 1992.

Governments around the world face similar problems where populations are ageing and have used a variety of policies to manage longevity risk, including raising retirement ages, expanding private pension coverage and, as in Australia, increasing mandatory

⁴ Australian Government Actuary, 'Australian Life Tables 2005-07' (2007).

⁵ As at 30 June 2011: Rice Warner Actuaries, 'Retirement Savings Gap at June 2011 (Prepared for the Financial Services Council)' (2012) at 4.

⁶ Organisation for Economic Co-operation and Development, 'Pensions at a Glance 2011: Retirement Income Systems in OECD and G20 countries' <<http://www.oecd-ilibrary.org/docserver/download/fulltext/8111011e.pdf?expires=1306301844&id=id&accname=guest&checksum=35AFDF9AFFC523669F123D62EEA72B76>> at 98.

⁷ See Australian Bureau of Statistics, 'History of Pensions and Other Benefits in Australia' (2009) <<http://www.abs.gov.au/ausstats/abs@.nsf/94713ad445ff1425ca25682000192af2/8e72c4526a94aaedca2569de00296978!OpenDocument>>

⁸ At 30 June 2011, there were around 2.23 million Age Pensioners, representing more than two-thirds of the Australian population over pension age. Expenditure on the Age Pension program has been growing due to policy changes and Australia's ageing population. In 2011-12, it is estimated that Age Pension expenditure will rise to \$34 billion: Housing Department of Families, Community Services & Indigenous Affairs, '2010-11 Annual Report' (2011) at 89.

⁹ P J Phillips, M Baczynski and J Teale, 'Self managed superannuation funds and the bear market of 2007-2008' (2009) 3(1) *Australasian Accounting Business and Finance Journal* 38 at 56.

contribution rates.¹⁰ As part of expanding private pension coverage, Australia has encouraged, through tax concessions, the proliferation of self-managed superannuation funds (SMSFs) wherein individuals control the investment of their own retirement savings. The genesis and history of this burgeoning sector of the superannuation industry is explored in detail in Chapter 2.

1.1.2. What is superannuation?

In order to appreciate the place of the SMSF in the system, it is important to understand the meaning of 'superannuation'. Superannuation is the provision of retirement and other permitted benefits such as disability benefits, either by lump sum or pension, to persons who are entitled to receive the benefits.

The Australian Labor government's *Review into the governance, efficiency, structure and operation of Australia's superannuation system 2010* hereafter referred to as the 'Super System Review' noted that superannuation is not merely another financial product, but an overarching social policy objective,¹¹ namely to assist and encourage people to achieve a higher standard of living in retirement than would be possible from the Age Pension alone, and with this to ensure Australians have security and dignity in their retirement.¹²

The self-managed superannuation fund sector has become a major part of Australia's superannuation system and has achieved extraordinary prominence, particularly over the last five years, as the numbers of funds continue to proliferate. There are close to 470,000 SMSFs in Australia and the numbers increase daily. They comprise the largest sector of the superannuation industry by numbers of funds and value of assets under management. SMSFs are regulated by statute and the common law, and in a

¹⁰ Organisation for Economic Co-operation and Development, 'Pensions: Raising retirement ages and expanding private pension coverage essential, says OECD' (2012)

<http://www.oecd.org/document/35/0,3746,en_21571361_44315115_50555875_1_1_1_1,00.html>

¹¹ Commonwealth of Australia, 'Phase One – Preliminary Report - 'Clearer Super Choices: Matching Governance Solutions'' (2009) at 6.

¹² Explanatory Memorandum to the *Tax Laws Amendment (Simplified Superannuation) Bill 2006* at 186.

supervisory sense by the Australian Taxation Office (ATO).¹³ However, since the ATO took over supervisory regulation in 1999, there has been very limited appraisal of its effectiveness in that role.

1.1.3. What is regulation?

In beginning the examination of the effectiveness and appropriateness of the ATO's regulation of the SMSF sector, it is apposite to consider what regulation means and why regulation is necessary. To 'regulate' is to control, govern, or direct by rule or regulations; to subject to guidance or restrictions; to adapt to circumstances or surroundings.¹⁴ In classical terms, regulation is effected by statute. The State intervenes through traditional command and control regulation, which means that the standards imposed are backed by civil or criminal sanctions, or both.¹⁵ There are various rationales for regulation, prime amongst them being market failure. It has been observed that '[a]n alleged inability of market or sector to manage its structural problems will suffice to justify a regulatory intervention', and that '[t]here is the general underlying assumption that an intervention by means of the introduction of rules by the state works as a corrective'.¹⁶ The same commentator adds that '[a] market failure gives rise to a policy issue', and that '[t]he usual, first response by governments to perceived policy issues is to regulate'.¹⁷

Regulation of superannuation in the market failure context is directed towards 'correcting the market failures in annuities markets that necessitate pension funds and social security'.¹⁸

Apart from market failure, it can also be argued that enhancing equity, adequacy, and security of pension arrangements can be seen as objectives of pension-fund regulation

¹³ The preferred abbreviation is currently 'the ATO'; previously it was 'the Tax Office'. The latter term is used in this thesis where it appears in a quote.

¹⁴ The Oxford English Dictionary, Volume XIII, 1991, 525.

¹⁵ Myriam Senn, *Non-State Regulatory Regimes* (1st ed, 2011).

¹⁶ Ibid 7.

¹⁷ Ibid 12.

¹⁸ E. Philip Davis, *Pension Funds: Retirement-Income Security, and Capital Markets* (1995) 93.

independent of financial aspects. Tax privileges to pension funds underpin this alternative approach.¹⁹

Regulations may be divided into regulation of the assets of superannuation funds, regulation of their liabilities (that is, provisions relating to benefits) and aspects of the structure of regulation. The latter, when examining the superannuation system of a particular country, may include plurality of regulatory bodies, state versus federal jurisdictional issues and the integration of superannuation and social security systems.

The integration of superannuation and social security in Australia is not entirely successful. As Davis notes:

Concerns over exploitation of integration have come to the fore in Australia, where state pensions are subject to means tests based on wealth and income; savings anticipated by the introduction of private pensions may not be realized if members of private schemes take benefits in a lump sum and dissipate them prior to eligibility for social security, thus obtaining a maximum state pension too. Known as 'double dipping', this phenomenon seems to argue for compulsory purchase of annuities with pension-fund monies.²⁰

In addition to this problem, common to all sectors of superannuation in Australia, SMSFs members' capital may be more readily exhausted by illegal early access or by investment mismanagement, allowing affected members access to the government Age Pension at age 65. The taxation concessions enjoyed by that capital whilst protected within the SMSF, at the expense of the remainder of society without SMSFs, will therefore have been squandered. Government policy underlying retirement income is directed at managing the longevity risk. The risk is perceived to be greater for SMSFs than for funds regulated by the Australian Prudential Regulation Authority (APRA) because of the fact that SMSF members have direct control of, and access to, their own retirement savings.

Regulation in this thesis is examined in two senses: firstly, the statutory regime under which SMSFs operate, secondly the supervisory regulation undertaken by the relevant government instrumentalities.

¹⁹ Ibid 91.

²⁰ Ibid 113.

1.2. Aim and overview of the thesis

Stated at its most basic, the aim of this thesis is to identify improvements in the regulation of SMSFs in Australia, beginning with the assumption that such regulation, either in a legislative or supervisory sense, is not ideal or complete.

The thesis commences with an historical excursus into the history of self-managed superannuation in Australia, found in Chapter 2. Chapter 3 then examines the characteristics of members of SMSF, all of whom must also be trustees, comparing them with characteristics of members of APRA-regulated public funds. The material in these chapters is descriptive and sociological in character. It outlines the development of the SMSF as a retirement income vehicle, examines the demographics and motivations of the individuals who make up the SMSF trustee population, explains the regulatory bodies involved and their roles and sets the scene for an examination of the efficiency and effectiveness of that regulation.

Directed to the above aim, two main sections then critically evaluate the statutory and supervisory regulation of SMSFs:

1. Chapters 4, 5 and 6 describe and evaluate the regulatory regime – both statutory and supervisory – under which SMSFs operate. The first of these chapters describes the legislative and supervisory landscape within which the sector operates. The second evaluates the appropriateness and effectiveness of the regulatory bodies' efforts, while the third evaluates the appropriateness of the legislative regime.
2. Chapter 7 compares and contrasts the regulation in selected overseas jurisdictions that provide for self-managed superannuation (generally termed 'private pensions'), namely the UK, Canada and US. In turn this supplies a vehicle for assessing features of other systems against those of the Australian regime.

Chapter 8 draws together conclusions about the significance of the findings in Chapters 4 to 7, makes recommendations for regulatory improvement, and identifies scope for further research in the SMSF sector.

1.3. Parameters of thesis

The thesis does not pursue a detailed analysis and evaluation of the trust law and trust deed environment that regulates SMSFs. Although SMSFs must be constituted as trusts,²¹ the statutory regime operating in the superannuation industry largely overlays and supplements applicable trust law and it is that regime which is subjected to detailed scrutiny in this thesis. The analysis of the statutory environment is largely confined to the Superannuation Industry Supervision regime,²² with a partial examination of the Australian taxation legislation and its role in influencing SMSF and member behavior.

As far as supervisory regulation is concerned, the thesis necessarily focuses on the ATO, as the main government agency involved with SMSFs.

In examining other jurisdictions in which self-managed retirement savings feature, this study is confined to developed, English-speaking countries, mainly because it is to those that self-managed retirement savings are largely confined.

The academic literature in this area of the law is fairly sparse, given the relative recency of the SMSF phenomenon. For this reason, what would otherwise be an undue reliance on newspaper and magazine reports on the SMSF sector, which appear on a daily basis, became a necessity.

Also by necessity, the legislative and statistical landscape described remains a snapshot view. The speed at which the superannuation world, particularly the SMSF sector, is evolving results in a situation where most statistics are rapidly superseded and new legislation enacted.

Additionally and in the interest of objectivity, it is important to note that the researcher has since 2006, been the trustee of an SMSF. Consequently, there was potential for a degree of subjectivity and potential bias in the researcher's view. As a counter, the

²¹ *Superannuation Industry (Supervision) Act 1993* s 19.

²² A collective term for the *Superannuation Industry (Supervision) Act 1993* (SISA) and the *Superannuation Industry (Supervision) Regulations 1994* (SISR).

research approach has underscored the importance of a critical and scholarly perspective.

1.4. Methodology

A literature review revealed scant academic writing on the subject of SMSFs. In order to assess the appropriateness and effectiveness of their regulation, it was necessary to seek empirical data on the perception of regulatees. A number of SMSF member surveys had been performed by various bodies. Rather than re-surveying that population, which was the original intention of this thesis, a field study methodology approach was taken in the form of open-ended interviews. Two main reasons informed this change of direction:

1. the difficulty of obtaining SMSF member names and addresses from the ATO; and
2. the availability of results of earlier SMSF member surveys, which are described and analysed in Chapter 3.

Case Study Methodology

Rather than structured interviews with a large number of individuals, the open-ended interview approach was chosen to cope with the diversity of interviewees and the diversity of information being sought. In-depth interviews were conducted with regulators and professionals representing a number of regulatees. The interview method was considered an appropriate methodology to investigate the SMSF phenomenon within its real-life context, relying on multiple sources of evidence and opinion. The triangulation of the sources derived from three main groups:

1. The regulator's perspective. Here the insider's concerns and impressions about those it regulates were sought. ATO officials who were repeatedly interviewed were most senior and knowledgeable regarding the sector. The views of the chair of the Government's Super System Review provided a unique perspective on the place of the SMSF sector in the country's superannuation system.

2. The perspective of SMSF professionals representing numbers of SMSFs. These interviews were partly an investigation of the demographic characteristics of SMSFs and their trustees and partly an enquiry regarding their assessment of the sector's regulatory environment. As these professionals represented large numbers of SMSFs and have day-to-day dealings with the ATO and the legislative environment in which SMSFs operate, their impressions and opinions were particularly valuable.
3. The opinions and issues of regulators in the UK, Canada and the USA, where self-managed personal pension plans exist with similarities to Australia's SMSFs. These regulators provided details concerning the types of self-directed retirement plans they regulated, the regulatory landscape and applicable legislation in their jurisdiction and their particular concerns as regulators. These interviews enabled a comparison with the Australian experience.

Interview transcription

In each case, interviews were conducted in the subject's place of work and were recorded. The tapes were subsequently transcribed verbatim, excepting where the interviewee withheld permission. In such cases extensive written notes were taken. The transcripts of tapes and notes were made available electronically to the interviewee within a week for any corrections to be made, or comments removed at the interviewee's request.

In accordance with the requirements of the University of Tasmania Human Research Ethics Committee,²³ the interview tapes were destroyed and the transcripts stored in a locked cupboard in the candidate's office. An index of interviewees is contained in Appendix 1. Interviewees who consented to being quoted are named; those who have been assured of being de-identified (group 2 above) are identified only by number and profession.

The transcripts were reviewed for themes and are extensively quoted throughout this thesis.

²³ Approval No. H11304, 25 July 2010, valid 4 years, as amended.

CHAPTER 2

THE HISTORY OF SELF-MANAGED SUPERANNUATION IN AUSTRALIA

2.1 Introduction

Though the general history of superannuation in Australia is well known,²⁴ the genesis of self-managed superannuation is less well documented. For much of its history, superannuation in Australia has been intrinsically linked with the contractual employment relationship. For the SMSF this is not the case, although SMSFs are generally able to accept compulsory employer contributions (since the 'choice' legislation was introduced)²⁵ and a significant minority in fact does so.²⁶ An enquiry into the reasons for establishing SMSFs forms part of the thesis, but the use of SMSFs to receive employer contributions is not considered to be important amongst those reasons, according to the available trustee survey data (see 3.5).²⁷

By the 1950s superannuation had spread to a proportion of the Australian workforce through industrial awards, but it continued to be provided mainly to permanent public servants and long time employees of major corporations, and was seen as a reward for long and faithful service. It was in the 1950s that private sector employers increasingly began to establish their own company-administered funds or paid contributions into life office administered funds.

²⁴ See for example Leslie Nielson, *Chronology of superannuation and retirement income in Australia* (10 September 2009,) Department of Parliamentary Services <http://202.14.81.34/library/pubs/bn/eco/Chron_Superannuation.pdf> Australian Prudential Regulation Authority, *A recent history of superannuation in Australia*, APRA Insight, Issue 2 (2007) <<http://www.apra.gov.au/Insight/upload/History-of-superannuation.pdf>>

²⁵ *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004* (Cth).

²⁶ See Barrie Dunstan, 'Member choice prompts exodus', *Australian Financial Review* 23 November 2011, 34.

²⁷ In any case, the available ATO statistical data reports only aggregate 'employer contributions' which may comprise an employee's salary sacrifice and after-tax contributions paid from an employer, as well as Superannuation Guarantee payments.

Superannuation gained in popularity during the 1960s when the tax treatment of contributions to funds became more generous for the self-employed.²⁸

From the mid-1980s Australia's level of state involvement in retirement saving policy increased and superannuation began to be championed as one of the solutions to funding the retirement of Australia's ageing workforce.²⁹ It was apparent that the State not only supported, but was prepared to actively encourage superannuation participation. For example, the May 1988 Economic Statement in Australia noted that it is 'a fundamental objective of the Government that every employee is entitled to superannuation cover'.³⁰ Prior to the major reforms of the superannuation system in the 1980s, catalogued below, less than 40% of workers were protected by superannuation cover.

By the 1986 national wage case decision, many workers became entitled to a 3% productivity superannuation contribution under industrial award provisions. This was subsequently extended to almost all employees by the *Superannuation Guarantee (Administration) Act 1992* (Cth). Compulsory employer contributions under the Superannuation Guarantee rose to 9% of total income in 2002-03. However, the Superannuation Guarantee does not cover the self-employed (some 12% of the total labour force), and it is this sector that remains most likely to use an SMSF.

SMSFs and their antecedents have existed for more than 30 years,³¹ although the current regulatory environment for SMSFs developed over the period 1987 to the present. Anecdotally, sophisticated, high wealth individuals have enjoyed the relatively free use of SMSFs since the early 1980s, at which time SMSFs lent to members (who could thereby pay off their mortgages or inject capital into business ventures)³². This situation was ended by the first major legislation impacting SMSF trustees, the

²⁸ Such that rules were applied to the self-employed, effectively allowing them "employer" tax treatment on part of their contributions, more favourable than "employee" treatment: Malcolm Edey and John Simon, 'Australia's Retirement Income System' in *Privatizing Social Security* (1998) 63 at 69.

²⁹ Lisa Marriott, 'The Politics of Superannuation in Australasia: Saving the New Zealand Standard of Living' (2009) 44(3) *Australian Journal of Political Science* at 487.

³⁰ Parliament of the Commonwealth of Australia 1988, 1.

³¹ Commonwealth of Australia, 'A Statistical Summary of Self-Managed Superannuation Funds' (10 December 2009) 1.

³² Interviewee A2.

Occupational Superannuation Standards Act 1987 (Cth) (OSSA). This Act prevented trustees from:

- lending to members or trustees of the fund;
- lending more than the value of 10% of the fund assets to an employer or associate who contributes to the fund (the in-house assets test);
- borrowing money; and
- using fund assets for anything other than creating retirement or death benefits.

The OSSA, as appears from its long title, was enacted to provide operating standards for 'certain superannuation funds ... and for related purposes'. The standards relating to trustees of small funds (less than 200 members) applied to each private sector fund established on or after 16 December 1985. The OSSA required each fund to have an approved auditor, to certify to the Commissioner³³ annually that the fund had satisfied the superannuation fund conditions.

With the mandating of superannuation contributions through the superannuation guarantee in 1992, the Government sought to build community confidence in the superannuation system and to ensure that monies contributed to superannuation were managed to maximise retirement benefits. The *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) and *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR) (collectively, 'the SIS regime') replaced the OSSA legislation from 1 July 1994. The SIS regime included measures that:

- required superannuation trustees electing to be regulated to be subject to the Commonwealth's corporations or age pensions powers under the Constitution;
- set out the basic duties and responsibilities of trustees and ensured that they had adequate powers to carry out those responsibilities;
- improved disclosure and regulatory reporting requirements;

³³ Namely, the Insurance and Superannuation Commissioner appointed under the *Insurance and Superannuation Commissioner Act 1987* (Cth).

- enlarged the roles performed by auditors and actuaries; and
- introduced more direct enforcement powers and improved audit resources for the superannuation regulators.³⁴

The SISA is now the main Act that regulates superannuation funds and continues the operating standards for superannuation funds found in OSSA, whilst introducing higher standards for the regulation of complying funds including codification of some general law rules.

2.2 Excluded funds

The history of the self-managed superannuation fund from the time of ATO responsibility for regulating the sector is described in the 2007 Australian National Audit Office report *The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds*,³⁵ partly excerpted below.

Until 30 June 1999, the Australian Prudential Regulation Authority (APRA) and its predecessor, the Insurance and Superannuation Commission (ISC), was responsible for regulating all small superannuation funds. All small funds were at this time known as 'excluded funds', which were superannuation funds with fewer than five beneficiaries. They were established to allow the self-employed and small business to maintain their own cost-effective superannuation vehicles.

The SISA had been enacted in 1993, pursuant to the 'old-age pensions' power of the Constitution (s 51(xxiii)). Funds that elected to become regulated under the SIS regime were asked to complete a short statistical questionnaire to provide the ISC with selected statistics of the fund as at June 1994. The ISC (in its submission to the 1997 Wallis Inquiry)³⁶ noted that:

³⁴ Australian Prudential Regulation Authority, 'A recent history of superannuation in Australia' (2007) *APRA INSIGHT ISSUE TWO* <<http://www.apra.gov.au/Insight/Documents/History-of-superannuation.pdf>> at 6.

³⁵ Australian National Audit Office, Audit Report No. 52 2006-07 Performance Audit.

³⁶ The Australian Financial System Inquiry, chaired by Australian businessman, Mr Stan Wallis, reported to the Treasurer in March 1997.

While a minor part of the growth in the excluded fund sector can be explained by small corporate funds converting to excluded funds, a more significant proportion of excluded fund growth has been due to high net worth individuals opting out of their current employer sponsored superannuation fund and directing contributions into their own personally managed excluded fund.³⁷

The genesis of self-managed or 'personal' superannuation funds in Australia is somewhat obscure. Some salient points are captured in the following extract from the 1975 Master Tax Guide.³⁸

An employee, for whom some benefits may or may not be being provided by his employer, may wish to supplement these and his life insurance cover by setting up a personal superannuation fund towards his retirement. In the same way, there may be considerable advantage to a self-employed person in setting up a personal superannuation fund to supplement his life cover...

No personal superannuation fund is exempt from tax, but subject to the overall annual limit of \$1200 for payments made by an individual taxpayer to super funds or as life etc policy premiums for the benefit of himself, his wife and children, the employee or self-employed person may obtain deductions for contributions to his personal fund and still enjoy the benefit of judiciously investing the fund's assets in securities providing a higher yield and greater capital growth than may be provided by the more stable public and Commonwealth securities.... Naturally, if his personal tax rate is in excess of 50% there will be the further advantage that the fund's net income from investments bears tax at the flat rate of 50%.

Another type of non-exempt fund - an employer may wish to set up a non-qualifying fund (often called an excessive benefits fund) for a key employee (including a company director) so as to be able to provide benefits for that employee in excess of the amount which the Commissioner approves as reasonable.(not deductible to the employer).

³⁷ ISC Submission to the Wallis Inquiry, contained in APRA Insurance and Superannuation Bulletin June 1996 at 12.

³⁸ CCH Australian Federal Tax Reporter, *Master Tax Guide* (1975).

Non-exempt funds can get relief in the form of a special deduction equal to 5% of the cost of the 'prescribed assets' included in the fund as at the end of the income year (excluding non-arms-length income).

Such funds are taxed at the rate of 50% on the net amount remaining after deducting from the assessable income (excluding contributions received) all allowable deductions (excluding benefits paid out).

No contributions tax applies however benefits paid by the fund are non-deductible. [545]

Interviewee A15, a retired former Australian partner in a (former) Big 4 international accounting firm, described how he became aware of the existence of 'personal' super funds:

I set up the first SMSF while working at [Big Four accounting firm] in Canberra around 1977. They didn't call them SMSFs, just 'super funds'. I was a manager, and at an in-house managers' tax conference in 1977, was told how to help clients pay less tax by using a SMSF.

I straightaway put it into effect with a high-net-worth academic. It was a legitimate strategy; no tax avoidance was involved... At that time the law required 30% of the amount contributed be invested in government bonds (this amount would be set aside for retirement); 70% was available to be lent back to one's business, with interest - this could be repaid when you sold your business. And a tax deduction was available for all of it, so the arrangement was cash-flow positive.

Small businesses had to repay business loans with after-tax money. Having a super fund to lend you the money was much better because you got a tax deduction for contributions to it and the interest you paid to it was in effect paid to yourself. The government was content because it was getting 30% of the contributions as bond money.

In the 1970s superannuation funds were run by AMP and some other big companies. A member of one of these may have thought 'I can do better on my own', so they would get a lawyer to draw up a trust deed to have their own super fund. The tax perks were so big; the strategy would have really caught on.

So for a self-managed super fund you needed:

1. a company as trustee (which could be your business company)
2. a trust deed
3. a bank account.

SMSFs became 'all the rage' in the 1980s. It was mainly small businesses, not multi-millionaires who used them.

In April 1997 the Wallis Inquiry recommended, inter alia, a significant change to Australia's superannuation regulatory framework. In particular, it recommended:

- *the establishment of a new agency known as the Australian Prudential Regulation Commission,*³⁹ to be responsible for the regulation of all deposit taking institutions as well as for life companies, friendly societies, general insurers and superannuation funds.
- *new responsibilities for excluded funds.* The inquiry recommended that the Australian Taxation Office be made responsible for regulating excluded funds, and that all members of these funds be trustees.

Importantly the *Wallis Inquiry* recommendations included the following:

The Inquiry considers that self-managed funds provide a worthwhile and competitive option for superannuation investors. However, as self-managed funds, they should not be subject to prudential regulation. To apply prudential regulation in such circumstances is impracticable. Moreover, it should be made clear that such schemes are conducted entirely at the risk of the beneficiaries – in relation to financial safety, there should be no regulatory assurance attaching to such schemes.⁴⁰

2.3 Excluded funds become SMSFs/SAFs

In June 1999 the *Superannuation Legislation Amendment Act (No 3)* (the *Amendment Act*) was enacted to give effect to the government's 1998-99 budget announcements of

³⁹ Later renamed the Australian Prudential Regulation Authority (APRA).

⁴⁰ Stan Wallis, March 1997, Financial System Inquiry Final Report [Wallis Report] at 333.

12 May 1998.⁴¹ This Act re-categorised excluded funds into two new categories of small funds – SMSFs and small APRA Funds (SAFs)⁴² – by means of amendments to SISA. The term ‘self managed superannuation fund’ was substituted for ‘excluded superannuation fund’ in the consequential amendments in Schedule 2 of that Act.

There had been concerns in the Senate Economics Legislation Committee about various matters in relation to the Amendment Bill, including the following:⁴³

- the addition of a third regulator (the ATO) to those regulating superannuation funds and the potential for inconsistencies in the application by the three of the same legislative provisions;
- the fear that the ATO would be more concerned with revenue collection than promoting self-regulation;
- the maximum number of members of a self-managed fund being four (Committee members and witnesses proposed alternatives ranging up to 14);
- the need for a family or business link between each member of the fund; and
- provisions for non-resident members of self-managed funds.

In relation to the fourth point, approximately 16% of the 180,000 excluded funds at the time had arm’s-length members. Some Committee members considered that arm’s-length members of excluded funds would not be able to represent their interests under the former framework, particularly employees who were members of employer-

⁴¹ Contained in budget paper No 2.

⁴² SAFs are similar to SMSFs in most respects, except for the following:

- SAFs are regulated by APRA;
- SAFs have a trustee that holds an extended public offer licence;
- SAFs are subject to the Registrable Superannuation Entity (RSE) licensing regime;
- members have access to the Superannuation Complaints Tribunal;
- members have the protection of the culpability test which is designed to protect arm’s length members who are not involved in trustee decision making; and
- the regulatory levy for SAFs (\$500 minimum) is higher than the levy for SMSFs (\$180).

⁴³ Parliament of Australia: Senate: Committee: Inquiry into Superannuation Legislation Amendment Bill (No 3) 1999, accessed online at <http://aph.gov.au/senate/committee/economics_ctte/completed_inquiries/1999-02/super/report/c01.htm>

sponsored excluded funds because of the (frequently) unequal relationship between employees and employers. Therefore the Bill required all members of a self-managed fund to be family members or business relations, on the assumption that these parties would be able to look after their own interests. However, this disentitled same-sex couples and friends from continuing their excluded funds as self-managed funds, necessitating transfer of the arm's-length member out of the fund or the appointment of an approved trustee and regulation by APRA, either of which would result in increased costs for the fund.

An opposition amendment, supported by the Australian Democrats, removed the family or business linkage requirement while ensuring that an employee could not be a member of an employer's self-managed super fund, except where they are relatives of the employer.

The Explanatory Memorandum to the *Amendment Act* clarified the ATO's regulatory role and explicitly stated it was not to have prudential responsibilities:

As members of self managed superannuation funds will be able to protect their own interests, these funds will be subject to a less onerous prudential regime under the *SIS Act*.⁴⁴

Self managed super funds were exempted from such onerous requirements of SISA as the requirement to establish internal complaints resolution systems, the requirement to have a registered company auditor and many other detailed requirements for reporting to members.

Another key change instituted by the *Amendment Act* was the reduction of the SMSF superannuation supervisory levy from \$200 to \$45. This was 'to better reflect expected Tax Office regulatory costs and to recognize the past cross subsidization of larger fund regulatory costs by small funds'.⁴⁵

⁴⁴ The Parliament of the Australian Government, House of Representatives 1998–99, Superannuation Legislation Amendment Bill (No 3) 1999, at 1.

⁴⁵ ANAO, above n 35, paragraph 3.10.

Thus, since 8 October 1999 SMSFs have been regulated by the ATO, and at that date they accounted for approximately:

- 98 per cent of the total number of excluded funds; and
- 90 per cent of the total value of excluded fund assets.

In undertaking this responsibility, the ATO faced a number of challenges. The Australian National Audit Office (ANAO) report states the following in respect of the transfer of responsibility for SMSFs:

In September 2000, approximately 187,000 SMSF records were transferred across from APRA to the Tax Office. The Tax Office considered that some of these records were of poor quality and required rectification. The Tax Office also suspected that prior to the *Amendment Act* coming into effect, compliance by a large proportion of these funds had been poor⁴⁶ and that ISC and APRA had undertaken a limited amount of compliance work on these funds in comparison to larger funds.⁴⁷

2.4 Subsequent events affecting SMSFs

Appendix 2 contains a table of legislative changes since 1992 that have impacted SMSFs. The more important of these are discussed below.

2.4.1 Disqualification of trustees by the ATO

Significant changes were made to the ATO's role as regulator when the *Financial Sector Legislation Amendment Act* was passed in January 2001, allowing the ATO to disqualify persons that they considered not to be 'fit and proper' to manage a fund.⁴⁸ Previously only APRA had been empowered to disqualify individuals from being a trustee or investment manager of any superannuation entity.

⁴⁶ In 1997, the ISC undertook a survey of the compliance practices of 1 000 funds. Approximately 20 per cent were investing in unit trusts controlled by the members or the employer sponsor, and about half of these unit trusts were involved with geared investments (see the Explanatory Memorandum to Superannuation Legislation Amendment Bill (No.4) 1999: Attachment F). The ANAO in its report *The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds* (above) notes that there were industry criticisms of the ISC's approach and the conclusions of the survey.

⁴⁷ ANAO, above n 35, paragraph 122.

⁴⁸ By the addition of SISA s 26A.

2.4.2 Auditor contravention reports

In September 2001 the (then) Senate Superannuation and Financial Services Committee produced the last of three reports into the prudential supervision of superannuation, banking and financial services. It recommended approved fund auditors be required to inform relevant regulators of funds breaching their obligations under the SISA.

In July 2004 the *Superannuation Safety Amendment Act 2004* came into effect. It required fund auditors (including approved auditors) and actuaries to lodge auditor contravention reports with fund regulators. Specifically, it required approved auditors to notify the ATO of any major breaches of the SISA by SMSFs, regardless of whether or not the offending SMSFs took action to resolve the breaches.

2.4.3 Supervisory levy increase

In April 2003 the Productivity Commission released a report into the SISA.⁴⁹ It recommended that the costs of administering SMSFs should be fully cost recovered. This was consistent with the Government's cost recovery policy as well as funding arrangements for APRA and the Australian Securities and Investments Commission (ASIC) regarding the regulation of superannuation funds.

In October 2003 the Department of the Treasury released a report into financial sector levies relevant to APRA, ASIC and the ATO. The superannuation supervisory levy relating to SMSFs was not examined as part of this report, suggesting that the levy did not operate on a cost recovery basis. The SMSF levy increased to \$150 from 1 July 2007 and to \$180 from 1 July 2011.

2.4.4 Fund choice

In July 2005 the Superannuation Choice legislation came into force. This gave many employees the right to choose the superannuation fund to receive their superannuation contributions. The ATO prepared for the possibility of significant increases in the number of SMSFs due to the Superannuation Choice legislation. Numbers of SMSFs had been

⁴⁹ Productivity Commission—*Review of the Superannuation Industry (Supervision) Act 1993 and Certain Other Superannuation Legislation*, December 2001.

increasing at a relatively consistent rate since 1999,⁵⁰ but it transpired that no significant increases in SMSF numbers occurred in the short term after the introduction of Superannuation Choice legislation. This was possibly because, firstly, SMSFs tend not to be principally established as receptacles for employer contributions (see 2.1) but rather for personal contributions and, secondly, because fund members appear generally to show a degree of apathy and inertia regarding switching funds.⁵¹

2.4.5 'Simplified Super'

In March 2007 the *Tax Laws Amendment (Simplified Superannuation) Act 2007* and related legislation received Royal Assent. This legislation implemented the Government's *Simplified Superannuation* reforms, which included changes to the reporting arrangements for SMSFs, clarification of SMSF trustee and approved auditor requirements, and the application of administrative penalties to SMSFs.

2.4.6 Instalment warrants

In September 2007 amendments to SISA permitted superannuation funds to borrow money of a limited recourse⁵² nature for investment purposes in certain circumstances.⁵³ Section 67A now provides an exception to the general prohibition from a regulated superannuation fund borrowing money. The original intent of the amending legislation

⁵⁰ The percentage increases have been 11% in 2000-01, 7% in 2001-02, 11% in 2002-03, 10% in 2003-04, 5% in 2004-05, 7% in 2005-06, 13% in 2006-07 and 9% in 2007-08.

⁵¹ Wilson Sy, 'Redesigning Choice and Competition in Australian Superannuation' (2011) 4(1) *Rotman International Journal of Pension Management* 52 at 52.

⁵² In limited recourse borrowing, an SMSF borrower which defaults will only be liable against the asset used as security. The loan provider cannot make claims on other assets that the SMSF borrower may own.

⁵³ This came about when the government decided to sell a major portion of its telecommunications monopoly by way of a float known as Telstra 2. Much of the selling activity took place in the form of warrants. All was well until it was suggested that the use of warrants was technically in breach of the law against borrowing by superannuation fund trustees. The Government's response was to introduce amendments to the SISA to allow the use of warrants in these circumstances, SISA s 67A inserted by the *Superannuation Industry (Supervision) Amendment Act 2010* (No. 100, 2010) Schedule 1. However, the new law went much further than expected. Surprisingly it opened up the possibility of borrowing by SMSF trustees to purchase direct property investments and the legislation contained no limit to borrowing by trustees, so that theoretically a loan of at least 100 per cent is possible, although anecdotal evidence suggests that most loans are limited to 70 per cent of valuation: Professional Planner, 'The truth about SMSFs' (2011) <<http://professionalplanner.com.au/?p=11468>>. An earlier ruling by the ATO prohibited the use of borrowed funds to renovate real property however that seems to have been relaxed: Australian Taxation Office, *Draft Self Managed Superannuation Funds Ruling SMSFR 2011/D1: Self Managed Superannuation Funds: limited recourse borrowing arrangements - application of key concepts* (2011) <<http://law.ato.gov.au/atolaw/view.htm?DocId=DSF/SMSFR2011D1/NAT/ATO/00001>>

was to permit an SMSF to invest in instalment warrant arrangements such as those in respect of Australian Stock Exchange (ASX) listed shares, but the amending legislation eventually extended the borrowing exception beyond the acquisition of ASX listed shares and allowed an SMSF to borrow money to acquire any asset which an SMSF is permitted by law to acquire directly.⁵⁴ The law permits the member to act as the trustee of the borrowing trust as well as being the lender. Over time the SMSF can make repayments that can then be contributed back into the fund by the member subject to the contribution caps. This has potentially made SMSFs even more attractive for those who wish to purchase real property or collectables through their superannuation fund.

2.4.7 The Super System Review and government response

The Australian Labor government's 'Super System Review' of governance, operation/efficiency, structure and operation of superannuation (private pensions)⁵⁵ final report was released in June 2010. It contained a number of recommendations specifically concerning the SMSF sector. The government responded and resolved to enact most of the Review's recommendations, re-badging the reforms as 'Stronger Super'.⁵⁶ Thus, the Super System Review and government response is set to become a major catalyst for change within the SMSF sector. Specific Stronger Super reforms directed at SMSFs are examined in detail in subsequent chapters.

2.5 Characteristics of SMSFs

An insight into SMSF characteristics in their early days can be seen from the APRA Superannuation Survey Methodology Overview in March 1999,⁵⁷ which noted three important defining characteristics of SMSFs (then called 'excluded funds'):

- *equity per member* - excluded funds have significantly higher average equity per member than other superannuation funds.

⁵⁴ Miller, Tim, *Borrowing within an SMSF - The New Instalment Warrants* (2008) Cavendish Superannuation Pty Ltd <<http://www.cavendishsuper.com.au/documents/techupdates/CavendishTechnicalUpdateJan08.pdf>>

⁵⁵ Hereinafter referred to as the Super System Review.
⁵⁶

http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/summary.htm

⁵⁷ Accessed online at <<http://www.apra.gov.au/Statistics/upload/Superannuation-survey-methodology-overview-March-1999-52kb.pdf>>..

- *propensity to directly invest in the market* - the decision to establish an excluded fund is often based on an intention by individuals to exercise increased control over their superannuation investments. This control is illustrated by the fact that 85% of excluded fund assets are directly invested in the market, whereas only 15% are invested through investment managers and life offices. This compares with 26% directly invested for all other superannuation funds. The high degree of direct investment by excluded funds is also consistent with the fact that excluded funds acting individually have limited market power to gain cost effective access to wholesale investment products.
- *contributions per member* - excluded funds have extremely high contribution rates per member.

These characteristics have not materially altered to date (see further Chapter 3). The average assets per SMSF as at March 2012 income year were \$889,395, with average assets per member of \$465,000.⁵⁸ This is considerably higher than the assets held by public offer fund members, indicating that SMSFs are primarily a vehicle for the wealthy. ATO data reveal that at the end of the March 2009 quarter there were 406,577 registered SMSFs, up from 187,000 in September 2000 when the ATO took over APRA's SMSF records. Latest reports from APRA show that whilst numbers of corporate, industry, public sector and retail funds decreased between June 2009 and June 2011 to total 386, SMSF numbers rose 11% in the same period.⁵⁹

2.6 Future growth in SMSF numbers

The likely future for the SMSF sector is subject to a number of demographic, legislative and regulatory variables, discussed below. Statistics on establishments over the last five years show steady growth and fee and performance statistics relative to other superannuation sectors are important factors in the sector's future prospects.

⁵⁸ Australian Taxation Office, *Self-managed super fund statistical report - March 2012*

<<http://www.ato.gov.au/superfunds/PrintFriendly.aspx?ms=superfunds&doc=/content/00319627.htm>> .

⁵⁹ Australian Prudential Regulation Authority, 'APRA Insight, Issue One' (2012)

<http://www.apra.gov.au/Insight/Documents/Insight_issue_1_2012_web.pdf>

2.6.1 General outlook for the sector

As at June 2012 there were 478,263 SMSFs, holding \$439 billion in assets, representing 31% of Australia's total superannuation assets of \$1,400.5 billion. This share has increased from 15% (\$78 billion of a total of \$519 billion) in June 2001. The transfer of assets has been principally from corporate, retail and public sector funds.⁶⁰

Some industry researchers forecast an imminent and severe downturn in the SMSF market-share because many people have been inappropriately advised to establish an SMSF, and the costs and work involved can be wearing for those without significant investment funds (\$1-2 million) and good tax and/or estate planning reasons to have an SMSF.

Rice Warner Actuaries' Superannuation Market Projections Report,⁶¹ based on data as at June 2010, predicts over the next 15 years that the SMSF segment of the superannuation industry will decline to 21.7% of total superannuation assets.⁶² This decline is projected due to lower sizes of newly formed plans, the lower contribution caps and winding up of plans as the current generation of retirees in these arrangements dies.⁶³ Certainly, a circumstance that will increasingly confront husband-and-wife SMSFs with the ageing of the population is the death of one spouse leaving the other possibly less willing or able to continue as a trustee.

⁶⁰ Superannuation asset share has changed between June 2001 and June 2012 as follows:

SMSFs	+16%
Corporate funds	-9.2%
Industry funds	+7.3%
Retail funds	-3.9%
Public sector funds	-3.7%
SAFs	-0.3%

Australian Prudential Regulation Authority, 'Annual Superannuation Bulletin: June 2012' (2013)

⁶¹ Accessed online at <<http://www.ricewarner.com/index.php?option=products&action=listpage&id=64>>

⁶² Rice Warner Actuaries, 'Superannuation Market Projections as at June 2010' (November 2010) – emailed in confidence 3/12/10.

⁶³ ATO statistics show that in 2010 34% of assets held within the SMSF segment are held partly or wholly in pension phase (up from 30% in 2009): Australian Taxation Office, 'Self-managed superannuation funds - A statistical overview 2009–10' (April 2012) <<http://www.ato.gov.au/content/downloads/SPR00316375n74068.pdf>>. This publication comprises an update of the *Statistical Summary of Self Managed Superannuation Funds* released by the Super System Review on 12 December 2009, which sourced from both publicly available and previously unpublished ATO data. The ATO update uses 2008-09 year data and the ATO intends to provide annual updates. Where appropriate, it refers to APRA data for comparisons to the SMSF sector.

Yet the broader informal view in industry is that this projection is incorrect.⁶⁴ SMSF growth is underpinned by the support of many advisers and accountants as well as the Australian trait of wishing to take personal control of one's own investments. There is little evidence to suggest this will wane. In fact, media articles⁶⁵ somewhat cynically suggest the numbers of new SMSFs will continue to rise as a result of the forthcoming abolition of commission-based financial advice and the removal of the 'accountants' exemption'.⁶⁶ Accountants presently do not need an Australian financial services licence to give advice on establishing or winding up an SMSF⁶⁷ but cannot give full financial advice. This has led to accusations of accountants recommending the establishment of funds inappropriately in order to drive their own fee income (to be derived from accounting, auditing and tax return preparation services for the SMSF). Many smaller SMSF trustees have been advised to set up their SMSF by a financial planner or adviser and, as commissions are removed by the government as a source of income,⁶⁸ this group can be expected to direct even more clients into SMSFs, thus earning a fee for service and increasing their engagement with the client via ongoing investment advice.

Another reason SMSF numbers may burgeon is the rapid increase in the use of Exchange Traded Funds,⁶⁹ a relatively new investment index-type vehicle traded on the stock exchange. These can give an SMSF access to a cheap, diversified holding in a

⁶⁴ See Michael Laurence, 'Into the SMSF Future' (2009) *Super Funds* April 34 accessed online at <<http://www.investmenttrends.com.au/wp-content/uploads/2009/05/into-the-smsf-future.pdf>>

⁶⁵ For example, Sally Patten, 'The gloves come off in super fight', *Sydney Morning Herald* 27 November, 2010, 26.

⁶⁶ The Federal Government announced that, as a result of the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry (the 'Ripoll Inquiry') which reported November 2009 recommended the accountants' exemption be removed and the Government consult on an appropriate replacement. There is also to be a prospective ban on conflicted remuneration structures, such as commissions and volume-based payments, a duty requiring advisers to act in the best interests of their clients when giving personal advice, and a requirement for advisers to obtain client agreement to ongoing advice fees (the opt-in): Commonwealth of Australia, 'Future of Financial Advice' (2011) <<http://www.treasurer.gov.au/Ministers/brs/Content/pressreleases/2011/attachments/064/064.pdf>>

⁶⁷ *Corporations Act 2001* (Cth) s 911A.

⁶⁸ Pursuant to the *Corporations Amendment (Future of Financial Advice) Act 2012* and *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012*, both amending the *Corporations Act and Regulations 2001* with date of effect 1 July 2012.

⁶⁹ Australian Securities Exchange, *Australian Exchange Traded Funds* (2012) <<http://www.asx.com.au/products/australian-exchange-traded-funds.htm>> ; David R Gallagher and Reuben Segara, 'The performance and trading characteristics of exchange-traded funds' (2005) 1(1) *Journal of Investment Strategy* 47.

sector, including international shares, which the trustees may not feel comfortable investing in directly.⁷⁰

2.6.2 Establishment statistics

New SMSF establishments,⁷¹ net of wind-ups, have been as follows (ATO data extracted 3 April 2012):

Quarters:

December 2006	6149
March 2007	8,963
June 2007	19,878
September 2007	7,971
December 2007	5,772
March 2008	6,568
June 2008	9,404
September 2008	8,788
December 2008	7,127
March 2009	4,489
June 2010	-3,446
September 2010	8,102
December 2010	7,113
March 2011	6,949
June 2011	7,072
September 2011	10,273
December 2011	8,690
March 2012	7,094

The spike in registrations in the June 2007 quarter was due to the well-publicised, once-only opportunity for each member to contribute up to \$1 million in non-concessional contributions between 6 December 2006 and 30 June 2007. Many would have made *in*

⁷⁰ Geoff Stewart, 'ETF super strategies' (2010)

<http://www.asx.com.au/resources/newsletters/investor_update/20100914_etf_super_strategies.htm>

⁷¹ Establishment date is the date when an SMSF is deemed by the super law to come into existence and is not necessarily the date of registration.

specie contributions into SMSFs, particularly of business real property, to take advantage of this opportunity and establishment of an SMSF enabled this.⁷²

The figures reveal that, aside from the said spike, growth in fund numbers has been generally steady, with a consistent increase each year. Logically a saturation point must exist where there are few new registrations but at present room for penetration in the market remains, it appears. For example, many public servants in defined benefit funds are approaching retirement age and can be expected to take a lump sum and, having time and interest in closely monitoring their retirement savings, use an SMSF as their investment vehicle.

2.6.3 Fees statistics

The opaqueness and high level of fees paid by public offer fund members compared with costs to operate an SMSF are an important factor in how attractive the sector remains. Over the past five years, the average fee was 1.03% per annum for not-for-profit funds (industry, corporate and public sector) and 2.11% per annum for retail super funds. Statistics reveal that, on average, SMSFs cost members only 0.79%.⁷³ APRA research disclosed that the average active investment manager for a public offer fund was unable to outperform the share market index when its fees were taken into account. The research concluded as follows:

The inability of investors to reliably compare individual funds or investment options, together with inadequate fund disclosures has led to a form of market failure that could help explain the rapid growth of self-managed funds to become the largest superannuation sector in Australia. However, for the bulk of workers who have insufficient assets or other resources,

⁷² After 1 July 2007, contributions caps existed to replace the repealed reasonable benefit limits. These caps were \$50,000 for concessional (employer) contributions (\$100,000 for over-50s), halved in the 2009 budget to \$25,000 into the 2013-14 income year for all ages - and \$150,000 non-concessional (with the ability of under-65s to bring forward two years' worth of contributions and make \$450,000 in one year). Contributions in excess of the caps are subject to punitive rates of taxation.

⁷³ Sara Rich, 'Super fund fees climb despite competition', *The Australian* 17 August 2009 23; Also see Wilson Sy, 'Cost, performance and portfolio composition of small pension funds in Australia' (2010) 9(3) *Journal of Pension Economics and Finance* 345. This article also noted that public funds tend to under-report expenses, whereas SMSFs and SAFs tend to fully declare expenses.

the self-managed alternative is not economically justifiable and they remain captives of the institutional market.⁷⁴

2.6.4 Performance statistics

Members may understandably resent paying fees to professional investment managers in public offer funds when their superannuation balance is eroded during difficult economic conditions. This may in turn have psychological effects that prompt movement to SMSFs. Taxation Commissioner Michael D'Ascenzo drove home this bear market point during an industry forum, saying that:

[g]rowth in [SMSF] registrations is consistent with economic downturns. The reason for this is not chiselled, but it is thought that people seek to be more self reliant in difficult economic times.⁷⁵

The global financial turmoil with attendant negative returns has the potential to create a 'loss of faith' in large institutional arrangements.⁷⁶ SMSFs appear to have survived the crisis better than public offer funds so far, although it can be difficult to source accurate, comparable figures in this area.⁷⁷ According to University of Adelaide Professor Ralf Zurbrugg, the average SMSF posted a gross loss of just over 11% in the 12 months to June 2008, outperforming the S&P/ASX 100 which lost 12.8% over the same period.⁷⁸ Selecting Super, a statistical research division of Rainmaker Group, reported the average loss for balanced portfolios in public offer funds (retail, industry and government funds) was 18.2%.⁷⁹

The apparent superiority in performance may be due to lower fees, conservative investment strategies, or both. Phillips, Baczynski and Teale found SMSFs had performed better than the average balanced retail fund during the 2007-2008 bear

⁷⁴ Wilson Sy and Kevin Liu, 'Investment performance ranking of superannuation firms' (23 June 2009) *APRA Working Paper* <http://www.apra.gov.au/Research/upload/SA_WP_IPRSF_062009_ex.pdf> at 26.

⁷⁵ 'Self-managed superannuation funds and the global recession: an ATO perspective', speech delivered at the SPAA Annual Conference, 11 March 2009.

⁷⁶ Deloitte Actuaries & Consultants, 'Dynamics of the Australian Superannuation System. The next 20 years: 2009-2028' (March 2009) at 21.

⁷⁷ Bryce, Jason 'DIY has Super Form', *Herald Sun (Melbourne)* 6 June 2009, 29.

⁷⁸ Michael Hobbs, 'SMSFs beat the market' (13 March 2009) *Financial Standard online* <<http://www.financialstandard.com.au/news/view/25267/>>

⁷⁹ Townsend, Peter, 'Cost v performance – assessing SMSFs' (2009) April 13-19 *Independent Financial Adviser* at 22.

market and concluded it was because of 'the insulation afforded to the portfolios by the high allocation to cash'⁸⁰ which they had earlier criticised as being a sub-optimal investment strategy.⁸¹

As an indication of how the Global Financial Crisis (GFC) affected SMSF trustee attitudes, the 2009 AMP Capital/Investment Trends Investor report completed in June 2009 surveyed over 17,000 SMSF trustees, asking whether or not their attitude had changed in regard to control over their superannuation investments over the past 12 months. 82% of respondents said they had not changed their attitude in this area despite the steep investment market falls experienced right around the world, with an additional 13% saying they wished to make more of their investment decisions in the future.

The current financial climate may be opportune to establish an SMSF: the falls in share and property values mean transferring listed and unlisted shares and real estate (including business premises) into concessionally taxed new SMSFs will result in lower capital gains tax and stamp duty with the change of ownership than before the GFC because of the eroded values of those assets.⁸²

2.6.5 Regulatory and legislative risk

The Rice Warner Actuaries' Superannuation Market Projections Report⁸³ comments that a factor that will encourage members of SMSFs to return to large funds is that the ATO, in its role as regulator of self-managed funds, is continually toughening its stance against trustees who breach superannuation law. The Assistant Treasurer in the second reading speech to the *Superannuation Legislation Amendment Act (No 3) 1999* stated:

The ATO has developed a compliance model on which its regulation of self-managed superannuation funds will be based. There are four stages to the model: education communication and service, self-regulation, assisted regulation and enforced regulation. The ATO expects to spend most of its time and effort at the first two stages to assist self-managed superannuation funds to regulate through education and communication. This

⁸⁰ Note 9 at 38.

⁸¹ P J Phillips, A Cathcart and J Teale, 'The Diversification and Performance of Self Managed Superannuation Funds' (2007) 40(4, December) *Australian Economic Review* 339.

⁸² Michael Laurence, 'Going it alone' (June 2009) *InTheBlack*, 30-33.

⁸³ Rice Warner Actuaries, 'Superannuation Market Projections as at June 2010' (November 2010).

reflects the ATO's belief that the vast majority of self-managed funds wish to comply with the law or would comply if made fully aware of the rules.

However, recent speeches by ATO senior officers⁸⁴ and the previous Minister for Superannuation⁸⁵ reveal continuing unease about SMSF trustees' understanding of their obligations.

The current uncertainty regarding detail, timelines and date of effect of impending legislative changes arising from the 'Stronger Super' reforms illustrates the ever-present legislative risk attending superannuation, and the SMSF sector in particular, which is the focus of many of the proposed reforms.

2.7 Conclusion

In conclusion it is worth emphasizing that, as the largest sector by numbers of funds and assets, SMSFs are an established part of the Australian financial, retirement and business environment. They attract continuing policy focus from government and are increasingly marketed to by service providers and product developers. No matter who ultimately proves to be correct about the future direction of the SMSF sector, there is little debate that it will remain a formidable force and provide intense competition for much of the superannuation industry. For instance, public offer funds considering how to counter loss of members to the SMSF sector could go to the extent of offering SMSFs access to wholesale versions of their diversified investment options and possibly access to the super funds' group insurance deals, as well as attempting to mimic some of the more attractive options available to SMSFs such as direct shares and real property.⁸⁶ AustralianSuper has recently targeted member retention with a 'Member Direct'

⁸⁴ For example, Neil Olesen, Deputy Commissioner of Taxation speeches 'Regulatory issues emerging from self-managed super fund cases' delivered at the SPAA Annual Conference 11 March 2009 and 'Regulating the self-managed super fund market' delivered at the ICAN SMSF Conference, 27 February 2009.

⁸⁵ Hon Nick Sherry, 'Putting You in the Professional Spotlight' speech delivered at the SPAA Annual Conference 13 March 2009, including the following comment: 'With superannuation being compulsory, supported by significant tax concessions and with the Government responsible (in the form of Age Pensions) for those for whom the SMSF experience may turn sour, I am sure you can see my interest.'

⁸⁶ Michael Laurence, above n 64 at 36; Stephen Shore, 'Super funds fight to keep members', *Australian Financial Review* 7 December 2010, 1: 'Direct share trading plan for members seen as a move to counter DIY surge'; Bianca Hartge-Hazelman, 'Funds fight drain to DIYs', *Australian Financial Review* 10 June 2011, 49.

investment option, allowing members to construct their own portfolios from S&P/ASX 300 stocks, exchange-traded funds and term deposits.⁸⁷

In the following chapter, the characteristics and motivations of SMSF trustee-members are explored, in an attempt to understand what makes up the membership of a cohort now approaching 900,000 Australians.

⁸⁷ Michael Laurence, 'Simply super fightback on SMSFs ', *The Australian* August 10 2011, 21.

CHAPTER 3

THE SMSF TRUSTEE-MEMBERS

3.1 Introduction

The sheer number of self managed superannuation funds (SMSFs) – numbering 468,133 at March 2012 – and their trustees – numbering 895,387 at March 2012⁸⁸ – make it practically impossible for the primary regulator, the ATO, to possess a complete and intimate knowledge of the trustees operating in this sector.⁸⁹ It is perhaps unsurprising, then, that relatively little is known of SMSF trustees' demographic and social characteristics, the reason they have chosen this particular superannuation vehicle and their level of involvement in their SMSF's accounting and investments. This is important and valuable information, as these people control 30.5% of Australia's \$408 billion concessional-tax retirement assets.⁹⁰

Statistical data on SMSFs is available from three main sources: the ATO's SMSF Statistical Report; APRA's Quarterly Superannuation Performance and Annual Superannuation Bulletin, which compare funds from all sectors including SMSFs; and the Statistical Summary of SMSFs by the Super System Review at December 2009. The latter, though predating the latest available ATO and APRA reports by a year, had the advantage of incorporating unpublished data provided by the ATO and unavailable elsewhere. The ATO has since published updates of the SMSF Statistical Summary for the 2008 and 2009 income years.

ATO statistics obtained from the SMSF Annual Return as at 30 June of the previous financial year supply the most up-to-date statistical data, but provide only a composite picture of the SMSF population.

⁸⁸ As reported in the latest ATO SMSF statistical report, above n 58.

⁸⁹ Refer Chapter 4 for a full explanation of the ATO's role.

⁹⁰ SMSF total assets were valued at \$407.6 billion at June 2011: APRA Annual Superannuation Bulletin June 2011 (issued 29 February 2012).

A significant proportion of SMSF members are also members of one or more APRA regulated funds. Although this may hamper a quantitative comparison between the average SMSF member and the average APRA fund member, it remains possible to identify general trends in demographic characteristics of SMSF members as compared with APRA fund members. The demographic characteristics of SMSF members can be expected to differ from those of APRA fund members mainly because, for much of its history, superannuation in Australia has been intrinsically linked with the contractual employment relationship, yet for the SMSF this is not the case. SMSFs are not generally a superannuation vehicle used by large numbers of workers to receive their employer contributions.

This chapter examines the available evidence about demographic characteristics of SMSF members, their reasons for using the SMSF vehicle for their retirement savings and its perceived advantages. The knowledge and understanding of those members in their role as trustee, with its significant duties and obligations, is then discussed. Finally, the conclusion poses a number of supplementary questions meriting research which may further an understanding of the investors in this sector.

3.2 Demographic characteristics of SMSF members

3.2.1 Geographic location

As can be expected, numbers of SMSFs are concentrated in the larger populated states: 35.3% are located in NSW, 31.5% in Victoria, 15.2% in Queensland and 8.7% in Western Australia.⁹¹ Tasmania and the Northern Territory are slightly underrepresented in SMSF numbers compared with their proportion of the Australian population,⁹² while Victoria, Queensland, Western Australia and the ACT are over-represented.

⁹¹ Australian Taxation Office, above n 58.

⁹² Total population at 30 June 2010, Australian Bureau of Statistics, *Population by Age and Sex, Regions of Australia* (2011)
<<http://www.abs.gov.au/ausstats/abs@.nsf/Products/3235.0~2010~Main+Features~Main+Features?OpenDocument#PARALINK7>>

The available statistical data does not enable analysis of what proportion of SMSFs are located in capital cities, as opposed to regional centres and rural areas. Australian Bureau of Statistics data suggests, though, that rural SMSF members closely mirror the 14% of the Australian population living in rural areas. SMSF members living in rural areas represent 13% of all SMSF members.⁹³

3.2.2 Business owners

Many sole traders and small family business owners use SMSFs as their superannuation vehicle. Nearly 39% of all SMSF members are self-employed or derive their income from a business or partnership, and half of all SMSFs have at least one member who is self-employed or derives income from a business or partnership.⁹⁴

However, there is nowadays greater diversity represented in the SMSF sector. Many retired public servants and others with time and interest in managing their own retirement savings have entered the sector.⁹⁵ There is a wide divergence in levels of engagement by trustees with their SMSF, ranging from those who are actually unaware of their trustee status,⁹⁶ to those who spend large amounts of time day-trading shares, currency and other listed assets to maximize their SMSF's accumulated funds. Business owners more commonly fall into the former category, with a high likelihood of outsourcing administrative and investment functions (see 3.8).

3.2.3 Gender

As at 30 June 2011, 46.4% of all SMSF members were women; 53.6% were men.⁹⁷ This may be compared with statistics reported by APRA for 2010, which show 44% of APRA

⁹³ ABS 2004, Measures of Australia's Progress, 21 April 2004 (quoted in Commonwealth of Australia, above n 31, 9).

⁹⁴ Commonwealth of Australia, above n 31, 9 (based on data collated from SMSF members' 2008 individual tax returns).

⁹⁵ Interview B6.

⁹⁶ According to the Explanatory Memorandum to the *Tax Laws Amendment (Simplified Superannuation) Bill 2006* (at 8.136), a survey by CPA Australia found that 30 per cent of self-managed superannuation fund members do not realise they are also a trustee of their fund.

⁹⁷ Australian Taxation Office, above n 58.

fund members are female and 56% are male.⁹⁸ Thus, women are slightly better represented in the SMSF sector than in other sectors.

3.2.4 Age

Members aged 55 and over represent 56% of the SMSF sector,⁹⁹ compared with only 22% of other superannuation sectors.¹⁰⁰ These statistics align with comments by Interview A11, an SMSF accountant/administrator:

Younger people can't be bothered with SMSFs; they're happy with APRA-regulated funds ... We don't see any young trustees; they're busy paying off their houses, not taking an interest in retirement. That said, trustee age has decreased a bit – a few are in their late 30s. Most are in their 40s to 70s. Paying off the house is the main consideration for young clients, plus they have young kids and an amount to put into an SMSF just isn't there.

However, member age for newly established SMSFs is younger than the existing age demographic (66% of members in new funds established in the March 2012 quarter were aged under 55, compared to 44% for all members).¹⁰¹ It appears, therefore that SMSFs are becoming more popular with younger generations.

3.2.5 Phase in accounts

Because SMSF members are generally older than APRA fund members, it is to be expected that a greater proportion of SMSF members' accounts will be in the pension rather than the accumulation phase. As at 30 June 2010, 22% of all superannuation fund members and 34% of all SMSFs were fully or partially in the pension withdrawal phase. Of the members who were fully or partially in the pension withdrawal phase at that time, 5.2% also received a full or partial government Age Pension. Overall, this represents

⁹⁸ Australian Prudential Regulation Authority, 'Superannuation Fund-level Profiles and Financial Performance' (27 January 2011).

⁹⁹ Australian Taxation Office, above n 58.

¹⁰⁰ Australian Prudential Regulation Authority, 'Annual Superannuation Bulletin (Year ended June 2010)' (19 January 2011), 25.

¹⁰¹ Australian Taxation Office, above n 58.

1.2% of the entire SMSF member population. SMSFs that commenced paying a pension in the 2008 financial year had, on average, been established for at least seven years.¹⁰²

Around 80% of Australia's superannuation in pension phase is held by SMSFs.¹⁰³

3.2.6 Education

As having an SMSF demands that trustee-members be involved in the management of their superannuation, SMSF trustees tend to *become* better educated about their trustee responsibilities, investment options and in tracking their fund's performance, compared with members of APRA funds. In any case, there is evidence that between 70%¹⁰⁴ and 81%¹⁰⁵ of SMSF trustees are tertiary educated or its equivalent, as compared with the APRA fund members whose tertiary education rates will generally be in line with the rate in the general population (31.6% based on Australian Bureau of Statistics 2006 Census Tables).¹⁰⁶

3.2.7 Health

SMSF members as a collective are likely to enjoy better health and longevity prospects than the average population due to more favourable socio-demographic characteristics.¹⁰⁷ At the same time, though, this means that they face a greater longevity risk, namely the risk of outliving their savings. This risk is compounded if the SMSF has a poor equity market return early in a member's retirement, as a high proportion of fund earnings tends to accrue during that phase and it is unlikely the member is able to make contributions to compensate for losses.

¹⁰² Commonwealth of Australia, above n 31, 8.

¹⁰³ Robert Gottlieb, 'Set for a self-managed super explosion' (24 July 2012) *Business Spectator* <<http://www.businessspectator.com.au/bs.nsf/Article/self-managed-super-fund-superannuation-banks-pd20120724-WGTST?opendocument&src=rss>>

¹⁰⁴ Gillian Bullock, 'OUTSOURCING SUPER - Taking the struggle out of self-managed funds', *The Australian* 9 September 2009, 1.

¹⁰⁵ Russell Investments, 'Intimate with Self Managed Superannuation: An inaugural annual study of Self-managed Superannuation Funds' (2011) <http://www.russell.com/AU/_pdfs/market-reports/spaa/R_EVE_SPAA_Report.pdf>

¹⁰⁶ Australian Bureau of Statistics 2006 Census Tables viewed 5 March 2012.

¹⁰⁷ Andrew Robertson, 'Understanding & measuring longevity risk & related SMSF strategies' (Paper presented at the SPAA conference, Brisbane, 2011).

3.2.8 Wealth

It is unsurprising that SMSF members, being older and better educated, tend to be wealthier and have higher incomes than the average APRA fund member.

3.2.8.1 Income

SMSF members have higher earning capacity than members of APRA-regulated funds. On average, over all age groups, SMSF members have an annual taxable income of \$92,000, while members of other types of funds, on average, earn less than \$47,000 annually.¹⁰⁸

Information about SMSFs' acceptance of employer Superannuation Guarantee contributions, and the proportion of SMSF assets they represent, is not available, as these contributions are not reported separately in the SMSF Annual Return.

3.2.8.2 Superannuation balances

As the value of an individual's superannuation portfolio grows, he or she is more likely to be a member of an SMSF, as a survey by Investment Trends in December 2010 (High Net Worth Investor Report) discloses:¹⁰⁹

Super portfolio value

\$250,000 - \$500,000	29% have an SMSF
\$500,000 - \$1M	47% have an SMSF
\$1M - \$2.5M	70% have an SMSF
\$2.5M to \$10M	78% have an SMSF
\$10M +	84% have an SMSF

¹⁰⁸ Australian Prudential Regulation Authority, above n 100, 9.

¹⁰⁹ Reported in Darin Tyson-Chan, 'Wealthy investors favour SMSFs' (14 March 2011) *Independent Financial Adviser* 12.

The survey also indicated that the higher the balance in the SMSF, the higher the proportion of direct shares (as opposed to managed funds).¹¹⁰

Additionally, SMSFs average \$465,000 in value of assets per member¹¹¹ compared with \$51,847 average account balance for APRA fund members.¹¹² Also, SMSFs are not necessarily the sole source of superannuation savings for SMSF members. As at 30 June 2008, around 25% of SMSF members had accounts in other types of funds, averaging \$78,000 in superannuation outside the SMSF.¹¹³

3.2.8.3 Low SMSF asset balance SMSFs

There remains, though, concern on the part of commentators and government that low-balance SMSFs (with less than \$200,000 in assets) tend to have unacceptably high proportional running costs and that members may be better off in APRA-regulated funds.

The Super System Review suggested many low-balance SMSFs might be in the latter stages of pension phase, running down the assets of the fund as retirement progresses. The Review therefore requested the ATO determine what proportion of the funds under \$200,000 fell into that category.¹¹⁴

The ATO reported that such funds were 6.2 years old on average, were more likely than the general SMSF population to be two-member SMSFs, more likely to have younger members with lower income levels and were *less* likely to be in pension mode. Only 5% were in full or partial pension mode, significantly below the SMSF average of 27.5%, so that the low-balance SMSF phenomenon is not explained by funds being at an advanced stage of decumulation. The statistics suggest such funds are established by younger persons who intend to accumulate via contributions and earnings as they progress through their working lives, taking advantage of the concessional taxation environment in which superannuation operates. These people may view investing outside of

¹¹⁰ The survey was conducted online in Nov-Dec 2010 and there were 7811 valid responses.

¹¹¹ ATO data: Reported total SMSF Australian and overseas assets divided by total member numbers at December 2011.

¹¹² Australian Prudential Regulation Authority, 'Annual Superannuation Bulletin, June 2011' (2012), 6.

¹¹³ Commonwealth of Australia, above n 31, 11.

¹¹⁴ Jeremy Cooper, 'A conversation about SMSFs' (Paper presented at the SPAA Annual conference, Melbourne, 2010).

superannuation until a large balance becomes available to establish an SMSF as a sub-optimal strategy.

The governmental response to the low asset-balance SMSF issue remains uncertain. It is unlikely to legislate a minimum asset value to establish an SMSF, given the general freedom of choice the sector enjoys and the presumption that the SMSF trustee cohort, being relatively sophisticated, have strategies in place to accumulate assets to a financially viable level.

In any case, the proportion of SMSFs with less than \$200,000 total assets has been declining over the last five years from 37.8% in 2004-05 to 24.3% in 2009-10. (Over the same time period, the proportion of SMSFs with assets of more than \$1 million has increased from 15% to 26.7%).¹¹⁵

3.2.9 Risk takers?

It seems intuitive to conclude that many SMSF trustee-members are risk takers. After all, they decide to take control of their own superannuation, subject themselves to the vagaries of the market and assume all the risk of buying and selling assets as amateurs, rather than paying fees to a professional fund manager. They undertake all this without the protection of Part 23 of SISA ('Financial assistance to certain funds')¹¹⁶ or access to the Superannuation Complaints Tribunal, where non-SMSF fund members may seek review of decisions or conduct of trustees.¹¹⁷

Yet statistics do not support the view of SMSF trustees as risky operators. A comparison of asset allocation between SMSFs and APRA funds for the quarter ended 30 June 2012¹¹⁸ reveals that SMSFs invest in classes of investment with an overall lower risk

¹¹⁵ Australian Taxation Office, above n 58.

¹¹⁶ Which makes provision for the grant of financial assistance for certain superannuation entities that have suffered loss as a result of fraudulent conduct or theft.

¹¹⁷ See further Chapter 5.

¹¹⁸ Comparison between the sectors in asset allocation is difficult because the categories are differently reported. APRA funds report for the following asset classes:

- Australian shares
- International shares
- Listed property
- Unlisted property

profile than APRA funds. SMSFs average 31% of total assets in cash and term deposits, 31% in Australian listed and unlisted shares, 0.31% in international shares and 0.73% in 'debt securities'. APRA funds (corporate, industry, public sector and retail) average 9% in cash, 28% in domestic shares, 23% in international shares and 14% in fixed interest securities.¹¹⁹ Further, the percentage of an SMSF portfolio's investable funds allocated to risky assets exhibits no clearly defined relationship with portfolio size.¹²⁰

Whether by design or accident, this conservative bias served the SMSF sector well during the Global Financial Crisis which began in 2007.¹²¹

Another risk SMSF trustees face are that they are unwittingly in competition in their investments with an unknown computerised adversary, the algorithmic trading systems employed by professional traders:

There are legitimate reasons for Australian investors to be concerned about the orderliness of the market but it is too early to say there is a danger of a widespread loss of confidence in the

-
- Australian fixed interest
 - International fixed interest
 - Cash
 - Other assets.

By contrast, SMSFs report for the following asset classes:

- Listed and unlisted trusts
- Insurance policies
- Other Managed Investments
- Cash and term deposits
- Debt securities
- Loans
- listed shares, unlisted shares
- Derivatives and instalment warrants
- Non-residential real property
- Residential real property
- Artwork, collectibles, metal or jewels
- Other assets
- Overseas shares
- Overseas Non-residential real property
- Overseas Residential real property
- Overseas Managed Investments
- Other overseas assets.

¹¹⁹ Australian Taxation Office, 'Self-managed super fund statistical report - June 2012' (; Australian Prudential Regulation Authority, 'Annual Superannuation Bulletin: June 2012' (2013)

¹²⁰ Peter J Phillips, 'Are Larger Self-Managed Superannuation Funds Riskier?' (2009) 1(1) *Asian Journal of Finance and Accounting* 54.

¹²¹ Phillips et al, above n 9, 38.

market...the end result of this sweeping fragmentation of the structure of the equities market is that investors trading through physical exchanges are like second-class citizens.¹²²

Jeremy Cooper alluded to this in interview, remarking

...information asymmetry of course is the asymmetry between what I'll call the professional market and your member-trustees. You're doing it yourself when it comes to shares and other investments, going online through Comsec or whoever their online broker is and they're effectively trading with the professionals, against them in other words. I think that gets a little bit underestimated as to whether that economically makes a lot of sense - for mums and dads to be trading shares against Goldman Sachs. Whether people have actually thought about who the winners and losers might be in that kind of thing, but that's all inherent in doing it yourself.

...it's all part of the advisers and indeed the self-managed community being realistic about some of these things. I don't think it's a fatal flaw. It's just something the industry could be a little more upfront about. That in some respects you need to be realistic about what your own limitations are I suppose. That's an important aspect of having a self-managed fund – that you do realise where you sit in the universe of investors and be realistic about the sort of information you might have, as opposed to...there's just nothing that can be done about that, other than to be aware of it and just steel yourself every so often and cause you to have a little bit more of a think about what you're doing.

If your day job, your entire career is valuing financial products, and trading in them and understanding how they work and all the rest of it, as compared to the amateur self-managed super players, I don't think you're ever going to be able to level that out, although disclosure is the tool the system uses to try to level that out. But realistically it doesn't work so well. The main thing is there not to be a delusional component where people think that just because they've got an online trading account and know a few things that they can go in there and do battle with the pros.¹²³

Given the above circumstances it is somewhat remarkable that SMSFs are so successful (see 2.6.4).

¹²² Tony Boyd, 'ASIC confronts a trading monster', *Australian Financial Review* 14 August 2012, 52.

¹²³ Interview B8.

3.3 Familial characteristics

SMSFs are often used by families wishing to combine superannuation balances and purchase significant appreciating assets, or to achieve taxation benefits by inserting a superannuation fund into a family trust/company investment structure. According to Interview A6, an accountant,

A lot of people have an SMSF as part of their business structure. They might have a family trust, SMSF and a company or partnership that runs their business.

But little is known of the degree of inter-relatedness in the make-up of individual SMSF membership (and corporate trustee directorship) because of the aggregate nature of SMSF statistics collected by the ATO.

3.3.1 Corporate trustees

Around 74% of SMSFs have individual trustees. In recent years, over 90% of SMSFs have been established without a corporate trustee,¹²⁴ despite its advantages. For example, without a corporate trustee, if there is a change in one or more trustees, the name in which all fund assets are held must generally be changed in the case of individual trustees.¹²⁵ Many SMSF trustees comprise husband and wife, with assets being held in the names of both as trustees for the fund, so that when one is deceased, the names in which all the assets are held must be changed.

Nevertheless, corporate trustees are increasingly unpopular presumably for cost-related reasons, namely the cost of incorporation and ongoing corporate reporting.

¹²⁴ Australian Taxation Office, 'Self-managed superannuation funds: A statistical overview 2009–10' (2012) at 22.

¹²⁵ David Shirlow, 'SMSF trusteeship - corporate or individual?' (2006) 17(6) *Australian Superannuation Law Bulletin* 81.

3.3.2 Families

As at 30 June 2010, 22.6% of SMSFs had a single member, 68.8% had two members, while 4.2% had three and 4.4% had four.¹²⁶ Anecdotal evidence from interviewees suggests the greatest proportion of SMSFs consist of husband and wife:

A lot [of trustees] are husband and wife and typically there will be the husband dominating. (Interview A6, accountant)

They tend to be a mum and dad in business or formerly in business, used to managing their own financial affairs ... some have children involved, though this is uncommon. They like to keep their financial affairs separate from their children. (Interview A7, accountant)

In the case of three and four member SMSFs, the aggregate nature of the available statistics means that the relationship between the members is unknown – whether parents and children, other family members or unrelated individuals. It is also unclear whether all of the trustees in an SMSF are regularly involved in its day-to-day running or if there is generally one main controller.

Some SMSFs consist of friends who wish to pool their superannuation to enable investment in property (as an alternative to instalment warrant arrangements)¹²⁷ or business associates who wish to own business real property jointly in a concessional taxed vehicle.

3.3.3 Superannuation and divorce

Since 28 December 2002, pursuant to amendments of the *Family Law Act 1975* (Cth), a superannuation entitlement can be split between parties to a divorce, and a 'flagging order' (a form of injunction that binds the trustees of a fund from making a payment to a member of that fund) may be made in relation to a superannuation entitlement.¹²⁸ Such orders are binding upon the trustees of a fund.¹²⁹

¹²⁶ Australian Taxation Office, above n 58.

¹²⁷ See Peter Freeman, 'A DIY Super Team' May 2010(123) *Money* 52.

¹²⁸ *Family Law Act 1975* (Cth) s 90MJ.

¹²⁹ *Family Law Act 1975* (Cth) s 90MZD.

To facilitate the above changes, Part 7A was inserted into SISR, imposing an additional raft of obligations upon trustees of superannuation funds to give effect to payment splitting arrangements established under Part VIIIB of the *Family Law Act* and provide for additional options that may be exercised in relation to superannuation interests that are subject to a payment split under that Act.¹³⁰

Different valuation provisions of the *Family Law Regulations 1984* apply to SMSFs and non-SMSFs where there is to be a payment split. For SMSFs, this is effected via a formula whereas for non-SMSFs the interest is simply valued by valuing the shares, real property or other assets contained in them.¹³¹ There can be great complexity in apportioning splits where both parties have made contributions and had variable membership periods in the fund. The ATO has no role in apportioning SMSF interests upon divorce, according to the Director, SMSF Segment.¹³²

The ATO's role as regulator is really only to ensure that the trustees meet their obligations under the SISA. We would not get involved with Family Law issues.

3.4 Compliance and demographic characteristics

There is thus a wide diversity amongst SMSFs over a number of demographic characteristics, and it is conceivable that there may be correlations between one or more of these characteristics and degree of compliance with obligations imposed by the SIS regime. This could be measured by the rate of Auditor Contravention Reports (ACRs) in respect of those SMSFs. An auditor will lodge an ACR with the ATO where the SMSF has contravened one or more of a number of specific sections or regulations in the SIS regime during the audit year.

However, according to the Super System Review Statistical Summary, the demographic of SMSFs for which ACRs were lodged in the 2009 income year generally aligns with the overall SMSF population.¹³³ There is no correlation between the receipt of an ACR and

¹³⁰ See Greg Shoebridge, 'Superannuation: Where are we at, five years on?' (2008) 13 *Current Family Law* 70 at 71.

¹³¹ Superannuation Industry (Supervision) Regulations 2004 (Cth) reg 7A.13(2)(c)(ii).

¹³² Interview B2.

¹³³ Commonwealth of Australia, above n 31, 17.

the SMSF size, SMSF income range, years since establishment, structure or geographic location of the SMSF. Though there may conceivably be some correlation between receipt of an ACR and individual trustee demographic characteristics (for example age, ethnicity, gender), the statistics do not facilitate that level of analysis. Nor is any information available concerning characteristics of SMSFs and individual trustee demographics where the SMSF has been subject to an ATO audit.

3.5 Reasons for establishing an SMSF

As noted above, the available statistical data, being quantitative and aggregated, are limited in their ability to provide insight into the SMSF world. Attempts to obtain qualitative data by surveying individual SMSF trustees are discussed below, with particular emphasis on their motivations for entering the sector.

3.5.1 Surveys

There have been several attempts in surveys of SMSF trustees to determine their reasons for establishing an SMSF. A major deficiency in all the surveys is small sample size; the numbers of respondents are typically between 1,000 and 2,000 (out of a population of close to 900,000). A second deficiency is that the surveys were potentially unrepresentative, as sampling generally occurred from membership of industry associations, most notably the Self-Managed Super Fund Professionals' Association of Australia (SPAA), which is likely to be comprised of the more engaged and active trustees who are not representative of the entire sector.¹³⁴

3.5.1.1 Australian Stock Exchange

The Australian Stock Exchange (ASX) conducted the first qualitative research of SMSF trustees in 2003 in order to understand why and how investors were using SMSFs. The study consisted of eight focus groups among SMSF members/trustees in Sydney, Brisbane and the Gold Coast, covering a mix of occupations/professions (including self-

¹³⁴ SPAA membership is \$660, renewable annually.

employed/business owners), ages and gender and eight 'opinion leaders in-depth interviews' among association representatives, financial planners and accountants.¹³⁵

Findings were that control is the dominant characteristic of SMSF trustees, who tended to have an independent, self-reliant mindset. Motivations to establish an SMSF included flexibility and choice in assets, better returns, greater control, greater transparency and enhanced tax benefits. Respondents stated that investment management was the most difficult aspect of managing an SMSF, that is, choosing investments, and deciding when to invest and when to divest. This led many to stay with investments they knew and understood.

Respondents' comments were generally positive concerning the ATO, including the comment that it was more customer-focused than in the past and more active than the ASX in SMSF education.¹³⁶

3.5.1.2 ATO surveys

The ATO has conducted two SMSF trustee surveys. The first surveyed all new SMSF trustees in the 2007-08 financial year. One of the survey questions was: 'What were the reasons you established an SMSF?' Respondents were instructed to select up to two of the following options:

- Advice from tax agent/ accountant
- Advice from solicitor
- Advice from friends/ family
- Advice from financial planner
- Super Simplification measures
- To consolidate a number of super accounts
- Control of investments

¹³⁵ Australian Stock Exchange, *Self-Managed Superannuation Fund (SMSF) Market Research (Qualitative Project)* (November 2003)

<http://www.asx.com.au/documents/resources/ASX_SMSF_Market_Research_Summary_03_Final.pdf>

¹³⁶ Ibid 55.

- Changing jobs
- Save money on fees
- Poor performance from previous superfund
- Became self employed
- Redundancy
- Transfer funds from overseas
- Tax planning
- Retirement
- Other – Please specify

The outcome of this survey has not been made public, although background briefings were given to the Super System Review from this information.¹³⁷

A second ATO questionnaire was included in a notification of review during the 2008-09 financial year. It was issued to 3,000 trustees and 2,423 responses were received. The population of respondents consisted of both random and risk-based selection¹³⁸ of funds, 37% and 63% respectively. The results were made public in the Super System Review Statistical Summary, which reported that 81% of respondents said they had existing superannuation accounts prior to establishing their SMSF, and 85% said they rolled over some or all of their existing superannuation into their new SMSF.¹³⁹

The second ATO questionnaire sought, inter alia, the reasons the trustees had established an SMSF. Respondents were instructed to rank the options relevant to them in order of importance. In this version of the questionnaire, the specific options:

- advice from tax agent/accountant

¹³⁷ Interview B7.

¹³⁸ An examination method based on taxpayer risk, taxpayer needs and effectiveness of treatment, See OECD Centre for Tax Policy and Administration, 'Compliance Risk Management: Audit Case Selection Systems', October 2004, <<http://www.oecd.org/dataoecd/44/36/33818568.pdf>>.

¹³⁹ Commonwealth of Australia, above n 31, 4.

- advice from financial planner
- advice from solicitor, and
- advice from friends/family

were replaced by:

- for greater flexibility over investment options
- desire to have my family in the same fund, and
- better tax outcomes.

Respondents cited control of investments in 86% of responses as a reason for establishing their SMSF; 46% ranked this as their principal reason. Greater flexibility over investment options and the belief they could perform better than their previous funds were also cited, by 64% and 53% respectively.¹⁴⁰

3.5.1.3 Russell Investments/SPAAN SMSF trustee survey

An online survey of 1,331 Australian consumers was conducted by Russell Investments and SPAA in late 2010.¹⁴¹ Of the respondents, 431 were SMSF trustees and 258 were high net worth (HNW) individuals without SMSFs. The remainder were non-HNW members of super funds other than SMSFs. Ten per cent of respondents without an SMSF responded they were likely to establish one within the next two years.

SMSF trustees typically cited control as the key driver for establishing their fund and responses revealed a high correlation between owning all or part of a business and having an SMSF (44.7% of SMSF trustees ran small- to medium-sized enterprises). The survey found that SMSF trustees have a much higher preference for remaining in the workforce post-retirement from full-time work, with 53.2% intending to work part-time, compared with only 32% of non-trustees.

¹⁴⁰ Ibid 6.

¹⁴¹ Russell Investments, 'Intimate with Self-Managed Superannuation' (2011)
<http://www.russell.com/AU/_pdfs/market-reports/spaa/R_EVE_SPAA_Report_ExecSummary.pdf>

3.5.1.4 Latest surveys

SPAA commissioned two surveys in late 2010 – of SMSF trustees and of SMSF advisers – administered to SPAA members.¹⁴²

A further survey, this time of retired SMSF members, was conducted October 2011, by Colmar Brunton, an international market and social research company. Its focus was to determine how retired SMSF members would prefer to receive communications from the ATO about the ‘Stronger Super’ changes to superannuation, not yet legislated, what they knew about them and whether they would be impacted.¹⁴³

In summary, the available survey data confirms the tendency of SMSF members to be independent, self-reliant individuals accustomed to control in most aspects of their lives; in fact control over one’s retirement savings and investments is the dominant motivation for setting up an SMSF. SMSF members see themselves as experienced and capable in financial matters and their self-belief suggests to them that they will be successful in managing their own retirement savings. They appreciate the advantages that an SMSF may be able to give them in this endeavour.

3.6 SMSF advantages

Apart from disaffection with public offer funds, other perceived advantages of SMSFs include:

¹⁴² Survey questions are grouped into the following categories:

- trustee profile (including risk profile and interest in managing finance)
- use of products
- asset allocation and investment issues
- performance, fees and costs
- use of information and advice
- benefits and challenges
- understanding of roles and responsibilities
- demographics.

¹⁴³ There were also a number of demographic/sociological questions, including:

- how long the SMSF had been operating
- motivations for establishing it
- whether it had lived up to expectations
- whether the trustee would encourage others to establish one
- how much time they devoted to running it, and
- whether they made financial decisions independently or with assistance from a financial adviser.

- control over asset allocation, speed and flexibility;¹⁴⁴
- the ability to invest directly in chosen assets;
- personal strategies for income splitting and restructuring to better access social security benefits;
- scope to borrow via instalment warrants;
- withdrawal and recontribution strategies;¹⁴⁵
- access to transition to retirement pensions (not available through all public offer funds);
- scope to acquire premises from which a small business operates; and
- highly-controlled estate planning (for example, use of indefinitely continuing binding death nominations).

Each is developed below.

3.6.1 Control

An illustration of the advantage of control is possible delay in the processing of APRA fund members' rollover and switching requests. For example, a superannuation fund's delay in processing a member's rollover request at the height of the global financial crisis in mid-2008 eventually cost him more than \$4,000 on a rollover amount of less than \$24,000, according to evidence adduced before the Superannuation Complaints Tribunal.¹⁴⁶

A closer involvement in their superannuation (unless they have completely outsourced all management decisions) demands that trustees become more educated on investment decisions. With this, trustees may prove more likely to behave rationally in difficult market

¹⁴⁴ See Geoffrey Newman, 'Volatile markets to hit super again', *The Australian* 27 May 2010, 20.

¹⁴⁵ Once a condition of release is met (most commonly attaining preservation age and retiring or transitioning to retirement), an SMSF member can withdraw a superannuation benefit comprising wholly or partly taxable component (tax-free to them after 60), recontribute it (subject to the non-concessional contributions cap) and thereby convert it to an entirely tax-free component which is not subject to taxation as a death benefit in the hands of a non-dependent.

¹⁴⁶ Mike Taylor, 'When time is money' (15 July 2010) *SuperReview* <http://www.superreview.com.au/articles/When-time-is-money_z520370.htm#>

conditions¹⁴⁷ (for example, by remaining in equities in a market which has declined, rather than switching to 'cash' or conservative options, thus crystallising any notional losses). This may be one reason why SMSFs, as a whole, weathered the Global Financial Crisis more successfully than APRA fund members. Another reason was that SMSF funds have only minor exposure to international shares (less than 1% of SMSF investments are in overseas shares or overseas managed fund investments) whereas larger funds have had a significant proportion of their assets in global investments, which also suffered from the foreign currency exposure associated with such investments.¹⁴⁸

Interview A13, an actuary, expressed such conservatism as a further advantage of SMSFs:

It's common practice in large funds to reduce risk by diversifying overseas, but *that* is subject to currency risk. A general principle is, if your liabilities are in Australian dollars, you should invest in Australian dollars. That way you have no currency risk. SMSFs tend not to invest overseas because it's difficult for an individual to do and that has been good for returns and not just during the GFC.

3.6.2 Transparency

SMSFs can offer greater clarity and perspective as to what a member actually 'owns' in the way of investments. The freedom to invest in what the trustee understands is part of this advantage:

They can invest in what they understand, like a lot of my clients are invested in business premises and a handful in farms. That's part of the control aspect. (Interview A6, SMSF administrator)

This transparency and familiarity can be compared with membership of a public offer fund where the only investment choice a member may make is between generally-described 'options'. These are usually designated in terms of risk ('cash', 'conservative', 'growth', 'balanced') and 67% of APRA funds do offer investment choice, with 112 being

¹⁴⁷ John Wasiliev, 'Experience helps calm frayed nerves', *Australian Financial Review* 14 October 2009, 2.

¹⁴⁸ Ibid.

the average number of investment choices offered in the year ended June 2012.¹⁴⁹ However the makeup of such options is generally unknown to the fund member, and is continually adjusted internally without members' knowledge.

Another dimension to the transparency advantage enjoyed by SMSFs is the members' awareness of fund expenses. SMSF trustees are not remunerated¹⁵⁰ and any payments to providers of outsourced functions are within the control of the trustee-members. In contrast, the situation for APRA fund members is one of reliance on external fund managers. Such fund managers pass indirect expenses such as operation cost, executive bonuses, shareholder income, brokerage, 'soft dollar deals,' etc. to the superannuation fund by subtracting expenses from the gross investment earnings and thus delivering a net investment earning to the fund. Many indirect expenses are difficult, if not impossible, to quantify, particularly when there are several layers of service providers. And currently there is no regulatory requirement to report indirect expenses.¹⁵¹

Of course SMSFs may face indirect expenses in the opportunity cost of time devoted by trustees to operating the fund.

3.6.3 Speed and flexibility

SMSFs can be more responsive to market conditions than APRA funds, which need permission for any major investment rebalance. In the words of Interviewee A13, an actuary:

I'm on the board of a large super fund. I advised them to cut their proportion of equities in favour of fixed-interest before the GFC happened, but any change takes 6 months to happen in an APRA fund. You need to give members 3 months notice of the change and there are a lot of other delays built into the regulatory system of larger funds. SMSFs are much more nimble.

¹⁴⁹ Australian Prudential Regulation Authority, 'Annual Superannuation Bulletin: June 2012' (2013)

¹⁵⁰ SISA s 17A(1)(f).

¹⁵¹ Wilson Sy, 'Scale and Competition in Australian Superannuation' (Paper presented at the 20th Annual Colloquium of Superannuation Researchers, UNSW Sydney, 2012) at 7.

3.6.4 Tax advantage(s)

3.6.4.1 *Reducing an income tax liability*

Anecdotal evidence from the accounting profession suggests some SMSFs are established for the sole purpose of providing a one-off end-of-financial year tax deduction for a member with a large potential tax income tax liability.¹⁵² The member, usually self-employed, makes a deductible non-concessional contribution sufficient to nullify the liability¹⁵³ and the SMSF tends to be left as a cash-only investment vehicle thereafter.

An SMSF auditor (A9) describes the phenomenon as follows:

An accountant says: you've got a tax problem, start up an SMSF, drop \$100,000 into it, get a \$100,000 deduction. When I'm auditing the SMSF I see a term deposit for \$100,000 in the bank; there's no diversification. The accountant doesn't suggest any other investment. A minimum of 25% of the SMSFs I come across are a tax haven ... they're relying on the tax saving to be the investment, not the return on the investment.

3.6.4.2 *SMSF fund earnings and in specie transfers*

Because earnings of an SMSF are taxed at 15%,¹⁵⁴ and not at all if derived from an asset supporting a pension,¹⁵⁵ the ability to transfer assets into a fund *in specie* is an attractive feature. A high net worth individual owning significant assets may, subject to contributions caps, transfer those assets into the fund without converting them to cash. Once in the fund, earnings from those assets are taxed concessional.

3.6.4.3 *Avoiding a CGT liability*

A further motivation to set up an SMSF may be avoidance of capital gains tax (CGT) on appreciating assets. The strategy is to establish an SMSF to buy the assets, switching

¹⁵² A taxpayer can only claim a deduction for contributions to superannuation if their assessable income, exempt income and reportable fringe benefits amount from employment is less than 10% of their total assessable income and reportable fringe benefits. This is known as the ten per cent rule. See ITAA 1997 s 280.10.

¹⁵³ Since 1 July 2007, there is no limit to the deduction amount, but the contribution caps have imposed a limit of a different kind.

¹⁵⁴ *Income Tax Rates Act 1986* (Cth) s 26.

¹⁵⁵ ITAA 1997 s 295-385. This provision exempts from the fund's annual assessable income any income or capital gain from assets set aside to meet current pension liabilities.

the fund into pension phase once the member meets a condition of release, then realising the assets at a profit, when no CGT is payable. This strategy works mainly for assets purchased by the fund; those transferred *in specie* would attract CGT liability to the member at the time of transfer.

3.6.5 Ability to invest in collectables

SMSFs, in contrast to public funds, can and do invest in artwork, rare coins, vintage cars, wine, jewellery and gemstones, gold ingots and vacant land. However, the percentage of SMSFs invested in so-called exotic assets is small – ranging from 0.7% in smaller size funds to 0.1% for funds with in excess of \$500,000 total assets.¹⁵⁶ The available aggregate data does not reveal the features that characterise SMSFs that do so invest. Presumably their member/trustees have – or believe they have – specific expertise in a particular collectible, and with this the confidence that it can be expected to generate significant capital gains.

Following a vigorous debate on the desirability of this type of investing, the Federal Government promulgated guidelines for storage, insurance, valuation and sale of such assets, effective from July 2011.¹⁵⁷ These measures are designed to deter personal use as well as the manipulation of purchase (and sale) price to avoid tax.

3.6.6 Estate planning

SMSFs have estate planning advantages over APRA-regulated funds, the most important being perpetual succession and the indefinite binding death benefit nomination. This in turn has led some critics of SMSFs to claim that they may be established predominantly for estate planning reasons rather than for provision of retirement income.¹⁵⁸

¹⁵⁶ Commonwealth of Australia, above n 31, 32.

¹⁵⁷ Australian Taxation Office, *Collectables and personal use assets - questions and answers* (2011)

<<http://www.ato.gov.au/superfunds/content.aspx?menuid=49150&doc=/content/00301181.htm&page=6&H6>>

¹⁵⁸ Barrie Dunstan, 'Warning on 'weak link' super funds', *Australian Financial Review* 11 November 2009, 4.

3.6.6.1 *Perpetual succession*

Where an SMSF is a family concern – including adult children as trustees, for example – the death of one trustee need not cause the SMSF to be wound up. A new trustee may be appointed or the remaining trustees may continue the fund, with the deceased member's interest being paid to beneficiaries according to either a death benefit nomination within the trust deed or, in its absence, by addition of that interest to the deceased estate. If there is a corporate trustee, the SMSF trust may continue even if only one member/director remains (as opposed to the situation of a two member SMSF with individual trustees where, upon the death of one member, the single surviving member cannot remain as the sole trustee of the SMSF).¹⁵⁹

3.6.6.2 *Binding death benefit nomination*

A will does not automatically deal with the distribution of superannuation because the superannuation balance is not directly held by the member but in a trust structure. The trustee of the superannuation fund has a discretion (if this power is given to it by the trust deed, which it normally is) to pay out the super entitlements as the trustee sees fit; the trustee is not obliged to follow the wishes set down in the deceased member's will. Death benefits can be directed only to superannuation dependants of the deceased, or to their estate upon death, in fulfillment of the 'sole purpose test'¹⁶⁰ and the superannuation assets do not pass through the will.¹⁶¹ Generally the mechanism for implementing the distribution of these benefits¹⁶² grants the power to the trustee after the date of death, is determined by the trust deed, or is governed by a binding nomination made by the member. The most effective way for the members to control how their benefits are paid is to complete a binding death nomination that can remain valid indefinitely unless the member changes it.

¹⁵⁹ Refer SISA s 17A.

¹⁶⁰ SISA s 62(1)(iv) provides that death benefits must be provided to the member's legal personal representative, to any or all of the member's dependants, or to both.

¹⁶¹ Arlene Macdonald, 'Testamentary Trusts: Not Just "Another" Trust?' (2006) 4(2) *eJournal of Tax Research* 153, 175.

¹⁶² Generally to be found in Superannuation Industry (Supervision) Regulations 1994 reg 6.17A(4).

It is legally possible for retail and industry funds to offer non-expiring binding death benefit nominations but doing so involves a complex process.¹⁶³ As a result, almost all public offer funds that give the option of binding nominations to members use simpler procedures and the arrangements automatically lapse after three years.¹⁶⁴ An SMSF can avoid having a member die with a lapsed, and consequently invalid, nomination because it is excluded from the relevant regulation.

Another advantage of SMSF non-expiring binding nominations relates to the potential application of the family provision laws.¹⁶⁵ A person seeking to make a family provision claim is limited to challenging the estate assets of the deceased. As superannuation is not an asset of the estate, a person can pass benefits thereunder to anyone without the risk of having the decision contested in the courts.

The legal position has been modified in New South Wales, where the relevant legislation adopts the concept of the 'notional estate'.¹⁶⁶ The notional estate rules allow non-estate assets to be treated as estate assets if, within three years of death, they were the subject of a transaction made for the purpose of avoiding potential family provision claims. Although to date only NSW has proceeded in this fashion, there are plans for the other states to adopt this approach under the uniform succession laws.¹⁶⁷

The scope of transactions caught under the notional estate rules is broad, and may include changes to binding nominations executed within three years of death. Given that

¹⁶³ A nomination of a person as the recipient of a death benefit, would, in the absence of a statutory exception, represent a breach of SISA s 59(1), as it would be contrary to the prohibition on the exercise of a discretion by a person other than the trustee. As noted, s 59 does not apply to SMSFs. For APRA-regulated funds, s 59(1A) provides an exception to the s 59(1) prohibition, allowing members to determine, with substantial certainty, the persons to whom death benefits would be paid. Provided the regulations are complied with, a member's nomination binds the trustee. The regulations, specifically SISR 6.17A(7), limits the nomination to 3 years.

¹⁶⁴ The relevant provisions with respect to binding death benefit nominations are set out in ss 31, 55A and 59 of SISA. Section 59 does not apply to SMSFs. The standards referred to in SISA s 31 are prescribed in SISR 6.17A and SISR 6.17A(7) contains the 3 year limit.

¹⁶⁵ See *Family Provision Act 1969* (ACT); *Succession Act 2006* (NSW) Pt 3.2; *Family Provision Act 1970* (NT); *Succession Act 1981* (Qld) Pt 4; *Inheritance (Family Provision) Act 1972* (SA); *Testator's Family Maintenance Act 1912* (Tas); *Administration and Probate Act 1958* (Vic) Pt IV; *Inheritance (Family and Dependents Provision) Act 1972* (WA).

¹⁶⁶ *Succession Act 2006* (NSW) Pt 3.3.

¹⁶⁷ All States and Territories, (except for South Australia), have agreed to adopt the uniform succession laws, which are based on the New South Wales model set out in the *Succession Act (NSW) 2006*. The uniform succession laws may be adopted by the States and Territories who participated in the project over the next several years. The 2008/2009 Annual Report of the Standing Committee of Attorneys-General states that the Ministers will advise their respective States and Territories on the extent to which they should seek to achieve uniform legislation in this area.

most binding nominations by non-SMSF members must be renewed every three years, such nominations could be open to family provision claims. However, as binding nominations made through SMSFs remain effective beyond three years, if a member dies with a binding nomination more than three years old, the benefits will not be open to challenge by disgruntled or unsatisfied individuals. This provides a measure of certainty and highlights an estate planning benefit of SMSFs.¹⁶⁸

3.6.7 Sense of self-worth

The media has begun to portray the SMSF as a status symbol. For instance, a journalist has made the following observation:

If you really want to keep up with the smart set, see your accountant or financial planner about setting up a self-managed superannuation fund ... For some clients who come to see us, other than as a status symbol, there is no other reason why they would have a DIY fund ... The feeling is that Joe Bloggs and his wife down the road have got one [a DIY fund] and we want one too...Apart from social status, DIY funds have the added attraction of demonstrating to all and sundry that the trustee is in control of their destiny, and not some 'patsy' prepared to outsource their financial future to a third party ... A decade ago, who would have thought investing would have become so sexy?¹⁶⁹

An ATO director (Interview B7) confirmed that SMSFs have become fashionable and spread amongst certain social groups:

[from phone calls to new trustees we have found] word of mouth is a big reason people set up SMSFs and patterns are emerging - in small towns it's like a virus growth. Neighbours and associates copy the first of their group to set up an SMSF. Often you see a whole street gradually getting them over a 12 month period. This includes farmers from a certain district.

In summary, there are considerable advantages to an SMSF as a vehicle for retirement savings investment, not least of which is the ability to react quickly to changes in legislation and market conditions. The ability to maximise those advantages without

¹⁶⁸ Daryl Dixon, 'DIY Super: Great for your estate plans', *Financial Review Smart Investor*, June 2009, 62.

¹⁶⁹ Sally Patten, 'A super sense of self-worth', *Australian Financial Review* 15 April 2011, 4.

contravening SIS regime requirements depends to a large extent on an individual's knowledge and understanding of their obligations as SMSF trustee.

3.7 Knowledge and understanding of obligations as trustee

SMSF trustees range from the sophisticated, highly financially literate and committed to the naïve or ignorant, perhaps advised to form an SMSF by their accountant or financial adviser hoping to secure a new client (the SMSF) and correspondingly increased fees. Interviewee A10, an accountant, remarked that 'a lot of trustees have set an SMSF up because their accountant back in the day told them to'. Interviewee A7, a financial adviser, noted that:

... some people you try to explain simple concepts to just look at you blankly and you realise they are not suitable for an SMSF.

These latter trustees may devote little time and care to running their SMSF, and may lack the requisite understanding of their obligations as trustee. Yet new trustees undertake onerous responsibilities under the SIS regime, which require them to become knowledgeable about their obligations as a trustee. Even if they outsource most of the administrative, accounting and investment decisions and activities, the ultimate responsibility for compliance remains with them.

Since 1 July 2007 new trustees of SMSFs must sign and lodge with the ATO a Trustee Declaration¹⁷⁰ upon becoming a trustee (or director of a corporate trustee) of either a new or existing SMSF. The declaration begins with a summary of provisions in the SIS regime relevant to SMSFs, including investment restrictions, the sole purpose test and trustee duties and administrative requirements. By signing, trustees declare that they understand their obligations as trustee/director and that they have responsibility for ensuring their SMSF complies with SISA 'and other relevant legislation'.

An ATO Assistant Commissioner interviewed for the purposes of this study remarked that he has encountered many SMSF trustees who are not competent, do not know what a trust deed is and what a trustee has to do, and take no active part in running the fund

¹⁷⁰ ATO form NAT 71089-06.2010.

or are in fact unaware they hold the office of trustee. Some trustees in their later years may have lost mental competence and become unable to discharge their responsibilities as trustee. He questioned how readily people should be able to have an SMSF or become a trustee.¹⁷¹ These views, however, may arise from an unduly jaundiced view of the sector (see 5.4.12.1 ATO view of SMSF compliance).

The situation of SMSF trustees may be compared with that of trustees of APRA-regulated funds. The *Superannuation Safety Amendment Act 2004* (Cth) contained a range of Schedules that amended the SIS Act to require that, from 1 July 2004, both corporate and groups of individual trustees be licensed as Registrable Superannuation Entities¹⁷² ‘to ensure that all superannuation trustees are competent and have adequate systems to look after the interests of members and beneficiaries of superannuation entities’.¹⁷³ The licence conditions with respect to fitness and propriety, capital requirements, maintenance of risk management strategies and plans must be met on an ongoing basis. This requirement does not apply to SMSF trustees, who, once registered, remain trustees indefinitely without any review of fitness and propriety. The trustee registration requirements of APRA-regulated funds thus provide a tightness of regulation missing from the regulation of SMSFs.

One possible avenue to address possible SMSF shortcomings, considered by the Super System Review, is a ‘gatekeeper mechanism’ to prevent unsuitable SMSFs being established. A prospective SMSF member would be required to complete an online module on a government website which would examine their possible suitability to participate as a member and trustee of an SMSF on a self-assessment basis. The Super System Review preliminary report suggested that ‘[t]he existing ATO Trustee Declaration could be rolled into this process so that the new SMSF member would go through an

¹⁷¹ Interview B4.

¹⁷² Which do not include SMSFs: SISA s 10.

¹⁷³ Explanatory Memorandum, Superannuation Safety Amendment Bill 2003 (Cwlth), 3.18.

educative, and then a declarative, process'.¹⁷⁴ However, the final report declined to recommend such a tool, stating:¹⁷⁵

A 'gatekeeper' mechanism would not resolve the underlying problem of inadequate advice being provided at SMSF establishment by advisers. The Panel believes that the existing SMSF advice framework has led to people being inappropriately advised into SMSFs; a view expressed in a number of submissions.

Industry has already developed an on-line 'self test', released in 2010 jointly by CPA Australia, the Institute of Chartered Accountants in Australia and the National Institute of Accountants.¹⁷⁶ It follows the ATO Trustee Declaration form and aims to assist potential trustees to assess if an SMSF is suitable for them, and to educate them on trustee roles and responsibilities, investment restrictions, rules and limitations surrounding contributions and benefit payments, and the administration involved with an SMSF.

A 'gatekeeper' process, together with the trustee declaration, though it may assist in the initial stages of SMSF formation, cannot eliminate careless or incompetent trustees, those who have not made an active decision to take on that role or those who have deteriorated in their mental capacity. The approved auditor must then be relied upon to report any resulting financial or regulatory contraventions.

A high water mark in the imposition of responsibility on trustees may have been reached in the case of *Shail Superannuation Fund v Commissioner of Taxation*¹⁷⁷ in which the trustees of the SMSF were husband and wife. Mrs Shail claimed she was not liable for the actions of her estranged husband in illegally transferring nearly all the fund monies of \$3.46 million offshore without her knowledge or consent. This act left Mrs Shail liable for nearly \$3 million in additional tax and penalties. The Administrative Appeals Tribunal, while acknowledging sympathy for Mrs Shail, found that 'any appearance of unfairness to

¹⁷⁴ Commonwealth of Australia, 'Self managed super solutions: Phase Three - Preliminary Report' (2010), 20.

¹⁷⁵ Commonwealth of Australia, 'Super System Review Final Report, Chapter 8: Self-managed super solutions' (2010), 233.

¹⁷⁶ CPA Australia, *Self-managed superannuation funds trustee education training program* (2010)

<<http://www.smsftrustee.com/cpa/htm/SMSF/data/index.html>>

¹⁷⁷ [2011] AATA 940.

Mrs Shail as an individual should not, however, obscure the nature of the Fund, the role of trustees or the regulatory regime within which they function'.¹⁷⁸

3.8 Outsourcing of management by trustees

SMSFs may operate in a manner such that their trustees perform all services apart from the annual audit. Trustees may seek advice at the establishment stage and then take over management. At the other extreme, they may operate with virtually complete outsourcing. To this end, stockbrokers and advisers provide platforms that provide accounting, advising, transactions, taxation, custody services and arrangements, such that the member-trustee's role is effectively that of a signatory acknowledging ultimate responsibility.

The *2008 ATO new trustee* questionnaire reveals that, at establishment, 72% of trustees consulted with a tax agent/accountant and 42% with a financial adviser. Since establishment, 74% said they paid for the preparation of annual returns, 49% for ongoing administration and 49% for legal services. Only 11% self-administered and did not pay for any professional services¹⁷⁹ (apart from the mandatory annual audit).

There have been suggestions that there is a case for limiting the scope for individuals to completely self-manage their SMSF, utilizing only the services of an approved auditor, unless they can demonstrate the requisite expertise.¹⁸⁰ Any such initiative, to be successfully implemented, would need to be clear as to the form this demonstration might take and to whom it would need to be made, and be supported by a commensurate commitment to funding of whatever agency would be charged with such a 'licensing' role.

¹⁷⁸ Ibid, [69]

¹⁷⁹ Commonwealth of Australia, above n 31, 7.

¹⁸⁰ Kevin Davis, 'SMSFs should self-manage their own risks', *Australian Financial Review* 16 April 2011, 63.

3.9 Trustee Education

3.9.1 Compulsory education

Neither the industry nor the Super System Review favoured compulsory education for, or academic, professional or other qualification of, SMSF trustees, recommending instead compulsory standards of competence and continuing professional development be imposed on SMSF advisers.¹⁸¹ The industry view is that what is important for SMSF trustees is that they understand their basic obligations in that role.

ING Australia's submission to the Review highlights the potential for SMSF fund administrators to reinforce the message of the ATO Trustee Declaration by clearly disclosing trustee obligations at the time of establishment, and requiring trustees to read and acknowledge that they have read a summary of their obligations:¹⁸²

Given 97% of new SMSF trustees seek some form of advice in establishing and maintaining their fund it is not necessary (or desirable) to try to make them experts in superannuation, taxation and trust law. It would also be a time consuming and costly exercise which would provide a major disincentive for people to establish SMSFs, therefore representing a barrier to entry.

Whilst having been opposed to any form of 'mandatory' education for SMSF trustees, SPAA has begun accrediting providers to train SMSF trustees in their roles and responsibilities. The accreditation includes curriculum guides and SMSF trustee trainees receive CPD points (which SPAA states ought to be acknowledged by the SMSF auditor as part of the annual audit for the ATO).¹⁸³

3.9.2 ATO educative material

The educative material available on the ATO website is designed to assist potential SMSF trustees in deciding whether an SMSF is within their capabilities, and to educate

¹⁸¹ Commonwealth of Australia, above n 175, 225.

¹⁸² ING Australia, 'ING Australia Limited's Submission to the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System (The Cooper Review)' (February 2010) <http://www.supersystemreview.gov.au/content/submissions/downloads/ING_100305.pdf> , 15.

¹⁸³ Andrea Slattery, 'Trustee training' (2010) (April-May) *Professional Planner* 10.

them about their duties in that role. A suite of ATO publications targeted at appropriate life-stages of an SMSF was released in 2009:

1. *Thinking about a self-managed super fund?*
2. *Setting up a self-managed super fund*
3. *Running your self-managed super fund*
4. *Winding up a self-managed fund.*

A new publication aimed specifically at SMSF members in retirement phase is currently under development.

A further suite of products was released by the ATO in August 2009 offering and explaining self-managed super fund product rulings. Forms were released on the website for either:

1. a ruling about how the SIS regime applies to an investment by an SMSF in the applicant's product, or
2. specific advice about how the super law applies to a particular transaction or arrangement for an SMSF.

The product and transaction/arrangement rulings are not binding on the ATO (or the rulee) but are helpful and represent an attempt by the ATO to tailor its supervisory regulation to its SMSF constituency.

The ATO releases many public rulings that clarify its interpretation of key areas. Draft rulings and determinations are released for public comment before being released in final form. There are also a large number of publicly available Interpretative Decisions, specific to individual SMSFs, but dealing with common scenarios.¹⁸⁴

¹⁸⁴ Interpretative Decisions carry the following caveat:

CAUTION: This is an edited and summarised record of a Tax Office decision. This record is not published as a form of advice. It is being made available for your inspection to meet FOI requirements, because it may be used by an officer in making another decision.

Taxpayer Alerts are issued by the ATO as an 'early warning' of significant new and emerging higher risk superannuation planning issues or arrangements on which the ATO has not yet developed a formal view. This is said to be 'in the interests of an open tax administration'.¹⁸⁵ For example, Taxpayer Alert 2010/2 dealt with circumvention of excess contributions tax¹⁸⁶ by use of SMSFs, whereby the SMSF trust deed is amended to create a separate trust to hold excess contributions and allow their return to the contributor (although such amounts are in fact often intermingled with the SMSF's other assets).¹⁸⁷ The Alert was withdrawn on 29 November 2011.

3.9.3 Understanding of retirement income policy

Although there is no shortage of educational material provided by the ATO to assist motivated trustees, there appears a general dearth of appreciation and understanding in the community of the government's retirement income policies and the reasons for the trustee obligations and prohibitions contained in the SIS regime.¹⁸⁸ An example is the prohibition from borrowing in SISA s 67. It is likely that many trustees may not understand that the prohibition is based upon the requirement to deal conservatively with retirement assets and that borrowing is an inherently risky endeavour.¹⁸⁹

Contributions caps are another policy area causing widespread angst and confusion in the community,¹⁹⁰ yet neither the government nor regulator is seen to have adequately

This ATOID provides you with the following level of protection:

If you reasonably apply this decision in good faith to your own circumstances (which are not materially different from those described in the decision), and the decision is later found to be incorrect you will not be liable to pay any penalty or interest. However, you will be required to pay any underpaid tax (or repay any over-claimed credit, grant or benefit), provided the time limits under the law allow it. If you do intend to apply this decision to your own circumstances, you will need to ensure that the relevant provisions referred to in the decision have not been amended or repealed. You may wish to obtain further advice from the Tax Office or from a professional adviser.

¹⁸⁵ Wording in the introductory paragraph of Taxpayer Alerts.

¹⁸⁶ Pursuant to *ITAA 1997* Division 292 which limits the superannuation contributions made in a financial year for a person that receive concessional tax treatment. There are different annual limits for concessional and non-concessional contributions.

¹⁸⁷ See John Kehoe, 'Tax advisers warned on super gambit', *Australian Financial Review* 30 March 2010, 3.

¹⁸⁸ In general, knowledge and accurate perceptions of superannuation in Australia is unevenly spread across the population and is better for professionals, those aged over 40 or nearing retirement and the university educated.: Andrew C. Worthington, 'Knowledge and Perceptions of Superannuation in Australia' (September 2008) 31(3) *Journal of Consumer Policy* 349.

¹⁸⁹ See Inga Markovits, 'Exporting Law Reform - But Will It Travel?' (2004) 37(95) *Cornell International Law Journal* 95.

¹⁹⁰ See for example Bianca Hartge-Hazelman, 'Super tax relief 'near useless'', *Australian Financial Review* 12 May 2011, 20.

explained the reasons for the contributions caps (that is, to limit the avoidance of income tax by high income earners and high net worth individuals diverting excessive amounts into a concessional taxed environment).¹⁹¹

The ATO could address this deficiency by including some general explanation in its SMSF educational material of the policy reasons *why* trustees should fulfill their obligations as set out therein, in order to facilitate compliance.

3.10 Disqualification of trustees

Section 120 of SISA deals with disqualification of persons from being SMSF trustees. An individual may not be an SMSF trustee if at any time:

- the person has been convicted of an offence against or arising out of a law of the Commonwealth, a State, a Territory or a foreign country, being an offence in respect of dishonest conduct;
- a civil penalty order was made in relation to the person;
- the person is an insolvent under administration; or
- the Commissioner of Taxation has disqualified the individual pursuant to SISA s 126A.

3.10.1 Grounds for disqualification

The grounds for disqualification under s 126A include that the person has contravened the SISA or the *Financial Sector (Collection of Data) Act 2001* (Cth)¹⁹² on one or more occasions, and the nature, seriousness or number(s) of the contravention or contraventions provides grounds for disqualifying the individual. The Commissioner can also disqualify an individual if satisfied that the individual is otherwise not a fit and proper

¹⁹¹ The Explanatory Memorandum to the *Tax Laws Amendment (Simplified Superannuation) Bill 2006* (at 1.9 and 1.12) states 'The object of this Schedule is to ensure that the amount of concessional taxed superannuation benefits that a person receives results from superannuation contributions that have been made gradually over the course of the person's life... To ensure superannuation taxation concessions are targeted appropriately, limits will be placed on the amount of superannuation contributions a person can make that receive concessional treatment.'

¹⁹² The Act empowers financial sector agencies to collect information from bodies in that sector.

person to be a trustee, investment manager or custodian, or a responsible officer of a body corporate that is a trustee, investment manager or custodian.¹⁹³

When the Commissioner disqualifies an individual, he must give that individual written notice of the disqualification and publish details of the disqualification in the Australian Government Notices Gazette.¹⁹⁴

The Commissioner may revoke a disqualification on application by the disqualified individual or on his own initiative.¹⁹⁵ The Commissioner may also waive the disqualification¹⁹⁶ upon application by the individual if, having regard to:

- the offence to which the application relates;
- the time that has passed since the applicant committed the offence;
- the applicant's age when the applicant committed the offence;
- the orders made by the court in relation to the offence; and
- any other relevant matter;

the Commissioner (that is, the delegated ATO case officer) is satisfied that the applicant is highly unlikely to contravene SISA and do anything that would result in an SMSF not complying with SISA.

3.10.2 Issues with trustee disqualification

There are two main issues with the trustee disqualification regime: the broad scope of the terms used in the legislation, and the difficulty for the regulator in administering it.

The onus lies on the individual to apply for a waiver of disqualification. An individual who is a person disqualified from being an SMSF trustee under SISA s 126A because he or she was convicted of an offence in respect of dishonest conduct may apply to the ATO

¹⁹³ SISA s 126A(3).

¹⁹⁴ SISA s 126A(6), 126A(7).

¹⁹⁵ Under SISA s 126A(5).

¹⁹⁶ Under SISA s 126D.

for a declaration waiving his or her status as a disqualified person provided the offence was not one involving serious dishonest conduct.

Section 126B (and associated provisions) was inserted into the SISA to allow the ATO to waive the disqualified person requirements for a trustee if it believes that the individual is highly unlikely to be a prudential risk to a superannuation entity; for example, an individual whose only offence was a minor offence involving dishonesty, such as shoplifting, 20 years ago.¹⁹⁷

An individual is not eligible to apply for a waiver unless the offence that he or she has committed meets the conditions found in s 126B(2). Other factors, such as the length of time since committing the offence, are only considered by the ATO if the individual is eligible to apply (s 126D(1A)). Hence, the gravity of the offence is the most important factor in determining if an individual is a prudential risk to a superannuation fund.

Under s 126B(2)(a), an offence involves serious dishonest conduct if 'the penalty actually imposed for the offence is a term of imprisonment of at least 2 years'. So a person can apply for a waiver if he or she had less than a two year term of imprisonment imposed. But whether or not the offence involved 'serious dishonest conduct' is for the ATO to decide. The ATO has wide discretion in interpreting the terms 'serious dishonest conduct' and 'fit and proper person'.

Until ATO Interpretative Decision ATO ID 2011/24,¹⁹⁸ there was no indication of what matters the ATO would take into account in exercising the discretion to waive disqualification. In the circumstances of the ATO ID the member was sentenced to a period of imprisonment of more than 2 years but the period of time he spent in prison was less than 2 years. The ATO ID concluded that the phrase 'the penalty actually imposed' in SISA 126B(2) means the term of imprisonment that the court considers to be appropriate for the offence rather than the actual period of time that the offender spends in prison, which in this case had been reduced by a recognisance release order.

¹⁹⁷ Explanatory Memorandum for the Superannuation Industry (Supervision) Legislation Amendment Bill 1995, schedule 4, item 52.

¹⁹⁸ ATO ID 2011/24 Self managed superannuation fund: waiver of disqualified person status - meaning of 'serious dishonest conduct'.

The guidance provided by this ATO ID is of limited assistance, as it applies only to a particular set of circumstances and any which are materially different from those described in the decision may result in the ATO's discretion being exercised differently.

In any event, the SMSF Trustee Declaration does not require individuals to declare that they are eligible to be an SMSF trustee, only that they understand their duties and responsibilities as a trustee of the named SMSF. The ATO does little checking of trustee suitability and indeed such a task would be difficult, intrusive and possibly breach privacy law. Thus, the ATO will be unaware that an individual has been convicted of a crime of dishonesty, subject to a civil penalty order or is insolvent unless the individual discloses it and in so doing self-excludes from the trustee role.

3.11 Conclusion

Self-managed superannuation funds are a uniquely Australian retirement vehicle and there is no direct equivalent in any overseas jurisdiction. This chapter has revealed that there is some understanding of the identity, nature and motivations of SMSF trustees/members, but despite a number of surveys and an abundance of statistical information, a comprehensive picture of the SMSF trustee remains elusive. This is in large part the result of the aggregate nature of the statistics collected and published by the ATO, the small sample size of the surveys to date and the inaccessibility of most of those survey results. The academic literature on the sector is surprisingly sparse, due perhaps to the relatively recency of the SMSF phenomenon.

What is apparent is that a large and growing segment of the population is recognizing the advantages of taking control of their own retirement savings, the speed and flexibility enabled by SMSFs and the tax concessions and estate planning opportunities that are available to those with appropriate understanding and/or advice.

A number of questions about SMSF trustees remain unanswered, and might usefully be the subject of further research. There are regulatory questions such as:

- the proportion of funds which have been subject to an ATO audit and the characteristics of such funds;

- the reason(s) why SMSFs are wound up;¹⁹⁹ and
- how often SMSFs accept Super Guarantee contributions and whether this introduces employers as SMSF stakeholders.

Then there are sociological questions such as:

- the relationship between SMSF members (whether parents and children, other family members or unrelated individuals);
- whether all of the trustees in an SMSF are regularly involved in its day-to-day running or if there is generally one main controller; and
- the demographic characteristics of SMSFs that invest in collectables or have other unusual asset allocation patterns, eg 100% assets in business real property.

The answers to these questions, amongst many others, would be useful in the policy and regulatory debate surrounding SMSFs. The government and regulators are subjected to intense lobbying from proponents and promoters of SMSFs and, on the other hand, from those to whom the burgeoning sector presents a threat. The truth is sometimes difficult to decipher in the absence of hard evidence about the motivation and compliance of individuals operating in the sector.

On current trends, within a few years there will be a million SMSF members, accessing a large proportion of the tax expenditure attaching to superannuation and, in the context of government retirement income policy, it is important to discover how effectively those individuals are managing their retirement investment vehicles and the concessions they enjoy.²⁰⁰ There is certainly scope for further large-scale research into SMSF trustees as

¹⁹⁹ Australian National Audit Office, 'The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds' (52, 2007) ANAO No 2.. Recommendation No 5 was that a specific wind-up form be developed by the ATO, but this has not been done.

²⁰⁰ Superannuation tax concessions were estimated at \$26.6 billion in the 2010 income year: Australian Treasury, *Tax Expenditures Statement 2010* (2011) <http://www.treasury.gov.au/documents/1950/PDF/2010_TES_consolidated.pdf> ,238.

individuals, conducted on disaggregated data, but this will depend upon availability of data from the ATO, which is subject to significant privacy constraints.

Having now explored the background of the SMSF sector and the characteristics of its trustee-members, the focus now shifts, in Chapter 4, to a detailed examination of its legislative and supervisory regulation.

CHAPTER 4

REGULATION

4.1 Introduction

As at March 2012 SMSFs held over \$416 billion in assets. The generous tax concessions²⁰¹ they enjoy represent a considerable amount of foregone revenue to the government, as well as future cost if, through mismanagement, SMSF assets are eroded and members forced to draw the government Age Pension. It is therefore crucial that the regulation of this sector be effective and the attendant retirement income be adequately protected.

As this thesis is directly concerned with the regulation of SMSFs, this chapter deals with the existing regulators and regulatory framework. It is based upon the identified theoretical elements of regulation. The chapter follows a hierarchical structure, from the statutory regime and common law regulation, to the regulator and its supervisory activities, down to subsidiary functions of regulation performed by various bodies external to the regulator.

As one of the pillars of the regulation of financial institutions (including public offer superannuation funds) – prudential regulation – is notably absent in the regulation of SMSFs, the chapter also outlines the reasons for the lack of prudential regulation of SMSFs.

Several issues arise from the description of the current regulatory framework, summarised in the conclusion to this chapter, and these are expanded upon in Chapters 5 and 6.

²⁰¹ Refer ITAA 1997 Division 295 --Taxation of superannuation entities, in particular s 295-385 and s 295-390, which exempt from income tax and CGT any fund assets used to meet current pension liabilities.

4.2 'Regulation' in the SMSF environment

Regulation has been described in terms of control by the state through legislation of private (non-government) economic entities.²⁰² Its hallmark in this sense is a rule, backed by the power of the state, intended to modify behaviour.²⁰³ However, for the purposes of this chapter, the concept is defined more broadly, beyond the limitation of legislation and rules.

One formulation of a complete regulatory system is one that contains the following elements:²⁰⁴

- rulemaking: the establishment of the rules that will guide behaviour;
- communication of rules: making regulatees aware of the behaviour expected or required;
- monitoring: oversight to ensure compliance with the rules;
- enforcement: taking action when noncompliance is identified;
- adjudication: official decision making about the consequences of noncompliance or settlement of disputes;
- sanctions: negative consequences for noncompliance; and
- evaluation: the assessment and adjustment of the regulatory system.

In relation to the regulation of SMSFs, the highest level of regulation – 'rulemaking' – consists of legislation, case law and the rules contained within an entity's governing documents: see 4.3. Four of the next elements – 'communication of rules', 'monitoring', 'enforcement' and 'sanctions' – are performed under the cover of the regulator, and have a distinct supervisory aspect: see 4.4. In this sense, a distinction can be drawn between

²⁰² R F Cranston, 'Regulation and deregulation: General issues' (1982) 5 *University of NSW Law Journal* 1, 2.

²⁰³ Margot Priest, 'The Privatization of Regulation: Five Models of Self-Regulation' (1997-98) 29(233) *Ottawa Law Review* at 237.

²⁰⁴ *Ibid.*

'regulation' and 'supervision' – a distinction, simply put, between the rules of the game and how they are refereed²⁰⁵ – although, as noted earlier, when conceived broadly for the purposes of this chapter, 'regulation' can encompass 'supervision'. 'Adjudication' is directed at resolving disputes between regulator and regulatee, often in a court or tribunal setting: see 4.5. Finally, 'evaluation' involves an assessment of the conduct of the regulator's functions, to be performed principally by an independent party or body external to the regulator: see 4.6.

The ATO has prime responsibility for regulating SMSFs and for ensuring employers' and funds' compliance with the Superannuation Guarantee Charge.²⁰⁶ For this reason, this chapter focuses on the ATO's role as regulator of SMSFs. The ATO is generously resourced to supervise SMSFs, and is imbued with considerable statutory powers throughout the SIS scheme, being branded 'a regulator with a spectre of awesome and authoritative power'.²⁰⁷

That is not to say that other regulatory bodies have no role in this regard, but that their role is subsidiary. For instance, though the Australian Prudential Regulatory Authority (APRA) prudentially regulates financial services institutions including public offer superannuation funds,²⁰⁸ its involvement with SMSFs was confined to decision-making on applications by members for early release of superannuation (before that member's preservation age) on compassionate grounds.²⁰⁹ From 1 November 2011 administration of claims for early release of superannuation benefits on compassionate grounds is no longer an APRA responsibility, but that of the Department of Human Services (the Chief Executive, Medicare).²¹⁰ And the consumer protection responsibilities vested in the Australian Securities and Investments Commission (ASIC) are in the SMSF context

²⁰⁵ Byres, Wayne, 'Some Australian Perspectives on Procyclicality' (Paper presented at the 9th Annual International Seminar on Policy Challenges for the Financial Sector: Emerging from the Crisis – Building a Stronger International Financial System, Washington DC, June 3-5, 2009).

²⁰⁶ It was announced in November 2009 that Medicare is to act as a voluntary clearinghouse for SG contributions from small business with up to 20 employees: Association of Superannuation Funds of Australia Ltd, 'Voluntary Clearinghouse - First Step to Improving Efficiency and Lowering Cost' (6 November 2009)

<<http://www.superannuation.asn.au/mr091106-1/default.aspx>> 2.1 re Superannuation Guarantee

²⁰⁷ Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992), 47.

²⁰⁸ *Australian Prudential Regulation Authority Act 1998* (Cth) s 8(1).

²⁰⁹ SISR 6.19A.

²¹⁰ *Superannuation Legislation Amendment (Early Release of Superannuation) Act 2011* (Cth).

confined to protecting SMSFs as retail investors through the regulation of investment service providers. ASIC does, however, also regulate corporate SMSF trustees, as corporations, including registration and financial reporting.²¹¹

4.3 Rules

4.3.1 Legislation

The federal Government's constitutional power to regulate retirement incomes is sourced under three heads of legislative competence under the Australian Constitution: the taxation power (s 51(ii)), the 'corporations power' (s 51(xx)), and the 'old-age pensions power' (s 51(xxiii)). Pursuant to the principal legislative enactment of these powers – the *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA') – favourable tax treatment for a superannuation fund is premised on its trustee/s electing at the outset to be regulated under the Act, and that its rules require the trustee to be a company, or provide that the sole or primary purpose of the fund is the provision of old-age pensions (if the trustees are individuals).²¹² The latter forms the basis of the 'sole purpose test' in SISA s 62. The Act, via s 17A, defines 'self managed superannuation fund' by reference to features it must exhibit, viz:

Basic conditions—funds other than single member funds

(1) Subject to this section, a superannuation fund, other than a fund with only one member, is a *self managed superannuation fund* if and only if it satisfies the following conditions:

(a) it has fewer than 5 members;

(b) if the trustees of the fund are individuals—each individual trustee of the fund is a member of the fund;

²¹¹ In general terms, while ASIC covers the consumer protection aspects, APRA covers the prudential operation of superannuation funds. 'This division of responsibilities plays to each organisation's perceived strength, but is a potential cause of regulatory overlap': Leslie Nielson, 'Benchmarking Australian Superannuation Regulation and Practice' (2006) <http://www.aph.gov.au/Senate/committee/corporations_ctte/completed_inquiries/2004-07/superannuation/library_research_paper.pdf> at 12 December 2011.

²¹² SISA s 19(3).

(c) if the trustee of the fund is a body corporate—each director of the body corporate is a member of the fund;

(d) each member of the fund:

(i) is a trustee of the fund; or

(ii) if the trustee of the fund is a body corporate—is a director of the body corporate;

(e) no member of the fund is an employee of another member of the fund, unless the members concerned are relatives;

(f) no trustee of the fund receives any remuneration from the fund or from any person for any duties or services performed by the trustee in relation to the fund;

(g) if the trustee of the fund is a body corporate—no director of the body corporate receives any remuneration from the fund or from any person (including the body corporate) for any duties or services performed by the director in relation to the fund.

Basic conditions—single member funds

(2) Subject to this section, a superannuation fund with only one member is a *self managed superannuation fund* if and only if:

(a) if the trustee of the fund is a body corporate:

(i) the member is the sole director of the body corporate; or

(ii) the member is one of only 2 directors of the body corporate, and the member and the other director are relatives; or

(iii) the member is one of only 2 directors of the body corporate, and the member is not an employee of the other director; and

(b) if the trustees of the fund are individuals:

(i) the member is one of only 2 trustees, of whom one is the member and the other is a relative of the member; or

(ii) the member is one of only 2 trustees, and the member is not an employee of the other trustee; and

(c) no trustee of the fund receives any remuneration from the fund or from any person for any duties or services performed by the trustee in relation to the fund;

(d) if the trustee of the fund is a body corporate—no director of the body corporate receives any remuneration from the fund or from any person (including the body corporate) for any duties or services performed by the director in relation to the fund.

The SISA confers upon the ATO (being the Regulator in the relevant provisions) supervisory and enforcement powers, including:

- *Exemptions and modifications:* The ATO has power to grant exemptions from, and make modifications to, specified provisions of the SISA and the *Superannuation Industry (Supervision) Regulations 1994* (Cth) ('SISR').²¹³
- *Monitoring and investigation:* The ATO has been granted wide information gathering and investigating powers. In respect of monitoring, trustees must produce prescribed information to the ATO²¹⁴ and may be required to produce specified information on request.²¹⁵ The ATO may initiate an investigation of an SMSF, upon notice to the trustees, if it appears to the ATO that: (a) the SISA or SISR have been contravened; or (b) the financial position of the SMSF may be unsatisfactory.²¹⁶ In addition, wide

²¹³ SISA s 326. In respect of modifiable provisions the Regulator may either exempt, conditionally or otherwise, a particular person (class of persons, superannuation entity or class of superannuation entities) from compliance with the relevant provisions or declare that the relevant provision is to have effect as if it were modified as specified in the declaration: SISA ss 326-331, 333-336.

²¹⁴ Trustees of SMSFs are required to lodge an annual return in each year of income: SISA 35D. Furthermore, trustees of SMSFs established after 1 December 1993 must within 7 days of establishment lodge with the ATO the prescribed information [found in SISR]: SISA s 254(2).

²¹⁵ The Regulator may, by written notice require the trustees to produce specified information or the production of reports or books relating to the affairs of the superannuation entity: SISA s 255. Access to premises for the purpose of accessing and copying such books is also granted provided the occupier consents: SISA s 256.

²¹⁶ SISA s 263.

powers are conferred for the purpose of conducting the investigation, including power to enter premises for the collection of information,²¹⁷ require the production of information,²¹⁸ require the assistance of relevant persons²¹⁹ and, in prescribed circumstances, freeze the assets of the SMSF.²²⁰

- *Suspension and removal of trustees:* The ATO may suspend or remove the trustee of an SMSF in prescribed circumstances.²²¹
- *Sanctions:* The ATO has the power to make an application to the court for a civil penalty order.²²² As an alternative, the ATO may accept enforceable undertakings from trustees.²²³ It can issue a notice stating that an SMSF is not a complying superannuation fund if a trustee of the SMSF contravened one or more of the regulatory provisions, but retains discretion as to whether or not to issue such a notice.²²⁴ The ATO (or APRA) can also wind up an SMSF.²²⁵

Not all provisions of SISA apply to SMSFs.²²⁶ Of particular note in this context are the provisions covering prudential regulation.²²⁷ The rationale for exempting SMSFs from many of the prudential requirements of SIS can be traced to the 1997 Financial System Inquiry Final Report (the 'Wallis report'),²²⁸ which explained the case for prudential regulation of 'superannuation' in the following terms:²²⁹

The compulsory nature of some superannuation saving, lack of choice for a large proportion of members, mandatory long-term nature of superannuation and contribution to superannuation of tax revenue foregone provide a case for prudential regulation of all

²¹⁷ SISA s 268.

²¹⁸ SISA s 269.

²¹⁹ SISA s 270.

²²⁰ If it appears that the conduct engaged in by the trustee or investment manager is likely to adversely affect the values of the beneficiaries' interest, the ATO may give a written direction to the trustees or investment manager to provide the specified information and/or freeze the assets of the SMSF: SISA s 264.

²²¹ SISA s 133.

²²² SISA s 197.

²²³ SISA s 262A.

²²⁴ SISA s 42.

²²⁵ SISA s 142.

²²⁶ SISA s 6 specifies the provisions of the Act in respect of which the ATO has general administration.

²²⁷ Most notably, SISA Pt 2B, Pt 25 Div 3.

²²⁸ Stan Wallis, March 1997, Financial System Inquiry Final Report [Wallis Report], 127.

²²⁹ Ibid 305.

superannuation funds, even where investors have knowingly accepted market risk. This rationale is complemented by the need for government to regulate the compliance of superannuation funds with retirement income policies such as compulsory preservation ... the regulatory approach will focus ... on compliance issues and ensuring appropriate risk management practices.

In contrast, as noted in Chapter 2, the Wallis report recommended that SMSFs (then known as 'excluded funds') should not be subject to prudential regulation but that regulation of compliance be transferred to the ATO. It identified measures to improve prudent behaviour to include increasing responsibilities on trustees and auditors to ensure compliance by excluded funds with retirement income laws, and requiring all members of excluded funds to be trustees.²³⁰ As appears from the above, these recommendations were given effect (largely within SISA s 17A) and the Explanatory Memorandum to the relevant amending legislation²³¹ stated that '[a]s members of self managed superannuation funds will be able to protect their own interests, these funds will be subject to a less onerous prudential regime under the SIS Act'.²³²

4.3.2 Regulations

Statutory rules governing superannuation funds are contained in the SISR. As in SISA, many provisions are inapplicable to SMSFs. Those applicable to SMSFs deal with matters such as rollover or transfer of withdrawal benefits,²³³ the period within which an auditor must be appointed²³⁴ and an audit report must be given,²³⁵ prescribed information,²³⁶ operating standards on disclosure of certain information (name, address, membership, trustees, etc)²³⁷ and change in any of those or the status of an SMSF.²³⁸

²³⁰ Ibid 334.

²³¹ *Superannuation Legislation Amendment Act (No 3) 1999* (Cth).

²³² The Parliament of the Australian Government, House of Representatives 1998–99, Superannuation Legislation Amendment Bill (No 3) 1999, 1.

²³³ SISR 6.34.

²³⁴ SISR 8.02A.

²³⁵ SISR 8.03.

²³⁶ Referred to in SISA s 254(1) - *Information to be given to Regulator* SISR 11.04.

²³⁷ SISR 11.07AA.

²³⁸ SISR 11.07A.

According to some commentators, the SIS regime,²³⁹ having been adapted to make it fit the SMSF sector, has resulted in some anomalies and unnecessary administrative requirements on SMSFs trustees to document decisions made in their roles as trustee for the benefit of themselves as member (discussed in more detail in Chapter 6).

4.3.3 Common law and governing documents

As superannuation funds regulated by the SIS Regime ('regulated' funds) must be constituted as a trust,²⁴⁰ all general law notions of trustee responsibilities and duties are necessarily imported to govern the trustee-member relationship,²⁴¹ even though every SMSF member is also a trustee or director of the corporate trustee.²⁴² SMSFs are subject to centuries of general trust law that still applies to the extent that it has not been ousted or modified by the overlaid legislation. They are also subject to the Trustee Acts in each state or territory. In general, the SIS Regime overlays *additional* standards of conduct that funds and trustees must observe, for example SISA s 52 ('Covenants to be included in governing rules'), which comprise certain fiduciary and prudential duties required of all superannuation fund trustees.

All SMSFs are established via a trust deed that contains the fund's investment strategy (if it is in writing) and regulates what contributions the fund can receive, what pensions the fund can pay, who is to be paid a death benefit and many other important operating provisions. SISA s 55(1) provides that the trustees and any other person professionally involved with the fund must not contravene a rule contained in the trust deed (or any other governing rules of the fund, such as the constitution of a corporate trustee). If a rule is breached, the SMSF becomes a non-complying fund under SISA s 42A(1).

²³⁹ The collective term for the *Superannuation (Industry) Supervision Act 1993* and the *Superannuation (Industry) Supervision Regulations 1994*.

²⁴⁰ SISA s 19.

²⁴¹ Case law supports the conclusion that the trust principles are relevant to superannuation funds: *Scott v Federal Commissioner of Taxation* (1966) 40 ALJR 205, 208 per Windeyer J.

²⁴² SISA s 17A.

4.4 Regulation by the ATO

4.4.1 Communication of rules

Since taking over as SMSF supervisory agency in 1999, the ATO has devoted the majority of its efforts in communicating the rules, before moving into more heavy-handed compliance activity over the last two years or so. There is no lack of reading material for SMSF trustees who wish to make themselves familiar with their duties in that role.

As well as its generic taxation-related publications developed for superannuation funds, there are several SMSF-specific publications that emphasise SISA obligations and prohibitions,²⁴³ other more specific publications directed at SMSFs²⁴⁴ and an update service (*SMSF News*) available on the ATO website and emailed to subscribers. ATO staff routinely present free public seminars on aspects of SMSFs.²⁴⁵ See further 3.9.2 (ATO educative material).

Various industry forums (see 4.6.3) established by the ATO comprise a further means of communicating the rules. They feature technical questions raised by forum members, often on notice, with written responses provided by tax technical ATO staff, minuted and available on the ATO website, although the release of minutes is often delayed for months. SMSF sector associations are represented in all relevant superannuation forums.

4.4.2 Monitoring

The ATO is responsible for registering new SMSFs as regulated funds, providing them with an Australian Business Number (ABN) and Tax File Number (TFN), registering them for Goods and Services Tax (GST) if required, and entering their details on the Super Fund Lookup register, which is linked to the Australian Business Register maintained by

²⁴³ The first of its major publications targeted to SMSF trustees – *DIY Super: It's your money...but not yet!* was released in 2004. A raft of new SMSF publications was released in 2009, namely *Thinking about self-managed super*; *Setting up a self-managed super fund*; *Running a self-managed super fund*; *Winding up a self-managed superannuation fund*.

²⁴⁴ For example, *Role and responsibilities of trustees*, *Investment strategy* and *How your self-managed super fund is regulated*.

²⁴⁵ For example, a two-hour evening seminar in Hobart, Tasmania on 17 March 2010 entitled 'Running a self-managed super fund' was attended by around 150 people, most of whom appeared between 50 and 65 years old.

the ATO. SMSFs are registered as 'complying' funds if the registrant ticks a box to that effect and this status remains on the public register until removed by the ATO via notice (refer below 4.4.4 'Sanctions'). Registering an SMSF can be done online from the ATO website. Trustees do not need to verify their identity²⁴⁶ or verify a separate fund bank account with the ATO.²⁴⁷ Nor is there any duplicate check for funds with the same name as that proposed by a new registrant.²⁴⁸

Monitoring of SMSFs' compliance with legislative requirements is effected via approved auditors – the ATO has outsourced its functions here to the auditing body of professionals – on an annual audit.²⁴⁹ Questions by the auditor must be answered by trustees in respect of their SMSF and documented by the auditor, who must supply the ATO a statement of reasonable assurance that the trustee of the fund has complied, in all material respects, with the relevant requirements of the SIS regime.²⁵⁰ The auditor reports contraventions of these requirements to the ATO on an Auditor/Actuary Contravention Report (ACR).

Monitoring of SMSFs' compliance with legislative requirements is also done by the ATO via questions on the SMSF Annual Return, which contains a 'Regulatory Information' section with questions reflecting most of the above provisions. Though the annual report is likely to have been prepared by the fund's tax agent, a trustee must make a declaration that the current trustees and directors have authorised it and it is documented as such in the SMSF's records.

²⁴⁶ In general there are no formal requirements for appointment as a trustee, neither for SMSF nor public offer funds, however there are some grounds on which a person may be disqualified as a trustee. Trustees of public offer funds established from 1 July 2004 must be licensed by APRA, but not SMSF trustees: *Superannuation Safety Amendment Act 2004* (Cth).

²⁴⁷ See Alison Kahler, 'Mailbox thieves make hay with DIY super', *Financial Review* 18 November 2009 24.

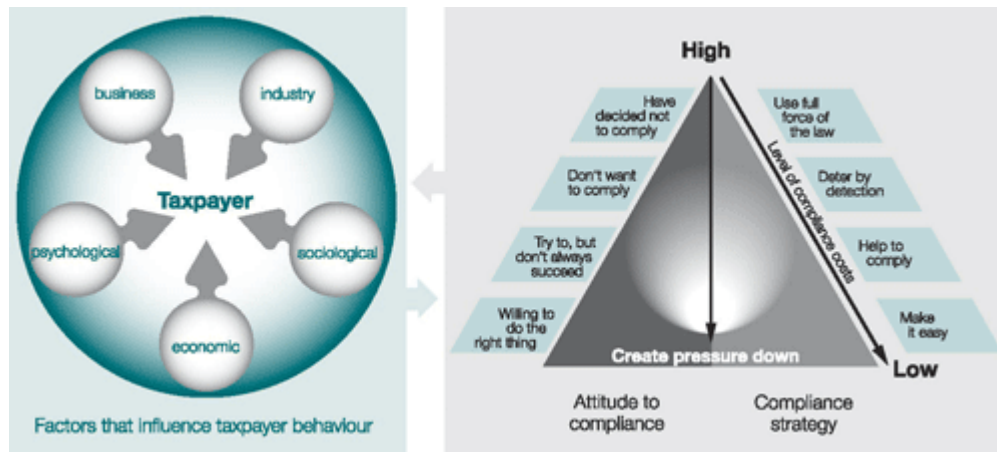
²⁴⁸ Barrie Dunstan, 'Warning on 'weak link' super funds', *Australian Financial Review* 11 November 2009, 4

²⁴⁹ Under SISA s 35C each trustee of a superannuation entity must ensure that an approved auditor is appointed to give the trustee or trustees (and the ATO) a report of the operations of the entity. Under SISA 129(3)(c) the auditor or actuary must notify the ATO in writing if there has been a contravention of SISA or under SISA 130(1) if the financial position of the SMSF may be, or may be about to become, unsatisfactory. An auditor or actuary who fails to do either is guilty of a strict liability offence.

²⁵⁰ SISA ss 17A, 35A, 35B, 35C(2), 52(2)(d), 52(2)(e), 62, 65, 66, 67, 69-71E, 73-75, 80-85, 103, 104A, 109, 126K; SISR regs 4.09, 5.08, 6.17, 7.04, 13.12, 13.13, 13.14.

4.4.3 Enforcement

The ATO insists on corrective action where the SMSF is not conducting its affairs within the rules. If corrective action is not completed in a timely manner, the ATO moves into enforcement, which is informed by the 'enforcement pyramid' at the core of the ATO's 'Compliance Model',²⁵¹ depicted below.



The ATO website describes the 2009-10 ATO Compliance Program in the following terms:²⁵²

The left side of the model recognises that a wide variety of factors influence taxpayer behaviour. These include business, industry, sociological, economic and psychological factors, all of which influence whether a person chooses to meet their obligations. The right side of the model reflects the different taxpayer attitudes to compliance, and the corresponding compliance strategy that best responds to each particular attitude. With the right responses and interventions (including a mix of alerts, audit, penalties, advice, guidance, education, procedural change, etc), we can influence taxpayer behaviour in a positive way.

The ATO's clients metaphorically move up the enforcement pyramid (and attract the relevant response) according to how compliant they prove themselves to be. The

²⁵¹ This model has been exported to and adapted by other tax jurisdictions – UK, New Zealand, Timor Leste, Indonesia and within the United States, Pennsylvania: Valerie Braithwaite, 'Responsive Regulation and Taxation: Introduction' (2007) 29(1) *Law and Policy* 1, 4.

²⁵² See <www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm>

Compliance Model relies on a mix of sanctions, threats, forgiveness and reward and further relies on the ATO being adequately resourced and empowered to apply the appropriate option at the appropriate time. These aspects are discussed in turn below. ATO employees are expected to follow the Compliance Model and give taxpayers the benefit of the doubt by assuming they act honestly and with the best intentions until they demonstrate otherwise.

4.4.4 Sanctions

ATO regulation of SMSFs includes an elaborate system of sanctions from administrative penalties through legal proceedings to imprisonment of trustees. In ascending order of potential seriousness, the sanctions are:

1. Persuasion/education
2. Warning letter
3. Civil penalty (set out in SISA s 193)
4. Criminal penalty (SISA Part 21, Div 3)
5. Disqualify trustee (SISA s 126A)
6. Fund made non-complying (SISA s 40)
7. Fund wound up (SISA s 142).

The serious sanction of making a fund non-complying by the regulator, with the practical result that half its assets and future income are forfeited in tax,²⁵³ is increasingly being

²⁵³ Loss of complying status means the fund's total assets (less the sum of the part of the crystallised undeducted contributions that relates to the period after 30 June 1983 and the contributions segment for current members at that time so far as they have not been, and cannot be, deducted) are subject to tax at the highest marginal rate: ITAA 1936 s 288A.

used by the ATO²⁵⁴ and endorsed at tribunal and court level.²⁵⁵ Unsurprisingly, it can have a devastating financial impact on the retirement assets in the SMSF.

Contraventions of legislative requirements by SMSF trustees need not result in loss of complying status. SISA, in tandem with ATO practice, makes provision for 'forgiveness'. The ATO may exercise a discretion not to make the SMSF non-complying, taking into account the factors set out in SISA s 42A(5)²⁵⁶ and following the ATO practice statement PS LA 2006/19. Also, the ATO may accept an 'enforceable undertaking' by the SMSF pursuant to SISA s 262A to correct a breach of the Act.

If SMSFs 'take their medicine', say, by agreeing to an enforceable undertaking to rectify the contraventions and prove that they have complied with the undertaking, they may secure immunity from further prosecution over that breach and move to a period of reintegration. Whether this occurs will depend on the severity of the breach (ATO interest targets matters affecting assets in the fund more so than regulatory irregularities), whether there have been recurring breaches, and whether or not trustees have rectified other breaches. Statistics reveal that the ATO receives about 7,000 ACRs a year; about half are unrectified.²⁵⁷

In general regulatory practice, the existence and use of adequate internal compliance systems can lead to additional incentives being offered to a firm – a 'reward'. The

²⁵⁴ In the early 2000s only 4 or 5 SMSFs were made non-complying, 20+ in the 2008 income year, then 97 in 2009. Delinquent SMSF Annual Return lodgers have been made non-complying recently for the first time and 'there will be a drastic increase in numbers of those in 2010. This represents an evolution in terms of the application of provisions of SISA/SISR. The ATO should not shy away from application of those sanctions that are applicable': Comment from ATO Assistant Commissioner, Interview B3.

²⁵⁵ See, for example, *JNVQ v Commissioner of Taxation* [2009] AATA 522 (14 July 2009) where the AAT upheld the ATO's action in making an SMSF non-complying because it had breached the 'in-house asset' rule. The ATO became aware of the breach because of a contravention report lodged by the fund's auditor. In a second non-complying fund case, *CBNP v Commissioner of Taxation* [2009] AATA 709 (13 August 2009), where the cause was non-residence, the ATO decision was again upheld.

²⁵⁶ These are:

- the taxation consequences that would arise if the fund was to be treated as a non-complying superannuation fund
- the seriousness of the contravention(s) and
- all other relevant circumstances.

²⁵⁷ Interview B3.

compliant may be subject to less frequent inspection or reporting requirements.²⁵⁸ Applying this to SMSFs, the possibility of a regime of incentive for compliance is explored at 5.4.10.

4.5 Regulatory oversight – Adjudication and Evaluation

Some aspects of regulation, including two fundamental elements – adjudication and evaluation – are performed by various bodies external to the regulator.

As governments, laws and the agencies that administer those laws can be oppressive and unfair, processes and structures that can constrain state action are needed. Contestation is a part of the Australian taxation and superannuation system and the ATO in its role as regulator of SMSFs is held accountable through courts, tribunals and oversight bodies as well as legislation that confers rights on members of the public to access government documents and to be provided with reasons for decision.²⁵⁹

Classes of oversight bodies playing a role in guarding against the abuse of tax authority power include courts, statutory offices and taxpayer advocates and professional associations. Grouped with these is the ATO's mechanism for self-oversight, the Taxpayers' Charter.

4.5.1 Court and tribunal oversight

Review rights attach to every piece of correspondence from the ATO that contains a decision or an assessment. These rights extend on to the AAT Small Tax Claims Tribunal (for amounts under \$5,000) or for larger amounts to the AAT Taxation Division, to the Federal Court²⁶⁰ and, by special leave, to the High Court.

There is, though, no direct tribunal oversight because the *Superannuation (Resolution of Complaints) Act 1993* (Cth) – which provides a mechanism for the review of trustees'

²⁵⁸ Margot Priest, 'The Privatization of Regulation: Five Models of Self-Regulation' (1997-98) 29(233) *Ottawa Law Review* at 295.

²⁵⁹ Robin Creyke and John McMillan, *Control of Government Action: Text, cases and commentary* (2nd ed, 2009) p 2.

²⁶⁰ If a presidential member has presided on the AAT case, it will be heard by the Full Federal Court, otherwise by one Federal Court judge: *Administrative Appeals Tribunal Act 1975* s 44(3). There is a \$68 filing fee for the AAT Small Claims Tribunal and \$682 to the normal AAT. The \$682 is refundable if the applicant is successful but the \$68 is not.

decisions, thereby overcoming the general law principle that the exercise of a trustee's discretion cannot be reviewed except where a power is exercised irresponsibly, wantonly or capriciously – does not apply to SMSFs.²⁶¹ There are accordingly no legislative mechanisms for SMSF members aggrieved by actions of trustees other than themselves to seek redress (except that under SISA s 55 they may have a cause of action against a trustee who has contravened a covenant contained, or taken to be contained, in the SMSF's 'governing rules');²⁶² the action must be taken via civil litigation in the courts.

4.5.2 Statutory offices

The Taxation Ombudsman²⁶³ reviews administration actions and receives and reports on complaints against the ATO in relation to such matters as superannuation co-contribution payments, compromise of tax debts, use of garnishee powers, the imposition of the general interest charge, release from tax debts on the basis of serious hardship and debt repayment arrangements. These are usually referred to an internal ATO resolution service in the first instance. Such matters would normally concern SMSF members as individuals.

The Inspector-General of Taxation regularly reviews ATO administration on various issues, and reports to the Minister for Revenue and Assistant Treasurer.²⁶⁴ Amongst the latter's 2009/10 work program was a review into the efficiency of the ATO's compliance and regulatory approaches to SMSFs.²⁶⁵ The review, however, did not proceed.²⁶⁶

The Privacy Commissioner regulates the manner in which personal information, including tax file numbers, can be collected, stored, used and disclosed.²⁶⁷

²⁶¹ SISA s 5.

²⁶² There are various statutory defences available to a trustee being sued under SISA Pt 6.

²⁶³ *The Ombudsman Act 1976 (Cth)* s 4(3) provides 'The Commonwealth Ombudsman, in performing his or her functions in relation to the Australian Taxation Office, may, if he or she so chooses, be called the Taxation Ombudsman.'

²⁶⁴ Under the powers provided by the *Inspector-General of Taxation Act 2003*.

²⁶⁵ Inspector-General of Taxation, *New IGT Work Program Announced* (2009)

<http://www.igt.gov.au/content/work_program/work_program_2009.asp#_ftn1>

²⁶⁶ Telephone advice from Inspector-General of Taxation's office 19 April 2012.

²⁶⁷ Under the *Privacy Act 1988 (Cth)*. The *Tax File Number Guidelines 2011* were issued under s 17 of the *Privacy Act*.

The Australian National Audit Office (ANAO) has a role in assessing whether the ATO has properly regulated SMSFs, and requires adjustments where it has not.²⁶⁸ ANAO audits of the ATO are expected to identify systemic instances of failure to apply the relevant regulations consistently and efficiently. For example, the ANAO has reported in *The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds*²⁶⁹ and *The Australian Taxation Office's Approach to Managing Self Managed Superannuation Fund Compliance Risks*.²⁷⁰ Both reports resulted in six recommendations that were implemented by the ATO. ANAO also reviews the ATO's performance against its Taxpayers' Charter,²⁷¹ noted below.

4.5.3 Overview role of taxpayer and professional associations

A number of taxpayer advocates and professional bodies also scrutinize ATO actions. Perhaps the main taxpayer advocates' organization is 'Taxpayers Australia'. It is an incorporated non-profit organisation, with a subsidiary, Superannuation Australia, which 'represents the interests of self-managed superannuation funds and their members at all levels of government and to the ATO to get a fairer go for those who want to be self sufficient in retirement'.²⁷² It has representation on three high-level liaison groups with the ATO and has given evidence to Senate hearings on issues affecting small superannuation funds.

In so far as professional associations are concerned, the main dedicated tax body is the Taxation Institute of Australia (the 'TIA'), a public company. It has as one of its objects 'to advance public knowledge and understanding of ... the practices of public authorities administering Taxation Laws'.²⁷³ It makes submissions to government, including one

²⁶⁸ The Auditor-General is responsible, under the *Auditor-General Act 1997*, for providing auditing services to the Parliament and public sector entities. The Australian National Audit Office (ANAO) supports the Auditor-General, who is an independent officer of the Parliament.

²⁶⁹ Australian National Audit Office, 'The Australian Taxation Office's Approach to Managing Self Managed Superannuation Fund Compliance Risks' (13, 2008).

²⁷⁰ Ibid.

²⁷¹ Australian National Audit Office, 'Performance audit: The Australian Taxation Office's Taxpayers' Charter follow-up audit' (40, 2008).

²⁷² Taxpayers Australia, *Superannuation Australia* (2009) <<http://www.taxpayer.com.au/about/superannuation-australia>>

²⁷³ Taxation Institute of Australia, *Constitution of the Tax Institute* (2010) <http://www.taxinstitute.com.au/files/constitution/TIA_Constitution.pdf>

made to the 1998 Inquiry into the operation of the Australian Taxation Office²⁷⁴ and on government's reviews into such matters as the governance and residency status of SMSFs.²⁷⁵ The TIA also makes responses/recommendations to draft public taxation rulings released by the ATO, and publishes papers such as *Litigating with the ATO – What You Need to Know* and *Managing ATO contact and tax disputes*. A large number of SMSF-specific seminar and convention papers are available to members on its website.²⁷⁶

CPA Australia and the Institute of Chartered Accountants in Australia ('ICAA') are 'self-regulating professional associations' that represent tax agents, scrutinise ATO actions and seek to influence the ATO, most particularly on any regulatory change that may affect the accounting profession. These organizations are important links between the ATO (as regulator) and tax agents, who lodge 98% of SMSF annual reports.²⁷⁷ As examples of the activities of professional organizations, the ATO provided CPA Australia with a summary of the outcomes of the 2007-08 SMSF audit compliance program, which that organization circulated to its members with comment. The ICAA surveyed its members via an SMSF Governance Questionnaire to prepare a submission to the Minister for Superannuation in 2008 on the set-up, administration, audit, education, estate planning and legal obligations of trustees of SMSFs.

4.5.4 Overview role of industry bodies

The ATO has a close relationship with the superannuation industry through the Superannuation Consultative Committee (SCC), SCC Approved Auditors' Working Group, SCC Education and Communication sub-committee, National Tax Liaison Group (NTLG) Superannuation Technical Sub-committee and Superannuation Funds Working Group. These bodies are established and managed by the ATO, which publishes minutes of their meetings on its website. Membership is by ATO invitation, and the

²⁷⁴ Taxation Institute of Australia, *Inquiry into the operation of the Australian Taxation Office* (01 Sep 98) <<http://www.taxinstitute.com.au/go/submissions/inquiry-into-the-operation-of-the-australian-taxation-office>>

²⁷⁵ See <http://www.taxinstitute.com.au/index.cfm?objectid=4770A996-D0B7-4CCD-1AAAB257F05115D2>.

²⁷⁶ For example 'Current issues in self managed super', 'SMSFs and loans', 'Real property investments and SMSFs'.

²⁷⁷ Australian Taxation Office, *SMSF newsletter - Edition 10 (30 September 2009)* <<http://www.ato.gov.au/print.asp?doc=/content/00214241.htm>> at 5.

bodies tend to continue in existence as long as members see value in them. They are a valuable means of resolving and communicating technical issues.

The Association of Superannuation Funds of Australia Ltd (ASFA), the Self Managed Super Funds Professional Association of Australia (SPAA) and the Financial Services Council (FSC) represent funds' interests and provide research, education and advocacy services to the industry.

SPAA, formed in March 2003, is the peak body for the SMSF industry and claims to have 'responsibility for self-regulating SMSF advisers'.²⁷⁸ It also takes on the role of public spokesperson for the SMSF sector and issues media releases on topics of concern.²⁷⁹ Included amongst its objectives is 'to support the Australian Taxation Office (ATO), the Australian Securities and Investment Commission (ASIC) and other regulatory bodies and industry associations 'to promote compliance, in line with the Federal Government's retirement incomes policy to provide, protect and preserve assets for retirement'.²⁸⁰ In recent years, SPAA has provided speakers to tour ATO offices delivering seminars to Superannuation business line staff about the SMSF sector and SPAA's role. It holds a conference each year, which some ATO staff attend and at which the Tax Commissioner and other senior ATO executives speak.

A second SMSF dedicated representative body is the Small Independent Superannuation Funds Association (SISFA), representing SMSFs and Small APRA Funds (SAFs). Formed in 1999, its role is stated to be:²⁸¹

- To represent the interests of self managed superannuation funds to Government, various departments and authorities within the superannuation industry
- To provide information, explain and educate Australians on issues specific to small superannuation funds, and

²⁷⁸ Self Managed Superannuation Funds Professional Association of Australia, *SPAA's Role* (2011)

<<http://www.spaa.asn.au/about/spaa's-role.aspx>>

²⁷⁹ For example, SPAA, *Self Managed Super Funds Professionals' Association applauds the appointment of SMSF specialist Meg Heffron to the Cooper Review*. <spaa.asn.au/portal/component/option,com_docman/.../gid,1709/> at 4 August 2009

²⁸⁰ <http://spaa.asn.au/portal/content/view/11/66/>

²⁸¹ <http://www.sisfa.com.au/main.htm>

- To complement existing industry association and professional bodies.

SISFA is a relatively low-profile organisation and does not appear as influential or representative of the sector as SPAA (based on amount of media exposure and membership of government and ATO forums).

4.5.6 Taxpayer Charter

The ATO's Taxpayer Charter can be interpreted as the ATO's mechanism for oversight of itself. It sets out the way the ATO aims to conduct itself when dealing with taxpayers and imposes quantitative standards with which ATO staff must comply (such as timeframes for response to written correspondence) and against which the ATO must report to Parliament in its annual report.²⁸² It is designed to help members of the public understand their rights as taxpayers, their taxation obligations, the service and other standards they can expect from the ATO, and what they can do if dissatisfied with ATO decisions, actions or service, or wish to lodge a complaint. The Charter is accessible to the public on the ATO website.²⁸³

4.6 Conclusion

Regulation is a set of rules, backed by the power of the state, intended to modify behaviour. The elements of regulation – rulemaking, communication of rules, monitoring, enforcement adjudication, sanctions and evaluation – apply to the superannuation environment through the main statutory regime, the SIS Regime, which generally aims to protect retirement savings, promote prudential management of those savings, ensure superannuation funds are managed by appropriate trustees and protect the general revenue.

The statutory regime overlays and supplements the general trust law that applies to SMSFs and trust deeds regulating the activities of individual SMSFs. The main SMSF supervisor, the ATO, performs the supervisory functions of communication of rules, monitoring, enforcement and sanctions, with the assistance of approved auditors and

²⁸² Under *Public Service Act 1999* (Cth) ss 63, 70.

²⁸³ <www.ato.gov.au/print.asp?doc=/content/25824.htm>

with minor regulatory roles for APRA and ASIC. Adjudication and evaluation are functions of regulation performed by bodies independent of the main regulator.

The regulatory framework discussed in this chapter brings to the surface several issues to be addressed in succeeding chapters, as follows:

- The broad question of whether the correct agencies are regulating SMSFs and whether they do so in a coordinated fashion, without duplication of effort. A subsidiary question is whether there is an irresolvable conflict between the ATO's roles of revenue collection and protection of retirement income in SMSFs.
- The SIS Regime, having been adapted to make it fit the SMSF sector, has resulted in some anomalies and unnecessary administrative requirements on SMSFs trustees to document decisions made in their roles as trustee for the benefit of themselves as member. This suggests the possibility of a simpler, adapted set of regulations for SMSFs or even a new SMSF-specific supervisory Act.
- The prudential provisions in the statutory regime do not apply to SMSFs, nor is there any mechanism to ensure that regulation of SMSFs is integrated with government retirement income policy. Indeed, at an individual trustee level, there may be a dearth of appreciation and understanding in the community of the government's retirement income policies and the reasons for the trustee obligations and prohibitions contained in SISA and SISR.
- Because SMSFs are exempt from prudential regulation or oversight, there is no legislative direction to their trustees about what should be in their fund's portfolio beyond the requirement for the trust deed to include an investment strategy. Some trust deeds may be deficient in this regard, raising the question whether portfolio controls should be imposed on SMSFs by the regulator.
- As new SMSFs can be registered online with ease and without any proof of trustee identity or separate bank account, there is potential for SMSFs to be used for fraudulent purposes. There may accordingly be aspects of the registration process that should be more closely supervised.

- There is the possibility that a type of reward or incentive could be used with SMSFs that lodge on time and without contravention of their statutory obligations over a period of time.

The following chapter explores some of these questions in an evaluation of the appropriateness and effectiveness of SMSF regulation in Australia. Chapter 6 then explores the appropriateness of the SMSF legislative regime itself.

CHAPTER 5

IS SMSF REGULATION APPROPRIATE AND EFFECTIVE?

5.1 Introduction

Chapter 4 described the existing SMSF regulatory framework and identified a number of issues to be addressed in succeeding chapters. This chapter explores in more detail the activities of the agencies with responsibility for regulating the SMSF sector, evaluating the appropriateness and effectiveness of their performance in that role. Because of its primacy as regulator, the ATO is the main focus of this evaluation. Chapter 6 targets the legislative regime applicable to the SMSF sector and explores the possibility and necessity for improvements to the legislation that endows the relevant agencies with their regulatory powers.

5.2 What is good regulation?

A recent International Monetary Fund publication concerning financial regulation during the global financial crisis identified as the key elements of good supervisory regulation ‘that it is intrusive, skeptical, proactive, comprehensive, adaptive, and conclusive’.²⁸⁴ The paper continued.²⁸⁵

To achieve these elements, the ‘ability’ to supervise, which requires appropriate resources, authority, organization and constructive working relationships with other agencies must be complemented by the ‘will’ to act. Supervisors must be willing and empowered to take timely and effective action, to intrude on decision-making, to question common wisdom, and to take unpopular decisions. Developing this ‘will to act’ is a more difficult task and requires that supervisors have a clear and unambiguous mandate, operational independence coupled with accountability, skilled staff, and a relationship with industry that avoids ‘regulatory capture’.

²⁸⁴ Jose Vinals and Jonathan Fiechter, ‘IMF Staff Position Note: The Making of Good Supervision - Learning to Say “No”’ (May 18 2010) <<http://www.imf.org/external/pubs/ft/spn/2010/spn1008.pdf>> , 4.

²⁸⁵ Ibid.

As part of the ‘will to act’, good regulation depends on empowerment, both legislative and political. It has been argued that good regulation is efficient regulation, which relies on both the strength and multiplicity of possible enforcement action:

The greater the heights of tough enforcement to which the agency can escalate ... the more effective the agency will be at securing compliance and the less likely that it will have to resort to tough enforcement. Regulatory agencies will be able to speak more softly when they are perceived as carrying big sticks.²⁸⁶

The more sanctions can be kept in the background, the more regulation can be transacted through moral suasion, the more effective regulation will be.²⁸⁷

The support of the government of the day is critical for regulatory success:

Supervisors are expected to stand out from the rest of society and not be affected by the collective myopia and consequent underestimation of risks associated with the good times. In this role, society and governments too must support this approach and stand by their supervisors as they perform this unpopular role.²⁸⁸

Good regulation also depends on the wisdom and knowledge of the individual regulator and his or her affiliation with the regulated industry:

...a blend of long-term supervisory staff and experienced industry professionals, recruited in mid- or late-career [is advocated] ... Agencies should have policies on the turnover of staff devoted to the supervision of individual institutions and on the movement of their staff into employment with regulated institutions.²⁸⁹

The words ‘supervision’ and ‘regulation’ are sometimes used interchangeably. John Kay in his 2010 book *Obliquity*²⁹⁰ offers the following comment on the difference between supervision and regulation and on the ideal regulator:²⁹¹

²⁸⁶ Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992), 6.

²⁸⁷ Ibid 51.

²⁸⁸ Vinals and Fiechter, above n 284, 19.

²⁸⁹ Vinals and Fiechter, above n 284, 17.

²⁹⁰ Obliquity is the principle that complex goals are best achieved *indirectly*.

²⁹¹ John Kay, *Obliquity* (2010), 133.

Supervision is shadow management with a public interest orientation, its purpose to ensure universal adherence to good behaviour. Regulation is narrowly focused on specific issues of public concern. Supervision demands knowledge of the industry, regulation demands knowledge of the public interest and public concerns ... If our objective is supervision, then the supervisor's primary qualification should be management experience and knowledge of the industry to be supervised. If our aim is regulation, knowledge of the public interest and of the right conceptual framework to protect it effectively and efficiently is needed – not intimate knowledge of the industry to be regulated.

In this regard, it is interesting to consider the opinion of APRA's Keith Chapman about the need for deep understanding of the fund being regulated:²⁹²

The one thing that you cannot do is to produce a good supervisor (whether of pensions or anything else) without quite a lot of experience and exposure to many many different circumstances/events. It is not merely a question of understanding the legal framework and the legislative requirements – a good supervisor needs to understand the principles of how the fund itself operates and the types of risks that need to be addressed by the trustees.

This comment underscores the difference between supervision and regulation – supervision requires deep understanding of the regulatees' business; regulation requires understanding of public policy in the area being regulated. The term 'supervisory regulation' is used throughout this chapter to refer to the role of the ATO and other agencies that supervise the activities of SMSFs. The term is intended to bridge the differences in meaning between regulation and supervision, there being no universal agreement in the literature on the distinction between these two terms. Such use of the term implies the importance of both an understanding and effective protection of the public interest and a good knowledge of the industry.

Issues relating to supervisory regulation are evaluated in this chapter in light of the above ideals, under the broad headings of appropriateness and effectiveness. 'Appropriateness' focuses on the type of regulation and whether it is sufficient to protect the retirement income of SMSF members, while 'effectiveness' focuses on the ability and

²⁹² Keith Chapman, 'Supervision of Private Pensions - An Australian Perspective' in *OECD Regulating Private Pension Schemes: Trends and Challenges* (2002) 255, 258.

will to act, with evidence of effectiveness provided by the degree of compliance by regulatees.

5.3 Appropriateness of regulation

This section is concerned with whether the relevant agencies are conducting the supervisory regulation of SMSFs with well-coordinated effort, whether the current compliance-based (as opposed to prudential) approach is appropriate and, in the absence of prudential regulation, whether portfolio controls should be imposed on SMSFs by the regulator. Because supervision requires knowledge of the industry, the supervisor should have developed an understanding of SMSFs, their trustees and the investment world they inhabit.

The primary regulator of SMSFs since 8 October 1999 has been the ATO, although the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) play minor roles in regulating the sector. Section 6 of the *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA') sets out how regulatory responsibility for the superannuation industry is shared between these three agencies. Their respective roles in relation to SMSFs are discussed below in order of increasing importance.

5.3.1 Department of Human Services

Since 1 November 2011 the Department of Human Services (the Chief Executive, Medicare)²⁹³ administers the very limited circumstances where benefits may be released on specified compassionate grounds. These are defined in the *Superannuation Industry (Supervision) Regulations 1994* (Cth) ('SISR'), and cover only expenses in respect of medical treatment, medical transport, mortgage assistance, modifications to home and/or motor vehicle, funeral assistance and care for terminal medical condition.²⁹⁴ Before that date, this administration was the responsibility of APRA.

²⁹³ *Superannuation Legislation Amendment (Early Release of Superannuation) Act 2011* (Cth)

²⁹⁴ Other grounds not administered by the Department of Human Services on which release can be sought are:

- Financial hardship (administered by the superannuation fund)

5.3.2 ASIC

ASIC regulates Australian companies, financial markets, financial services organisations and professionals who deal and advise in investments, superannuation, insurance, deposit taking and credit. Its activities in relation to SMSFs are limited to:

- protecting SMSFs as retail investors through the regulation of investment service providers – its roles include handling the registration and reporting of managed investments in which SMSFs place their assets.
- regulating corporate SMSF trustees, as corporations, including registration and financial reporting.
- prosecuting promoters of illegal early release schemes, for which the ATO does not have legislative fiat. For example in the Kassongo case,²⁹⁵ ASIC brought the action because Mr Kassongo was involved in the operation of an unlicensed financial services business, rather than for any breach of SISA, as SISA lacks penalty provisions applicable to scheme promoters.

ASIC has the general administration of parts of SISA, as set out in s 6, but none applies specifically to SMSFs. There is a Memorandum of Understanding (MOU), dated 9 May 2007, to express the understanding of the working relationship between the ATO and ASIC. It does not specifically mention superannuation.

-
- Permanent departure from Australia (administered by the superannuation fund, with conditions set by ATO)
 - Exempt Public Sector Superannuation Scheme (administered by the State / Territory regulated superannuation funds)
 - Permanent incapacity (administered by the superannuation fund)
 - Terminal illness (administered by the superannuation fund).

²⁹⁵ See Australian Securities and Investment Commission, *08-181 Trustee of self managed super fund appears in court on ASIC charge* (2008) <<http://www.fido.gov.au/fido/fido.nsf/byHeadline/08-181>>. The 2008 Kassongo case involved the promoter setting up an SMSF and for a large commission, rolling over the preserved super benefits of 192 members of public offer funds into the SMSF's bank account, then distributed those monies to the members who had retained him. The Palusi case was similar (Australian Securities and Investment Commission, *08-181 Trustee of self managed super fund appears in court on ASIC charge* (2008) <<http://www.fido.gov.au/fido/fido.nsf/byHeadline/08-181>>).

5.3.3 APRA

APRA collects statistics on superannuation fund performance (including SMSFs) and releases annual and quarterly statistical reports on the performance of the superannuation industry, sector by sector. The ATO provides APRA with aggregate data on SMSFs. The aim of APRA's reporting is to enable comparison of return on assets and fee structure between the sectors of the superannuation industry but this is confounded in the case of SMSFs because they report to the ATO via the SMSF Annual Report, which elicits different data from that reported to APRA by the funds it regulates. These are required to complete and lodge with APRA up to 11 different 'prudential forms'.²⁹⁶

SMSFs also tend to invest more widely than APRA funds in unlisted assets such as real estate, collectables and other personal use assets that should be (but are generally not) valued annually for the purposes of the SMSF Annual Report. In addition, SMSF fees are not reported, nor are trustees permitted to charge the fund for their services.²⁹⁷ Thus there is a mismatch in reporting requirements and with this comparability between sector performance.

The ATO makes *ad hoc* changes to the SMSF Annual Return every year according to perceived compliance risks, thus further widening the discrepancy between the data collected by APRA and the ATO.

Commentators have suggested that the appropriate statistician is not the immediate regulator. One has, for instance, made the following remarks:

A number of questions have been raised about the role APRA plays in collecting data and statistics across the financial services industry and whether this ought not be a task more properly undertaken by the Australian Bureau of Statistics ...

²⁹⁶ Small APRA funds (SAFs), despite their similarities to SMSFs, are regulated by APRA and are required to have appointed an independent trustee approved by APRA under Part 2 of SISA to protect the interests of any arm's length members. The approved trustee must meet relevant solvency, capital adequacy and operational capacity requirements. SAFs are prudentially regulated by APRA in the same way as larger funds and are subject to essentially the same reporting regime.

²⁹⁷ SISA s 17A(f): A fund is an SMSF only if no trustee of the fund receives any remuneration from the fund or from any person for any duties or services performed by the trustee in relation to the fund.

Over the past decade and a half, there has been a disturbing blurring of the lines with respect to the appropriate role of the financial services regulators – such that all too often they have sought to be players in the policy game rather than servants of a government charged with policing the regulations. This blurring of the lines is as much a product of bad government practice as it is of empire building and ego within the regulators themselves.²⁹⁸

There is indeed merit in the suggestion that industry statistics are more properly collected by the expert agency, the ABS, rather than individually by the respective regulators. On the other hand, there are registers that must be maintained current by the regulators.

APRA and ATO both contribute to the Super Fund Lookup (SFLU) register,²⁹⁹ which the ATO maintains.

APRA maintains a public register of individuals whom it has disqualified from being a trustee, custodian or investment manager of a superannuation entity. The ATO maintains no such register although it has greater disqualification powers than APRA (see 3.10).

APRA and the ATO operate under an MOU dated 16 April 1999 setting out how the two bodies will co-operate in the regulation of the superannuation industry (see 3.1.2).³⁰⁰ The two agencies have what appears to be a generally cooperative relationship and adopt a well-coordinated effort, for example, in the development of a response to fraudulent use of SMSFs in obtaining rollovers of members' superannuation from APRA-regulated funds (see 5.4.8.1).

²⁹⁸ Mike Taylor, 'Are the superannuation regulators taking sides?' (14 May 2012) *Super Review* <http://www.superreview.com.au/opinion/superannuation/are-the-superannuation-regulators-taking-sides?utm_source=SilverpopMailing&utm_medium=email&utm_campaign=Super%20Review%20Newsletter%20MRE%20-%20send%20-%3E%2031/05/2012%203:13:56%20PM&utm_content=>

²⁹⁹ SFLU contains publicly available information about all super funds that have an Australian Business Number. It includes those funds regulated by APRA and the ATO. It can be used to identify the complying status of a fund and view contact details for the fund. SFLU is used by APRA funds to check whether an SMSF is eligible to receive transfers or rollovers.

³⁰⁰ Under their MoU on superannuation, APRA and the ATO liaised on a range of superannuation administration and policy issues over 2007/08, including ATO rulings and determinations on the application of superannuation legislation for self-managed superannuation funds, illegal early access to superannuation benefits, Tax File Numbers (TFNs) for superannuation purposes and the public register of superannuation funds maintained by the ATO. The regular interaction between APRA and ATO staff is augmented by quarterly operational liaison meetings. APRA continues to participate in the ATO's Superannuation consultative Committee and the superannuation technical sub-committee of the National Tax Liaison Group: *APRA Annual Report 2008*, p 50.

There is, however, the occasional lapse, for example a commentator has pointed out a failure to share vital information in the context of a recent high-profile corporate collapse affecting many superannuation funds including SMSFs:

It was revealed during [May 2012]'s Senate Estimates Committee processes that the ATO knew only too well about one of the central figures in the Trio collapse, US lawyer Jack Flader, but had not passed that intelligence through to either ASIC or APRA in the context of the Trio/Astarra investments.³⁰¹

The opinion of actuary interviewee A13 is that the ATO compares favourably with APRA:

I'm more than happy with the ATO's regulation of SMSFs; I think it does a good job of it. The sector is relatively lightly regulated. ATO's background is in tax collection – its systems are designed to handle little things that go wrong with taxpayers. They are helpful – to get an answer to complex technical questions you might have to go through a few menu options on the Infoline, but you get sensible, cogent advice from the SMSF specialist area. I respect their views. In contrast, my dealings with APRA as appointed actuary of a life insurance company and board member of a large superannuation fund have been a painful experience.

5.3.4 ATO

The supervisory regulation provided to SMSFs by the ATO was detailed in Chapter 3. Although responsible for ensuring SMSF compliance with the SIS regime, the ATO's role is not all-encompassing, and the division of responsibilities between the ATO, ASIC and APRA is complex and possibly confusing for regulatees. The three main deficiencies in regulatory co-ordination appear to be between APRA and the ATO, namely:

1. The mismatch in data collection from funds by the two agencies and thus the impossibility of performance comparison.
2. The lack of a consolidated register of disqualified trustees.

³⁰¹ Mike Taylor, 'Trio Capital exposes APRA's failings' (26 June 2012) *Super Review* <<http://www.superreview.com.au/opinion/superannuation/trio-capital-exposes-apra-s-failings>>

3. The application process for release of superannuation benefits on grounds of permanent departure from Australia. As release on the various grounds is administered by the Department of Human Services (formerly by APRA) or by APRA-regulated funds themselves, the member may find it difficult to know which entity to approach. There is no formal application process as such for SMSFs, leaving illegal early access as the only available relief for SMSF members in severe financial distress.³⁰²

There may also be discrepancy between agencies in interpretation of the SIS regime. For example, because there is no definition of a 'reserve' in either the SISA, either of the Income Tax Assessment Acts, nor the Income Tax Assessment Regulations, despite the term being referred to in both the superannuation and tax legislation, the regulatory agencies have decided for themselves what the term means. The ATO, APRA and ASIC

³⁰² The ASFA Submission to the Super System Review – Phase Three – Structure 2010 at 87 included comment on the question whether SMSF members should be required to obtain regulator approval before accessing their superannuation on hardship grounds:

There is some intuitive appeal for requiring regulator approval before allowing SMSF members to access their superannuation on hardship grounds as this would remove some potential opportunities that currently exist for individuals to illegally access their super without satisfying the strict criteria set out in the SIS Act. However, introducing requirements for regulator approval on financial hardship cases for SMSFs would involve additional responsibilities for the regulator and therefore increased compliance costs.

In our submission to the Senate Select Committee on Superannuation and Financial Services in December 2001 on their inquiry into early access to superannuation benefits, ASFA recommended that all claims for financial hardship (for both APRA regulated funds and SMSFs) should be processed by a centralised agency in order to achieve a cost effective and consistent approach across the industry. Centrelink already provides certification to trustees on whether an individual has been receiving an eligible income support payment for the requisite timeframe. It could conceivably fill the role of a single approving authority by also undertaking the evaluation process of whether an individual is entitled to an early release on financial hardship grounds as an extension of their current role. That is, subject to appropriate guidelines being established, Centrelink could potentially conduct the process of determining whether an individual is "unable to meet reasonable and immediate family expenses" rather than this role continuing to be undertaken by trustees. Not only would our proposed solution remove some potential illegal early access opportunities for SMSFs by having an independent third party making the final determination, but it would also remove the obligation to consider financial hardship claims from trustees of APRA regulated funds and would result in a consistent approach across the industry.

In the event, the Super System Review and government Stronger Super response did not take up this suggestion and the law still requires a SMSF member to apply to the SMSF's trustee to access preserved superannuation in conditions of severe financial hardship.

have different views on what constitutes a reserve in superannuation fund accounts, the ATO's view being the broadest.³⁰³

5.3.4 Prudential regulation

A distinctive feature of the SMSF sector is that it is not prudentially regulated by the ATO, unlike APRA-regulated superannuation funds. Prudential³⁰⁴ regulation is generally recognised as meaning regulation of deposit-taking institutions and supervision of the conduct of these institutions including set down requirements that limit their risk-taking. The aim of prudential regulation is to ensure the safety of depositors' funds and maintain the integrity and stability of the financial system. It is generally acknowledged as the more highly evolved regulatory approach, as compared with regulation for compliance. According to two commentators:³⁰⁵

There are risks in taking a mainly compliance-based approach, particularly where associated with relatively detailed rules-based regimes. It can lead to excessive focus on more easily observed non-compliance ... and to insufficient understanding of key business drivers and flaws in risk management practices. It tends to be backward looking and can fail to identify the major risks that institutions are facing in the future. It can deal poorly with innovation.

SMSFs have been exempted from prudential regulation since the recommendations of the Wallis report were enacted into legislation and the ATO became supervisory regulator. At the time of the Wallis report, the superannuation landscape was dominated by defined benefit funds, which needed prudential regulation to ensure the fund as a whole could meet its liabilities as and when they fell due. In a defined contribution (sometimes termed 'accumulation') fund (including an SMSF), conversely, the principal risk – exposure to market-linked assets – is assumed entirely by the members.

³⁰³ Robert O'Donohue, 'The Latest in SMSF Reserving Strategies' (Paper presented at the 2011 SPAA National Conference, Brisbane,).

³⁰⁴ Prudential: Marked by prudence.

Prudence: 1. having good sense in dealing with practical matters;
2. careful in managing resources so as to provide for the future;
3. using good judgment to consider likely consequences and act accordingly. (Encarta online English (U.K.) dictionary)

³⁰⁵ Jose Vinals and Jonathan Fiechter, 'IMF Staff Position Note: The Making of Good Supervision - Learning to Say "No"' (May 18 2010) <<http://www.imf.org/external/pubs/ft/spn/2010/spn1008.pdf>> 7.

The reasons for exemption from prudential regulation were well articulated in neither the Wallis report nor the Explanatory Memorandum for the *Superannuation Legislation Amendment Act (No 3) 1999*, which amended the SIS Act and installed the ATO as SMSF regulator. The Wallis report contains the following statement about prudential regulation:³⁰⁶

The Inquiry considers that self-managed funds provide a worthwhile and competitive option for superannuation investors. However, as self-managed funds, they should not be subject to prudential regulation. To apply prudential regulation in such circumstances is impracticable. Moreover, it should be made clear that such schemes are conducted entirely at the risk of the beneficiaries – in relation to financial safety, there should be no regulatory assurance attaching to such schemes.

Further, the Explanatory Memorandum to the *Superannuation Legislation Amendment Act (No 3) 1999* contained the statement that '[a]s members of self managed superannuation funds will be able to protect their own interests, these funds will be subject to a less onerous prudential regime under the SIS Act'.³⁰⁷ Thus neither the Wallis report nor the EM articulates precisely why SMSFs should be exempt from prudential regulation or why it would be impracticable, merely stating that it is so.

The Super System Review likewise recommended continuing exemption of the SMSF sector from prudential regulation. The Review concluded that '[t]he role of the regulator and key industry participants (such as auditors) for this sector should be legislative compliance, rather than a prudential objective'.³⁰⁸ The rationale for this statement is, once again, unclear, although the report notes that 'ultimate responsibility' of the members is one 'guiding principle' for SMSFs and that:³⁰⁹

SMSFs are unique in Australia's superannuation system in that SMSF members have effectively assumed sole responsibility for the adequacy of their retirement savings. This affects a wide range of regulatory settings that are appropriate for SMSFs.

³⁰⁶ Stan Wallis, 'Financial System Inquiry Final Report' (1997) at 333.

³⁰⁷ The Parliament of the Australian Government, House of Representatives 1998–99, *Superannuation Legislation Amendment Bill (No 3) 1999*, 1.

³⁰⁸ Commonwealth of Australia, above n 175, 220.

³⁰⁹ Commonwealth of Australia, above n 174, 1.

Arguably, by assigning SMSF members 'sole responsibility' for the adequacy of their retirement savings, the Review ignores the underwriting of those savings by the government Age Pension system. It is accordingly inconsistent with general government superannuation objectives and the responsibility for government to ensure that all three of its retirement income pillars – Age Pension, Superannuation Guarantee and voluntary contributions – are effectively integrated (as well as with policies relating to investment outside superannuation). The need for policy integration means government agencies must be the regulators and it is impractical to allow the sector to self-regulate.

In the absence of any clear expression of the rationale behind the exemption of SMSFs from prudential regulation, one must speculate that it exists for practical reasons, catalogued below.

Large numbers

The first of these practical reasons is the sheer numbers of SMSFs. At the time of the Wallis report there were approximately 187,000 SMSFs; currently they exceed 468,000. These numbers mean the supervisory regulator cannot develop the depth of knowledge or understanding of the sector necessary to prudentially regulate it, encompassing as it does such a wide range of experience, level of assets and engagement by trustees.

The major problem facing the ATO is lack of transparency of the SMSF sector. APRA has a close relationship, depth of knowledge and good understanding of the 386 large funds and 3,519 Small APRA funds for which it provides supervisory regulation, and can easily 'tweak' regulations in response to perceived problems. SMSFs, on the other hand, cover a huge range from high-value, sophisticated vehicles to poorly resourced funds managed by naïve trustees who devote little time and care to running them. Anecdotally, some trustees are not even aware they hold that office.

Paternalism

The second practical reason is that the assumption of responsibility by trustees for their own retirement savings suggests that the paternalism involved in prudential regulation –

to protect trustees from their own greed, ignorance and foolishness – would be unnecessary and unwelcome.

The Super System Review's recommendation to exempt collectables and exotic investments for SMSFs approached paternalism and was vigorously resisted by the sector. The Review's reasoning was that such assets could be seen to be 'blurring the lines between investing purely for retirement versus making emotional decisions'.³¹⁰ The sector countered that only those with specific expertise in a particular collectible would invest in it and that APRA-regulated funds are permitted to include such assets in their portfolios and 'collectables are either a suitable asset class for all funds or not suitable for any fund'.³¹¹ In response, the head of the Super System Review stated in an interview that DIY funds could not compare themselves with large pooled schemes *because the latter were prudentially regulated* and, where they did hold collectable items, such investments formed only a small part of their portfolios.³¹² This somewhat circular argument reveals a belief that prudential regulation is needed to prevent trustees investing inadvisably if their investments are in any way unusual. In any event, the government specifically rejected this recommendation.³¹³ Instead, the government promulgated guidelines for storage, insurance, valuation and sale of such assets, effective from July 2011.³¹⁴

5.3.5 Portfolio regulation

Closely related to the issue of prudential regulation is portfolio regulation. 'Portfolio regulation' refers to rules that enjoin portfolio diversification and broad asset-liability matching, as well as rules that limit holdings of certain types of asset within the portfolio.

³¹⁰ James McCullough, 'Art world outrage Super shake-up', *Herald Sun* (Melbourne), 6 July 2010, 28.

³¹¹ Sally Patten, 'DIY funds likely to part with their art', *Australian Financial Review* 8 June 2010, 3.

³¹² *Ibid.*

³¹³ Michaela Boland and Ashleigh Wilson, 'Labor promises art investment won't be excluded from super funds', *The Australian* 31 July 2010, 3.

³¹⁴ Australian Taxation Office, *Collectables and personal use assets - questions and answers* (2011) <<http://www.ato.gov.au/superfunds/content.aspx?menuid=49150&doc=/content/00301181.htm&page=6&H6>>

It seeks to ensure adequate portfolio diversification and liquidity of the asset portfolio. Some OECD countries do regulate their pension funds' asset portfolios.³¹⁵

An aspect of the appropriateness of the ATO's supervisory regulation is its lack of investment expertise and inability to influence SMSFs' portfolio asset allocation and diversification. Some commentators note that SMSFs have inadequate diversification in their investments and many are restricted to cash and well-known Australian equities.³¹⁶ This is cause for concern in light of the fact that it is during the years following retirement that the bulk of an individual's retirement income is produced. Economic modeling suggests 66% of a fund member's retirement income will come from post-retirement investment returns, whereas only 6% come from contributions and 28% from pre-retirement returns.³¹⁷ Good management and investment of retirement savings are therefore crucial.

Because the current legislative regime restricts the ATO's role in portfolio oversight, this issue is explored more fully in Chapter 6, which is concerned with the appropriateness of the legislative regime within which SMSFs operate. However, it is appropriate to mention here suggestions that the ATO play a role in developing acceptable portfolios and requiring funds to adopt one of those portfolios which would average a beta of unity (beta is used in finance as a measure of relative investment portfolio risk, the market itself having a beta of 1.0, or unity).³¹⁸

Alternatively, investment advisers could develop market portfolios for the ATO to approve. It must be acknowledged that reducing choice in this way would reduce SMSFs' attractiveness and thus the incentive to save. An alternative approach is to require only a proportion of total portfolio to be invested in the 'approved' portfolio, or to exempt SMSFs with a balance exceeding a prescribed amount (say, \$500,000) from the requirements (with the effect of discouraging small, economically inefficient funds).

³¹⁵ Refer E Philip Davis, 'Portfolio Regulation of Life Insurance Companies and Pension Funds' (6-8 February 2002) *OECD Workshop on Insurance and Private Pensions and INPRS Regional Meeting* <<http://www.oecd.org/dataoecd/30/39/2401884.pdf>> , 3.

³¹⁶ Peter J Phillips, 'Self managed superannuation funds: Time for portfolio controls?' (2008) *Working Paper (unpublished)* with author's permission.

³¹⁷ Modelling reported by Peter Promnitz, Mercer region head, Asia Pacific, Peter Promnitz, 'No retirement age for super', *The Age* (Melbourne), 26 August 2009 12.

³¹⁸ Tom Valentine, 'Regulation of DIY Superannuation Funds' (2004) 37(2) *The Australian Economic Review* 215, 220.

To quote APRA's Keith Chapman at a conference of the International Network of Pensions Regulators and Supervisors:³¹⁹

We have a highly market oriented investment framework for pension funds which provides for very few prohibitions or directions over where funds can be invested. This is predicated on the fact that allowing the market to work will achieve higher returns for members than prescribing what can be invested in. This has generally worked extremely well and returns have been quite excellent for many years for our pension funds. However, if things go wrong for a few funds (as has happened in Australia recently) this gives rise to considerable public and political concern about 'why didn't the regulator do something about it'. This starts to bring in risks to do with outsourcing – eg how far down can the regulator go if downstream investment vehicles are used. The same issue applies, of course, in relation to operational risks as well if other parties are contracted to carry out tasks for the trustee – how do you protect your regulatory reach?

This quote illustrates some of the risks faced by a supervisory regulator in seeking to impose restrictions on fund investments. As regulator, the ATO is poorly equipped to regulate SMSFs' portfolios, given its main role is revenue collection. It cannot be expected to possess ASIC's expertise in financial markets.

There is a potential model for general guidance in prudential and portfolio controls that could be adapted by the ATO to assist SMSF trustees. APRA has been progressively releasing Prudential Practice Guides to their regulated funds (including separate sections for small APRA funds which share many features with SMSFs), setting out sound practice in order to satisfy obligations imposed under legislated licence conditions, operating standards or other provisions under the SIS Act and Regulations. In August 2010 Guides were released covering:³²⁰

1. minimum liquid assets;
2. risk management;

³¹⁹ Keith Chapman, 'Supervision of Private Pensions - An Australian Perspective' in *OECD Regulating Private Pension Schemes: Trends and Challenges* (2002) 255, 259.

³²⁰ Australian Prudential Regulation Authority, 'Discussion Paper: Guidance for superannuation licensees: Capital, Risk Management, Adequacy of Resources, Fitness and Propriety' (2009)
<<http://www.apra.gov.au/Policy/upload/Discussion-paper-desktop-published-version-as-approved.pdf>>

3. security risk in information and information technology;
4. adequacy of resources; and
5. fitness and propriety of directors, responsible officers and individual trustees.

Although neither the Australian government nor the sector itself contemplates prudential regulation of SMSFs, portfolio controls feature in other jurisdictions (see Chapter 7). In fact, Australia is outstanding in the freedom to invest its SMSF trustees enjoy.

5.3.6 SMSF performance, prudential regulation and portfolio controls

Economic rationalism was the intellectual foundation for many of the recommendations of the 1997 Wallis Report, which shaped the current financial system including the Australian superannuation system.³²¹ It is assumed that rational individuals making their own choices will optimize their own welfare and for SMSF trustee-members there is a strong element of self-interest motivating their investment performance. In the final analysis, if SMSF performance relative to other sectors is strong, this may suggest the absence of any need for prudential regulation or portfolio controls. As discussed in Chapter 2, on limited information that is indeed the case. Indications are that the SMSF sector's performance over the last few years (during the time of the GFC) is superior to that of all sectors of APRA-regulated superannuation funds.³²²

Comparison is less accurate for the years prior to the GFC. According to the Super System Review's SMSF Statistical Summary, 'care must be taken when using SMSF performance figures, particularly when making comparisons, as SMSF statistical data reported before 2008 is not necessarily reliable'.³²³ In addition, period-to-period return comparisons between sectors may be potentially inaccurate due to some self-managed funds not regularly marking-to-market their total assets.³²⁴

³²¹ Sy above n 51, 52.

³²² Commonwealth of Australia n 31, 12.

³²³ Commonwealth of Australia above n 31, 15.

³²⁴ Sy, above n 51, 59.

One longer-term comparison has been performed using data published by APRA in the 2009 Annual Superannuation Bulletin,³²⁵ demonstrating that SMSFs have out-performed the institutional funds since 1997. The average annualized net return for SMSFs was 3.9% compared with 2.6% for institutional funds and 2.8% for the whole system. Some potential explanations for higher average returns of SMSFs posited by the researchers include higher growth assets, a home-country bias, lower tax for a higher proportion of decumulating funds, and lower cost from more direct investing.³²⁶

In the absence of definitive research comparing SMSF investment performance directly with other sectors over the long term, it is risky to state categorically that the freedom of investment enjoyed by SMSF trustees is so far producing good outcomes, however all the available data suggest that this is the case. There is thus no convincing reason for portfolio controls to be imposed by the ATO or by legislative requirement.

5.3.7 The appropriate regulator

There is a compelling case to respond in the affirmative to the question of whether the ATO is the appropriate regulator for the SMSF sector.³²⁷ APRA regulates 386 corporate, industry, retail and public sector funds. The ATO regulates over 468,000 SMSFs. The ATO as regulator is accustomed to one-to-many regulation, as is the case with taxpayers it regulates. By contrast, APRA's approach features greater depth and knowledge of a small number of superannuation fund regulatees. Thus it can be expected to regulate super funds using a collaborative approach.

³²⁵ Sy, above n 51, 54.

³²⁶ Wilson Sy, 'Cost, performance and portfolio composition of small pension funds in Australia' (20 May 2008) *Journal of Pension Economics and Finance* <<http://journals.cambridge.org/download.php?file=%2FPEF%2F51474747208003661a.pdf&code=44560e59dbdd8f850e7fa9d615b280fd>>

³²⁷ Although see Mike Taylor, 'MetLife/Super Review survey: SMFSs should come under APRA jurisdiction' (19 May 2011) *SuperReview* <<http://www.superreview.com.au/Article/MetLife-Super-Review-survey-SMFSs-should-come-under-APRA-jurisdiction/529674.aspx>>

Whether APRA would be a more appropriate regulator for the SMSF sector was an issue identified by the Super System Review, which posed the question 'Is the ATO the appropriate regulator for SMSFs?'³²⁸ The Review's final report stated:³²⁹

While some submissions suggested a change of regulator to APRA (and greater prudential supervision) most agreed that the ATO, with its compliance-based approach, was best placed to continue regulating the SMSF sector.

Had the Review recommended a change of regulator, it is very doubtful that the government would have acted upon any such recommendation, for three reasons:

1. APRA is not funded or experienced in the regulation of funds in the numbers the SMSF sector represents.
2. The ATO is funded and experienced in that role and its regulation to date is reasonably effective, reinforced as it is by the role of approved auditors who check SMSFs for regulatory and financial compliance annually.
3. The basis of APRA's regulation is prudential, using a principles-based approach, whereas the ATO's is a compliance-based approach. Prudential regulation was, as noted earlier, considered by the government to be inappropriate for the SMSF sector.

Although there seems no viable alternative to the ATO's regulation of the SMSF sector, it remains in the developing stage so far as its knowledge and understanding of its regulates is concerned, with only the SMSF Annual Return and its two small trustee surveys having supplied it any more than a general sense of trustee behaviour. Apart from this, the lack of empirical data on the sector has not been greatly alleviated by the little ATO-sponsored research to date.

The results of the SPAA 2010 trustee survey should go some way to enhancing ATO understanding of the sector. However, the SPAA members who were asked to complete

³²⁸ Issue 17.4.2 (Role of the ATO and other regulators) in the issues paper of Phase 3 - Structure (including SMSFs), 14 December 2009

http://www.supersystemreview.gov.au/content/downloads/structure_issues_paper/Phase_3_Structure.pdf

³²⁹ Commonwealth of Australia, above n 175, 225.

the survey are those more engaged and concerned with their SMSF. The ATO's real concerns are with those who are disengaged and unconcerned about their trustee role.

Thus the ATO continues the development of the primary qualification required of a supervisor – knowledge of the industry to be supervised. In addition, there is an ostensible tension between its main role of revenue collection and its relatively recent responsibility for protection of retirement income.

5.3.8 Conflict between roles of revenue protection and protection of retirement income

The ATO's two roles of protection of revenue and retirement income must be balanced by individual case officers in their dealings with individual SMSFs, particularly where they are exercising discretion as delegates of the Taxation Commissioner.

The business community appears to regard the ATO as over-zealous in protecting the revenue and, in the words of Ken Henry at the 2010 Taxation Institute of Australia national conference:³³⁰

Perceptions of a pro-revenue bias seem to be based on an assumption that the Tax Office is out to maximise collections, rather than to administer the law objectively. If this were true, it would undermine the efficiency and equity of the tax system. Large numbers of disputes would be created and, for those who could afford to contest the Tax Office opinion, it would be necessary to resolve issues by getting an impartial view of the law through the courts. Obviously, this would impede business and detract from our ability to attract international investment.

This perception, of a pro-revenue bias, has persisted for at least as long as I have had any involvement in tax ... Yet [t]he Inspector-General of Taxation examined allegations of a pro-revenue bias last year and found no evidence of bias in private rulings involving complex matters. Even so, it is clear that perceptions of bias are firmly held in some quarters.

³³⁰ Ken Henry, 'Confidence in the operation of the tax system' (Paper presented at the Taxation Institute of Australia conference, Sydney, 13 March 2009 .

The Inspector-General of Taxation, in his Review of the potential revenue bias in private binding rulings (PBRs) in 2008, found that:³³¹

... around 70 per cent of large business private binding ruling applicants perceived the Tax Office to have a revenue bias in its PBRs. A major cause of these perceptions was identified as being a lack of transparency — taxpayers observed unexplained Tax Office behaviours and in the absence of cogent explanations interpreted those behaviours as being motivated by a revenue bias ... the Tax Office genuinely strives to provide an interpretation which supports the 'policy intent' of the law, as it understands it. This approach is consistent with the purposive approach to statutory interpretation and is not, of itself, a revenue bias ... The Tax Office has welcomed the finding that there was no evidence of undue revenue bias; it has accepted that perceptions of bias exist and that it will need to improve transparency to remove them.

This review was limited to examining PBRs issued to large business, which would involve significant amounts of revenue in areas of greater legal uncertainty. The extent to which its conclusions can apply to ATO supervisory regulation of SMSFs may be queried. The ATO's relationship with large businesses is one approaching a meeting of equals, the ATO recognising the significant resources which large businesses can direct towards legal advice and defence, as well as political influence which large business may bring to bear. SMSFs, on the other hand, are relatively isolated and practically powerless. It is possible the ATO's approach towards them may differ.

One example of a somewhat high-handed and perhaps prematurely dismissive attitude toward taxpayers objecting to an assessment is the following paragraph in a letter sent to taxpayers in 2011:³³²

The decision of the AAT in the *McMennemin* case³³³ [concerning whether a valid objection to an excess contributions tax discretion decision can be lodged] is currently the subject of an appeal with the Federal Court of Australia. It is expected a decision on this matter will be handed down early in 2011. Should the decision be favourable to the Commissioner, and you still wish to pursue a formal review of this decision, you may be able to lodge an

³³¹ Inspector-General of Taxation, 'Review of the potential revenue bias in private binding rulings involving large complex matters' (February 2008) at 3.

³³² Personal correspondence – email 28/2/11.

³³³ *McMennemin v Commissioner of Taxation* [2010] AATA 573 (3 August 2010).

objection at that time. However in the absence of any additional information to support your objection it is highly unlikely that our decision would change.

At an agency level, such communications with taxpayers do imply a revenue bias, potentially at odds with the ATO's role in relation to SMSFs. As supervisory regulator of the SMSF sector it must ensure the retirement income of SMSF members is protected, not applied in contravention of the sole purpose test³³⁴ or accessed early (and possibly exhausted before the member reaches government Age Pension eligibility). On the other hand, the ATO's main mission and focus of all its other activities is to collect taxes – it is the Australian Government's 'principal revenue management agency' with effectiveness indicators of 'revenue collections as a per cent of budgeted revenue' and 'cost of collection' (which measures the cost of collecting every \$100 of cash, net of refunds paid).³³⁵

At an individual level, case officers dealing with SMSFs are required to follow the ATO Compliance Model, discussed at 4.4.3 *Enforcement*, 'to apply the most appropriate compliance strategy', giving taxpayers the benefit of the doubt by assuming they act honestly and with the best intentions until they demonstrate otherwise. The Compliance Model 'summarises the different sorts of support and intervention that may be needed to collect the required revenue'.³³⁶ The Model's 'responsive regulation' gives the ATO a way to influence taxpayer behaviour through its response and interaction and this approach has been admired by tax authorities in other jurisdictions.³³⁷

Whether all ATO case officers actually follow the Compliance Model in their interactions with SMSFs is an open question. As delegates for the Taxation Commissioner, they have discretion in several areas in the agency's application of the SIS regime – acting on auditor contravention reports (ACRs), issuing complying and non-complying

³³⁴ SIS Act s 62: Each trustee of a regulated superannuation fund must ensure that the fund is maintained solely for the provision of benefits for each member of the fund on their retirement or death.

³³⁵ Australian Taxation Office, 'Commissioner of Taxation Annual Report 2008-09' (2009); Commissioner of Taxation, 'Australian Taxation Office Annual Report 2008-09' (The reference to 'net of refunds paid' reflects the notion that all costs and receipts that do not relate to the collection of Australian Government tax revenue are excluded from the calculation.

³³⁶ <http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm>

³³⁷ See Sagit Leviner, 'An overview: A new era of tax enforcement - from "big stick" to responsive regulation' (2008) 2 *Regulation & Governance* 360.

superannuation fund notices, disqualifying trustees and disqualifying auditors.³³⁸ The former two discretions are discussed below by way of example, examining the factors taken into account when decisions of this type are made by the ATO, whether those factors are public knowledge, and whether they involve a conflict for the ATO between its roles in protecting retirement income of SMSF members and protecting the revenue.

5.3.8.1 Acting on Auditor/Actuary Contravention Reports

Actuary Contravention Reports

An actuary provides an Actuary Contravention Report to the ATO in a case where there were inadequate assets to support an Asset Test Exempt (ATE) pension.³³⁹ This report is unlike an Auditor Contravention Report because the actuary is not reporting on a contravention of SISA. As long as the trustees had minuted a conversion of the ATE to another pension (a market-linked income stream or a retail annuity), rectification of the contravention will have occurred and this is reported to the ATO as well.³⁴⁰ Because ATEs are uncommon within SMSFs and actuary contravention reports are very rarely made, this thesis focuses on auditor contravention reports.³⁴¹

Auditor Contravention Reports

In the 2008 income year, approved auditors qualified almost 4% of their SMSF audits, due to either a financial or regulatory compliance issue, or both.³⁴²

³³⁸ **Disqualifying trustees and auditors:**

The ATO has greater powers than APRA in disqualifying trustees and auditors. The Commissioner of Taxation may directly disqualify an individual from acting as an SMSF trustee (SISA s126A), whereas APRA must apply for the Federal Court to disqualify a person as a trustee (SISA s126H); the ATO can directly by written order (a *disqualification order*) disqualify a person from being an approved auditor or actuary for the purposes of the SIS Act (SISA s131), whereas APRA must apply to the Federal Court to do so (SISA s130D). Both agencies may also refer matters to a professional association of an auditor or actuary (SISA s 131A). There is *prima facie* no conflict for the ATO in decisions concerning disqualification of individual trustees and auditors, therefore these discretions are not discussed in this section.

³³⁹ Also known as a 'lifetime' pension, defined benefit pension or SISR 1.06(2) pension, which since 1 July 2007 may no longer be commenced.

³⁴⁰ Interview A12, actuary.

³⁴¹ An actuary's main business is the annual provision of a certificate pursuant to ITAA 1997 s295-390. This specifies the proportion of the fund's assessable income which is income tax exempt because it relates to assets used to support current pensions. The certificate is only required where such assets are unsegregated from the fund's other assets (ITAA 1997 s 295-385).

³⁴² Commonwealth of Australia, above n 174, 22.

Should an auditor/actuary contravention report (hereinafter 'ACR') be lodged with the ATO following an approved audit of an SMSF, it is placed on record against the SMSF and the trustees. An automatic letter is sent, warning the trustees of the need to rectify the contravention. The ATO risk-assesses ACRs and follows up those rated high risk, with the result that penalties may be applied to the SMSF. The normal ATO processes and review/appeal rights attach to transactions between the ATO and SMSF from the point in time that any sanction is applied, but it can be 12 to 18 months from receipt of the ACR before that happens.³⁴³ Three recent AAT cases illustrate how appeals against the ATO may arise from ACRs.³⁴⁴ There is a certain lack of transparency in this arrangement in that the risk assessment of ACRs is an internal ATO process. The trustees are not privy to deliberations about whether sanctions should be applied against them or their fund, if in fact no sanctions are applied.

The demographic of SMSFs with ACRs are generally in line with the overall SMSF population, indicating that there is no correlation between the receipt of an ACR and the SMSF size, income range, years since establishment, structure or geographic location.³⁴⁵

If the ATO decides to act on an ACR, it can apply to the court under SISA s 196(3) for a civil penalty order in respect of any of the following matters:

- Breach of the sole purpose test (in SISA s 62)
- Lending to members of regulated superannuation fund (SISA s 65)
- Borrowing (SISA s 67)
- Exceeding in-house asset rule (SISA s 84)
- Avoidance scheme to avoid breach of the in-house asset rule (SISA s 85)
- Failure to notify the Commissioner of significant adverse event (SISA s 106)

³⁴³ ATO Assistant Commissioner, Interview B3.

³⁴⁴ *JNVQ v Commissioner of Taxation* [2009] AATA 522; *CBNP v Commissioner of Taxation* [2009] AATA 709; *ZDDD and Commissioner of Taxation* [2011] AATA 3 (10 January 2011).

³⁴⁵ Commonwealth of Australia, above n 31, 17.

- Investments not made and maintained on arm's-length basis (SISA s 109).

A court order means the SMSF trustee must pay a monetary penalty to the ATO, which may enforce the order as if it were a judgment of the court (SISA s 200). The court may also order punitive damages to be paid (SISA s 222).

Upon receipt of an ACR, the Commissioner may demand information about whether or not the fund was a self-managed superannuation fund as at a certain date under s 252A. If that information is not supplied within 21 days (or whatever shorter time is specified), a strict liability offence is committed and the Commissioner may issue a contravention notice under s 252B. The person may choose to have the matter dealt with by a court or pay the requisite penalty direct to the ATO.

In these scenarios, exercise of the discretion to act upon an ACR may result in collection of revenue by the ATO from the assets of the SMSF. There is nothing in the SIS Act to require a trustee who has contravened its provisions and is subject to a civil or criminal penalty to pay such penalty from their own resources rather than from fund assets, although under SISA ss 215 or 216 the court may order the trustee to compensate the fund for a loss suffered.

In fact, as it has moved from the educative to the enforcement phase of its oversight of SMSFs, the ATO has increased its compliance coverage. From 400 funds audited in 2006 it has increased its audit rate to 4% in 2011, which reflects around 16,000 funds, with a much larger focus on follow-up activities. It expects to act on about 2000 ACRs in 2012.³⁴⁶

Thus, a case officer exercising discretion on whether or not to act on an ACR is making a decision with revenue implications, which in some cases can be significant. The same is true of the decision to declare an SMSF non-complying.

³⁴⁶ Victoria Papandrea, 'Auditor independence on ATO radar' 24 February 2011 *SMSF* 1 quoting from a speech by the ATO Commissioner at the 2011 SPAA conference, Brisbane.

5.3.8.2 Non-complying fund notice

The ATO's main regulatory tool with SMSFs is the ability to declare a fund to be non-compliant pursuant to SIS Act s 40 (in which case tax revenues from contributions and fund assets and earnings will increase, in some cases by large sums). 'Use of this tool could be seen as involving a conflict of interest for the ATO',³⁴⁷ namely, between its interest in maximising revenue collection and its duty to administer the SIS regime impartially and consistently. In fact, the number of funds being declared non-complying has been trending upward,³⁴⁸ from 5 in 2007, 24 in 2008, 99 in 2009, 185 in 2010, 70 in 2011 and 74 in 2012.³⁴⁹

In exercising discretion as to whether the ATO renders an SMSF non-complying, Practice Statement Law Administration 2006/19 outlines the relevant criteria case officers should take into consideration.³⁵⁰ Application of these criteria should provide a check against the *prima facie* conflict within the SMSF segment of the ATO between protection of retirement income and revenue collection, as well as any possible bias, although the criterion 'all other relevant circumstances' admits a large degree of subjectivity on the part of an individual case officer.

If the ATO is considering issuing a notice of non-compliance, it generally sends a position paper explaining its reasons and provides the trustee with the opportunity to submit reasons why the fund should not be made non-complying. The ATO's decision to issue a notice of non-compliance is reviewable and objection can be lodged against the ensuing income tax assessment.

³⁴⁷ Tom Valentine, 'Regulation of DIY Superannuation Funds' (2004) 37(2) *The Australian Economic Review* 215, 218

³⁴⁸ Bryce Figot and Daniel Butler, 'ATO's step up in rendering SMSFs non-complying' (2010) March *Australian Superannuation Law Bulletin* 113.

³⁴⁹ Australian Taxation Office, *Compliance program 2012–13* (2012)

<http://www.ato.gov.au/content/downloads/COR00326650_NAT7769.pdf>

³⁵⁰ However if the SMSF does not meet the definition of Australian superannuation fund ITAA 1997 s 295-95(2) the ATO must issue a notice of non-compliance and the tax liability automatically applies (see 295-320 ITAA 1997). *CBNP Superannuation Fund v Commissioner of Taxation* [2009] AATA 709 confirmed such absence of discretion in this instance.

5.3.8.3 Revenue bias and lack of transparency in decision-making

The ATO as an agency is accountable to Parliament on 'cost of collection', with a strong incentive to maximise collections in terms of its effectiveness indicators. In addition, the various 'business lines' within the ATO (including the Superannuation business line) have budgets to meet and are rewarded if they do so. Rewards may include promotion and public praise for senior business line managers, increased resourcing for the business line in the following year's internal budget, with correspondingly increased numbers of employees for that business line.

A revenue bias may accordingly exist within the ATO, which may impact negatively on its supervisory regulation of SMSFs where its primary responsibility is to protect members' retirement savings.

The main problem with ATO exercise of discretion in the exercise of sanctions against SMSFs is a continuing lack of transparency, systematisation and openness to public scrutiny. None of its deliberations are made known to those affected by the outcome. This can lead to a perception of revenue bias, as in the words of the Inspector-General of Taxation, 'taxpayers observed unexplained Tax Office behaviours and in the absence of cogent explanations interpreted those behaviours as being motivated by a revenue bias'.³⁵¹ The extent of any genuine revenue bias on the ATO's part is not possible to ascertain, given the paucity of case law – the only arena for objective assessment of ATO decisions in relation to SMSFs. However, public statements by the Commissioner and senior staff in the SMSF Segment³⁵² do imply a distrust and suspicion of the sector and media commentary is often seen accusing the ATO of 'trying to place a self-serving interpretation on tax law'.³⁵³

Lack of transparency in decision making extends to areas in SMSF supervisory regulation that have no revenue implication. As discussed in 3.10 (Disqualification of Trustees), a case officer's decision to disqualify an SMSF trustee is a highly subjective exercise, the only guidance for which is a recent ATO ID of limited applicability.

³⁵¹ Inspector-General of Taxation, above n 331, 3.

³⁵² Refer n 458 and n 459 below.

³⁵³ See for example Max Newnham, 'Tackling the Tax Office over its interpretations', *The Age* 15 June 2012, 10.

5.4 Effectiveness of regulation

Where regulation is intended to protect the 'public interest' and, in particular, to protect the public from some harm, it should also be effective.³⁵⁴ The public interest being protected by the regulation of SMSFs is relief from excessive burdening of the workforce and general revenue by government Age Pensions. This is achieved by facilitating SMSF members in providing for their own retirement. The potential harm from which the public is to be protected must be the prospect of SMSF members unnecessarily claiming the government Age Pension at public expense, paid for by a dwindling proportion of taxpayers, because their retirement savings have not been effectively protected. Thus, regulation of SMSFs must be effective because it is designed to protect the public interest.

By 'effectiveness' is meant 'adequacy to produce the intended or expected result' and, in this case, the expected result is regulatory compliance by the SMSF population as well as preservation and enhancement of SMSF members' retirement savings. Evidence of efficiency will be ascertainable by degree of compliance and SMSF performance, discussed below.

Regulation may 'fail' because:³⁵⁵

1. the legislative provisions establishing it are ambiguous, conflicting or simply not commensurate with its ostensible goals;
2. the enforcement of regulation by the agencies charged with the task may be inadequate for reasons such as a shortage of financial or human resources; or
3. the effectiveness of a regulatory agency may be subverted by pressures from the environment in which it operates.

The first of these factors is more properly explored in Chapter 6, which deals with the legislative regime under which SMSFs operate. The remaining two factors are discussed

³⁵⁴ Margot Priest, 'The Privatization of Regulation: Five Models of Self-Regulation' (1997-98) 29(233) *Ottawa Law Review* 271.

³⁵⁵ R F Cranston, 'Regulation and deregulation: General issues' (1982) 5 *University of NSW Law Journal* 1, 11.

below as limitations on the effectiveness of the ATO's supervisory regulation of the sector. Resourcing of the ATO includes gaps in regulatory reach, skill levels of ATO staff and issues with the registration process. Pressures from the environment in which the ATO operates includes fraudulent use of SMSFs, dangers or weaknesses in the delegation to approved auditors and possible capture of the regulator.

5.4.1 Resourcing of the ATO

5.4.1.1 *Reactive versus proactive*

A regulator's law enforcement capacity is dependent on adequate resources, especially to investigate complex wrongdoing and then to pursue it through the courts. Without adequate resourcing, an agency's decisions must be reached with inadequate information, unless the agency relies on those it regulates for information, whereupon it is more susceptible to unacceptable influence.

Regulatory agencies must strike a balance between being reactive (obtaining their cases through complaints) and being proactive (taking the initiative themselves to obtain cases). Generally the better they are resourced, the more proactive they can be. The ATO is generally proactive in its audit program directed at businesses and individuals. By contrast, its main activity to secure SMSF compliance is reacting to 'complaints', that is, auditor contravention reports. 'An over-reliance on complaints can', it is said, 'lead regulatory agencies to handle trivial matters without any thought as to how these fall into the overall strategy mapped by legislative purpose'.³⁵⁶

The ATO as regulator of SMSFs has always been large and increasingly well endowed for this purpose by successive governments, so has an expansive and confident view of its powers. However, the sheer numbers of regulatees mean that the ATO must adopt a risk-based approach to policing regulatory and financial compliance. It can only hope to cover about 1% of SMSFs in any one financial year, as evidenced from its 2010-11 Compliance Program, which reported that in 2009-2010:

³⁵⁶ Ibid 16.

- The ATO implemented a real time risk profiling of new SMSF registrations to address illegal early release of super. It stopped 827 funds from being registered on Superfund Lookup. It sent letters to all trustees of newly registered SMSFs outlining their responsibilities and other obligations.
- The ATO enhanced the electronic superannuation audit tool (eSAT) to provide support to and improve approved auditor compliance.³⁵⁷
- The ATO reviewed the compliance of over 5,700 SMSFs (approximately 1% of those registered), raising approximately \$20 million in liabilities and resulting in a range of actions including making 160 SMSFs non-complying, winding up 55 funds and 190 enforceable undertakings.³⁵⁸

In response to the question what proportion of these reviews were 'reactive' (arising from ACRs) and what proportion were 'proactive' (arising from ATO risk assessment activity independent of any ACR), an ATO SMSF Director responded in the following terms:

The ATO undertook compliance activity on approximately 2,300 SMSFs due to ACR lodgment. The rest are a combination of SMSF Annual Return lodgments (risk assessed), Intel referrals (for example behaviour of a particular trustee), AUSTRAC³⁵⁹ reports, and registration reviews.

The ATO is planning to significantly expand the ACR part of our program once Approved Auditors are registered with the Commonwealth as we believe the standard of the reports we receive will be increased with the tighter qualification process.

5.4.2 Resourcing of oversight bodies

The issue of resourcing extends to those statutory offices that perform subsidiary regulatory functions. The Henry Review Final Report listed a number of improvements

³⁵⁷ There has been some complaint about eSat: 'It only does part of the audit on there, not engagement, planning, testing or sample size. It's not a complete tool, it only covers some of the compliance side. So we do it on our own work papers, we don't use it, although I saw it had good potential.' (Interview 10, auditor).

³⁵⁸ Australian Taxation Office, 'Compliance program 2010–11'

<http://www.ato.gov.au/content/downloads/cor00248103_NAT7769.pdf> 43.

³⁵⁹ The Australian Transaction Reports and Analysis Centre.

that could be made to bolster oversight of the ATO, including improved resourcing of the ANAO, Ombudsman and Inspector-General of Taxation and establishment of a board to advise the Commissioner of Taxation on the general organisation and management of the ATO.³⁶⁰ However, these recommendations have to date not been adopted by the Government.

5.4.3 Skill levels of ATO staff

Anecdotal evidence is that skill levels of staff directly interacting with SMSF trustees and members may not be optimal. In its submission to the Super System Review the National Institute of Accountants³⁶¹ complained of ATO compliance activity:³⁶²

A number of members subject to ATO reviews of SMSF have complained about the level of training of ATO staff. Many of the findings of such reviews have been appealed and on many occasions the tribunals and courts have found the ATO processes wanting and the staff knowledge of this complex area insufficient. It is costly to members to appeal these reviews and where the ATO has been found to be negligent or 'reckless' then there should be compensation to the taxpayer. Further, the ATO needs to ensure that its employees who undertake the reviews are both better trained and have a less confrontational and suspicious attitude towards SMSF. Members have reported that ATO staff seem excessively zealous in seeking to uncover minor deficiencies. The ATO needs to deal with this issue through better training and better selection of staff who undertake the reviews.

³⁶⁰ **Recommendation 115:** A board should be established to advise the Commissioner of Taxation on the general organisation and management of the ATO. The board would not be a decision-making body and would have no role in interpreting the tax laws or examining individual taxpayer issues. The government would appoint members to the board. **(this is now Labor party policy)**

Recommendation 116: The government should clarify that the role of the Inspector-General of Taxation is to examine systemic tax administration issues that affect businesses.

Recommendation 117: The government should ensure that sufficient resources are devoted to the functions of the Inspector-General of Taxation, the Australian National Audit Office and the Commonwealth Ombudsman, recognising their importance in maintaining a fair and efficient tax system.

Recommendation 118: The Joint Committee of Public Accounts and Audit should examine reports of the Inspector-General of Taxation and the Commonwealth Ombudsman, and monitor the ATO's implementation of the recommendations in those Reports:

Commonwealth of Australia, *Australia's future tax system: Report to the Treasurer, December 2009*
<http://taxreview.treasury.gov.au/content/downloads/final_report_part_1/00_AFTS_final_report_consolidated.pdf>
at 128.

³⁶¹ Since early 2011 known as the Institute of Public Accountants.

³⁶² National Institute of Accountants, 'Submission to Cooper Review: Phase 3: Structure' (February 2010)
<http://www.supersystemreview.gov.au/content/submissions/downloads/NIA_100319.pdf> 8.

If there is any substance to these claims, presumably these problems have resulted from a deficit in resourcing for adequate training and staffing levels.

5.4.4 Support by ATO to SMSF professionals

Many interviewees complained about the difficulty they have in accessing technical assistance from ATO staff. Interviewee responses included the following to this end:

It is hard to find someone in the ATO to provide a specialized answer; it might take a few phone calls before you find someone who knows what they're talking about. Getting information out of the ATO is difficult on out-of-the-ordinary issues - they are slow on IDs and rulings ... Even in a private ruling you might not get the answer. They refer you back to the regulations because they're trying to cover their own butts. (Interview A12, actuary)

Things don't seem to be administered in a timely manner, whether that's due to computer problems or lack of staff in the ATO. They tell you a fund's due to lodge in October this year and you ring up and say no, it's due at the end of February and they say, well we just haven't updated our records yet. They say that a lot. (Interview A14, auditor)

As an administrator, I've found you don't turn to the ATO for advice, generally the people you can get through to can't give advice, you get scripted responses from the Info Line on advice-related matters and they have trouble understanding the real issue you're calling about. It gets escalated but you usually don't have time to wait for a call back. (Interview A6, SMSF administrator)

Often it takes a little while, especially with respect to superannuation, to find someone who is knowledgeable about the matter; it escalates up the management chain, but usually up the line somewhere there's someone who'll make a decision. (Interview A11, accountant)

If you don't get an answer you like, ring someone else at the ATO until you do. I know enough of the internal workings of the ATO to not expect always consistent answers. For technical stuff I look to legal contacts in Melbourne for SISA questions. That's quicker than trying to get an answer from ATO and better from a due diligence point of view. Instead of just giving me an answer to my initial question, they will ask me questions to clarify. That's better due diligence on behalf of the client and better protection for [our firm] knowing that advice is the best possible and we've exhausted all our avenues. (Interview A10, accountant/administrator)

They are helpful; to get an answer to complex technical questions you might have to go through a few menu options on the Infoline, but you get sensible, cogent advice from the SMSF specialist area. I respect their views. (Interview A13, actuary)

Based on the foregoing, it appears that one of the major weaknesses in the ATO's performance in regulating the SMSF sector is providing technical assistance to trustees and industry professionals, although this view is not unanimous. The ATO has made some attempt to provide more direct tailored advice to the sector through a pilot 'Superannuation Professional 2 Professional support service' to the Top 100 approved auditors (who together cover over 25% of the SMSF population).³⁶³ To date, it is not clear whether this pilot is to be extended, or indeed continued.

5.4.5 Gaps in regulatory reach

With over 468,000 SMSFs to regulate, the ATO must use risk-based approach in determining which SMSF obligations to check. To be effective, such risk-based approaches need to ensure that resources are committed not simply to the highest risks, but to those which the supervisor has the best chance of mitigating.³⁶⁴ There are a number of gaps in the ATO's supervisory regulation of SMSFs resulting from resourcing constraints. These gaps are identified from the candidate's personal experience and anecdotal evidence. Presumably, the ATO has decided these gaps in its regulatory reach are less important or able to be mitigated.

5.4.5.1 SMSF income tax assessments

There have been suggestions from SMSF professionals that the ATO has developed a possible over-emphasis on compliance with SISA at the expense of its normal income tax risk assessment processes:

³⁶³ Australian Taxation Office, *ATO's regulation of SMSFs including the compliance program, specific risks and other areas of focus - Keynote address by Stuart Forsyth Assistant Commissioner, Superannuation, ICAA National SMSF Conference, Melbourne* (2011)

<<http://www.ato.gov.au/corporate/PrintFriendly.aspx?ms=corporate&doc=/content/00294345.htm>> ..

³⁶⁴ Jose Vinals and Jonathan Fiechter, 'IMF Staff Position Note: The Making of Good Supervision - Learning to Say "No"' (May 18 2010) <<http://www.imf.org/external/pubs/ft/spn/2010/spn1008.pdf>> at 8.

Big refunds are often issued to SMSFs with no questions asked, whereas for individuals questions are asked and there is contact from the ATO and maybe a review. I think there must be no risk assessment built into SMSF tax assessments. (Interview A8, accountant)

The ATO response to this statement was.³⁶⁵

Yes, the ATO does have different risk tolerances for individuals than for trusts. There is more potential for fraud with individuals. Dollar thresholds are higher for SMSFs than individuals, when it comes to incorrectly claiming large refunds. What these thresholds are is very closely held within the ATO. SMSFs are treated just like trusts – the threshold is the same – and the ATO does risk assess them. The SMSF has been subject to an approved auditor's scrutiny whereas an ordinary trust hasn't.

It is true that large income tax refunds are unquestioningly issued to SMSFs that may be multi-million dollar trusts, but this is tempered by the external scrutiny provided by the approved auditor. SMSF taxation reporting through the SMSF Annual Return is simply a manifestation of the generally accepted self-assessment taxation system administered by the ATO.

5.4.5.2 No checking that newly non-complying funds have informed employers of change in status where an SMSF receiving employer contributions becomes non-complying

Newly registered SMSFs will receive a Notice of Complying Fund Status in respect of that year and those following after lodging their first SMSF Annual Return. The notice states:

Fund [XYZ] is a regulated complying super fund for the [XXXX] income year and will continue to be eligible for concessional tax treatment in subsequent years unless the ATO formally notifies trustees otherwise. You can provide this notice to an employer as evidence that the fund is a regulated superannuation fund. The fund is also an eligible choice fund under the choice of superannuation fund legislation. ***If this notice is withdrawn, the trustees must inform all contributing employers of the change in status of the superannuation fund.*** [emphasis added]

³⁶⁵ Interview B7.

Neither the ATO nor the approved auditor checks compliance with the requirement of a non-complying fund to notify contributing employers of its change in status.

5.4.5.3 Real property, collectables and personal use assets

There is no verification of the existence or value of these assets as they are reported in an SMSF's Annual Report. However, some innovative practices by the ATO have emerged, as this tongue-in-cheek comment describes:³⁶⁶

One asset class that continues to be contentious is business real property. To verify the legitimacy of this kind of property, physical sighting of the asset can sometimes be required. But of course Australia is such a massive continent it makes it implausible to always do this. So how has the ATO got around this? By starting to use Google Earth images to observe and validate some of these property holdings. Perhaps the regulator should be renamed Big Brother.

5.4.5.4 No verification that personal use assets are not being enjoyed by members in contravention of the sole purpose test

The ATO's Self-Managed Superannuation Funds Ruling SMSFR 2008/2 '*The application of the sole purpose test in section 62 of the Superannuation Industry (Supervision) Act 1993 to the provision of benefits other than retirement, employment termination or death benefits*' provides that in the case of collectables and boutique investments – such as works of art, antiques, jewellery, classic cars and wine – trustees must take care to ensure that SMSF members are not granted pre-retirement use of or access to the assets in circumstances that suggest that the trustee is maintaining the fund for a purpose not specified in SISA s 62(1).³⁶⁷

This means art cannot be hung, nor cars driven, wine consumed, jewellery worn, holiday home occupied or any other personal use asset enjoyed in a way that confers a pre-retirement benefit to a member or associate. However, neither the ATO nor approved auditor monitor compliance with these requirements.

³⁶⁶ Darin Tyson-Chan, 'It's 1984 in 2010' (2010) March 15-21(496) *Independent Financial Adviser* 34.

³⁶⁷ At para 33. Note that this ruling is stated not to be binding on the Commissioner.

The Government has released guidelines on storage of such assets to prevent them from giving rise to a personal benefit, with effect from July 2011, but it appears that neither the ATO nor the approved auditor will be monitoring compliance with the guidelines.³⁶⁸

5.4.5.5 Bankruptcy of trustees and trustee companies not monitored

No super fund (including SMSFs) may have a trustee or a director of a trustee company who is bankrupt.³⁶⁹ Penalties for contravention of this rule are strict and can include imprisonment. If someone has an SMSF and is facing bankruptcy, they must move their benefits to a non-SMSF super fund and cease being a member and trustee/director. Alternatively, the person could convert the SMSF into a small APRA fund (SAF) and arrange for a new special trustee (with a registrable superannuation entity (RSE) licence)³⁷⁰ to be appointed. Once the person becomes discharged from bankruptcy, he or she may return to trusteeship and membership of an SMSF.³⁷¹

There is, however, no mechanism for excluding trustees bankrupt or 'insolvent under administration' (SISA s 10) from trusteeship of an SMSF, either at startup (see 5.4.6) or during the life of the SMSF. The ATO does not monitor trustee solvency as ASIC does for company directors.

5.4.5.6 No checking that SMSF pays a pension or has a corporate trustee

SISA s 19 provides that a fund is only a regulated superannuation fund (being regulated being a prerequisite to entitlement to taxation concessions) if it either has a corporate trustee or its governing rules provide that its sole or primary purpose is the provision of old-age pensions. But there is no requirement for an SMSF to prove to the ATO that one or the other of these requirements applies to their fund.

³⁶⁸ Chris Kennedy, 'SPAA welcomes SMSF collectibles decision' (3 August 2010) *SuperReview* <http://www.superreview.com.au/articles/SPAA-welcomes-SMSF-collectibles-decision_z521450.htm> ; see also note 314.

³⁶⁹ SISA s 120.

³⁷⁰ Pursuant to SISA s 29M.

³⁷¹ Bryce Figot, 'How to protect your super during bankruptcy' (2010) April-May *Professional Planner* 60.

A senior ATO officer has stated he considers many SMSFs neither have a corporate trustee nor pay a pension. They are set up without the intention to pay pensions, rather to minimize tax for the member until he or she reaches preservation age (or 60, depending on the taxation situation)³⁷² and then pay a tax-free lump sum.³⁷³

Further, Pauline Vamos, CEO of the Association of Superannuation Funds of Australia ('ASFA'), has stated she considers many SMSFs are being used as an estate planning vehicle³⁷⁴ (see 3.6.6) rather than a retirement vehicle.³⁷⁵ Empirical evidence to evaluate the validity of this statement remains elusive, however.

What appears true is that if an SMSF does not have a corporate trustee and its trust deed does not state that its sole or primary purpose is the provision of old-age pensions (whether or not in fact it does ever pay a pension), then *prima facie* it is not and never was a regulated super fund and therefore was never entitled to tax concessions. Yet neither the ATO nor the approved auditor monitors compliance with this requirement.

5.4.6 Issues with the registration process

The ATO deals with approximately 2,500 new SMSF registrations each month. Its resources are insufficient to check each individual registration application and, apart from limited pre-registration checks, discussed below, it is essentially an on-line self-registration system.

Pauline Vamos (ASFA) has been quoted in the *Australian Financial Review* stating that SMSFs are not sufficiently well regulated, with issues including the excessive ease with which they can be established. There is no need for trustees to verify who they are or verify the SMSF has its own bank account and no way to prevent the use of the name of

³⁷² Between the ages of 55 and 60, lump sums from taxed elements paid to a member are tax-free up to \$175,000 (the low rate cap) and taxed at 15% thereafter. After the age of 60, the taxed element of both pensions and lump sums of any amount are tax-free.

³⁷³ Interview B4.

³⁷⁴ Because of its perpetual succession, the SMSF can function as a vehicle to transfer wealth between generations of trustee-members in a concessional-tax environment.

³⁷⁵ Barrie Dunstan, 'Warning on 'weak link' super funds', *Australian Financial Review* 11 November 2009, 4.

another fund so that duplicate funds can exist with the same name.³⁷⁶ These comments have some validity and are discussed in greater detail below.

5.4.6.1 Pre-registration checks of trustees

Until recently, registration of a new SMSF could occur quickly (within a few days) and by the time a new fund had been identified by the ATO as risky and been suspended from SFLU, it may already have been too late – money may have been rolled over or withdrawn.

Over the past 18 months, the ATO has been tightening its SMSF registration procedures by building in some risk assessment upfront. It now performs more pre-registration checks before a newly registered SMSF is listed on SFLU. New funds will not be registered until the ATO is satisfied they are legitimate. The ABN and TFN are issued immediately but the ATO performs some checks of whether its trustees are fit and proper persons. The latter involves checking their compliance history as individual: for instance, have they had any prosecutions by a Commonwealth agency? do they have ATO debts, a poor lodgment history, a history of living on Centrelink benefits? If a compliance case is created for that particular SMSF, the ATO will request trust deeds and bank account details.

5.4.6.2 Trustee/member bankruptcy checks

Identity checks of the member/trustees are not part of the registration process. By contrast, although ASIC is not required or entitled to perform identity checks on a person seeking to become a director or shareholder in a corporation either, it does have a data matching protocol with the Insolvency and Trustee Services Australia concerning bankruptcies and other circumstances that disqualify a person from being a director or other officer.³⁷⁷ This check is absent for SMSF trustees.

³⁷⁶ Barrie Dunstan, 'Warning on 'weak link' super funds', *Australian Financial Review* 11 November 2009, 4.

³⁷⁷ Commonwealth of Australia, above n 175, 253.

5.4.6.3 Bank account checks

There is no general requirement for newly-registered SMSFs to provide proof to the ATO of the opening of a bank account in the fund's name nor that, if a bank account exists, it is exclusively used by that fund. In fact, there can be multiple registered SMSFs sharing one bank account.

What is to become available from 2015 is the ability of APRA-regulated funds and employers to check online an SMSF's bank account details prior to remitting contributions or rollovers to it (see further 7.6.1).

5.4.6.4 Naming convention for SMSFs

A feature of ASIC's regulation of corporations is that applicants for registration can only choose a company name that is not already registered to a company or business. A National Names Index is searchable on the ASIC website.

This contrasts with the situation for SMSFs, where an SMSF can be set up with the same name as another SMSF and an SMSF can also be established with the same name as an APRA regulated fund, thus 'mirroring' a well-known and fully compliant APRA regulated fund. The danger is that employers, who under the 'choice' regime are required to make super guarantee payments into an employee's superannuation fund of choice and may use Super Fund Lookup to check that a legitimate fund exists, are falsely reassured if the SMSF carries the name of a well-known APRA fund.

The Association of Superannuation Funds of Australia (ASFA), in its submission to the Super System Review, stated that SMSFs names should not be allowed where they are similar to an existing superannuation fund. It called for a mechanism to be established to enable the ATO as regulator of SMSFs to prevent such a fund name from being used.³⁷⁸ The Review agreed, recommending that the ATO establish controls to ensure SMSFs can be neither established with, nor subsequently change their name to, the name of, or

³⁷⁸ The Association of Superannuation Funds of Australia Limited, 'ASFA Submission - Super System Review – Phase Three: Structure (incl. SMSFs)' <http://www.supersystemreview.gov.au/content/submissions/downloads/ASFA_100219.pdf> , 4.

a name similar to, an existing APRA-regulated entity and that other naming rules applicable to bodies corporate under the *Corporations Act* be applied to SMSFs.³⁷⁹ The Review did not recommend against duplicate SMSF registrations, but this would also be prevented by such controls.

5.4.6.5 Capture of adviser details

The Super System Review recommended that where an SMSF was established through an adviser, the registration process capture the details of the person who has provided advice. This information should also be available to ASIC to assist in regulating Australian Financial Services licence holders and form part of the risk assessment process for both ASIC and the ATO.³⁸⁰ In ATO risk assessment, SMSFs established with professional advice are considered *less* risky than those established without it.³⁸¹

It is noteworthy that, from 1 July 2012, the Australian Financial Services Licence (AFSL) exemption³⁸² for accountants providing advice on SMSFs will be removed (see 2.6.1). However, the government proposes to investigate alternative licensing arrangements in consultation with industry, including a streamlined licensing regime.³⁸³ The three accounting bodies are not opposed to the removal of the exemption because accountants providing SMSF advice to their clients have been unable to make comparisons with alternative superannuation products³⁸⁴ because they are exempted from the requirement to obtain an AFSL (which enables advice to be given on all types of superannuation).

5.4.7 Resourcing of the ATO - conclusion

There are several weaknesses in the supervisory regulation of SMSFs stemming from resourcing constraints and the consequential risk-based approach to administration. Despite the ATO's efforts to introduce greater stringency into the SMSF registration process, weaknesses remain, some of which may be remedied as the government

³⁷⁹ Commonwealth of Australia, above n 175, 255.

³⁸⁰ Ibid 254.

³⁸¹ Interview B6.

³⁸² Part 7.6 *Corporations Act 2001* (Cth).

³⁸³ Michael Chaaya, 'The future of financial advice - beyond Ripoll' (2010) May *Australian Superannuation Law Bulletin* 138.

³⁸⁴ Victoria Papandrea, 'Doubling up' August 2-8, 2010(516) *Independent Financial Adviser* 18, 20.

progressively implements the Stronger Super responses to the Super System Review's recommendations.

Closely related to lack of stringency in the registration process, the regulators (ATO and APRA) are concerned with reported use of SMSFs in fraudulent activity, either illegal early access to superannuation or their use in various forms of tax evasion. Each is addressed below.

5.4.8 Fraudulent use of SMSFs

5.4.8.1 Rollovers from APRA-regulated funds

Commentators have called for regulators to make it more difficult to establish SMSFs because identity theft schemes use SMSFs to remove victims' retirement savings from public offer funds via rollover.³⁸⁵ Usually, members of a newly-established SMSF will consolidate their superannuation by requesting their existing APRA-regulated fund(s) to rollover their super savings into their new SMSF. This is done using an ATO *Request to transfer balance of superannuation benefits between funds* form. There is weakness in the mechanisms available for APRA-regulated fund to check the bona fides of SMSF members who request rollovers. Privacy laws prevent them from verifying members' identity.³⁸⁶ And they have a 'portability' obligation, which requires rollover to a requesting member's new fund within 30 days (SISR reg 6.33).

Illegal early release is the ATO's top-rated superannuation risk and may consist of a scheme involving repeated illegal access.³⁸⁷ Such schemes may be one of two types – access to a member's retirement savings *with* the knowledge and collusion of the member, or access thereto *without* the member's involvement. The well-publicised Kassongo³⁸⁸ and Palusi³⁸⁹ cases in 2008 involved the collusion of members. A newly-

³⁸⁵ Alison Kahler, 'Mailbox thieves make hay with DIY super', *Financial Review* 18 November 2009 24.

³⁸⁶ Although according to the ATO, 'a member verification service concept is to be implemented in less than one year': Interview B6.

³⁸⁷ Personal anecdote, Director - Super Illegal Early Release, SMSF Segment, Superannuation Line, ATO: Interview B5.

³⁸⁸ Mr Kassongo set up an SMSF and for a large commission, rolled over the preserved super benefits of 192 members of public offer funds into the SMSF's bank account, then distributed those monies to the members who had retained him: Australian Securities and Investment Commission, *08-181 Trustee of self managed super fund appears in court on ASIC charge* (2008) <<http://www.fido.gov.au/fido/fido.nsf/byHeadline/08-181>> .

discovered scam whereby individuals' TFNs were obtained during sham job interviews, and their superannuation rolled over into the perpetrators' SMSF, is an example of a scheme without member involvement.³⁹⁰

5.4.8.2 ATO-APRA activities to combat SMSF fraud

In 2010 APRA sent two letters to trustees of all their regulated superannuation funds concerning potential fraud in rollovers to SMSFs. The latest, dated 5 May 2010 and headed '*Fraud Alert: SMSF Identity Fraud and Theft of Superannuation Benefits*', stated that false documentation from the Australian Business Number Register (administered by the ATO) had been sent to APRA-regulated funds as evidentiary documentation to support applications submitted to those funds seeking rollovers to SMSFs.

On 5 February 2010 a letter was sent to all APRA regulated super funds headed '*Managing the Risk of the Illegal Early Release of Superannuation Benefits – Transfers and Rollovers into SMSFs*'. The letter provided guidance on additional processes that trustees should consider implementing to assist in verifying the validity of transfer or rollover requests to SMSFs. This letter was announced by the Commissioner in a speech to the SPAA Annual Conference in February 2010 as an initiative that allows APRA-regulated funds requested to rollover members' accounts to an SMSF more time to verify the bona fides of that fund.³⁹¹

ATO staff claim all the APRA-regulated funds supported the development of the guidance letter, rather than resisting it as an impost on them, because it gives them cover in the form of a step-by-step process (in line with common ATO practice, rather than the principles-based regulatory approach APRA uses). The letter allows them an excuse if they fail to meet the 30 day 'portability' deadline, as the period suspends if the SMSF is not on the SFLU or does not give requested information to the APRA fund. That

³⁸⁹ Australian Securities and Investment Commission, *Trustee of self managed super fund sentenced on ASIC charges* (24 August 2010) <<http://www.asic.gov.au/asic/asic.nsf/byheadline/10-178AD+Trustee+of+self+managed+super+fund+sentenced+on+ASIC+charges?openDocument>>

³⁹⁰ Margaret Wenham, 'Fraudsters steal victim's super', *Courier Mail* (Brisbane), 28 July 2010, 14.

³⁹¹ Australian Taxation Office, *A common caring: nest building with self-managed super funds* (Speech by Michael D'Ascenzo to the SPAA National Conference, Melbourne, 17 February 2010) (2010) <<http://www.ato.gov.au/print.asp?doc=/content/00231629.htm>>

information includes confirmation that an SMSF trust deed exists, an investment strategy has been created, and a bank account has been established.

In discussing the 'guidance' letter, ATO staff in the Illegal Early Access team stressed that APRA regulated funds are not limited to the steps set out in the letter – they can develop their own risk-based approach. APRA funds have an obligation to ensure every rollover is valid. They will face questions from regulators if they rollover to an SMSF as part of a scheme, and if the rollover involves theft from a member they could be sued by that member.

In placing the onus on APRA-regulated funds to verify the bona fides of SMSFs requesting rollovers, the ATO essentially delegates some of the regulatory function to APRA-regulated funds. It is not clear what the 'additional guidance' in the letter will mean in terms of APRA funds' liability in the event of illegal early access. As the checking measures are 'steps large funds can take', it is evidently not mandatory for them to do so.³⁹² In Superannuation Complaints Tribunal Determination No D08-09\047 the Tribunal found in favour of the trustee of a public offer fund that wrongly rolled over a member's superannuation into an SMSF after receiving fraudulent documentation purporting to identify the member, so that the member's benefit was stolen. The tribunal found the trustee had applied 'a reasonable standard of care' in the payment of the benefit, having requested some proof of identify, and so was not required to compensate the member for his loss.³⁹³

5.4.8.3 Super Fund Look Up

APRA-regulated funds that receive a rollover request from a member rely on the ATO website Super Fund Look-Up (SFLU) to verify the existence and complying fund status of any SMSF into which they have been requested to forward their member's

³⁹² Australian Prudential Regulation Authority, 'Managing the risk of the illegal early release of superannuation benefits - Transfers and Rollovers into SMSFs' (5 February 2010)

<<http://www.apra.gov.au/Superannuation/upload/IER-FINAL-LETTER-TO-TRUSTEES-5-Feb-2010-Vn-2.pdf>>

³⁹³ [2008] D08-09\047 (Unreported, Jocelyn Furlan, Superannuation Complaints Tribunal, 14 January 2009). By contrast, in an earlier case (not involving an SMSF), the Tribunal had found in favour of the member, whom the APRA fund trustee was required to compensate: [2006] D06-07\032 (Unreported, Janet Martin, Superannuation Complaints Tribunal, 22 August 2006).

superannuation benefit. SFLU is therefore the first level of defence against the use of SMSFs for fraud.

Since February 2010 a newly-registered SMSF is not automatically listed as 'complying' on SFLU. There is now a new category: *Registered – status to be determined* (that is, the fund has not yet been audited, lodged an SMSF annual return or been assessed for tax). APRA funds can rollover to a *complying* SMSF more readily, but need to do more checking in the case of a *Registered – status to be determined* SMSF.³⁹⁴

The new *Registered – status to be determined* status for SMSFs on SFLU has caused some concern on the part of SPAA, which recently approached the ATO highlighting two cases where the APRA fund had wrongly refused a rollover (resolved by the ATO by discussion with the APRA fund). SPAA's concern was that the new status on SFLU would give APRA funds an excuse not to rollover to an SMSF, given their general reluctance to rollover members' accounts to SMSFs, thereby losing members.³⁹⁵

The Super System Review recommended that SFLU (or an alternative system) provide appropriate SMSF information to APRA-regulated funds (which would include member level details, confirmation that identification of member/trustees has occurred and the SMSF's bank account number) to enable an APRA-regulated fund to verify the details of SMSF membership before processing rollover requests to SMSFs.³⁹⁶ However, privacy issues may prevent the full implementation of this initiative.

In 2010 the ATO released a new SMSF member verification system to assist with the processing of rollovers from APRA-regulated funds to SMSFs. The verification system was designed to allow the larger funds and their administrators to confirm that, when a member requests a rollover of their superannuation benefits to an SMSF, the individual for whom the rollover request was being made was a bona fide member of that SMSF.

³⁹⁴ ATO staff claim that employers are now also using SFLU to check employees' super contributions (under the 'choice' regime) are going to a legitimate fund: Interview B5.

³⁹⁵ See for example Benjamin Levy, 'Super funds can stop SMSF defectors' (3 August 2010) *SuperReview* <http://www.superreview.com.au/articles/Super-funds-can-stop-SMSF-defectors_z521452.htm>

³⁹⁶ Commonwealth of Australia, above n 175, 255.

APRA funds are expected to also use SFLU to ensure that the SMSF is a regulated fund and check payment details.³⁹⁷

5.4.8.4 SMSFs in criminal activity

SMSFs have been used to launder the proceeds of crime, often involving the repatriation of criminally obtained funds from overseas into an Australian SMSF. These are added to the SMSF bank account and reported either as contributions or foreign investment returns, then removed as pension or lump sum payments.³⁹⁸ Because the trustees and members of an SMSF are the same, there is also wide scope for assets, once received in the SMSF, to be diverted for illicit purposes.

Under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) (AML/CTF Act), entities that perform designated services are reporting entities for AML/CTF purposes and have reporting responsibilities to AUSTRAC. Some functions of prudentially supervised funds are subject to the AML/CTF Act as designated services, but trustees of SMSFs are excluded. In addition, the rollover of a superannuation benefit to another fund (including an SMSF) is not a designated service because preservation requirements mean that the assets are retained within a regulated financial sector;³⁹⁹ it is therefore reasoned that the transaction represents a low risk of being used for money laundering or terrorism financing. And given the principles-based nature of this regime and the nature of SMSFs, it would be counter-intuitive to have the same people responsible for ensuring compliance with these laws as those who in many respects have the greatest opportunity to use the SMSF for fraudulent activities.

Yet, if SMSFs are being used to facilitate criminal activity and money laundering, it may be time to examine how the regime can be applied to their transactions. Amendments may be needed to the SIS payment standards (in Division 6.5 of SISR) to relieve trustees from the 30-day requirement in relation to rollover requests where they have concerns or

³⁹⁷ Liz Westover, 'Rollovers to SMSFs made easier' (2011) 82(4) *Charter* 59.

³⁹⁸ Commonwealth of Australia, *Phase Three: Structure - Issues Paper* (14 December 2009)

<http://www.supersystemreview.gov.au/content/downloads/structure_issues_paper/Phase_3_Structure.pdf> , 14.

³⁹⁹ *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) s 39.

suspensions about the legitimacy of the request or the SMSF.⁴⁰⁰ The opening of a bank or stockbroking account by a trustee does invoke the AML/CTF provisions. Even though a rollover that comprises the *in specie* transfer of assets does not require the transferor to verify the identity of the member, the purchase of a financial product (eg a bank account to receive dividends) would invoke the AML/CTF provisions.⁴⁰¹

The Super System Review recommended that rollovers to an SMSF be captured as a designated service under the AML/CTF Act⁴⁰² so that consideration can be given to the AML/CTF risk associated with the rollover, and that appropriate customer identification and reporting obligations are put in place when assets exit the formal financial sector. The government accepted this recommendation and undertook to consult with stakeholders on its implementation.⁴⁰³

5.4.8.5 SMSFs in tax evasion

As superannuation funds are concessional tax, diverting income or capital gains through an SMSF can reduce an individual's taxation burden. This diversion can be achieved legitimately if the preservation rules are adhered to. However, the danger is that trustees will treat SMSF assets as their own.

As discussed at 4.4.4 and 6.7, there is a range of sanctions, both civil and criminal, available to the ATO to counter breaches by trustees – *if* they are reported by the auditor or discovered by ATO risk-based audit activity. In June 2010 widespread media coverage was given to an ATO statement that more than 8,000 taxpayers have been detected breaching SIS regime rules in the 2010 financial year. Examples included illegal early release schemes 'within particular ethnic communities', loans to members, buying homes to rent at a discount and paying off lay-bys.

⁴⁰⁰ Marlene Hewer, 'Fraud and super: the regulatory tensions' (2009) November/December *Australian Superannuation Law Bulletin* 68.

⁴⁰¹ Self Managed Superannuation Funds Professional Association of Australia, 'Super System Review (Phase Three: Structure) Submission' (2010) <http://www.supersystemreview.gov.au/content/submissions/downloads/SPAA_100226.pdf>

⁴⁰² Commonwealth of Australia, above n 175, 257.

⁴⁰³ Commonwealth of Australia, *Stronger Super - Government response to the Super System Review* (2011) <http://strongersuper.treasury.gov.au/content/publications/government_response/downloads/Stronger_Super.pdf>, 52.

A more sophisticated, systematic tax fraud using SMSFs (discovered via the ATO's Project Wickenby) operates as follows. Offshore trusts (disguised as superannuation funds) are set up by business executives who are planning on moving, or returning, to Australia but do not wish the ATO to know the full extent of their assets. Money is hidden in the offshore trust while it earns interest, with the taxpayer, who is by now living in Australia, not paying tax on the income. This can go on for years before the money is brought into Australia as a 'benefit' or 'contribution' to an SMSF. Australian executives are also setting up the fake super funds offshore. These individuals typically have a foreign employer and are often hired as contractors. Instead of declaring their full income, part of the money they earn is sent to the offshore trust, and again is not declared but later brought into the country and deposited into a (legitimate) SMSF.⁴⁰⁴

The use of SMSFs to divert taxable income into a low-taxed environment is attacked by the ATO under ITAA anti-avoidance provisions. In *Allen (Trustee), in the matter of Allen's Asphalt Staff Superannuation Fund v Commissioner of Taxation*⁴⁰⁵ the Federal Court found that the amount of income derived by an SMSF was greater than might have been expected if it and a related trust had been dealing with each other at arm's length in relation to the arrangement. The court upheld the ATO's default income tax assessment and penalties imposed on the SMSF.⁴⁰⁶

ATO Taxpayer Alert TA 2010/5 describes an arrangement where an SMSF invests funds in an unrelated trust. The trust then on-lends the funds to an SMSF member or a relative of the member. This arrangement purports to circumvent the prohibition on SMSF trustees lending money or providing financial assistance to a member or a relative of the member using the resources of the fund. The Alert identifies a number of issues relevant to taxation laws, but does not categorically state that any anti-avoidance provision is

⁴⁰⁴ Susannah Moran, 'ATO targets offshore bogus funds' (16 December, 2009) *The Australian* <<http://www.theaustralian.com.au/business/ato-targets-offshore-bogus-funds/story-e6frg8zx-1225810749725> >

⁴⁰⁵ *Allen (Trustee), in the matter of Allen's Asphalt Staff Superannuation Fund v Commissioner of Taxation* [2010] FCA 1276 (19 November 2010).

⁴⁰⁶ The Commissioner had applied former s 273(7) of the ITAA 1936. The case was varied on appeal to the Full Federal Court but as to the question of penalty only and the appellants ordered to pay three-quarters of the Commissioner's costs of the appeal: see *Allen (Trustee), Re; Allen's Asphalt Staff Superannuation Fund v Commissioner of Taxation* (2011) 195 FCR 416; [2011] FCAFC 118.

breached by the arrangement, merely that the ATO is 'currently examining these arrangements'.⁴⁰⁷

A converse, seemingly legitimate 'member as lender' strategy allows the circumvention of contribution caps and therefore avoidance of Excess Contributions Tax. The strategy consists of a member lending an (unlimited) amount of money to their SMSF rather than making a direct contribution. This arrangement is legitimate as long as the loan is done on commercial terms at a market interest rate and the money is used to invest in permitted assets. Once the loan money is in the SMSF its earnings are concessional tax. ⁴⁰⁸ The other major benefit is that the money lent to the fund can be withdrawn at any time, unlike superannuation contributed directly.⁴⁰⁹

One recent area of concern for the ATO is what it perceives as avoidance of Excess Contributions Tax (which is a true tax rather than a penalty) by incorrect re-reporting of member contributions immediately after a member being notified of a breach of the contributions caps arising from information contained in the original SMSF Annual Return. The ATO 2010-11 Compliance Program includes verification of contributions re-reporting in the SMSF market.⁴¹⁰

5.4.8.6 Conclusion - fraudulent use of SMSFs

SMSFs are increasingly used in activities and schemes of concern to the regulators, which are reacting by tightening their procedures (as in the case of rollovers from APRA-regulated funds) or by public pronouncements about the legitimacy or otherwise of schemes as they become aware of them. This aspect of the regulation of SMSFs is illustrative of the constant challenge faced by the ATO as 'revenue management agency' as it seeks to find and close legal loopholes and counter illegal activity. The SMSF approved auditor should be one of its most effective allies in this effort.

⁴⁰⁷ Australian Taxation Office, 'Taxpayer Alert TA 2010/5: The use of an unrelated trust to circumvent superannuation lending restrictions' (2010) <<http://law.ato.gov.au/atolaw/view.htm?DocID=TPA/TA20105/NAT/ATO/00001>>

⁴⁰⁸ Geoffrey Newman, 'Loophole allows loans to self-managed super', *The Australian* 24 November 2010, 8.

⁴⁰⁹ Geoffrey Newman, 'Lending money to super can make tax sense', *The Australian* 27 November, 2010, 33.

⁴¹⁰ Australian Taxation Office, 'Who is in the driver's seat of the SMSF car? (Speech Neil Olesen, Deputy Commissioner of Taxation, ASFA 2010 National Conference, Adelaide, Friday 12 November 2010)
' <<http://www.ato.gov.au/corporate/content.aspx?doc=/content/00261824.htm>>

5.4.9 Delegation to approved auditors

Through necessity, the ATO relies heavily on 'approved auditors' to act as representatives of the ATO in relation to SMSF compliance. Accordingly, the ATO has delegated much of its supervisory regulation responsibility to this body of professionals. Approved auditors, therefore, 'operate as a key integrity indicator for SMSFs by providing an independent assessment that an SMSF complies with its regulatory obligations'.⁴¹¹ SMSF auditors conduct two annual audits, a financial audit and a SISA compliance audit.

The main weakness in the SMSF regulatory regime appears to be in the role of the approved auditor, expertise and independence being the chief concerns. As noted in the Super System Review final report:⁴¹²

... the approved auditor population has no minimum, consistently policed, competency and independence standards, which undermines the ATO's ability to regulate the sector.

The specific deficiencies in the delegated auditing function are outlined below.

5.4.9.1 Lack of independence

In order to retain its complying status, every SMSF must be audited annually and the audit report lodged with the ATO together with the SMSF Annual Return.⁴¹³ The approved auditor's role involves checking the SMSF's financial and regulatory compliance with the SIS regime and reporting any contraventions to the ATO for follow-up. As that role involves performing a delegated function of the regulator and applying an objective judgment of the SMSF's compliance, it is important that the auditor be independent of the SMSF and be free from conflict of interest, bias, personal interest and association.

The issues

⁴¹¹ Power, Trish, 'Headaches Ahead' (2007) 319(November 2007) *Superfunds* 40.

⁴¹² Commonwealth of Australia, above n 175, 217.

⁴¹³ SISA s 35C.

Threats to independence in an SMSF audit engagement may include:⁴¹⁴

- Self-interest threat – where the auditor could benefit from a financial interest in, or other conflict with, an audit client. For example, this could arise if the auditor or an immediate family member is a trustee or member of the SMSF or the SMSF principals are the sole or the significant client of the firm.
- Self-review threat – where any product, such as a set of financial accounts, or a judgment of a previous engagement needs to be re-evaluated in reaching conclusions on the audit engagement, so that the auditor is reviewing his or her own work (possibly having also prepared the SMSF's financial report or accounting records or provided complex financial advice to the fund or fund members).
- Advocacy threat – where the auditor promotes, or may be perceived to promote, an audit client's position to the point that objectivity may be, or be perceived to be, compromised (for example, where an auditor acts as an advocate for the SMSF in litigation or a dispute).
- Familiarity threat – where, by virtue of a close relationship with the audit client, its directors, officers or employees, the auditor becomes too sympathetic to the client's interest (for example, when a close family member is a trustee or member of the SMSF or an employee of the SMSF's administrator, or where the auditor has a long association with a trustee).
- Intimidation threat – where the auditor is deterred from acting objectively by actual or perceived threats from the trustees of an SMSF, or the directors, employees, or officers of a related entity of a trustee (for example, where a threat of replacement is made over a disagreement about the application of an accounting principle).

Some interviewees expressed concern at lack of auditor independence and ethical shortcomings:

... in accounting firms where I did consulting work, they had the tax partner and the audit partner and by the time they did the audit they'd spent all the money on the administration. I did the external audits for funds they looked after outside the firm, the external audit had

⁴¹⁴See Australian Taxation Office, *Approved auditors and self-managed super funds: Your role and responsibilities as an approved auditor* (2010) <<http://www.ato.gov.au/content/downloads/spr46460n11375.pdf>> 7.

been done but the internal audit hadn't been done at all though the internal auditors had signed off that it had been done ... I said fraud first of all – you're charging \$200 for an audit you haven't even done ... and I've heard of some firms swapping each others' work ... you don't have true independence – you're tempted to turn a blind eye if they turn a blind eye where they find problems. (Interview A14, auditor)

Producing financials that match the tax return is not an audit – that's what accountants do and what they think an audit is. (Interview A9, auditor)

In the absence of legislated independence, the ATO should do something to require it. Accountants have been getting around it by getting their mate to say 'I'm the auditor' and vice-versa. A tax agent and an auditor have completely different mindsets and think totally differently. (Interview A9, auditor)

There are some bad things happening out there ... about 5 years ago I worked with one accounting firm giving bad advice and then not auditing the funds they gave it to. I heard that instead of sampling within the audit, they sampled within the firm which SMSFs they were going to audit – 80 SMSFs within the firm and they only audited 10 but charged them all \$200. (Interview A14, auditor)

Based on 2010 SMSF annual return data, auditors of 13% of SMSFs provided some other services – such as acting as a tax agent, accountant, financial adviser or administrator – and this percentage is probably understated because different individuals in the one accounting practice may provide services in addition to the audit.⁴¹⁵

The ATO conducts compliance activities directed at auditors (see 5.4.9.5). Its 2009 compliance work targeting high-risk approved auditors identified 29% of auditors who were an SMSF's accountant and who had prepared a material part of its financial statements. Additionally 28% of auditors exhibited evidence of a relationship or conflict of interest that might impact their ability to be independent and had no safeguards to

⁴¹⁵ Australian Taxation Office, 'Self-managed superannuation funds: A statistical overview 2009–10' (2012).

mitigate that risk.⁴¹⁶ There are even auditors with their own SMSF who audit it themselves.⁴¹⁷

A recent case, *Confidential and Commissioner of Taxation*,⁴¹⁸ concerned an auditor who had audited a number of SMSFs in circumstances where he was a member of some of the funds, was the director of the corporate trustee of some of the funds, and had prepared the accounts for all of the funds. The Administrative Appeals Tribunal affirmed the Commissioner's decision not to revoke the disqualification order issued to the applicant.

Responses

The Super System Review report recommended legislating full audit independence whereby an individual or firm providing any service in connection with an SMSF or its individual trustees or trustee directors in any capacity (including their individual tax returns) would be expressly prohibited from auditing that SMSF.⁴¹⁹ The profession objected to this proposal on the ground that it would cause difficulties and raise costs for SMSFs in rural and regional areas, where there is less SMSF specialisation in accounting and auditing.⁴²⁰

SISFA published an opinion that auditor independence standards set out in APES 110 (Code of Ethics for Professional Accountants) issued by the Accounting Professional and Ethical Standards Board (APESB) are appropriate for SMSF auditors.⁴²¹ The government's 'Stronger Super' response to the Super System Review endorsed this

⁴¹⁶ Commonwealth of Australia, above n 175, 238.

⁴¹⁷ Over 200 auditors had audited their own fund and others had audited a relative's fund, according to Australian Taxation Office, *10 rounds with the regulator - Speech by Ian Read, Assistant Deputy Commissioner, at Taxation Institute of Australia SA State Conference - 8 May 2009 - Barossa Valley* (2009) <<http://www.ato.gov.au/print.asp?doc=/content/00196719.htm>>

⁴¹⁸ [2011] AATA 403.

⁴¹⁹ Commonwealth of Australia, above n 175, 239.

⁴²⁰ Victoria Papandrea, 'Audit independence lifts rural SMSF costs' August 2-8, 2010(516) *Independent Financial Adviser* 6.

⁴²¹ APES 110 provides a conceptual framework that members of accounting professional bodies are to apply to identify, evaluate and eliminate threats to compliance with the principles of integrity, objectivity and professional competence and due care. It also describes how the conceptual framework applies in certain situations.

opinion.⁴²² ASIC, on the other hand, is of the view that the current APES 110 is not specific enough in relation to SMSF auditor independence.⁴²³

The profession itself is, in any event, moving towards improving auditor independence. The new standard being applied by the Auditing and Assurance Standards Board includes a new quality control standard (ASQC 1)⁴²⁴ regarding independence that will be legally enforceable under the *Corporations Act*. This means that SMSF audit firms will need to obtain written assurance from all their staff that they have complied with the firm's independence policies and procedures. Audit plans also require documentation that states that ASQC 1 has been complied with.⁴²⁵

Under the 'Stronger Super' reforms, in undertaking its new role in registration of approved auditors (see 5.4.9.3), ASIC is to develop new independence standards 'if necessary'.⁴²⁶

5.4.9.2 Auditor competence

The Super System Review acknowledged problems with auditor competence. It concluded that the focus of any mandated education requirements should be directed at advisers and other service providers who provide professional support to SMSF trustees, given that 97% of new SMSF trustees seek some form of advice in establishing and maintaining their fund.⁴²⁷

⁴²² Commonwealth of Australia, *Stronger Super Information Pack* (21 September 2011) <http://strongersuper.treasury.gov.au/content/publications/information_pack/downloads/information_pack.pdf> 17.

⁴²³ Small Independent Superannuation Funds Association, 'SISFA News' (October 2011) <<http://www.sisfa.com.au/news-media.html>> 2.

⁴²⁴ The Auditing Standard establishes requirements and provides application and other explanatory material regarding the firm's responsibilities for its system of quality control for audits and reviews of financial reports and other financial information, and other assurance engagements.

⁴²⁵ Association of Superannuation Funds of Australia Ltd, 'Submission on Review of the self managed superannuation fund independent auditor's report (NAT 11466) publication' (April 2010) <<http://www.superannuation.asn.au/submissions/default.aspx>>

⁴²⁶ Commonwealth of Australia, *Stronger Super - Government response to the Super System Review* (2011) <http://strongersuper.treasury.gov.au/content/publications/government_response/downloads/Stronger_Super.pdf>

48.

⁴²⁷ Commonwealth of Australia, above n 31, 23.

In order to complete the regulatory aspect of their auditing, approved auditors should have an understanding of the provisions of SISA with which SMSFs are required to comply and about which the audit must report. Auditors who perform few SMSF audits may have insufficient competence to discharge this obligation, and a significant proportion of approved auditors perform very few SMSF audits in any one year. For example in the 2009 income year, 21.1% of auditors performed only one SMSF audit, 18% performed 2-4 SMSF audits, 31.3% performed 5-25 audits, after which the proportions reduced significantly so that only 1.7% of auditors performed more than 250 SMSF audits.⁴²⁸

Although an approved SMSF auditor must be a member of a professional association,⁴²⁹ this membership gives no assurance of auditor competency. The required qualifications for membership are not specific to SMSF auditing and some such associations are *not* specialist audit associations. However, technically under the formal regime any member of, for instance, the National Institute of Accountants, can conduct an SMSF regulatory and financial audit, even though their own association does not treat them as specialist auditors and they are not in fact qualified auditors.⁴³⁰

Since 2008 SPAA has run an SMSF Specialist Auditor Program, equivalent to a university postgraduate audit qualification. As a prerequisite, the program requires proof that participants have completed 1000 or more audit hours on SMSFs or signed off on 75 or more SMSF audits in 12 months.⁴³¹ However, many SMSF auditors hold no specialist accreditation as such.

⁴²⁸ Australian Taxation Office, 'Self-managed superannuation funds: A statistical overview 2009–10' (2012).

⁴²⁹ An approved auditor must be:

- a member of CPA Australia Ltd
- a member of the Institute of Chartered Accountants in Australia
- a member of the National Institute of Accountants (now the Institute of Public Accountants)
- a member or fellow of the Association of Taxation and Management Accountants
- a fellow of the National Tax and Accountants Association Ltd
- an SMSF specialist auditor of the SMSF Professionals' Association of Australia Ltd
- a registered company auditor, or
- an auditor-general of the Commonwealth, a state or a territory.

⁴³⁰ Interview B4.

⁴³¹ Darin Tyson-Chan, 'SPAA tweaks auditing program' (3-9 August 2009) *Independent Financial Adviser* 12.

5.4.9.3 Register of approved auditors

The ATO has estimated that there were 11,500 approved auditors operating in the SMSF sector in the 2007 financial year.⁴³² However, the ATO's data on auditors comes from the individual who prepares the SMSF Annual Return rather than directly from the auditors themselves (unless the auditors lodge an ACR direct with the ATO). The preparer of the annual return is generally a different individual from the auditor, who reports the fact that a named auditor has conducted an audit. Anecdotal comment from an ATO Assistant Commissioner is that many mistakes are made during this process. An initial may be changed or surname incorrectly spelt (there is no unique identification number for the auditor), making this data not very reliable and capable of inflating the numbers of auditors in the ATO's records.⁴³³

ASFA's submission to Phase 3 of the Super System Review suggests that SMSF auditors should be placed on a Register of Approved SMSF Auditors administered by the ATO.⁴³⁴ The Report supported the idea of auditor registration, suggesting instead that the register be maintained by ASIC, and noting that registration would enable targeted communication and education leading to raised auditor competency, especially on the compliance aspect of audits. It would also enable better targeting by the ATO of non-compliance, as SMSF auditors would become identifiable through a unique registration number.

The government's Stronger Super response to the Super System Review was to give ASIC responsibility for registration of auditors (see 6.4.1.1).

Responsibility for maintaining a register of approved auditors (and removing those who are disqualified) carries some moral hazard for the supervisor, as APRA General Manager, Keith Chapman points out:⁴³⁵

⁴³² Commonwealth of Australia, above n 31, 7.

⁴³³ Interview B6.

⁴³⁴ The Association of Superannuation Funds of Australia Limited, 'ASFA Submission - Super System Review – Phase Three: Structure (incl. SMSFs)' <http://www.supersystemreview.gov.au/content/submissions/downloads/ASFA_100219.pdf>

⁴³⁵ Keith Chapman, 'Supervision of Private Pensions - An Australian Perspective' in *OECD Regulating Private Pension Schemes: Trends and Challenges* (2002) 255.

... you give serious consideration to the licensing issues. There are two sides to this - as a supervisor it is very good to have entry criteria and assessments ... but you have to always remember that licensing does create at least some (and sometimes considerable) moral hazard for the supervisor. We have recently had a couple of cases where we are being blamed for losses in funds because we licensed the trustee. It is not always a simple process or exercise to require that the regulator has a licensing role!

The ATO website carries an 'Approved auditor disqualification register', presently listing 28 names.

5.4.9.4 Financial threshold test for ACR

The Electronic Superannuation Audit Tool (eSAT), supplied free of charge to SMSF auditors via the ATO website, contains a materiality threshold for the need to report contraventions.⁴³⁶ The ATO publication NAT 11299 *Completing the Auditor/actuary contravention report* mirrors the eSAT criteria for mandatory reporting.

ATO staff have commented anecdotally that the financial threshold test for an ACR (which applies unless the fund is less than 15 months old) allows many breaches to remain unreported. However, if the breach remains uncorrected as at the following year, the auditor in that year is obligated to report the breach, regardless of dollar amount. This deficiency is another example of sub-optimal risk-assessment in the supervisory regulation of SMSFs.

Another criticism that has been levied by the profession is that of the ATO forms with which they must work:

One issue with the SMSF Annual Report is that the questions don't give space to *describe* minor breaches. (Interview A8, auditor)

⁴³⁶ In 2010 there was a document on the ATO website outlining changes to the reporting of contraventions from the 2008 income year (the document has since been removed). It stated that an ACR was required if:

- The SMSF was less than 15 months old as at the end of the financial year, or
- The total value of all contraventions was greater than \$30,000, or
- Total value of all contraventions was greater than 5% of the total value of the fund's assets, or
- The trustee/s failed to meet a statutory time period [in SISA or SISR] by more than 14 days.

When SMSFs have gone into pension mode, there is no way of notifying the ATO by written means or via the Tax Agent Portal. Then PAYG-Instalment notices are received by the trustees in waves and contradict each other. (Interview A5, auditor)

5.4.9.5 ATO audits of auditors

The ATO conducts a compliance program for reviewing approved auditors. Over the past few years it has intensified its auditing program for SMSF auditors (as part of the Compliance Program) in response to identified weaknesses and more closely scrutinised SMSF clients of those auditors who have not met the ATO's standards of independence, timeliness and thoroughness.

In the 2007-08 the ATO completed 665 cases relating to auditors; that number rose to 1,100 cases in 2010-11. This led to nine persons being disqualified from being approved auditors in 2010-11.⁴³⁷ The ATO website carries an approved auditor disqualification register with 28 individuals named, their states of residence and dates of disqualification.⁴³⁸

The program of audits and reviews of approved auditors, the ATO has indicated, 'involves risk rating and selecting auditors for review on the basis of such measures as whether it is a low fee audit, whether the auditor lacks independence, if the auditor only audits a handful of SMSFs or alternatively, where a single auditor audits a very large number of funds'.⁴³⁹

There is to date little available evidence of the success or otherwise of the ATO's efforts in reviewing SMSF auditors. The proportion of auditors subjected to compliance activity each year is not high: 900 from a population of 11,500 in the latest reported financial year. This reflects the general resourcing problem faced by the regulator.

Since the auditor is performing a delegated function for the regulator, it is open to question what accountability normally attaching to the regulator has been lost and what

⁴³⁷ Australian Taxation Office, *Compliance program 2011-12*

<<http://www.ato.gov.au/corporate/PrintFriendly.aspx?ms=corporate&doc=/content/00284023.htm>>

⁴³⁸ However the Register has not been updated since 29 September 2011.

⁴³⁹ Australian Taxation Office, above n 437, 41.

the government's liability is where delegated functions are not adequately performed by the delegate.

5.4.9.6 Loss of accountability

Where the industry is performing a quasi-governmental function – a function that has been delegated to it by government – it is necessary to ask what specific forms of accountability have been lost or diminished by the delegation of government functions. It is arguable that accountability mechanisms attaching to the ATO have been weakened by the delegation of SMSF auditing to the auditing profession.

Although privatizing monitoring clearly saves the government money, it may not be socially cheaper overall. In effect, an additional tax is imposed on the SMSF by having it hire the self-regulator. It might be more efficient to impose the tax directly and have government hire the self-regulator. Specialist government regulators who move from firm to firm may well be more efficient than self-regulators confined to one or a small number of funds.⁴⁴⁰ Thus, rather than registering (and in effect licensing) SMSF approved auditors and then leaving SMSF trustees to choose from and hire their auditor from the list, the ATO could appoint auditors to each SMSF.

As things stand, the public accountability and scrutiny faced by the ATO (see 4.5) is avoided by approved auditors performing the delegated task of ensuring SMSF compliance and protecting retirement income of SMSF members.

5.4.9.7 Liability where delegation fails

In recent years, the courts have been increasingly likely to find that members of the public, whom a regulatory regime was intended to protect, are owed a duty of care by the regulator, such that negligence in carrying out operational regulatory responsibilities can leave the regulator open to liability.⁴⁴¹ The general trend in liability indicates that

⁴⁴⁰ Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992), 121.

⁴⁴¹ Beginning with *Home Office v Dorset Yacht Co Ltd* [1970] AC 1004, followed in Australia in *Adam Richard Swan by His Next Friend Richard John Swan v The State Of South Australia*, (1994) 62 SASR 532; see Thomas Geuther, 'The Search for Principle - The Government's Liability in Negligence for the Careless Exercise of its Statutory Powers' (2000) 31(3) *Victoria University of Wellington Law Review* 629.

government bodies, including bodies operating under delegated powers, must take their regulatory responsibilities seriously to avoid liability.

Under-regulation, favouritism and failures of the disciplinary process are not only objectionable on their own terms, but can also lead to liability to those whom the regulatory structure was established to protect. For example, in the US two victims of Bernard Madoff's ponzi scheme filed a federal lawsuit against the US Securities and Exchange Commission in 2009, seeking at least the \$US2.4 million they lost in the fraud.⁴⁴² In Australia ASIC and APRA have been heavily criticised and may face litigation over the Trio Capital collapse.⁴⁴³ It was placed into liquidation on 22 June 2010, six months after those regulators froze its Australian financial services licence and suspended it as the trustee for over \$300 million worth of superannuation money. It is unclear whether any money will ultimately be returned to the fund's members.⁴⁴⁴ In defending APRA's role in the collapse before a Senate Standing Committee on Economics in May 2012, the Deputy Chairman stated:

APRA's prudential supervision has not been based on the premise that fund owners, trustees and employees are engaged in fraudulent activity. In its supervision of superannuation APRA acts as a third line of defence after trustees and auditors.⁴⁴⁵

There have been no successful cases to date imposing liability on Australian government agencies for purely monetary loss and civil liability legislation has placed a greater emphasis on personal responsibility in recent years.⁴⁴⁶

⁴⁴² Tom Hals, *Two Madoff victims file lawsuit against the SEC* (15 October 2009)

<<http://www.businessspectator.com.au/bs.nsf/Article/Two-Madoff-victims-file-lawsuit-against-the-SEC-WTNFV?OpenDocument&src=FIN001&ir=4>> ; but see Wilson Sy and James Murray, 'Rethinking the role of financial regulators' (2009) *Centre for Policy Development - Insight Edition: The Global Financial Crisis in Review*

⁴⁴³ Mike Taylor, 'APRA and ASIC have case to answer on Trio Capital' (17 May 2012) *Super Review*

<http://www.superreview.com.au/news/superannuation/apra-and-asic-have-case-to-answer-on-trio-capital?utm_source=SilverpopMailing&utm_medium=email&utm_campaign=Super%20Review%20Newsletter%20MRE%20-%20send%20-%203E%2017/05/2012%201:02:27%20PM&utm_content=>

⁴⁴⁴ Vishal Teckchandani, 'Trio Capital placed in liquidation, as govt criticised' June 28-July 4 2010(511) *Independent Financial Adviser* 6.

⁴⁴⁵ Ross Jones, *Opening Statement to the Senate Standing Committee on Economics, Canberra* (29 May, 2012)

<http://www.apra.gov.au/Speeches/Documents/Ross%20Jones_Senate%20Estimates_opening%20statement_29%20May%202012.pdf>

⁴⁴⁶ For example, the *Civil Liability Act 2002* (Tas) and corresponding legislation in other states and territories.

Within SMSFs, internal fraud may be a concern in cases of family breakdown or in cases where trustees are business partners, the business suffers losses and one or more trustees fraudulently accesses SMSF funds to cover those losses. The regulatory responsibility the ATO faces is almost exactly the same as that which ASIC has faced in regulating corporations audited by company auditors. The auditors are recognised as the first line of defence. According to Auditing Standard ASA 240 (*The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report*) the approved auditor must be alert to this possibility and a defrauded member may have access to the auditor's professional indemnity insurance where the fraud has not been discovered at audit.

Although there has not been any direct attempt from the SMSF sector to impose liability on the regulator for loss occasioned by audit failure,⁴⁴⁷ the risk of this is not mitigated by current policy approaches to SMSFs that tend towards the administrative rather than engaging with a notion of duty-of-care on the part of the regulator.⁴⁴⁸ Yet an administrative approach may be the only appropriate one in the SMSF case where a prudential mandate has not been given.

The 'harm' of auditor failure is to the general public (who are unlikely to take action) in the form of loss of revenue through illegal early access or misuse of retirement savings by SMSF members (and possibly subsequent access to taxpayer-funded government Age Pensions) and to SMSF members not involved in the misuse. If auditor failure ultimately leads to the SMSF being made non-complying, members will not have the same cause of action against the regulator as members of public offer funds may have against APRA because members of SMSFs are also trustees.

⁴⁴⁷ *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241 [1] is generally seen as authority for the proposition that auditors do not owe a duty of care to third parties which may rely on their reports because of the following policy considerations:

- to impose liability would increase the cost of auditing services
- the potential group of plaintiffs have the means to avoid the risk of loss
- the auditor's role in causing the loss is secondary
- to impose liability would culminate in prolonged litigation.

⁴⁴⁸ Phillips et al, above n 9, 56.

5.4.10 Possibility of incentive for compliance by SMSFs

To explicitly apply a regime of incentive for compliance by SMSFs would require government policy change, as well as legislative amendment. The ATO at one time considered recommending to government that audit requirements be reduced from annually⁴⁴⁹ to once every three years for compliant funds. The question was asked whether the approved auditor would need to audit all three years and the answer was that they would, thus nullifying the incentive to the SMSF. A further consideration was that a change in members/trustees might have caused a change in compliance behaviour after the 'reward'. Not unsurprisingly, the audit profession was also strongly opposed to the idea, which was quickly abandoned.

In any case, Active Compliance (that is, ATO audit) defaults to a type of reward scenario – if an SMSF lodges on time without an ACR for several years, it is less likely to be targeted by ATO risk-based audit activity (because of the huge number of SMSFs only a very small percentage can be targeted (see 5.4.1.1 **Reactive versus proactive**). There is accordingly a de facto reward for compliant behaviour, that is, no contact from the ATO.⁴⁵⁰

5.4.11 Capture of the regulator

Regulatory capture refers to the tendency for regulators to see through the eyes of the industry they regulate.⁴⁵¹ It can be exacerbated when there is movement of staff between industry bodies and public service. Those individual regulators who have previously served in the superannuation industry may be indoctrinated with its views and those who intend to join it later temper their actions so as not to jeopardize their careers.⁴⁵² This is unlikely to apply to the ATO/SMSF relationship, as there is little movement between regulator and regulated although there may be ATO staff members with their own SMSF.

⁴⁴⁹ SISA s 35C mandates an annual audit of accounts and statements for all superannuation entities.

⁴⁵⁰ Interview B3.

⁴⁵¹ John Kay, 'How the skies proved the limits of regulation' (14 October 2009) *Financial Times* <<http://www.johnkay.com/2009/10/14/how-the-skies-proved-the-limits-of-regulation/>>

⁴⁵² R F Cranston, 'Regulation and deregulation: General issues' (1982) 5 *University of NSW Law Journal* 1, 17.

Other avenues of 'capture' include government-industry committees. These feature strongly in the ATO's relationship with business and with superannuation, but not specifically with the SMSF sector apart from SPAA and SISFA, the industry mouthpieces. SPAA in particular has a seat on every ATO superannuation committee and is part of all consultation on superannuation issues by the ATO and government in general.

It must be questioned whether the ATO has become unduly sympathetic to the industry viewpoint. The ATO has a close relationship with the superannuation industry through the six committees it has established (see 4.6.3) and, in examining the membership of those committees, the names of the same industry and ATO participants appear repeatedly.

On the other hand, there is evidence of industry support for the ATO's efforts to remove the non-compliant from the sector, though this can hardly be termed 'industry capture'. For SMSFs, the sector will be in favour of the ATO making non-complying funds set up to facilitate illegal early access, or whose trustees are not managing them with the necessary care and diligence, and in this fashion discrediting the sector and drawing ever more heavy-handed regulatory response. The observations of two commentators highlight the point:

In some respects industry associations can be more important regulatory players than single firms. For example, individual firms will often follow the advice of the industry association to cooperate on a particular regulatory requirement because if the industry does not make this requirement work, it will confront a political backlash that may lead to a more interventionist regulatory regime.⁴⁵³

Associations can help individual firms maintain a focus on the long-term benefits of compliance, can help in sharing best practices, and can apply peer pressure where the reputation of the entire industry will suffer from individual misfeasance.⁴⁵⁴

⁴⁵³ Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992), 39.

⁴⁵⁴ Margot Priest, 'The Privatization of Regulation: Five Models of Self-Regulation' (1997-98) 29(233) *Ottawa Law Review* at 267.

SPAA does this regularly via its newsletter, media releases and other communications, which are widely reported in the mainstream media. The tone of the newsletter is somewhat urgent, with regular warnings about oft-breached or misunderstood SISA requirements, and setting out the possible consequences should an SMSF be caught in breach.

The ATO reports that tax agents completed over 98% of the SMSF income tax and regulatory returns⁴⁵⁵ lodged and 100% of SMSFs had an approved auditor.⁴⁵⁶ ATO scrutiny of tax agents and auditors (who make up a large part of SPAA membership) to discourage the dishonest or mistake-prone from the industry find favour within the wider sector for the same reasons.

It appears, therefore, that industry associations are generally cooperative and supportive of the regulator. Although there is little evidence of regulatory capture of the ATO, regular rotation of ATO personnel at its superannuation forums is recommended to avoid a too-close personal relationship between individual representatives from the ATO and SPAA and the other industry bodies.

5.4.12 Degree of compliance by SMSFs

In evaluating the effectiveness of the regulation of the SMSF sector, it is logical to examine the degree of compliance by the sector with its legal obligations, as evidence of that effectiveness.

The growing importance and profile of the SMSF sector had made its trustees and their advisers subject to intense public scrutiny. There are differing views about how compliant the sector is, depending on the perspective of the commentator, whether the regulator (principally the ATO), other sectors of the superannuation industry, or the SMSF industry associations. ATO cynicism and reaction by APRA-regulated funds to the threat posed to them by the SMSF sector are often reflected in the media, giving the impression that

⁴⁵⁵ Renamed SMSF Annual Return from 2008 income year onwards.

⁴⁵⁶ Australian Taxation Office, 'Self-managed super funds: A statistical overview 2008-09' (2011) <<http://www.ato.gov.au/content/downloads/SPR00301485n74068.pdf>> , 7.

SMSFs are secretive, misused vehicles accessible only to the wealthy as yet another means of making themselves wealthier still at the expense of the ordinary taxpayer. Their regulation is characterised as extremely difficult because of their private nature and sheer numbers.

5.4.12.1 ATO view of SMSF compliance

The ATO is perceived, at least by some, as posturing and threatening as a method of regulating where knowledge is lacking.⁴⁵⁷ At a macro level, the ATO Compliance Program signals its determination to enforce compliance. This is backed up by regular speeches by the Tax Commissioner and other senior staff to professional associations explicitly raising issues of concern to the ATO and often making what amount to threats (for example, 'if any trustee can't or won't comply with the rules, we will take action',⁴⁵⁸ or 'we'll take appropriate action to deal with people who are disingenuous with us and getting entitlements unfairly').⁴⁵⁹ In this way senior executives also foster a demeanour of confidence among their own staff, keeping any doubts about the fragility of their powers to themselves and nurturing a culture of invincibility within the organisation.⁴⁶⁰

This has hardly gone unnoticed. For instance, the National Institute of Accountants' submission to the Super System Review contained the following statement:⁴⁶¹

The sector has been subjected to much conjecture about poor compliance ... some of it comes from the ATO's own comments on compliance, where it has extrapolated data of non-compliance from targeted activities (targeting suspected non-compliance) with the overall performance of the SMSF sector.

⁴⁵⁷ Alison Kahler and John Kehoe, 'ATO tires of excuses on super limits', *Australian Financial Review* 25 March 2010, 4.

⁴⁵⁸ Australian Taxation Office, *10 rounds with the regulator - Speech by Ian Read, Assistant Deputy Commissioner, at Taxation Institute of Australia SA State Conference - 8 May 2009 - Barossa Valley* (2009)
<<http://www.ato.gov.au/print.asp?doc=/content/00196719.htm>>

⁴⁵⁹ Australian Taxation Office, *Self-managed superannuation funds and the global recession: an ATO perspective: Speech by Michael D'Ascenzo, Commissioner of Taxation to the Self-Managed Super Fund Professionals' Association of Australia (SPAA), National Conference, Adelaide, 11 March 2009*
<<http://www.ato.gov.au/print.asp?doc=/content/00182952.htm>>

⁴⁶⁰ Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992), 46.

⁴⁶¹ National Institute of Accountants, 'Submission to Cooper Review: Phase 3: Structure' (February 2010)
<http://www.supersystemreview.gov.au/content/submissions/downloads/NIA_100319.pdf>, 7.

ATO officers in the SMSF segment admit they can tend to a 'police' mentality. In the words of one Assistant Commissioner, 'people who aren't well-intentioned or don't know what they're doing are the ones the ATO has to deal with, so may bias our perception'.⁴⁶² The ATO's ostensibly jaundiced view of the SMSF sector appears to be shared by organisations representing other superannuation industry sectors (see 5.4.12.2).

On the other hand, the Assistant Commissioner for the SMSF Segment commented on what he had told the Super System Review:⁴⁶³

... what we said to Cooper [Chair of the Review] was 'there's not a burning platform here'. There are issues, there will always be issues, but basically SMSFs work OK. There will always be problems at the margin – some people will always be poorly motivated. That's what we said to him. I think a lot of people in industry were surprised by that because I think they confused what the Minister who set the Inquiry up [Senator Nick Sherry] thought with what Cooper was going to find and I don't know what conversations occurred between the Minister and Jeremy Cooper – I'm not privy to that at all – but if they thought that because it was set up by Sherry who has strong views, that Cooper would reach the same conclusion they were mistaken, which is probably a sign of a good process.

Whether less senior ATO employees share the Assistant Commissioner's ultimately benign view of the sector's compliance remains an open question.

5.4.12.2 APRA-regulated funds' view of SMSF compliance

The Super Review newsletter of 13 April 2010 notes that 'other sectors of the superannuation industry have been responsible for much of the negative publicity that has impacted self-managed superannuation funds'.⁴⁶⁴ Pauline Vamos of ASFA (the APRA-regulated funds' industry association) has been quoted in the *Australian Financial Review* stating that SMSFs are not well enough regulated with issues including the following, many which have been discussed earlier in this chapter:⁴⁶⁵

⁴⁶² Interview B4.

⁴⁶³ Interview B6.

⁴⁶⁴ Mike Taylor, 'Accountants hit ATO and funds on SMSF criticisms' (13 April 2010) *Super Review* <http://www.superreview.com.au/articles/Accountants-hit-ATO-and-funds-on-SMSF-criticisms_z515287.htm>

⁴⁶⁵ Barrie Dunstan, 'Warning on 'weak link' super funds', *Australian Financial Review* 11 November 2009, 4.

- Lending provisions are too loose.
- It is too easy to establish an SMSF, with no need for trustees to verify who they are or verify bank accounts, and no way to prevent people using the name of other funds (duplicate funds with same name may exist).
- SMSFs are being used as an estate planning vehicle rather than a retirement vehicle.
- SMSFs are used for fraud.
- SMSFs misuse tax benefits.

In evaluating these comments, it should be borne in mind that SMSFs represent a serious threat to the APRA-regulated superannuation funds, facing as they do pressure from APRA and the government to consolidate. Over the last few years they have been concerned with countering loss of members, particularly high net worth individuals, to the SMSF sector.⁴⁶⁶

5.4.12.3 SPAA view of SMSF compliance

SPAA, the SMSF sector peak industry body, is generally cooperative with the ATO and influential with service providers and government. An examination of its submission to the Super System Review reveals an understandably benign view of SMSF compliance and a fervent wish to maintain the status quo.⁴⁶⁷

5.4.12.4 Statistics on SMSF compliance

The data provided in the statistical summary of SMSFs by the Super System Review shows that the rate of non-compliance is not statistically different from other

⁴⁶⁶ See Benjamin Levy, 'Super funds can stop SMSF defectors' (3 August 2010) *SuperReview* <http://www.superreview.com.au/articles/Super-funds-can-stop-SMSF-defectors_z521452.htm> ; Tony Rumble, 'Industry gangs up on SMSFs', *Australian Financial Review* 8 December, 2010, 63.

⁴⁶⁷ Self Managed Superannuation Funds Professional Association of Australia, 'Super System Review (Phase Three: Structure) Submission' (2010) <http://www.supersystemreview.gov.au/content/submissions/downloads/SPAA_100226.pdf>

superannuation sectors.⁴⁶⁸ In fact, statistics reveal a reduction in contraventions from 11% in 2008 to 7.2% in 2009⁴⁶⁹ and only 1.9% in 2010 and 2011.⁴⁷⁰ According to Jeremy Cooper, Chair of the Super System Review:⁴⁷¹

Stories about investor losses, dangerous investment products, non-compliance, bad advice and general mayhem were often bandied around as 'truths' about SMSFs – yet there was very little hard evidence to go on ... On the whole, the statistics show that the SMSF sector is in pretty good shape.

Those who assert the SMSF sector is out of control may, therefore, be doing so at least in part for self-interested reasons. At the same time, those who defend the sector's performance may likewise be at least partly motivated by self-interest.⁴⁷²

5.5 Conclusion

The regulation of the SMSF sector is shared between the ATO, APRA and ASIC, with the ATO having primacy due to the nature of the sector and the numbers involved. There is some minor lack of coordination of effort between the three agencies, particularly with regard to reporting of performance, rendering comparison between superannuation fund sectors problematic. In addition, the MOUs between the ATO and the other two agencies are in need of review.

The absence of prudential and portfolio regulation of the SMSF sector are remarkable, yet arguably appropriate given the nature of the sector.

As to effectiveness, the ATO's regulation effort is necessarily reactive, as new methods of using SMSFs to perpetuate fraud and tax avoidance become evident. Its cooperative effort with APRA to tighten the SMSF registration process and procedures for rollover of

⁴⁶⁸ Commonwealth of Australia, above n 31.

⁴⁶⁹ Karina Barrymore, 'Blitz stems super breaches', *Herald Sun* (Melbourne), 20 March 2010, 81

⁴⁷⁰ Australian Taxation Office, 'Self-managed superannuation funds: A statistical overview 2009–10' (2012)

⁴⁷¹ Jeremy Cooper, 'A conversation about SMSFs' (Paper presented at the SPAA Annual conference, Melbourne, 2010), 3.

⁴⁷² Rice Warner Actuaries suggest the Super System Review's light treatment of SMSFs was understandable given several members of the Review panel have an SMSF: Rice Warner Actuaries, 'The Future of Super' (July 2010) <http://www.ricewarner.com/images/newsroom/1279676461_Touchstone%20Newsletter%20-%20The%20Future%20of%20Super.pdf> 4.

superannuation into SMSFs from APRA-regulated funds is an example of a progressive response to perceived threats to the revenue and to SMSF members' retirement savings.

The delegation of the audit function to members of professional bodies is not without risk and SMSF auditor independence and competence remain concerns. Recommendations from the Super System Review regarding to this issue may improve the situation as the current government adopts and implements them.

The ATO's task in regulating the SMSF sector is a difficult one, given the huge numbers of regulatees, their private nature and the limitations on ATO resourcing that restrict it to a risk-based approach to policing regulatory and financial compliance. However, the performance of the SMSF sector (measured as return on assets)⁴⁷³ and the reported reduction in SMSF contraventions are indications that either the ATO is regulating successfully or the sector is self-regulating, or both.

Several areas of deficiency in the appropriateness and effectiveness of SMSF regulation cannot be rectified without legislative revision. These areas are further explored in Chapter 6.

⁴⁷³ For financial years 2006, 2007 and 2008, the return on assets for the SMSF sector was 12.6%, 16.9% and -6.1%, respectively. By comparison, at a whole of industry level, APRA-regulated funds with more than four members returned 12.2%, 13.3% and -7.8%, respectively: Commonwealth of Australia, above n 31, 12.

CHAPTER 6

IS THE SMSF LEGISLATIVE REGIME APPROPRIATE?

Appropriateness is defined as ‘the quality of being especially suitable’⁴⁷⁴ and in this chapter the current legislative regime is evaluated by examining how well the regime is: (1) crafted to be applicable to SMSFs; (2) easy for the ATO to enforce; and (3) easy for trustees and their advisers to understand and comply with.

The rules and regulations covering trustees of SMSFs come from several sources. They include trust law, the trust deed of the superannuation fund, the *Superannuation Industry (Supervision) Act 1993* (Cth) (‘SISA’) and *Superannuation Industry (Supervision) Regulations 1994* (Cth) (‘SISR’) (collectively the ‘SIS regime’), the *Corporations Act 2001* (Cth) (if there is a corporate rather than individual trustee) and the *Income Tax Assessment Acts 1936* and *1997* (Cth).

A detailed discussion of trust law application to SMSFs and of SMSF trust deeds is beyond the scope of this thesis, other than highlighting the unique characteristics of the SMSF trust and considering the likely non-compliance of SMSF deeds attributed to the frequency of relevant legislative change.

6.1 Trust law

Superannuation funds regulated by the SIS Regime must be constituted as a trust.⁴⁷⁵ In general, the trust is accepted as the most appropriate vehicle for an SMSF, trust law principles having been developed in the context of family relationships and SMSFs generally being family structures.⁴⁷⁶

⁴⁷⁴ WordWeb Pro online.

⁴⁷⁵ SIS Act s 19.

⁴⁷⁶ See Lisa Butler, *The priority of the trust in the age of superannuation* (University of Tasmania, 2003).

Almost all submissions to the government’s Super System Review, Phase 3: Structure (including SMSFs) supported continuance of the trust as vehicle for SMSFs: Commonwealth of Australia, above n 175, 221.

The distinctive feature of the SMSF trust is the unusual circumstance that trustees and members (beneficiaries) are often the same individuals (apart from members who are under a legal disability and cannot act as trustees).

The merger of legal and beneficial interests in this circumstance would normally mean that there could be no real trust. In the SMSF context, the question is whether the trustee and beneficiary are the same person. If not, there is no issue with merger. If so, merger ensues, because there is an identity between legal and beneficial ownership of the trust assets (and thereby not the dual levels of ownership required of a trust by definition).⁴⁷⁷

However, it is open to the legislature to alter this outcome by specific provision (as statute necessarily ousts the general to the extent that they cannot function consistently together) and this has been accomplished in the SIS Act. Apart from the case of single-member funds, if the trustee of the fund is a body corporate, each director of the body corporate must be a member of the fund.⁴⁷⁸ Each trustee holds the trust property for the benefit of the other member(s).

For single member funds, if the trustees are individuals, there must be a second individual trustee who is either a relative of the fund member or an individual who is not an employee of the fund member.⁴⁷⁹ If the trustee of the fund is a body corporate, the member must be sole director of the body corporate or there must be two directors, the non-fund member being either a relative of the fund member, or not an employee of the member.⁴⁸⁰

Own property versus property of another

One consequence of the fact that SMSF trustees and beneficiaries are generally the same individuals concerns the requisite trustee standard of care, in particular the distinction between care for the property of another and for one's own property and the

⁴⁷⁷ In the context of a public offer fund, a recent High Court decision has confirmed that a member of a superannuation fund has a beneficial interest in the assets of that fund: *Finch v Telstra Super Pty Ltd* (2010) 84 ALJR 726, [30].

⁴⁷⁸ SISA s 17A(1).

⁴⁷⁹ SISA 17A(2)(b).

⁴⁸⁰ SISA s 17A(2)(a).

standard of care expected from the ordinary prudent person and the prudent person of business.

At general law, a high standard of care and caution applies to a trustee holding in trust the property of another. The standard of care and caution expected under trust law is arguably lower when a non-professional SMSF trustee is dealing with his or her own property.⁴⁸¹ Interestingly, the statutory trustee covenant in SISA 52(2)(b), with which SMSF trustees must conform, refers to the care, skill and diligence an ordinary prudent person would exercise in dealing *with property of another for whom the person felt morally bound to provide*. This is distinguished from the general law duty of care that refers to the fictitious person *dealing only with his or her own affairs*.⁴⁸² Presumably this wording in s 52(2)(b) is either a drafting oversight or was considered too difficult to modify when the SISA was amended to specify those provisions applicable to SMSFs.⁴⁸³

The standard of care required of SMSF trustees is thus somewhat ambiguous. They are voluntarily assuming the risk of placing their property in trust, yet – apart from the SMSF with a single member who is also sole corporate trustee director – each trustee can be understood to be holding the others' assets in trust and exercising the degree of care skill and diligence the law requires in that circumstance.

Ordinary prudent person versus prudent person of business

At general law, the standard of care the law requires of a trustee in exercising his or her duties and powers is that of an ordinary prudent businessperson.⁴⁸⁴ Where the standard relates to professional trustees, it is higher still, importing the standard of care and skill required of one engaged in that profession.⁴⁸⁵

However the s 52(2)(b) standard is that of the ordinary person, not the ordinary *business* person of general law. The government's Stronger Super reforms include legislative

⁴⁸¹ See *Fouche v Superannuation Fund Board* (1952) 88 CLR 609, 641 per curiam.

⁴⁸² *Australian Securities Commission v AS Nominees* (1995) 133 ALR 1, 12 per Finn J.

⁴⁸³ By the *Superannuation Legislation Amendment Act (No 3)* 1999.

⁴⁸⁴ *Re Speight* (1883) 22 Ch D 727, 739-740.

⁴⁸⁵ *Bartlett v Barclays Bank Trust Co Ltd (No 1)* [1980] Ch 515, 534 per Brightman J.

amendment strengthening the standard of care, skill and diligence required of trustees and directors of corporate trustees, to that of a prudent person of business:

To exercise the degree of care, skill and diligence as an ordinary prudent person of business would exercise in dealing with the property of another for whom the person felt morally bound to provide.⁴⁸⁶

However, this requirement is to be specifically excluded for SMSF trustees.⁴⁸⁷ Thus SMSF trustees are not expected to possess any particular business skills. This is appropriate, given that the sole purpose test is used by regulators to prohibit superannuation funds from carrying on a business.⁴⁸⁸

These features of the standard of care imposed upon SMSF trustees by SISA are of little significance at an individual SMSF level, given the unlikelihood of actions in equity for breach of trust or fiduciary duty. However, the distinction from the standard expected of professional trustees explains in part the absence of prudential regulation of SMSFs.

6.2 Trust deeds

SMSF trust deeds are non-standard and many versions exist. These range from custom-made, personalized deeds developed by lawyers for their clients to pro formas (originally developed by lawyers) purchased over the internet following a process of prompts for the purchaser to add member details, trustee details, relevant dates and various clauses concerning allowable investments. Some clauses are included only where the trustee is a corporation, and deeds must also distinguish between a sole-purpose corporate superannuation trustee and one that conducts other business.

Legislative changes may mean older SMSF trust deeds are out of date. Appendix 2 contains a table of the main legislative changes since 1992 that have impacted SMSFs.

⁴⁸⁶ Exposure draft *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012*, 13.

⁴⁸⁷ *Explanatory Memorandum to the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012*, 1.65.

⁴⁸⁸ In the SMSF context, see ATO publications *Self Managed Superannuation Funds – Roles and Responsibilities of Trustees* and Australian Taxation Office, 'Carrying on a business in a self-managed superannuation fund' (2010) <<http://www.ato.gov.au/superfunds/content.asp?doc=/content/00241937.htm>>

One important example is that, from 1 July 2008, the SISA definitions of both 'spouse' and 'child' were expanded, meaning the definition of a member's 'dependant' also expanded. Accordingly, the categories of person eligible to receive a member's death benefit broadened. If a trustee wished to pay a death benefit from a pre-July 1998 SMSF to a same-sex spouse, he or she could not (unless the deed contained an effective catch-all clause).⁴⁸⁹

The Super System Review recommended – as an alternative to government making available a standard trust deed – that SISA be amended to deem inclusion of various catch-all clauses in the trust deed of each SMSF to reduce the need for amendments to SMSF trust deeds when the SIS legislation or tax laws change.⁴⁹⁰ But the government declined this recommendation, reasoning as follows:⁴⁹¹

The Government considers that SMSFs should have the flexibility to tailor their trust deeds and that SMSF trustees should be aware of the obligations imposed by their trust deed. Therefore, the Government will not amend the superannuation legislation to automatically deem anything permitted by the superannuation or taxation legislation to be permitted by SMSF trust deeds.

A discussion of the advantages that might be afforded SMSFs were the government or regulator to make available an up-to-date model trust deed appears below at 6.9.

6.3 Corporations Act and ITAA

Except to highlight below the impact of corporations and taxation law upon the regulation of SMSFs, this thesis does not attempt a detailed discussion or explanation of these areas.

⁴⁸⁹ Such as 'In addition to any powers expressly conferred upon the Trustee by the SIS Act or by the provisions of this Deed, the Trustee has the power to do anything which is not prohibited by the SIS Act'. Most SMSF deeds also contain a general 'compliance clause' to protect the fund's complying status and resultant tax advantages. An example is 'Where compliance with a SIS requirement is a prerequisite for the fund as a self-managed superannuation fund to qualify as a complying fund, and that requirement has not been set out in this Deed, then the SIS requirement will be deemed to have been included in this Deed.'

⁴⁹⁰ Commonwealth of Australia, above n 174, 46.

⁴⁹¹ Commonwealth of Australia, *Stronger Super Information Pack* (21 September 2011)

<http://strongersuper.treasury.gov.au/content/publications/information_pack/downloads/information_pack.pdf> , 18.

6.3.1 Corporate trustees

In 2006 Macquarie Bank estimated that around 60% of SMSFs had individual trusteeship and 40% had corporate trusteeship.⁴⁹² In 2009, however, the SSR Statistical Summary of SMSFs reported that only around 29% of SMSFs had a corporate trustee and that this percentage was decreasing.⁴⁹³ The latest statistical data indicates that of new registrations during the 2011 income year, 90% of SMSFs had individual trustees.⁴⁹⁴

SISA s 52(8) extends the SMSF trustee covenants to corporate trustees so that each of the directors of the trustee must exercise a reasonable degree of care and diligence to ensure that the trustee carries out the s 52(2) covenants, and so operates as if the directors were parties to the governing rules (contained in a trust instrument, other document or legislation).

One interviewee⁴⁹⁵ stated an area requiring law improvement is the control of corporate trusteeship. There may be governance issues within corporate trustees that are not addressed by the SIS regime such as the constitution, shareholding, voting (casting votes, number of votes per director, changes in control upon death or divorce). However, an examination of whether the *Corporations Act 2001* provides adequate legislative guidance to corporate trustees in a superannuation context is beyond the scope of this thesis.

6.4 The SIS Regime

As discussed at 4.3.1, the SIS Regime was introduced in 1993 for the purpose of effecting the prudential regulation of 'superannuation entities', a term that refers collectively to regulated superannuation funds,⁴⁹⁶ approved deposit funds and pooled superannuation trusts. SMSFs are subject to less onerous standards than the large

⁴⁹² David Shirlow, 'SMSF Trusteeship – Corporate or Individual?' (2006) 17(6) *Australian Superannuation Law Bulletin* 81.

⁴⁹³ Commonwealth of Australia, above n 31, 6.

⁴⁹⁴ Australian Taxation Office, 'Self-managed superannuation funds - A statistical overview 2009–10' (April 2012) <<http://www.ato.gov.au/content/downloads/SPR00316375n74068.pdf>> , 7.

⁴⁹⁵ Interview A1.

⁴⁹⁶ Comprising 'employer-sponsored' funds, 'public offer' funds and SMSFs.

funds regulated by APRA, in that their trustees are not required to be licensed,⁴⁹⁷ nor the funds themselves to be registrable superannuation entities,⁴⁹⁸ and none of the provisions relating to remuneration or equal representation of employers and members applies.

Some of the legislative supplementation simply reinforces the existing general law, the trustee covenants in SISA s 52(2) being a typical illustration.⁴⁹⁹

6.4.1 General observations on the SIS Regime

As detailed in Chapter 2, SISA was enacted at a time before the SMSF was a recognized fund type, and has since been amended and adapted to enable the ATO to regulate SMSFs.⁵⁰⁰ There was always a danger that the adaptation would be incomplete or inappropriate, and so it has proven. The changes to the SIS regime to adapt it to the regulation of SMSFs underscore the overly bureaucratic system that currently exists within which agency responsibilities are shared, and SMSF trustees must comply with a

⁴⁹⁷ SISA s 29D.

⁴⁹⁸ SISA s 29M.

⁴⁹⁹ These are:

- (a) to act honestly in all matters concerning the entity;
- (b) to exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing **with property of another** for whom the person felt morally bound to provide;
- (c) to ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries;
- (d) to keep the money and other assets of the entity separate from any money and assets, respectively:
 - (i) that are held by the trustee personally; or
 - (ii) that are money or assets, as the case may be, of a standard employer-sponsor, or an associate of a standard employer-sponsor, of the entity;
- (e) not to enter into any contract, or do anything else, that would prevent the trustee from, or hinder the trustee in, properly performing or exercising the trustee's functions and powers;
- (f) to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the following:
 - (i) the risk involved in making, holding and realising, and the likely return from, the entity's investments having regard to its objectives and its expected cash flow requirements;
 - (ii) the composition of the entity's investments as a whole including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification;
 - (iii) the liquidity of the entity's investments having regard to its expected cash flow requirements;
 - (iv) the ability of the entity to discharge its existing and prospective liabilities;
- (g) if there are any reserves of the entity—to formulate and to give effect to a strategy for their prudential management, consistent with the entity's investment strategy and its capacity to discharge its liabilities (whether actual or contingent) as and when they fall due;
- (h) to allow a beneficiary access to any prescribed information or any prescribed documents.

⁵⁰⁰ By Acts No. 121 and 128, 1999; Nos. 24 and 160, 2000; No. 123, 2001; No. 53, 2004; No. 82, 2005; Nos. 9 and 154, 2007

host of obligations developed for governance of trustees of large funds entrusted with the retirement savings of others. This outcome has arisen from the adaptation of a regime enacted for a purpose incompatible with the regulation of SMSFs, namely prudential regulation of superannuation entities.

6.4.1.1 Agency responsibilities

SISA s 6 divides administration of specified provisions between APRA, ASIC and the Commissioner of Taxation. Those administered by the Commissioner are set out in s 6(2A)(1)(e), (f) and (g), and s 6(4)(b). A note to s 6(2A) states 'Generally, the Commissioner of Taxation is not referred to in these provisions, *Regulator* is used instead'. This is because the provisions specified in s 6(2A) are general-purpose, administered by all three agencies.

The general administration of the Act is poorly set out. For example, SISA s 6(1)(e)(ii) provides the Commissioner of Taxation with administration of Part 12 (other than s 105), yet paragraph (f) gives the Commissioner of Taxation administration of s 105.

A new complication will be introduced with the upcoming Stronger Super legislation requiring registration of approved auditors, which will presumably carry consequential amendments to SISA and/or SISR. Although SMSF approved auditors' interactions concerning their clients are exclusively with the ATO and the ATO will be responsible for 'policing' the standards that govern their work,⁵⁰¹ it will not be this agency but ASIC that approves and registers them. It remains to be seen how well the two agencies integrate their efforts in this important area. As noted at 5.3.2 **ASIC**, the current MOU between ASIC and the ATO makes no specific mention of superannuation. The Assistant Commissioner, SMSF Segment, stated he and others within the ATO considered the ATO should be the registration body but that view was not accepted by the Review.⁵⁰²

⁵⁰¹ Commonwealth of Australia, *Stronger Super - Government response to the Super System Review* (2011) <http://strongersuper.treasury.gov.au/content/publications/government_response/downloads/Stronger_Super.pdf>, 48.

⁵⁰² Interview B4.

6.4.1.2 *Applicability to SMSFs*

The SISA provisions that apply to SMSFs are scattered throughout the Act. In some cases a Part of the Act will apply to SMSFs except for only one section, in others only some Divisions within a Part are applicable. It is certainly confusing for the scholar and is likely confusing for the regulator that must enforce the applicable provisions. There is no doubt that the legislation is difficult for SMSF trustees and their advisers to interpret.

The Regulations (SISR) are also cumbersome to interpret for an SMSF trustee because each regulation must be examined to determine if it applies to an SMSF. Unless the regulation specifies it is inapplicable to an SMSF, it applies. The Regulations are not well indexed and there are some provisions in the SISA that should be in the regulations and vice versa. As an example, the prohibition against employee members is contained in an exceedingly complex interaction between the Act and the Regulations, all the parts of which should logically appear together in the Act.⁵⁰³

Anecdotally, the Schedules to the Regulations⁵⁰⁴ confuse many people.⁵⁰⁵ The Regulations are split into two volumes: Volume 1 contains the regulations themselves that must be read together with Volume 2, containing the Schedules and the Notes. Each volume has its own table of contents.

The Regulations contain requirements for trustees to behave in quite bizarre ways because they are both trustee (or fiduciary) and member (or beneficiary). The

⁵⁰³ See SISA s 17A and SISR reg 1.04AA. In general, subordinate legislation is intended only for easily-updated exceptions, qualifications and definitions of terms.

⁵⁰⁴ Schedules to the SIS regulations deal with the following matters:

- Approved auditors -- professional organisations
- Exempt public sector superannuation schemes
- Payment limits for annuities and pensions with a commencement day before 1 January 2006
- Payment limits for annuities and pensions with a commencement day on and after 1 January 2006
- Pension valuation factors
- Conditions of release of benefits
- Modifications of the OSS laws in relation to preserved benefits in regulated superannuation funds
- Request to transfer whole balance of superannuation benefits between funds form
- Prescribed form of advertisement of scheme for winding-up or dissolution
- Approved bodies
- Payments for market linked income streams
- Minimum payment amount for a superannuation income stream

⁵⁰⁵ ATO Assistant Commissioner, Interview B4.

Regulations having been developed for public offer funds and being designed to protect the superannuation of members who have nothing to do with the running of the fund, to comply with them, SMSF trustees must ‘talk to themselves’ in their dual roles of trustee and member and hold artificial minuted meetings to document what they as trustees have decided to do for the benefit of themselves as members.⁵⁰⁶ For example, Part 2 of SISR deals with information to be given by trustees to members or non-member spouses within certain timeframes, in writing. This can be contrasted with the requirement for a single individual trustee simply to retain records of all decisions made.⁵⁰⁷

Income Tax Assessment Act

It is not only the SIS Regime that imposes unnecessary administrative burdens on SMSF trustees by treating them identically to trustees of public offer funds. The ITAA 1997 requires fund members to provide to their superannuation fund trustee written notice of their intent to deduct superannuation contributions from their income⁵⁰⁸ (which notice cannot be revoked or withdrawn)⁵⁰⁹ and for the ‘trustee or provider’ to provide written acknowledgement of a valid notice without delay.⁵¹⁰ Without both these requirements having been met, an income tax deduction for a personal superannuation contribution is not available.⁵¹¹

These provisions result in the bizarre outcome of obliging an SMSF member to give written notice to himself as trustee of an impending claim for a tax deduction and for himself as trustee to acknowledge that notice in writing.

Corporations Act – Product Disclosure Statements

Another area in which the legislative regime governing SMSFs may be inappropriate is the possible requirement under the *Corporations Act*, as amended by the *Financial Services Reform Act 2001* (Cth), for trustees of an SMSF to provide a Product Disclosure Statement (PDS) to themselves. The PDS is a summary of the important

⁵⁰⁶ SIS Act s 103(1) (‘If a superannuation entity has a group of individual trustees, the trustees must keep, and retain for at least 10 years, minutes of all meetings of the trustees at which matters affecting the entity were considered’).

⁵⁰⁷ SIS Act s 103.

⁵⁰⁸ ITAA 1997 s 290.170(1) - This must be done before lodgment of the member’s income tax return for that year.

⁵⁰⁹ ITAA 1997 s 290.180.

⁵¹⁰ ITAA 1997 s 290.170(3).

⁵¹¹ ITAA 1997 s 290.175.

provisions of a financial product, showing how the product works and how it affects the members.⁵¹²

In general terms, a 'regulated person'⁵¹³ (which can include the trustee/members of an SMSF) of a 'financial product' must issue a PDS to all its members.⁵¹⁴ A 'superannuation interest' within the meaning of SISA⁵¹⁵ is a 'financial product' as defined in s 764A(1)(g) of the *Corporations Act*. The issue of or advice on a financial product is the provision of a financial service,⁵¹⁶ however SMSF trustees are not required to hold an Australian financial services licence because the financial service they provide is in their capacity as trustee of an SMSF (*Corporations Act* s 911A(2)(j)). Thus a member in their capacity as trustee may need to assist themselves in their capacity as member to decide if they want to be a trustee. This strange outcome has arisen because of the intersection of the *Corporations Act* and SISA.

Although s 1012D of the *Corporations Act* appears to exempt SMSFs from the PDS requirement,⁵¹⁷ the onus is placed on the trustee to be reasonably sure that all members know all the information a PDS would be required to contain. Developers of SMSF trust deeds available commercially are uncomfortable with the exclusion, as most contain a PDS.⁵¹⁸

⁵¹² Paragraph 14.28 of the Explanatory Memorandum to the Financial Services Reform Bill 2001 states (in part): '... the broad objective of point of sale obligations is to provide consumers with sufficient information to make informed decisions in relation to the acquisition of financial products, including the ability to compare a range of products'.

⁵¹³ As defined in *Corporations Act 2001* (Cth) s 1011B.

⁵¹⁴ *Corporations Act 2001* (Cth) s 1012A(3).

⁵¹⁵ SISA s 10 'superannuation interest' means a beneficial interest in a superannuation entity.

⁵¹⁶ *Corporations Act 2001* (Cth) s 766A.

⁵¹⁷ The relevant subsection provides:

(2A) In a recommendation situation or issue situation, the regulated person does not have to give the client a Product Disclosure Statement for the financial product if:

- (a) the financial product is an interest in a self-managed superannuation fund; and
- (b) the regulated person believes on reasonable grounds that the client has received, or has, and knows that they have, access to, all of the information that the Product Disclosure Statement would be required to contain.

⁵¹⁸ As mentioned in the explanatory material that accompanies one pro forma SMSF trust deed package (the ClearDocs SMSF Trust Deed), the usual obligation for a superannuation trustee to provide new member information by way of a PDS does indeed apply to self managed superannuation, notwithstanding that the new member must become a trustee. The ClearDocs PDS carries the following explanation:

This PDS contains a summary of the important provisions of the fund's deed and the effects which those provisions may have on you. The *Corporations Act* requires that you be given this PDS within 3 months after

Additionally, there is a situation where a PDS *will* need to be given to the SMSF member, namely where some or all of a pension's account balance is moved into the accumulation part of an SMSF.⁵¹⁹ This constitutes in most cases the issue of a financial product – despite the *Corporations Act* s 1012D exclusion – and a PDS will need to be issued unless the member already has the current PDS that provides all relevant information.⁵²⁰

ASIC guidance on contents of PDSs includes the option of a Short-Form PDS, which 'summarises the key information in a PDS (eg information about the issuer, benefits, risks, costs, return, dispute resolution and cooling off)'⁵²¹ and can be given in all cases except general insurance products and this would be the appropriate form to use in the SMSF context. Notwithstanding, the apparent obligation for SMSF trustees to issue PDSs to themselves as members presents another example of the inappropriate administrative burdens afflicting SMSF trustees, especially questionable since an SMSF is arguably better characterised as an investment and tax structure than a financial product.⁵²²

Removal of administrative burdens

The Super System Review Report recommended that (after appropriate industry consultation) legislation be amended to remove SMSF trustee 'administrative burdens' that are identified as unnecessary.⁵²³ The government responded that it would consult with relevant stakeholders to determine any administrative requirements that are unnecessary for SMSF trustees.⁵²⁴

you become a member of the fund. **If you have any questions at any time, you should refer those to the trustee.**' [emphasis added]

⁵¹⁹ This will occur where a member wishes to add later contributions to the asset balance supporting their pension. The pension must cease, move to the accumulation part, the later contributions are added, then a new pension commences from the member's new enlarged pension account.

⁵²⁰ Tony Negline, 'Cashing out or rolling back: an administrator's guide' (August-September 2010) *Professional Planner* 47, 49.

⁵²¹ [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ps168.pdf/\\$file/ps168.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ps168.pdf/$file/ps168.pdf)

⁵²² See Victoria Papandrea, 'Doubling up' August 2-8, 2010(516) *Independent Financial Adviser* 18, 21.

⁵²³ Commonwealth of Australia, above n 175, recommendation 8.19, 251.

⁵²⁴ Commonwealth of Australia, *Stronger Super - Government response to the Super System Review* (2011)

<http://strongersuper.treasury.gov.au/content/publications/government_response/downloads/Stronger_Super.pdf>, 51.

6.4.2 Specific deficiencies in the SIS Regime

There are several, more specific, areas where the SIS Regime may be inadequate or inappropriate with respect to SMSFs: statutory inconsistency relating to 'complying' status, exclusion from financial assistance measures, lack of specificity about investment strategy and asset allocation, penalty provisions, and inability for the ATO to issue directives and prosecute promoters. These are elaborated below.

6.4.2.1 When an SMSF becomes 'complying'

There is a disparity between administrative and legislative treatment of a fund's complying status in its first year of existence and reporting. The *Income Tax Assessment Act 1997* (Cth), in s 995-1, defines a 'complying superannuation fund' with reference to SISA s 45; the latter provides that in relation to a year of income a fund is only complying when a notice of compliance⁵²⁵ has been issued, a notice of non-compliance has not been issued and the fund is a regulated fund. SISA s 42A contains two additional conditions for complying status: that the fund is Australian resident, and that no trustee of the entity has contravened any of the regulatory provisions in relation to the entity during the year of income. During an SMSF's first year it is treated as though it is compliant, having access to tax advantages afforded complying funds, although it is not yet technically compliant according to SISA.⁵²⁶

6.4.2.2 No access to financial assistance for loss due to fraud or theft

One feature of the statutory scheme that illustrates the significance of SMSF trustee-beneficiary proximity is the non-applicability of SISA Pt 23 – *Financial assistance to certain funds*.⁵²⁷ Regulated funds that suffer losses as a result of fraudulent conduct and

⁵²⁵ These have been sent to funds after their first SMSF Annual Return is successfully lodged, first by the Insurance and Superannuation Commission now by the ATO however in fact some funds have never received them because of system glitches early in the ATO's period as regulator (ATO Assistant Commissioner, Interview B4).

⁵²⁶ The ATO has recently changed its procedures in listing new SMSFs on Super Fund Lookup, a website managed by the ATO listing regulated superannuation funds. Since February 2010 new funds that have not yet lodged their first return are given a new status on SFL of 'registered – status not determined', rather than 'complying' as previously. This status flags for APRA-regulated funds the need to take additional care in processing rollovers to these funds. (refer 5.4.8.3 Super Fund Look Up).

⁵²⁷ See Stuart Washington, 'Self-managed super and the Trio trap', *Sydney Morning Herald* (Sydney), 17 January 2011, 5; Barrie Dunstan, 'Trustees need to take responsibility', *Australian Financial Review* 18 April 2011, 46.

theft have access to financial assistance from the government from which SMSFs are specifically excluded by SISA s 229(1)(aa)(i). The Senate Select Committee on Superannuation reported in March 2003 that some APRA funds had received compensation associated with the collapse of CNAL (Commercial Nominees of Australia Limited), but while SMSFs also suffered financial loss as a result of fraud and theft associated with the collapse of CNAL they were excluded from the protection afforded by Part 23.⁵²⁸ The Committee saw this as regrettable but appropriate, reasoning as follows:⁵²⁹

... discretionary compensation mechanisms, such as an act of grace payment under the FMA Act [*Financial Management and Accountability Act* 1997], are available for trustees of those funds to seek compensation in such circumstances, once other avenues for redress, such as the courts, have been examined. The Committee accepts that SMSFs, as internally managed superannuation entities, are not eligible for grants of financial assistance under the SIS Act ... The Committee considers that the Australian Taxation Office and any financial advisors or other intermediaries involved in the establishment of SMSFs should be specifically required to inform current and prospective trustees of SMSFs that they are not covered by the provisions of Part 23 of the SIS Act, and to highlight the consequences or potential consequences of that exclusion.

The same exclusion applied to the failure in 2010 of Trio/Astarre.⁵³⁰ SMSFs are, in this sense, in the same position as other non-superannuation fund investors.

In fact, there is increasing community disquiet over the exclusion of SMSF members from legislative protection. The Chairman of ASIC told a Senate estimates committee in May 2012 that he recommended investors in self-managed super funds be required to sign a written document acknowledging a warning that their funds would not be compensated for theft or fraud.⁵³¹

⁵²⁸ Senate Select Committee on Superannuation 'Provisions of the Superannuation Industry (Supervision) Amendment Bill 2002 and the Superannuation (Financial Assistance Funding) Levy Amendment Bill 2002', March 2003, 19.

⁵²⁹ Ibid 25.

⁵³⁰ Kate Kachor, 'Govt to compensate Trio victims' (18 April, 2011) *Investor Daily* <<http://www.investordaily.com.au/cps/rde/xchg/id/style/11451.htm>>

⁵³¹ Patrick Durkin, 'ASIC wants SMSFs regularly warned', *Australian Financial Review* 30 May 2012, 19.

Yet no reference to the non-applicability of SISA Pt 23 appears on the ATO website or in any of its flagship SMSF publications (see 3.9).

6.4.2.3 Lack of access to dispute resolution for SMSF members

As outlined at 4.5.1, there is no direct Superannuation Complaints Tribunal oversight over SMSFs because the *Superannuation (Resolution of Complaints) Act 1993* (Cth) does not apply to SMSFs.⁵³²

The Family Court has jurisdiction to resolve disputes over superannuation (including SMSF account balances) in the context of a property settlement⁵³³ and an argument might be mounted that the jurisdiction of the SCT should be similarly extended to resolve death benefit disputes between an SMSF trustee and a beneficiary who is not a member, particularly in the cases of blended families and former partners. Since 2006, superannuation monies are not required to be paid out upon retirement,⁵³⁴ meaning that more wealth is being accumulated in superannuation and potentially available upon a member's death. Because the SISA and superannuation trust deeds, rather than wills, govern how superannuation fund assets are dealt with upon death, it can be expected that more disappointed potential recipients will be looking to challenge trustees' decisions as to how death benefits are distributed.⁵³⁵

Access to the SCT for the purpose of resolving death benefit disputes could be achieved by amendment to ss 5 and 14 of the *Superannuation (Resolution of Complaints) Act 1993* to extend its applicability to SMSFs funds as a 'severable operation' of the Act. The Act was introduced at the same time as SISA⁵³⁶ 'to give effect to the new prudential

⁵³² *Superannuation (Resolution of Complaints) Act 1993* (Cth) s 5.

⁵³³ Superannuation accrued up to the time of separation can be split via consent order or by court order, as part of a property settlement.

⁵³⁴ The compulsory cashing rules (which required benefits to be paid to members over the age of 65 when they ceased to meet the work test or when they attained age 75) were simplified in 2004 and then abolished with effect from May 2006.

⁵³⁵ The SCT reported that death benefit complaints made up 36.1% of their workload in the quarter 1 January – 31 March 2012, up from 29.1 per cent in the previous quarter: Superannuation Complaints Tribunal, 'Quarterly Bulletin, Issue No. 67' (2012) <http://www.sct.gov.au/downloads/Jan_Mar12QtlyBltn.pdf>

⁵³⁶ The full package of Bills was:

arrangements for superannuation' and the Superannuation Complaints Tribunal was established to provide superannuation fund members with access to such a dispute resolution mechanism, as a low cost alternative to the courts'.⁵³⁷ The Explanatory Memorandum offers no explanation of why SMSFs are specifically excluded from this dispute resolution mechanism. Presumably the exclusion was consistent with the exclusion of SMSFs from prudential regulation (see 5.3.4 **Prudential regulation**, namely that SMSF members can be expected to take care of themselves.

Were SMSFs to be brought within the jurisdiction of the SCT, its workload would presumably increase, though by how much can only be speculated upon.⁵³⁸

6.5 SMSF Investments

As long as SMSFs operate in an environment premised on flexibility and choice, with relatively little regulation so far as investment is concerned, there will always be criticisms of how they invest, as ultimately their failures will be underwritten by society through the government Age Pension. Commentators have identified a number of potential shortcomings in SMSF investing:⁵³⁹

- no requirement for a written investment strategy;
- no requirement for professional financial advice on an investment strategy;
- too much cash and overly conservative share portfolios;
- propensity to invest in exotic assets;

Superannuation Industry (Supervision) Bill 1993
 Superannuation (Resolution of Complaints) Bill 1993
 Superannuation (Financial Assistance Funding) Levy Bill 1993
 Superannuation (Rollover Benefits) Levy Bill 1993
 Superannuation Industry (Supervision) Consequential Amendments Bill 1993
 Occupational Superannuation Standards Amendment Bill 1993
 Superannuation Supervisory Levy Amendment Bill 1993

⁵³⁷ Parliament of Australia Senate, Second Reading Speech, 1998, Senator Ian Campbell.

⁵³⁸ It is not currently possible to obtain data on numbers of SMSF-specific dispute cases in all Australian courts.

⁵³⁹ See for example Peter J Phillips, 'Self managed superannuation funds: Time for portfolio controls?' (2008) *Working Paper (unpublished)*, above n 316.

- unease about limited recourse borrowing;
- lack of weighting requirements and poor diversification within and between asset classes; and
- no rate-of-return restrictions.

SMSF trustees have almost absolute discretion in how they invest the fund's money. Trustee legislation gives general discretion to invest in all Australian jurisdictions, so a trustee may, unless expressly prohibited by the trust instrument, invest trust funds in any form of investment, and vary such an investment at any time.⁵⁴⁰ Also, typical SMSF trust instruments allow very wide discretion, for example, an investment strategy from a *pro forma SMSF* trust deed and attachments provides as follows:

The trustee must invest any assets of the fund that are not required for payment of benefits or other amounts under this deed. The trustee must do so in accordance with the current investment strategy or strategies.

After listing a large number of investment types, the deed concludes:

Any other investment allowed by superannuation law that the trustee thinks appropriate.

The SISA fetters the SMSF trustees' investment discretion to some extent, with restrictions on borrowing,⁵⁴¹ lending to⁵⁴² or acquiring assets from⁵⁴³ members or their relatives and in relation to in-house assets.⁵⁴⁴ The term 'invest' in itself contains a limitation, because not all outlays of moneys are necessarily investments. SISA defines it

⁵⁴⁰ See *Trustee (Amendment) Act 1999* (ACT); *Trustee Amendment (Discretionary Investments) Act 1997* (NSW), *Trustee Amendment Act (No 2) 1995* (NT); *Trusts (Investments) Amendment Act 1999* (Qld) *Trustees (Investment Powers) Amendment Act 1995* (SA); *Trustee Amendment (Investment Powers) Act 1997* (Tas); *Trustee and Trustee Companies (Amendment) Act 1995* (Vic); *Trustees Amendment Act 1997* (WA).

⁵⁴¹ SISA s 67.

⁵⁴² SISA s 65.

⁵⁴³ SISA s 66 except for listed securities and business real property.

⁵⁴⁴ SISA s 83 provides that if the market value ratio of the fund's in-house assets exceeds 5%, a trustee of the fund must not acquire an in-house asset and must not acquire an in-house asset if the acquisition would result in the market value ratio of the fund's in-house assets exceeding 5%. Basically an in-house asset of an SMSF is an asset that is a loan to, or an investment in, a related party of the SMSF; an investment in a related trust; or an asset of the SMSF that is subject to a lease or lease arrangement between the trustee of the SMSF and a related party of the SMSF: SISA s 71. A related party is a member, member's relative, company controlled by the member or member's fellow partner or trustee: SISA s 70B.

as 'to apply assets (any form of property including money – whether Australian currency or currency of another country) in any way or make a contract for the purpose of gaining interest, income, profit or gain'.⁵⁴⁵

There is also a de facto limitation to investment arising out of the 'sole purpose' test, whereby each trustee must ensure that the fund is maintained solely for the provision of benefits upon retirement, disability or death. This prevents the fund from conducting a business and necessarily requires its investments to be relatively conservative and risk-averse.

6.5.1 Investment Strategies

Amongst the covenants listed in SISA, s 52(2)(f)⁵⁴⁶ requires each SMSF trustee to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to:

- the risk involved in making, holding and realising, and the likely return from, the entity's investments having regard to its objectives and its expected cash flow requirements;
- the composition of the entity's investments as a whole including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification;
- the liquidity of the entity's investments having regard to its expected cash flow requirements;
- the ability of the entity to discharge its existing and prospective liabilities (of which pensions would be the most common).

Yet it cannot be assumed that all SMSFs have formulated or give effect to an investment strategy. One auditor interviewee stated:

⁵⁴⁵ SISA s 10.

⁵⁴⁶ Also as an operating standard under SISR reg 4.09 for the purposes of SISA s 34.

Thirty percent of funds I audit don't have a written investment strategy and a lot have this sort of investment strategy:

Fixed deposit	0-100%
Australian shares	0-100%
International shares	0-100% ... etc.

That's useless. I had one case, a private company run by a dimwit. He convinced his SMSF trustee mates to invest in his business. They will lose their money. If the SMSF had a proper investment strategy and applied it, they would have to say no. (Interview A9, auditor)

Because SMSFs are not prudentially regulated, the ATO as regulator has no role to play in ensuring an investment strategy is developed and implemented, other than requiring the approved auditor to report a contravention (an 'Audit Contravention Report' or 'ACR') if there is no investment strategy in place. The investment strategy need not be in written form. The approved auditor is required to report 'yes' or 'no' to the questions: 'Did the trustees have an investment strategy for the fund?' and 'Are the fund's investments in line with the investment strategy?' The auditor will lodge an ACR only in the event that the trustees deny having a written or oral investment strategy. There remains a lack of research into the investment strategies of SMSFs and the consistency with which they are applied.⁵⁴⁷

ING Australia's submission to the Super System Review included recommending greater surveillance to ensure that the fund's investment strategy is correctly drafted and implemented as required by the legislation and that the SISA be amended to require that the fund's investment strategy be in writing.⁵⁴⁸ There is a strong argument for requiring SMSF trustees to obtain professional financial advice on their fund's investment strategy. Alternatively this requirement could apply only those managing a small pool of assets below a certain low threshold, given that many SMSF trustees are sophisticated investors.

⁵⁴⁷ Phillips, above n 120, 73.

⁵⁴⁸ ING Australia, 'ING Australia Limited's Submission to the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System (The Cooper Review)' (February 2010) <http://www.supersystemreview.gov.au/content/submissions/downloads/ING_100305.pdf> 11.

Both the recommendations for greater surveillance of the investment strategy and that it be documented would require legislative amendment and neither was adopted by the Review. However, the Stronger Super reforms have included the insertion of 'review regularly' to s 52(2)(f), the trustee covenant requiring the formulation and implementation of an investment strategy.⁵⁴⁹

6.5.2 Peculiarities of SMSF investing

For most members, the larger component of their end benefits will be the investment return on contributions rather than the contributions themselves; in fact, asset allocation drives 90 per cent of the performance of a portfolio,⁵⁵⁰ making good investment returns critical to the provision of adequate retirement income.⁵⁵¹

The SISA s 52(2)(f) covenant (refer 6.5.1) effectively requires trustees to take a portfolio management approach to investment, that is, a business-like approach.⁵⁵² The salient features of 'modern portfolio theory' have been described as follows:⁵⁵³

First, the measure of a person's wealth is the value of her portfolio looked at as a whole. Second, the security of the investor's fund can be enhanced by diversifying it across a range of counter-reacting ('negatively correlated') investment vehicles. Third, decisions as to which investment vehicles ought to be included in a portfolio cannot be made in isolation; they may be made in light of the nature of the other elements of the portfolio. Thus investment vehicles which might be thought speculative when considered in isolation may not be speculative when considered in the context of a portfolio's overall holdings. Fourth, the return on a portfolio reflects both income and capital returned and to separate the two is an artificial exercise.

⁵⁴⁹ *Explanatory Memorandum to the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012*, 1.143.

⁵⁵⁰ Caroline Munro, 'Russell has eye on SMSF trustee and adviser education' (17 June 2010) *SuperReview* <http://www.superreview.com.au/articles/Russell-has-eye-on-SMSF-trustee-and-adviser-education_z519006.htm>

⁵⁵¹ John Dawkins, *Strengthening Super Security: New prudential arrangements for superannuation* (1992), 3.

⁵⁵² There is some inconsistency between this requirement and the standard of care covenant, SISA s 52(2)(b), which applies only the 'ordinary prudent person' standard.

⁵⁵³ Andrew Butler, 'Modern Portfolio Theory & Investment Powers of Trustees: The New Zealand Experience' (1995) 7 *Bond Law Review* 119, 119.

Whether SMSF trustees take such an approach is questionable. They often exhibit the incongruity of both high allocations to a risk-free asset (cash) and high allocations to risky assets (shares) compared with other types of funds.⁵⁵⁴ It appears that the flexibility afforded by loosely constructed investment strategies is a likely source of this SMSF characteristic.

Some commentators consider that this results in portfolios designed 'with random structures', and instead recommend a 'constant proportional' investment policy (whereby the proportions invested in various assets in the fund are maintained by frequent trading) or the adoption of managed investments.⁵⁵⁵

6.5.2.1 Conservatism

Commentators have drawn attention to the fact that SMSFs tend to have higher proportions of their assets in cash than other sectors of superannuation.⁵⁵⁶ However, what is known about SMSF asset allocation comes from ATO aggregate data. As the ATO measures the percentage of cash in total assets as at 30 June on the SMSF annual return, and as SMSF members tend to inject large amounts of cash at year's end before investing it over the following months, the data on cash proportion may be skewed.

SMSFs tend to favour well-known Australian blue chip shares (banking and mining in particular), invest directly rather than via managed schemes and steer away from international assets. This may be deliberate but is more likely the result of poor investment strategy construction. Such SMSFs have little recourse to risk management tools because trustees are either unaware of their existence or because the relevant legislation or trust deed does not permit SMSFs to utilise derivative securities such as futures and exchange traded options. The result is often an unhedged long position in a small number of shares in a small number of sectors.⁵⁵⁷

⁵⁵⁴ Phillips, above n 120, 74.

⁵⁵⁵ Ibid 74.

⁵⁵⁶ Commonwealth of Australia, above n 31, 5.

⁵⁵⁷ Phillips et al, above n 9, 46.

A further characteristic of SMSF shareholdings is the propensity to build a portfolio over a short period of time, concentrating in well-known Australian Blue Chip companies.⁵⁵⁸ Their portfolios tend to exhibit infrequent revisions with most portfolios remaining stationary for a number of years. This 'set and forget' tendency has probably served SMSF trustees well and is accorded a great deal of support by empirical studies, for example, Jensen (1968) found that no portfolio manager was able to consistently outperform (on a risk adjusted basis) an investment in T-bills and the market index during the period 1955 to 1964.⁵⁵⁹ More recent evidence has confirmed this finding.⁵⁶⁰ Because SMSF trustees are generally non-professional investors, it makes sense that they employ a buy-and-hold strategy for their investments, as well as avoiding the transactions costs and management expenses involved in an active trading strategy.

6.5.2.2 Exotic investments

As well as being accused of undue conservatism, the opposite criticism has been leveled at SMSFs – that their investments may be too exotic and risky. SMSFs, in contrast to public funds, can and do invest in artwork, rare coins, vintage cars, wine, jewellery and gemstones, gold ingots, vacant land and residential real estate. However, the percentage of SMSF assets invested in so-called exotic assets is small – around 0.1% of total assets.⁵⁶¹ The Super System Review recommended legislative change to restrict SMSF investment in collectibles⁵⁶² because such assets could be seen to be 'blurring the lines between investing purely for retirement versus making emotional decisions'.⁵⁶³ However, on representations from the SMSF sector, artists and gallery owners, the government announced it would not adopt the Review's recommendation.

⁵⁵⁸ P J Phillips, 'Self Managed Superannuation Funds: Theory and Practice' (June 2007) 6(1) *Journal of Law and Financial Management* 8, 15.

⁵⁵⁹ M C Jensen, 'The Performance of Mutual Funds in the Period 1955 to 1964' (1968) XXXVI(2) *Journal of Finance* 217.

⁵⁶⁰ Phillips, above n 558, 15.

⁵⁶¹ Australian Taxation Office, *Self-managed super fund statistical report - March 2012* <<http://www.ato.gov.au/superfunds/PrintFriendly.aspx?ms=superfunds&doc=/content/00319627.htm>>

⁵⁶² Defined in SISR reg 13.18AA as artwork (within the meaning of ITAA 1997), jewellery, antiques, artefacts, coins, medallions or bank notes, postage stamps or first day covers, rare folios, manuscripts or books, memorabilia, wine or spirits, motor vehicles, recreational boats and memberships of sporting or social clubs.

⁵⁶³ James McCullough, 'Art world outrage Super shake-up', *Herald Sun* (Melbourne), 6 July 2010, 28.

Instead, guidelines as to storage, insurance and valuation have been promulgated by the ATO.⁵⁶⁴

6.5.2.3 Borrowing

Though regulators remain uneasy with the 2007 amendment to SISA allowing SMSFs limited recourse borrowing via instalment warrant (see 2.4.6), the Super System Review merely recommended that the new borrowing provisions be reviewed in two years' time to ensure that borrowing has not become, and does not look like becoming, a significant focus of SMSFs.⁵⁶⁵ Latest statistics reveal only 0.2% of total SMSF assets are invested in 'derivatives and instalment warrants', slightly higher than the proportion invested in collectables.⁵⁶⁶

6.5.2.4 Weighting

The typical SMSF trust deed contains complete flexibility regarding the asset class weightings (the proportion of total assets in each class)⁵⁶⁷ and the SIS regime is silent on this issue. This does allow SMSF trustees a certain freedom in designing a portfolio that they feel is consistent with their expectations and risk aversion but may result in a lack of structure and diversification within the portfolio.⁵⁶⁸ This can be compounded if inexperienced trustees, far from taking advantage of the flexibility associated with

⁵⁶⁴ Australian Taxation Office, *Collectables and personal use assets - questions and answers* (2011) <<http://www.ato.gov.au/superfunds/content.aspx?menuid=49150&doc=/content/00301181.htm&page=6&H6>>

⁵⁶⁵ Commonwealth of Australia, above n 175, 29.

⁵⁶⁶ Australian Taxation Office, *Self-managed super fund statistical report - March 2012* <<http://www.ato.gov.au/superfunds/PrintFriendly.aspx?ms=superfunds&doc=/content/00319627.htm>>

⁵⁶⁷ The SMSF Annual Return contains categories for either domestic or overseas:

- listed and unlisted trusts
- insurance policy
- managed investments
- cash and term deposits
- debt securities
- loans
- listed and unlisted shares
- derivatives and instalment warrants
- residential and commercial real property
- collectibles
- other assets.

⁵⁶⁸ Phillips et al, above n 81, 351.

broadly defined weightings schedules to design portfolios well suited to personal and market conditions, design portfolios with random structures.

A related problem is under-diversification. Government has so far done little to require or encourage trustees to adopt diversified portfolios. The size of an SMSF may be influential. In *Cowan v Scargill*⁵⁶⁹ Megarry VC, speaking in general of public superannuation funds, observed that '[t]he large size of pension funds emphasizes the need for diversification'. From this, it can be concluded that a large SMSF should exhibit greater diversification in its assets than a small, and that it may be reasonable for a small fund to focus on one asset class. There is anecdotal evidence that some SMSFs invest 100% in commercial property from which their trustees conduct a business and there is in general no policy issue with this. However, the trustee covenant s 52(2)(f) requires the trustees' investment strategy (no matter how small the fund) to have regard to

the composition of the entity's investments as a whole including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification.

6.5.2.5 Rate of return restrictions

There is no legislative requirement for SMSFs to achieve any particular rate of return on their investments, nor even that return should be positive over a number of years, though such a requirement may be worth consideration from a public policy viewpoint. There is some legislative protection in the form of 'minimum benefit standards', which require the maintenance of set minimum benefits – essentially those arising from member and employer contributions – in respect of each member until the benefits are cashed, rolled over or transferred in accordance with the SISR.⁵⁷⁰ But these standards cannot guarantee positive investment returns and general trusts law does not require trustees to make real gains.

Recent data suggests SMSFs have been achieving *average* net investment returns that, while not being directly comparable to returns in other (APRA-regulated) sectors, appear

⁵⁶⁹ *Cowan v Scargill* [1985] Ch 270, 290.

⁵⁷⁰ SISR regs 5.04–5.08.

to be at least as good as (if not better) than the returns in those sectors.⁵⁷¹ Caution should be observed in drawing any conclusion from these statistics, given the wide diversity of SMSF trustee expertise and commitment. It is likely there are many SMSFs with set-and-forget investments, operated like a savings accounts, or otherwise imprudently invested, and these are balanced by highly successful SMSFs. And it is likely that the former are smaller in asset size and may not be cost-effective.⁵⁷²

Valentine⁵⁷³ suggests that all funds – or those below a certain asset value – should be required to invest in an approved portfolio with a beta of unity⁵⁷⁴ relative to some asset market relevant for Australian investors. This investment could be all or a proportion of their total assets. This would overcome the perceived problem of lack of diversification and/or expertise. However, the ATO is not in favour of mandating any particular investment structure or diversification, both because it has no recognizable expertise in financial regulation or prudent investment behaviour, and because of a possible expectation by the SMSF of compensation if it loses money as a result of investing in an ATO-approved portfolio.⁵⁷⁵

6.6 Member number limit

The limit on member numbers to four has been criticised as arbitrary and unnecessary as it disadvantages families with more than four members. Commentators have stated that clients of some accounting firms have been forced to establish two separate SMSFs to accommodate all family members, unduly adding to the cost burden and decreasing efficiency.⁵⁷⁶

⁵⁷¹ Jeremy Cooper, 'A conversation about SMSFs' (Paper presented at the SPAA Annual conference, Melbourne, 2010), 3.

⁵⁷² The Super System Review, using unpublished ATO data found a large number of members of SMSFs with assets less than \$200,000 potentially experience fixed costs well above what they might have experienced in APRA-regulated funds, though there were also a number of small-sized funds that appear to be very cost effective: Commonwealth of Australia, above n 175, 52.

⁵⁷³ Tom Valentine, 'Regulation of DIY Superannuation Funds' (2004) 37(2) *The Australian Economic Review* 215, 220.

⁵⁷⁴ Beta is used in finance as a measure of relative investment portfolio risk, the market itself having a beta of 1.0, or unity.

⁵⁷⁵ Interview B3.

⁵⁷⁶ Chris Kennedy, 'Accountants call for family extension on SMSFs' (19 August, 2010) *SuperReview*

A solution would be to allow more members into an SMSF, provided they were part of a nuclear family unit and met the definition of 'spouse' or 'children'. The term 'spouse' is legally applied to same sex and de facto couples, so no families would be penalised by the expanded definition. Rather than increasing the limit to another arbitrary number such as six or eight, the family member definition would ensure that no family was penalised for having too many children and blended families could be accommodated. Not permitting extended family members such as aunts and uncles would ensure the number would not become too large. The Super System Review, whilst considering this issue, declined to recommend a legislative expansion of the permissible number of SMSF members.

6.7 Does the legislation sufficiently empower the regulator?

Regulation is only as strong as its legislative mandate, however well endowed with resources and dedicated to legislative purpose a regulatory agency might be, or however compliant the regulatees.⁵⁷⁷ The ATO seems *prima facie* to have a very strong legislative mandate in the SIS regime. Yet commentators have queried whether legislatively endowed powers are always as effective in practice as they appear:

What look like strong powers in the legislation providing an ability for the regulator to take action, may not actually be so strong when you get to the crunch.⁵⁷⁸

Those drafting the legislation might not foresee particular problems, which might be attributable to the difficulty with all legislation of capturing the future, especially if those regulated can employ substantial legal and other talent to maximize avoidance.⁵⁷⁹

As outlined in Chapter 3, it is principally the SIS Regime that gives the ATO powers and responsibilities towards SMSFs, including to:

- issue complying (or non-complying) fund and contravention notices;⁵⁸⁰

⁵⁷⁷ R F Cranston, 'Regulation and deregulation: General issues' (1982) 5 *University of NSW Law Journal* 1, 11.

⁵⁷⁸ Keith Chapman, 'Supervision of Private Pensions - An Australian Perspective' in *OECD Regulating Private Pension Schemes: Trends and Challenges* (2002) 255.

⁵⁷⁹ Cranston, above n 577, 12.

⁵⁸⁰ SISA s 252B.

- disqualify trustees;
- disqualify auditors and actuaries;
- refer matters involving auditors and actuaries to their professional association;
- demand and assess SMSF annual returns;
- monitor and investigate SMSFs;
- accept and enforce undertakings by trustees; and
- grant exemptions from, and make modifications of, certain provisions of SISA and the regulations.

Trust law and corporations law (which applies if there is a corporate trustee) are not directly enforced by the ATO, which generally confines itself to administering the SIS regime. Taxation law provides the lever the ATO can apply to enhance SMSFs' compliance with the SIS regime.

One area in which the legislation currently impedes the ATO is in the inflexibility of available penalties for wrongdoing.

6.8 Penalties

SISA contains a range of penalties the ATO can apply to an SMSF or its trustees. Many offences are strict liability offences;⁵⁸¹ others require fault elements of intention, knowledge, recklessness or dishonesty. Penalties attaching to the offences may be civil or criminal.

6.8.1 Strict liability, civil and criminal liability

Strict liability offences throughout SISA are specifically denoted as such, with numbers of penalty units also specified. The offences may be committed by trustees, auditors or

⁵⁸¹ Defined in s 6.1 *Criminal Code Act 1995* (Cwth) as meaning there are no fault elements for any of the physical elements of the offence. The defence of mistake of fact is available for such offences.

others, and deal mainly with administrative matters such as the duty to keep records of changes of trustees.⁵⁸²

SISA s 193 sets out the civil penalty provisions relevant to SMSFs:

- breach of sole purpose test (s 62(1));
- loans to members or relatives (s 65(1));
- borrowing by the fund (s 67(1));
- market value of in-house assets exceeding 5% of fund's total assets (s 84(1));
- avoidance scheme to artificially reduce percentage of in-house assets (s 85(1));
- failure to notify ATO of an event having a significant adverse effect on fund's financial position (s 106(1)); and
- investments of fund not at arm's length or at terms and conditions no more favourable to the other party than if the investments were at arm's length (s 109(1)).

A person is not guilty of the offence unless so convicted by a court,⁵⁸³ and it is the court that must make any civil penalty order.⁵⁸⁴

Fault is the basis of the choice between the civil and criminal proceedings available to the ATO. A person is guilty of a criminal offence if he or she contravenes a civil penalty provision knowingly, intentionally or recklessly: (a) dishonestly and intending to gain an advantage for any person; or (b) intending to deceive or defraud someone. Such an offence is punishable by imprisonment for not longer than 5 years.⁵⁸⁵ An advantage of this approach is that it focuses on the particular behaviour of the person charged. A range of sanctions may also be seen to be more just in that it allows the criminal law to

⁵⁸² SISA s 104, failure to do so attracting a maximum of 50 penalty units.

⁵⁸³ SISA s 195.

⁵⁸⁴ SISA s 196.

⁵⁸⁵ SISA s 202.

be reserved for the worst examples of dishonest or reckless behavior and discretion lies with the ATO to treat such behaviour as criminal. The Director of Public Prosecutions may prosecute criminally for the more serious breaches.

Given the ATO's main concerns are that SMSFs may be used as vehicles to avoid tax through money laundering or otherwise illegitimately diverting ordinary income (see 5.4.8.5), and may be used to provide illegal early access to superannuation (see 5.4.8.1), it appears that the legislation gives the necessary flexibility to treat non-compliance according to the principles of the Compliance Model (see 4.4.3). However, it is expensive and time-consuming to prosecute a trustee via the court system, as opposed to imposing an administrative penalty where the non-compliance is less egregious.

6.8.2 SMSF: Non-complying

One punitive action that the ATO can take directly against an SMSF, without court order, is to declare it non-complying for tax purposes. As discussed in Chapter 1, the objective of Australia's superannuation system is to assist and encourage people to achieve a higher standard of living in retirement than would be possible from the Age Pension alone, to ensure Australians have security and dignity in their retirement.⁵⁸⁶ In view of this, the ATO does not automatically declare an SMSF non-complying,⁵⁸⁷ thereby removing its tax concessions, if there is a breach of the superannuation laws. The ATO has stated that its role in regulating SMSFs is focused on retirement income, not revenue protection,⁵⁸⁸ although as discussed in Chapter 5 there is a definite and possibly escalating tension between those roles.

Loss of complying status means the fund's total assets (less the sum of the part of the crystallised undeducted contributions that relates to the period after 30 June 1983 and the contributions segment for current members at that time so far as they have not been, and cannot be, deducted) are subject to tax at the highest marginal rate.⁵⁸⁹ In addition, any income in a year in which a fund is non-complying is taxed at the highest marginal

⁵⁸⁶ EM to the *Tax Laws Amendment (Simplified Superannuation) Bill 2006* (Cth), 186.

⁵⁸⁷ By issuing a non-compliance notice under SISA s 40(1).

⁵⁸⁸ ATO response to ANAO No 2, 99.

⁵⁸⁹ ITAA 1936 s 288A.

rate and the fund can no longer accept Superannuation Guarantee contributions. It is possible in some cases that the retirement assets those funds contained would have already been depleted, thereby making the impact minimal, but assets wrongly 'lent' to an associated entity (a common contravention) can also be recovered and taxed. As a debt to the fund, such a loan forms part of the fund's assets.

The ATO has discretion as to whether it renders an SMSF non-complying. ATO Practice Statement Law Administration 2006/19 outlines what criteria case officers should assess in deciding whether to exercise the discretion.⁵⁹⁰ If the ATO is considering issuing a notice of non-compliance, it generally sends a position paper explaining its reasons and provides the trustee with the opportunity to submit reasons why the fund should not be made non-complying. At this point, the fund can rectify the contravention, but may still be declared a non-complying fund. The ATO's decision to issue a notice of non-compliance is reviewable and the income tax assessment that follows can be objected against.

6.8.3 Locus of liability

Generally, penalties levied against trustees should not be payable from the corpus of the fund. However SISA s 56 provides that trustees can be indemnified from liability by fund assets unless:

- the trustee has acted dishonestly or intentionally;
- the trustee recklessly fails to exercise the required degree of care and diligence; or
- the liability is a monetary penalty under a civil penalty order.

Interestingly, s 56 is phrased in terms voiding any provision in the trust deed that purports to preclude or limit the indemnity right, rather than endowing a positive right of indemnity to the trustee.

⁵⁹⁰ However if the SMSF does not meet the definition of Australian superannuation fund ITAA 1997 s 295-95(2) the ATO must issue a notice of non-compliance and the tax liability automatically applies (see 295-320 ITAA 1997). *CBNP Superannuation Fund v Commissioner of Taxation* (2009) 76 ATR 726; [2009] AATA 709 confirmed the absence of discretion in this instance.

Where an SMSF becomes liable to a civil penalty for making a false and misleading statement to the ATO and is a body corporate, the directors of the body corporate at the time it becomes liable to the penalty are jointly and severally liable to pay the amount of the tax-related liability in respect of the penalty.⁵⁹¹

6.8.4 Trends in non-compliance

The proportion of SMSFs that had significant sanctions applied in 2009 was small (approximately 2% of all compliance activities, not including amended income tax assessments for SMSF or member). In imposing those sanctions, 99 were made non-complying, 17 funds were wound up and 29 trustees were disqualified. Additionally, ATO compliance activities applied sanctions to 15 scheme promoters and 1,055 participants, suppressed 500 SMSFs from 'Super Fund Lookup' because of suspected illegal early access activities and froze 17 bank accounts containing around \$1.5 million.⁵⁹²

The number of SMSFs being made non-complying has trended upward from 5 in 2007, 24 in 2008, 99 in 2009, 185 in 2010, 70 in 2011 and 74 in 2012.⁵⁹³ The Federal Government has stated that the 'increase in the number of compliance outcomes in recent years is primarily due to an increase in the number and intensity of compliance activities being undertaken by the ATO, rather than a deterioration in compliance behavior'.⁵⁹⁴

The latest annual survey of SMSFs by Partners Superannuation Services showed 7.2% breached the SIS regime requirements in 2009, compared with 11% the previous year. For the 2010-11 year the ATO Statistical Summary reported only 2% of SMSFs (8,792 of 442,076) received an ACR and just under 50% of those contraventions were reported rectified.⁵⁹⁵ Media commentary suggests increased ATO compliance activity coupled with

⁵⁹¹ *Taxation Administration Act 1953* (Cth) Schedule 1, s 284-95.

⁵⁹² Commonwealth of Australia, above n 31, 19.

⁵⁹³ Australian Taxation Office, above n 349.

⁵⁹⁴ Bryce Figot and Daniel Butler, 'ATO's step up in rendering SMSFs non-complying' (2010) (March) *Australian Superannuation Law Bulletin* 113, 113.

⁵⁹⁵ Australian Taxation Office, *Self-managed super fund statistical report - March 2012*

<<http://www.ato.gov.au/superfunds/PrintFriendly.aspx?ms=superfunds&doc=/content/00319627.htm>>

a high number of ATO assessments being upheld by the Administration Appeals Tribunal were the prime reasons for the lower number of compliance breaches.⁵⁹⁶

6.8.5 Crudeness of current penalty regime

One criticism of the sanctions available for the ATO to apply directly against the SMSF are that they are overly blunt, the 'nuclear option' in the ATO's regulatory armoury being the power to make an SMSF non-complying for taxation purposes.

The Super System Review recommended the introduction of legislation to provide the ATO with the power to issue administrative penalties against SMSF trustees on a sliding scale reflecting the seriousness of the breach, in addition to its existing punitive powers. The Review remarked that '[t]he absence of an option for the ATO to apply graduated penalties results in the vast majority of contravening trustees avoiding any sanction by simply rectifying their contravention if and when it is detected'.⁵⁹⁷

Such penalties would overcome the inflexibility inherent in the existing penalty regime and would be more cost-effective than recourse to the courts. In addition, they would align with the ATO Compliance Model (see 4.4.3 **Enforcement**), which mandates a response from the ATO to the 'taxpayer' that is graduated, and proportionate to the severity of the non-compliant behaviour. The administrative penalties would be applied jointly or severally against the trustees or trustee directors rather than payable from the corpus of the fund (see 6.8.3 **Locus of liability**).⁵⁹⁸

6.8.6 Inability of ATO to issue directions

Existing enforceable undertaking arrangements rely on SMSF trustees initiating the undertaking with the ATO.⁵⁹⁹ The ATO then has the option to accept or decline the undertaking offered. It does not have the ability to issue directions to an SMSF to rectify specified contraventions within a specified time period.

⁵⁹⁶ Karina Barrymore, 'Blitz stems super breaches', *Herald Sun* (Melbourne), 20 March 2010, 81, (quoting superannuation lawyer Bryce Figot, DBA Lawyers).

⁵⁹⁷ Commonwealth of Australia, above n 175, 10.

⁵⁹⁸ Ibid 227.

⁵⁹⁹ SISA s 262A - *Acceptance and enforcement of undertakings*.

One documented AAT case illustrates the difficulty this poses for both the ATO and the SMSF.⁶⁰⁰ Following an ACR and ATO advice to an SMSF trustee that the reported contraventions needed to be rectified, a number of proposed undertakings from the trustee were rejected by the ATO over a 17 month period, with the result that the fund was ultimately declared non-complying. The trustee appealed to the AAT for directions that the ATO accept the latest enforceable undertaking, however the AAT declined to issue those directions to the ATO. Had the ATO been vested with the power to issue directions itself in the first instance, significant time and expenditure might have been saved.

The ASFA submission to the Super System Review suggested it would be useful for the ATO to have some 'directive' powers so that it has some immediate measures that it can employ to promote and encourage compliance. It opined that '[g]iving the Commissioner the power to direct SMSF trustees would streamline the ATO's ability to rectify breaches'.⁶⁰¹

The Super System Review eventually recommended the same thing, in addition that any breach of a direction should be a strict liability offence. The Government accepted this recommendation and undertook to consult with relevant stakeholders on its implementation.⁶⁰²

6.8.7 Lack of mechanism to prosecute promoters

Existing laws enabling the ATO to target and address illegal tax scheme promoters do not apply to the SIS Act. The penalties within SISA are directed towards SMSFs and their trustees. Currently, illegal scheme promoters are principally dealt with by ASIC,

⁶⁰⁰ Reported in John Wasiliev, 'Rule breakers should own up quickly', *Australian Financial Review* 9 February, 2011, 33.

⁶⁰¹ The Association of Superannuation Funds of Australia Limited, 'ASFA Submission - Super System Review – Phase Three: Structure (incl. SMSFs)' <http://www.supersystemreview.gov.au/content/submissions/downloads/ASFA_100219.pdf> 11.

⁶⁰² Commonwealth of Australia, *Stronger Super - Government response to the Super System Review* (2011) <http://strongersuper.treasury.gov.au/content/publications/government_response/downloads/Stronger_Super.pdf> 46.

which relies on its powers to take action against them, often on the grounds that they are providing unlicensed financial advice, as in the Kassongo case.⁶⁰³

For this reason, the Super System Review recommended that civil sanctions be included within SISA to enable the ATO to penalise and discourage illegal early release scheme promoters.⁶⁰⁴ The Government accepted this recommendation and undertook to consult with relevant stakeholders on its implementation.⁶⁰⁵

6.9 Separate SIS Scheme for SMSFs

The objective of the SIS Scheme is the prudential regulation of superannuation entities, the impetus for this intervention stemming from the compulsory nature of the Superannuation Guarantee Scheme. At the time the package of Bills constituting the scheme was introduced, former Treasurer John Dawkins, outlining the policy of the Government, stated that:⁶⁰⁶

An appropriate supervisory framework is a central component of superannuation policy. Notwithstanding the sound record of superannuation funds in this country, the growth of superannuation has necessitated a full review of the supervisory arrangements. The government has undertaken to establish a comprehensive and effective *prudential framework* to give added *protection* to superannuation savings and to promote a more efficient superannuation industry ...

That SMSFs are not prudentially regulated indicates that the SIS Scheme, as enacted, was not appropriate for them and subsequent amendments have done little to adapt it to the sector other than to exclude applicability of the provisions administered by APRA and ASIC. Expecting trustees to comply with legislation that is disorderly, confusing and largely inapplicable is a recipe for non-compliance. The ATO survey finding that only

⁶⁰³ See Australian Securities and Investment Commission, *08-181 Trustee of self managed super fund appears in court on ASIC charge* (2008) <<http://www.fido.gov.au/fido/fido.nsf/byHeadline/08-181>> . ASIC brought the action on the grounds that Mr Kassongo was involved in the operation of an unlicensed financial services business.

⁶⁰⁴ Commonwealth of Australia, above n 175, 44.

⁶⁰⁵ Commonwealth of Australia, *Stronger Super - Government response to the Super System Review* (2011) <http://strongersuper.treasury.gov.au/content/publications/government_response/downloads/Stronger_Super.pdf> , 52.

⁶⁰⁶ Department of Treasury Commonwealth of Australia, *'Strengthening Super Security'*, Statement by the Honourable John Dawkins MP, Treasurer of the Commonwealth of Australia' (1992), 1 (emphasis supplied).

30% of SMSF trustees⁶⁰⁷ were able to explain the 'sole purpose test'⁶⁰⁸ is illustrative and perhaps more telling in relation to the appropriateness of the legislative regime than to trustee knowledge and understanding. Certainly the phrase 'sole purpose' is vague terminology embedded in a voluminous piece of legislation, much of which is inapplicable to SMSFs.

The ATO is likewise uneasy with the level of supervisory responsibility the SIS scheme imposes on it, for example, that it should disqualify an individual who is not a fit and proper person to be a trustee or auditor.⁶⁰⁹ Anecdotally, the ATO considers that some SMSF trustees are indeed not competent; they do not understand what a trust or a trust deed is, have insufficient understanding of the duties of a trustee and may lose mental competence over time.⁶¹⁰ The ATO also has concerns about auditor independence and that 'some auditors are not identifying and reporting serious contraventions by funds they audit as would be expected of a professional auditor'.⁶¹¹

However, the ATO does not have the resources to scrutinise the trustees and auditors of over 468,000 SMSFs and the SISA provisions concerning disqualification imply the ATO has not only the power but the responsibility for such disqualification. This responsibility is inappropriate to the one-to-many nature of SMSF regulation.

A 'Self Managed Superannuation Fund Regulation Act' may well be the solution. SMSF numbers continue to grow at a rate of about 2,500 a month and a compelling case can accordingly be made for this rapidly burgeoning sector to merit its own regulatory Act, or else a separate division in SISA, preferably written in plain English and adapted more closely to the environment of SMSFs.

⁶⁰⁷ Australian Taxation Office, 'The SMSF Regulatory Environment - Speech by Ian Read, Assistant Deputy Commissioner for Institute of Chartered Accountants in Australia (ICAA) inaugural SMSF Conference Friday 22 February 2008' <<http://www.ato.gov.au/print.asp?doc=/content/00125226.htm>> at 8.

⁶⁰⁸ SISA s 62 ('Each trustee of a regulated superannuation fund must ensure that the fund is maintained solely to provide retirement or death benefits').

⁶⁰⁹ SISA s 126A for individual trustees, SISA s 131 for auditors.

⁶¹⁰ Interview B4.

⁶¹¹ Australian Taxation Office, *ATO's regulation of SMSFs including the compliance program, specific risks and other areas of focus - Keynote address by Stuart Forsyth Assistant Commissioner, Superannuation, ICAA National SMSF Conference, Melbourne (2011)* <<http://www.ato.gov.au/corporate/PrintFriendly.aspx?ms=corporate&doc=/content/00294345.htm>>

The 2012 Stronger Super reforms have begun the process by signalling the relocation of the existing SISA s 52 covenants applying to SMSFs to a separate section 'to aid the readability of the SIS Act, in particular for SMSF trustees'.⁶¹²

The possibility that trustees who lose capacity, become bankrupt (see 5.4.5.5) or otherwise disqualified, or become non-resident may wish to transfer the SMSF assets to a Small APRA Fund (in preference to a large fund because the SMSF may be holding business premises or other illiquid assets) would mean a change both in regulator and in applicable legislation if a separate SMSF Act were introduced. This is currently difficult:

... it's currently too hard to set up a SAF, to translate from a SMSF to a SAF. I expect however that the industry will step in and make it easier. There's a limited range of people that have bothered to run a business around SAFs; most accountants wouldn't know what a SAF was, I don't think. Their business model is pushing people into SMSFs, but I don't think they understand what's involved in a SAF, which is not all that much more complicated; it just requires you to get one of the licensed trustees (Interview B6).

Jeremy Cooper favours SAFs as an alternative to SMSFs where trustees lose competence or motivation to continue in that role, but explains their reluctance to make the transition:

In my view, SAFs should be a lot more popular than they are because they offer quite a few advantages to people, but ... there's a bit of a dead end. I think it offers quite a middle-ground solution for a lot of these issues, but there's a fairly strong cultural resistance across the market, that 'don't go into a SAF, they're bad news'...the big difference in all of those cases you always have the third party custodian. And that's the bit that makes those systems work pretty well because if you've come up with some crazy sort of idea like, 'I want to invest half of my savings in these great paintings that I've found' they'll just say 'no'...they would say 'have you got the thing insured?'...and what's your strategy for being able to sell this at the appropriate time?' and all those sort of things. I guess the reason that people are in the SMSF in the first place is they don't want that sort of scrutiny: Interview B8.

⁶¹² *Explanatory Memorandum to the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012*, 1.142.

6.10 Should the statutory regime governing SMSFs include a model trust deed?

There are well documented deficiencies in trust deeds currently in use by SMSFs that threaten their compliance with their legal obligations. These stem from a failure by SMSF trustees, their advisers and auditors⁶¹³ to regularly review trust deeds to ensure that they reflect the current law and constitution of the fund:

- There are a number of provisions in a trust deed relevant to whether individuals or a company are trustee of the fund. If the trustee changes, as it often does, the trust deed must be amended (as well as the asset holdings), yet there is no mechanism to ensure this occurs.
- Updates are often needed to reflect the frequent changes in superannuation legislation, for example *de facto* and same-sex superannuation legislation in 2008, the abolition of reasonable benefit limits in 2007 and the ability for SMSFs to benefit from limited recourse loans in 2007 meant that most SMSF trust deeds needed review.

There is no government-sanctioned SMSF model trust deed for establishing an SMSF and no publicly available information or guidance on what updates to SMSF trust deeds may be required. A standard trust deed could be included in the SMSF legislation, similar to model rules for incorporated associations in most jurisdictions in the associations incorporation legislation or regulations. A model SMSF trust deed could be appended as a schedule to the Act, noting that all terms in the Act are deemed to be incorporated in the deed. The challenge here, however, is that maintaining the currency of the schedule would require legislative amendment, presumably initiated by the regulator. Alternatively, a model trust deed could be attached to the regulations (which are more readily amended) and updated annually in consultation with the ATO.

A further possibility for a model deed is that, once developed (and noting that all terms in the Act are deemed incorporated), it would be made available by the ATO on its website.

⁶¹³ Whose responsibilities do not extend to examination of the deed.

A precedent for such a model exists. From February 2010 the ATO has provided on its website a Private Ancillary Fund model trust deed for consideration for use by applicants for endorsement as a deductible gift recipient in the category of private ancillary fund. Such a model SMSF deed would need regular updating, listing legislative impacts for those using earlier versions.

An alternative suggestion to avert non-complying deeds is a requirement to register the SMSF deed with the ATO (or another party) along the lines of Benefit Fund Rules with APRA or Product Disclosure Statements with ASIC (see 6.4.1.2). However, as ING Australia's submission to the Super System Review pointed out, the previous practice of registering fund trust deeds with the ATO was abandoned due to the resources required and in light of the role of the ATO being not to act as pseudo legal adviser for the superannuation fund. There are also liability issues relating to the checking of deeds, as a level of liability must rest with the ATO if the vetting of the deed proves to be inaccurate or subsequently modified by the courts.⁶¹⁴

The adoption of a model trust deed can, moreover, be expected to be unpopular with the legal profession and others with commercial interests in the development and updating of SMSF trust deeds. Some existing deeds can be up to 60-80 pages, whereas a model deed could be as short as 2-3 pages.⁶¹⁵

The government's 'Stronger Super' response to the Super System Review rejected the recommendation to deem anything permitted by SISA to be included in an SMSF trust deed (see 6.2). Many non-complying deeds will therefore remain in use. In any event, the adequacy and currency of SMSF trust deeds is currently not scrutinised at all, either by the ATO, or the approved auditor.

⁶¹⁴ ING Australia, 'ING Australia Limited's Submission to the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System (The Cooper Review)' (February 2010) <http://www.supersystemreview.gov.au/content/submissions/downloads/ING_100305.pdf> 14.

⁶¹⁵ ATO Assistant Commissioner, Interview B4.

6.11 Investment rules as black letter law

As discussed at 5.3.5 **Portfolio regulation**, legislatively mandated investment rules or asset allocation rules would be hazardous for the ATO in terms of implied guarantee of safety, as well as difficult to supervise. The current investment rules in the form of prohibitions are considered by most commentators to be sufficient, and flexibility in investment strategies is beneficial and commensurate with trustees taking responsibility and control, the hallmarks of SMSFs.

6.12 Conclusion

The ATO's 'responsive regulation' approach, epitomised in its Compliance Model, is based on findings that an increase in the severity of punishment may not have the same effect on compliance as a rise in the probability of detection. Responsive regulation is based on a fine balance between the regulatee's perception of the probability of detection and the likely severity of penalty.

Although taxpayers are highly responsive to the perceived or actual risk of detection, imposing rare but severe sanctions may also lead to an increase in the severity of wrongdoing as offenders realise that sanctions will be extreme regardless of the actual offence committed and will attempt to maximise their gain from that wrongdoing.⁶¹⁶

Applying this to the regulation of SMSFs, the extreme sanction of a non-complying notice may not be as effective as a graduated range of penalties and the identified weaknesses in the auditing function (especially in auditor independence) lessen the probability of breaches being detected. Thus, legislative change introducing a range of less extreme penalties that can be applied by the ATO and a legislative mandate of auditor independence can be expected to improve SMSF compliance.

There should at a minimum be a simpler set of regulations for SMSFs, and whatever SMSF legislative regime is developed should incorporate the following:

⁶¹⁶ Sagit Leviner, 'An overview: A new era of tax enforcement - from "big stick" to responsive regulation' (2008) 2 *Regulation & Governance* 360, 364.

- flexibility introduced to allow the maximum number of members to be extended to accommodate larger nuclear families.
- an SMSF's investment strategy should be in writing.
- a standard trust deed should be attached to the Regulations, as a schedule to the Act, or, optimally, developed and updated by the ATO and made available on its website.
- a flexible regime of administrative penalties for administration by the ATO as an alternative to prosecution or declaring the SMSF non-complying.
- empowering the ATO to issue directions to trustees to rectify specified contraventions within a specified time period.
- empowering the ATO to prosecute scheme promoters using SMSFs to provide illegal early release of superannuation to benefit themselves and fund members.

The government's Stronger Super announcements indicate some measures are to be taken to implement these enhancements to the ATO's supervisory regulation:

New penalties will be introduced to prevent illegal early release. Criminal and civil sanctions will be introduced for illegal early release scheme promoters and amounts illegally released early will be taxed at the superannuation non-complying tax rate, with an additional penalty that takes into account the individual circumstances...

The ATO will be provided with new regulatory powers to prevent and penalise breaches of the superannuation legislation. A sliding scale of administrative penalties will be introduced for less serious cases of non-compliance and will be payable by the trustee, not from the assets of the SMSF.

The ATO will also be given the power to issue trustees with a direction to rectify contraventions within a specified timeframe and to enforce mandatory education for trustees where there is non-compliance with the superannuation legislation.⁶¹⁷

However, to date no further information has been made available by Treasury on what form these measures are to take.

In the next chapter, a comparison is made between the regulation of SMSFs in the Australian context (including the statutory regime) and regulation of self-managed retirement savings in some other western jurisdictions. A number of the more admirable features of those regulatory regimes would require change to the current legislative regime should they be adopted in this country.

⁶¹⁷ Commonwealth of Australia, *Stronger Super - Government response to the Super System Review* (2011) <http://strongersuper.treasury.gov.au/content/publications/government_response/downloads/Stronger_Super.pdf> 11.

CHAPTER 7

INTERNATIONAL COMPARISON OF SELF-MANAGED SUPERANNUATION REGULATION

7.1 Introduction

Having examined SMSFs at length in the forgoing chapters, it is important to further note that they remain a uniquely Australian retirement vehicle. There are however several jurisdictions where a degree of self-management of retirement savings is permitted. None of these applies the term 'superannuation'; rather, they are generally termed a variant of the OECD definition 'Voluntary Personal pension plans'.⁶¹⁸ Detailed discussion of the regulation of such superannuation savings vehicles in the United Kingdom (with brief mention of Ireland), Canada and the United States forms the basis of this chapter. The superannuation savings vehicles are referred to as 'pension schemes' in the UK and Ireland, and 'retirement plans' in the US and Canada.

For each relevant self-managed voluntary personal pension plan, this chapter summarises the following features:

1. allowable investments
2. asset title and custody arrangements
3. taxation treatment of
 - 3.1. contributions
 - 3.2. plan/fund earnings
 - 3.3. benefits
4. allowable withdrawals and borrowings.

⁶¹⁸ Access to these plans does not have to be linked to an employment relationship. The plans are established and administered directly by a pension fund or a financial institution acting as pension provider without any intervention of employers. Individuals independently purchase and select material aspects of the arrangements. The employer may nonetheless make contributions to personal pension plans. Some personal plans may have restricted membership: Organisation for Economic Co-operation and Development, 'Private Pensions, OECD Classification and Glossary' (2005) <<http://www.oecd.org/dataoecd/0/49/38356329.pdf>> at 49.

Challenges for overseas regulators – as expressed by their representatives in the course of interviews undertaken for the purposes of this thesis – are identified, as well as major and minor differences with Australia’s SMSF regulation. The conclusion enumerates features of regulation of self-managed superannuation in other jurisdictions that may be considered worthy of adoption in this country.

Research material for this chapter was derived from interviews conducted in July 2011 with officials at the following agencies:

- Australian Taxation Office (Sydney)
- Financial Services Authority (London, UK)
- Her Majesty’s Revenue & Customs (London, UK)
- The Pensions Advisory Service (London, UK)
- Canada Revenue Agency (Ottawa, Canada)
- Office of Supervisory of Financial Institutions (Ottawa, Canada)
- Financial Services Commission of Ontario (Toronto, Canada)
- Internal Revenue Service (Washington DC, USA)
- Department of Labor (Washington DC, USA)
- Government Accountability Office (Washington DC, USA).

7.1.1 Pillars of the retirement income system

All countries under comparison make use of a three pillar retirement income system, albeit with various minor differences among them.

7.1.1.1 Australia

The three pillars in the Australian system are the following:

1. The Commonwealth Age Pension, which commenced in 1909, is set at a relatively frugal level,⁶¹⁹ and provides a safety net rather than a comfortable lifestyle. This is subject to means and assets tests.
2. Private provision is made for retirement through the compulsory 9% Superannuation Guarantee (progressively increasing to 12% from 2013 to 2019). Over time, the government Age Pension is projected to recede in importance as a source of retirement income, as this system of compulsory retirement saving matures.⁶²⁰
3. There is encouragement for voluntary contributions to superannuation by the offer of tax concessions and co-contributions to those who choose to save more for their retirement. SMSFs are a variant of voluntary private superannuation savings.⁶²¹

Growth assets (shares and property) make up over half of the total superannuation assets of Australians. This is more than double the average for industrialised countries.⁶²²

7.1.1.2 United Kingdom

The three pillars of the United Kingdom retirement income system are as follows:⁶²³

1. State pensions – Basic State Pension and State Second Pension (some 35% of employees are ‘contracted-out’ of the state second pension into an occupational pension scheme (provided by an employer), and/or a personal pension or a stakeholder plan (both provided by financial services companies).
2. Occupational Pensions, mainly defined benefit schemes.⁶²⁴

⁶¹⁹ Maximum payment rates are \$712.00 per fortnight for a single person and \$536.70 for each member of a couple. These amounts are indexed twice a year: Department of Human Services, *Payment rates for Age Pension* (2013) <<http://www.humanservices.gov.au/customer/enablers/centrelink/age-pension/payment-rates-for-age-pension>>

⁶²⁰ Alan J Auerbach, 'The Taxation of Savings and Superannuation' in Chris Evans, Richard Krever and Peter Mellor (eds), *Australia's Future Tax System: The Prospects After Henry* (2010) 93, 94.

⁶²¹ Australian Treasury, 'A Plan to Simplify and Streamline Superannuation - Detailed Outline' (May 2006) at 1.

⁶²² See in general George Rothman and Cliff Bingham, 'Retirement Income Adequacy Revisited' (Paper presented at the Twelfth Colloquium of Superannuation Researchers, University of New South Wales, 2004).

⁶²³ Organisation for Economic Co-operation and Development, *Pensions at a Glance: Retirement-Income Systems in OECD Countries - UNITED KINGDOM* (2011) <<http://www.oecd.org/dataoecd/34/15/47273227.pdf>>

3. Individual or personal pensions – Stakeholder Pensions, Group Personal Pensions and Personal or Individual Pensions (including Self-Invested Personal Pensions).

7.1.1.3 Canada

The three pillars of Canada's retirement income system are as follows:

1. Old Age Security and Guaranteed Income Supplement provide a basic minimum income guarantee for seniors.
2. The Canadian Pension Plan and Quebec Pension Plan are public defined benefit plans with employer involvement that provide a basic level of earnings replacement. The employee contribution is matched by the employer; the self-employed contribute both components.⁶²⁵
3. Private pension plans provide tax-assisted savings opportunities to encourage Canadians to save for retirement.⁶²⁶

7.1.1.4 United States

The three pillars of the US retirement income system are as follows:⁶²⁷

1. Government-mandated Social Security savings.

⁶²⁴ Beginning October 2012, compulsory automatic enrolment in defined contribution schemes is to be phased in, so that employers must enrol their 'jobholder' employees with pension schemes. The legislation at this stage is still in draft form and in the consultation phase: Mark Latimour, 'Let's get personal: UK pensions reform in 2012' (2011) 23(2) *Australian Superannuation Law Bulletin* 15.

⁶²⁵ 'These are voluntary arrangements, the employer *chose* to set up this plan (unlike Australia) - whether defined benefit or defined contribution - and it is something that they chose to do, it's not the case that we forced everyone to have a pension plan; they aren't mandatory. They could have *no* pension plan': Interview C10. There are \$2.1 trillion in retirement savings in Canada, with a population of 34,278,400 (Statistics Canada 5/10/11) and optional employer contributions, equating to \$61,263 per capita versus Australia with \$1.23 trillion (APRA Superannuation Bulletin June 2010, issued 19 January 2011) in retirement savings for a population of 22,723,848 (ABS Population Clock 5/10/11), equating to \$54,128 per capita and mandatory employer contributions. It is interesting that Canada's per capita retirement savings outpace Australia's, despite the optional nature of the second pillar, however speculation on the possible reasons for this is beyond the scope of this thesis.

⁶²⁶ Bob Baldwin, 'Research Study on the Canadian Retirement Income System: Final Report (Prepared for the Ministry of Finance, Government of Ontario)' (November 2009) <<http://www.fin.gov.on.ca/en/consultations/pension/dec09report.pdf>>

⁶²⁷ Neil Sandhu and Paul T Schultz, 'The US Pension System and The Role of the IRS' 44(June 2003) *International Pension Lawyer* 33, 33.

2. Government-encouraged voluntary pension savings.
3. Private savings outside of tax-favoured vehicles.

7.1.2 Self-managed voluntary personal pension plans

For the purposes of international comparison, Australia's SMSFs and their regulation are compared with Third Pillar self-managed voluntary personal pension plans permitted in the United Kingdom, Canada and the United States, which may be described as follows.

7.1.2.1 United Kingdom

In the United Kingdom, Self-Invested Personal Pensions (SIPPs)⁶²⁸ were introduced in 1989 and are considered suitable for large funds and for people who are experienced with investing. They allow the individual the freedom to choose and manage their own investments, but afford the option for individuals to engage an authorised investment manager to make those decisions for them. SIPPs are regulated by the Financial Services Authority (FSA), which has overall responsibility for non-employee sponsored individual personal pensions.⁶²⁹ The FSA is responsible for setting the advising and selling guidelines for firms that sell and administer SIPPs.⁶³⁰ It shares many features with Australia's ASIC.

Her Majesty's Revenue & Customs⁶³¹ is responsible for determining qualified investments and taxation of pensions in general. It is also responsible for approving providers of SIPPs, which are thenceforth regulated by the FSA. The SIPP provider is usually an insurance company.⁶³² The Pensions Ombudsman⁶³³ is empowered to investigate complaints about the management of personal pensions.

⁶²⁸ Defined in Reg 3 of *The Personal Pension Schemes (Restriction on Discretion to Approve)(Permitted Investments) Regulations 2001* (UK).

⁶²⁹ The Pensions Regulator regulates employer-sponsored pension funds, occupying a similar role to that of APRA, save that APRA also regulates superannuation funds that are not linked to the workplace.

⁶³⁰ Via its Conduct of Business Sourcebook: www.fsahandbook.info/FSA/html/handbook/COBS

⁶³¹ Formed by the merger of the Inland Revenue and Her Majesty's Customs and Excise which took effect on 18 April 2005: <http://www.hmrc.gov.uk/menus/aboutmenu.htm>

⁶³² The Association of Member-Directed Pension Schemes is the SIPP provider industry body; all its 200+ members are listed on its website.

In the past, SIPPs tended to have high fee structures; now online SIPPs, with far lower charges, first offered in 2000, are more suitable for a wider range of people. It is believed that there are several hundred thousand SIPPs in existence currently, enjoying a period of rapid growth in popularity.⁶³⁴

In Ireland, a Self-directed Personal Pension (SDPP) is very similar to the SIPP; however, the allowable investments are more constrained and the tax relief on contributions is age-specific. It offers tax-free growth, and income tax deduction at an individual's marginal rate for personal contributions from 15% of net relevant earnings (aged under 30) graduated up to 40% (aged over 60). Tax relief is limited to €150,000 per annum (at 2010). As in the UK, 25% of any lump sum benefit is tax-free. An 'investment partner', which gives investment advice and facilitates the purchase and sale of assets, is interposed between the investor and provider of the SDPP (usually an insurance company). The investor or the pension scheme trustees will own the pension policy provided by the insurance company, which owns the underlying assets.

7.1.2.2 Canada

In Canada, Registered Retirement Savings Plans (RRSPs) were first legislated in 1957, and were enhanced in the 1970s.⁶³⁵ They allow either one or two associated individuals⁶³⁶ to build and manage their own investment portfolio. The RRSP issuer may be a bank, credit union, trust or insurance company.⁶³⁷ Not all such issuers offer self-

⁶³³ The Pensions Ombudsman was established with effect from April 1991 by Act of Parliament. Its statutory powers are contained in the *Pension Schemes Act 1993* and regulations. Its role is to investigate and decide pension complaints between members and their pension schemes (including personal pensions). It is not a regulator but an adjudicator and its decisions are published on its website.

⁶³⁴ For example Paula Hawkins, 'The latest trend in DIY is... pensions', *The Sunday Times* April 28, 2007; Standard Life, an insurance company, reported that its SIPP business experienced 38% growth over the half year to July 2011: Investoo, 'Standard Life SIPPs to Success' (August 11, 2011) <<http://www.investoo.co.uk/standard-life-sipps-to-success/>>

⁶³⁵ Tony Wohlfarth, 'Deconstructing the Great Canadian Pension Debate' (Paper presented at 19th Annual Colloquium of Superannuation Researchers, The University of New South Wales, Centre for Pensions & Superannuation Research, Australian School of Business, 2011), 10.

⁶³⁶ It is possible for employers to establish 'group RRSPs', which are essentially a collection of individual RRSPs for the employees or members of the applicable organisation.

⁶³⁷ If the issuer is a depository the form of the plan will be a statement of its terms and conditions, if a trust company, a declaration of trust and if an insurance company, the form of the plan will be an endorsed policy.

directed RRSPs. An RRSP can be converted to a Registered Retirement Income Fund (RRIF)⁶³⁸ upon the account holder's retirement.

Another type of plan, the Tax Free Savings Account (TFSA), introduced on 1 January 2009, allows individual Canadians to manage their own investment portfolios. These accounts differ from the RRSP in their taxation treatment (see 7.4).

The Canada Revenue Agency (CRA) registers plans that meet its requirements and also determines which investments are eligible for investment by RRSPs and TFSAs. The CRA is responsible for plan compliance and, to that end, employs risk criteria established at each stage of the process: registration, review and compliance.⁶³⁹

The Office of Supervisor of Financial Institutions (OSFI) prudentially regulates the banks and other financial institutions that offer RRSPs and TFSAs,⁶⁴⁰ although they do not regulate their sale of RRSPs from a consumer protection aspect, for instance, that there is appropriate disclosure provided. That function is performed by the securities commission of each province (for example, the Ontario Securities Commission) because the provinces are responsible for contract law. The Canadian provincial governments regulate many employer-sponsored pension plans (depending upon what industry the employer is in; some industries are federally-regulated). This becomes relevant when amounts are rolled over from those plans into an RRSP.

The Canadian regulatory landscape is complex due to the balance between federal and provincial responsibilities under the Canadian Constitution. The longstanding desire within financial markets for streamlining or harmonising regulation remains hindered by constitutional impediments.⁶⁴¹ There are ten different pension regulators in Canada in addition to the CRA and Finance Canada, all represented on a collective body, the Canadian Association of Pension Supervisory Authorities, which facilitates the interaction between regulators. The remark of a Canadian Interview that '[i]t would make life simpler

⁶³⁸ An RRIF is an income stream established by transferring monies directly from an RRSP. All RRSPs must be converted to RRIFs (or an annuity purchased) by the end of the year in which the participant turns 71. A minimum amount (which is taxable) must be withdrawn from the RRIF each year, beginning the year after it is established. An RRIF allows for tax-deferred growth, but contributions are not permitted.

⁶³⁹ Interview C4.

⁶⁴⁰ In the same manner as APRA in Australia, using a risk-based, rather than a compliance-based regime: Interview C7.

⁶⁴¹ Interview C7.

in Canada if there was constitutional power for federal regulation of pensions' (Interview C9) is therefore hardly surprising.

Another complicating and costly factor is the legal requirement for both French and English language in all documentation associated with retirement savings accounts.⁶⁴²

7.1.2.3 United States of America

The United States recognises two retirement vehicles designed for self-management: Individual Retirement Accounts (IRAs) and 401(k) plans.⁶⁴³

IRAs were introduced upon the enactment of the *Employee Retirement Income Security Act 1974* (ERISA)⁶⁴⁴ and are constituted as trusts.⁶⁴⁵ The 401(k), established by the *Revenue Act* of 1978, is a type of retirement savings account, a 'qualified plan' controlled by ERISA, which takes its name from s 401(k) of the *Internal Revenue Code* (Title 26 of the United States Code). Generally a 401(k) plan is established by an employer or sole proprietor, and an IRA by an individual, making both available to a self-employed individual without an employer-sponsored pension plan. Similar percentages of households own IRAs and participate in 401(k) plans, and IRA ownership is associated with higher educational and income levels.⁶⁴⁶

The Internal Revenue Service (IRS), a division of the US Treasury, and the Department of Labor (DOL) jointly regulate IRAs and 401(k) plans. The DOL regulates and supervises the occupational pension system. The IRS determines the tax-qualified status of plans. It has jurisdiction over eligibility, vesting and funding requirements under ERISA. The IRS administers the *Internal Revenue Code* (IRC), which is enforced

⁶⁴² Interview C7: 'There's always a problem with Quebec because Quebec has a lot of concerns about losing nationality and jurisdiction, so that's always a sensitive relationship and then depending on the government [which party is in power], both federally and provincially, and the issue, they might be quite pragmatic about it or they might be very territorial.'

⁶⁴³ Lawrence H. Thompson, 'US Retirement Income System' (Spring 2006) 22(1) *Oxford review of Economic Policy* 95

⁶⁴⁴ Portions of ERISA are codified in various places of the United States Code, particularly the Internal Revenue Code.

⁶⁴⁵ ERISA substantially increased federal jurisdiction over the operation of pension plans and pre-empted most state law in the area: Neil Sandhu and Paul T Schultz, 'The US Pension System and The Role of the IRS' 44(June 2003) *International Pension Lawyer* 33, 34.

⁶⁴⁶ United States Government Accountability Office, *Individual Retirement Accounts: Government Actions Could Encourage More Employers to Offer IRAs to Employees* (2008) <<http://www.gao.gov/products/GAO-08-590>>

through the tax system; the DOL administers US labour laws, which are enforced primarily through private actions brought in federal courts.

The main differences between IRAs and 401(k) plans are the annual contribution limits and allowable loans to the account holder, 401(k) plans being the more flexible (allowing loans for any purpose). Both IRAs and 401(k) plans have what is known as a 'Roth' version,⁶⁴⁷ which differs from the 'traditional' version in its tax treatments and preservation rules (described in more detail below).

In an effort to increase retirement savings in the US, which is very low, the US Treasury and IRS has legislated progressively to allow automatic enrolment in 401(k) plans by workers, so that participation has increased from 2/3rds to 9/10ths of eligible employees. In contrast, for workers lacking access to a retirement plan at their workplace, the IRA participation rate is less than one-tenth. Among the US Treasury's 2012 Financial Year Revenue Proposals is the introduction of the same automatic enrolment in IRAs,⁶⁴⁸ as well as doubling the tax credit for small employer 401(k) plan start-up costs, to become effective from the beginning of 2013.⁶⁴⁹

In the following sections, 7.2 to 7.6, particular features of the self-managed voluntary personal pension plans in the UK, US and Canada are described, with some analysis of their differences.

7.2 Allowable investments

7.2.1 Asset categories

In contrast to Australia's remarkable freedom of investment by SMSFs, where the only restriction on allowable assets is that in-house assets are restricted to a maximum of 5%

⁶⁴⁷ Named for their chief legislative sponsor, the late Senator William Roth of Delaware; IRC §402A deals with the Roth version of the 401(k) plan; IRC §408A deals with the Roth version of the IRA (see IRC §408).

⁶⁴⁸ *Automatic IRA Act of 2011* (S. 1557); also refer J. Mark Iwry and David C. John, 'Pursuing Universal Retirement Security Through Automatic IRAs: Testimony before Select Revenue Measures Subcommittee of the Committee on Ways and Means, United States House of Representatives' (2008).

⁶⁴⁹ United States Department of the Treasury, 'General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals' (February 2011) <<http://www.treasury.gov/resource-center/tax-policy/Documents/Final%20Greenbook%20Feb%202012.pdf>> 5.

of total investments,⁶⁵⁰ other jurisdictions impose greater restriction on allowable investments by self-managed private personal pensions. All jurisdictions in fact prohibit 'self-dealing'. Permitted investments in the UK and Canada are specifically itemised, rather than excluded, the result being that anything not specified in the relevant legislation is prohibited as an investment. By contrast, the US Internal Revenue Code operates by excluding certain investments.

Permitted investments in each jurisdiction are as follows.

7.2.1.1 United Kingdom

The rules and conditions for a broader range of investments were originally set out in *Joint Office Memorandum 101* issued by the Inland Revenue in 1989. Investments by SIPP's are now governed by the *Personal Pension Schemes (Restriction on Discretion to Approve) (Permitted Investments) Regulations 2001* (SI 2001/117), which came into force on 6 April 2001. The member has the power to direct how the contributions are invested. Members may make choices about what assets are bought, leased or sold, and decide when those assets are acquired or disposed of. The role of the scheme administrator in this situation is to oversee the pension portfolio and to ensure that the requirements for tax approval continue to be met.

HMRC determines qualified investments for SIPP's, which include:⁶⁵¹

- UK and overseas stocks and shares;
- Unlisted Shares;
- Unit Trusts;
- Investment Trusts;
- Open ended investment companies;
- Insurance company funds;
- Deposit accounts;
- Gilts and overseas securities;

⁶⁵⁰ SISA s 82.

⁶⁵¹ *The Personal Pension Schemes (Restriction on Discretion to Approve) (Permitted Investments) Regulations 2001* (UK) Sch ('List of investments that may be held directly or indirectly for the purposes of a self-invested personal pension scheme').

- Investment grade gold bullion;
- Commercial properties (including hotels, guest houses and nursing homes which a SIPP member may occupy at a commercial rate); and
- Cash.

Some investments, although allowed by HMRC, are subject to tax penalties of up to 55%.⁶⁵² They include:

- Residential property;
- 'Pride in possession' assets such as paintings, antiques, vintage cars; and
- Non-investment grade gold bullion.

A SIPP can be started from scratch or by transferring funds from another plan, but in each case must have as its sole purpose the provision of benefits for retirement.⁶⁵³

7.2.1.2 Canada

The *Income Tax Act 1985* (Canada), administered by the Canada Revenue Agency, sets out 'qualified investments' for an RRSP.⁶⁵⁴ These include public and private company shares, debt obligations of Canadian and foreign government instrumentalities and corporations, cash, mutual funds/unit trusts, annuity contracts, warrants, rights and options and mortgages (including a mortgage to a plan participant so long as it is administered by an approved lender and insured – see 7.2.3 **Loans by the fund**), gold or silver coins or ingots.⁶⁵⁵ Anything other than investments specifically mentioned in the Act and Regulations is not a qualified investment and, if acquired by an RRSP, the fair market value of that property at the time it is acquired is added to the income of the account holder. All real estate and collectables are thus excluded investments for RRSPs.

⁶⁵² *Finance Act 2004* (UK) c 12, ss 174A, 185A–185I, 273ZA and Sch 29A.

⁶⁵³ *Income and Corporation Taxes Act 1988* (UK) c 1, ss 630 and 633.

⁶⁵⁴ In general refer to Canada Revenue Agency, *Qualified Investments -- Trusts Governed by Registered Retirement Savings Plans, Registered Education Savings Plans and Registered Retirement Income Funds* (2002) <<http://www.cra-arc.gc.ca/E/pub/tp/it320r3/>>

⁶⁵⁵ *Income Tax Regulations*, RSC, c. 945, s 4900(1).

7.2.1.3 United States

IRC §408(a)(3) prohibits investment in life insurance contracts by IRAs but not 401(k) plans. It also specifies that any investment in a collectable⁶⁵⁶ will be treated as a distribution and subject to income tax in the account holder's hands, together with an additional 10% penalty tax. These very limited exclusions give IRA and 401(k) holders considerable freedom in what they can purchase. The limitations on IRA/401(k) plan investments tend to be imposed more by the custodian than the regulator. For example, the largest custodian of self-directed plans in the US, Equity Trust, allows investment in 'approved stocks, bonds, mutual funds, Certificates of Deposit, real estate, notes, private placements, tax lien certificates and much more'.⁶⁵⁷

The IRS has pointed out that, although permitted by law, real estate investment may not necessarily be offered by trustees.⁶⁵⁸

IRA trustees are permitted to impose additional restrictions on investments. For example, because of administrative burdens, many IRA trustees do not permit IRA owners to invest IRA funds in real estate. IRA law does not prohibit investing in real estate but trustees are not required to offer real estate as an option.

Provided the custodian allows it, investment in all types of real estate is allowed in 401(k) plans and IRAs,⁶⁵⁹ including investments in single-family houses, apartment and office buildings, shopping centres, hotels, raw land and real estate in foreign countries. In each case the real estate must be for investment purposes only⁶⁶⁰ and a disqualified person is prohibited from providing goods or services to the asset. Costa Rica is very popular in this regard with US retirees for holiday homes (transferred as an *in specie* benefit).

⁶⁵⁶ Defined as any work of art, rug or antique, metal or gem, stamp or coin (with the exception of certain coins and bullion) or alcoholic beverage: IRC §408(m).

⁶⁵⁷ Equity Trust Company, *IRA-Permitted Investments* (2011) <<http://www.trustetc.com/new/allowable-investments/ira-permitted-investments.html>>

⁶⁵⁸ United States Internal Revenue Service, *Retirement Plans FAQs regarding IRAs* (2011) <<http://www.irs.gov/retirement/article/0,,id=111413,00.html#14d>>

⁶⁵⁹ By virtue of not being excluded by either IRC §408(a)(3), § 408(m) or § 4975.

⁶⁶⁰ Although the plan may rent/allow use by aunts, uncles, cousins, brothers, sisters, nieces, nephews - these are not 'disqualified persons' within the meaning of IRC § 4975(e)(2).

Commentators have noted that liberating retirement money for injection into the housing market is one way to address the current crisis in real estate prices across the US. Yet the take-up rate of this option remains relatively modest.

IRAs can borrow money for a real estate purchase via a non-recourse loan; upon default, the lender can seize subject property only, a 25-35% deposit is generally required, personal guarantees by the account holder are not permitted, but they are permitted from non-disqualified persons (such as a brother).

Capital gains on real estate transactions are tax-free (for Roth plans) or tax-deferred (for traditional plans), and can remain in a tax-advantaged environment to appreciate further.

The plan can co-own the property with the account holder, an individual, or with other plans, but none can ever buy the other out; upon making such an arrangement they become 'disqualified' to each other and cannot deal. While the arrangement continues, profits and expenses are apportioned according to percentage ownership.

7.2.2 Related party transactions

Australia's SISA limits all regulated superannuation funds, including SMSFs, to a maximum 5% of the market value of the fund's total assets⁶⁶¹ as in-house assets.⁶⁶² The Policy Objective set out in the Explanatory Memorandum to the *Superannuation Legislation Amendment Act (No 4) 1999* – which introduced the limitations to in-house assets and prohibited the acquisition of assets from members of a fund and their relatives⁶⁶³ – is as follows:

The primary policy objective is to ensure that the investment practices of superannuation funds are consistent with the Government's retirement incomes policy. That is, superannuation savings should be invested prudently, consistent with the SIS requirements, for the purpose of providing retirement income and not for providing current day benefits.

⁶⁶¹ SISA s 82.

⁶⁶² Defined in SISA s 71.

⁶⁶³ Contained in SISA s 66.

This policy statement appears to be directed squarely at the SMSF sector. The effect of these limits is to curtail self-dealing between SMSFs and their members and other related parties, reducing the opportunity for artificial manipulation of asset sale and purchase prices. Some variant of this prohibition is common to each jurisdiction under examination.

7.2.2.1 United Kingdom

There are limits on SIPP's buying or selling assets from or to 'connected persons',⁶⁶⁴ defined generally to refer to relatives and associated or controlled entities. SIPP's may not enter into transactions with a member or person connected with a member, except for commercial property acquired on the open market that is then leased on commercial terms for the purposes of a trade or profession to the business of the member or company connected with the member.⁶⁶⁵

Transactions between a pension plan and a connected party must be carried out on 'arm's length bargain' terms. 'Arm's length bargain' is defined by HMRC as 'a normal commercial transaction between two or more persons'.

Transactions between connected persons that are not carried out on 'arm's length bargain' terms may result in an unauthorised payment (and a tax charge of up to 55%). Example: A pension plan sells an asset worth £100,000 to a member at a price of £50,000. There is value passed to the member of £50,000 and this amount will be taxed as an unauthorised payment.⁶⁶⁶

7.2.2.2 Canada

There are prohibitions against self-dealing in the Income Tax Regulations. In the case of private and public corporation shares, if an individual owns, directly or indirectly, 10% of

⁶⁶⁴ As defined in *Income and Corporation Taxes Act 1988* (UK) 1988 c. 1, s 839.

⁶⁶⁵ Inland Revenue SPSS, *Personal Pension Schemes Guidance Notes: IR76* (2000) <<http://webarchive.nationalarchives.gov.uk/20110615130158/http://hmrc.gov.uk/pensionschemes/ir76.pdf>>, paragraph 11.14.

⁶⁶⁶ The Pensions Advisory Service, *Self Invested Personal Pension (SIPP) Plans* (2011) <[http://www.pensionsadvisoryservice.org.uk/personal-and-stakeholder-pensions/self-invested-personal-pension-\(sipp\)-plans](http://www.pensionsadvisoryservice.org.uk/personal-and-stakeholder-pensions/self-invested-personal-pension-(sipp)-plans)>

more shares in a company (making them a ‘connected shareholder’), such an investment is not a ‘qualified investment’ unless such a person is dealing at arm’s length with the corporation or any other related corporation. Also, the aggregate cost amount of all shares of the corporation or any other related corporation the person owns, or is deemed to own, cannot exceed \$25,000.⁶⁶⁷

This is a particular compliance issue for TFSA’s rather than RRSPs because controlled share price can be manipulated such that they are bought by the TFSA at an artificially low price, then distributed tax-free at a much higher price. In contrast to RRSPs, there is no deduction available for contributions to a TFSA, however such amounts grow tax-free while in the account and can be withdrawn tax-free at any time: see 7.4.

In Australia, the in-house asset limitation and prohibition on the acquisition of assets from a related party of the SMSF⁶⁶⁸ serves the same purpose as the Canadian ‘connected shareholder’ rules, and the compliance risk is somewhat less, as benefits are taxable to the member between preservation age and 60.

7.2.2.3 United States

For both IRA and 401(k) accounts, ‘prohibited transactions’⁶⁶⁹ are excluded from allowable investments. An individual selling personal property to the plan, using the plan as security for a loan, borrowing money from the plan, purchasing property for personal use with plan funds and having their business located in a property owned by the plan (which is allowed in Australia) engages in a ‘prohibited transaction’. Disqualified individuals for the purposes of these prohibitions essentially consist of the account holder and their linear blood relations. Any determination as to whether a prohibited transaction has taken place comes under the jurisdiction of the Department of Labor (DOL).⁶⁷⁰ Somewhat surprisingly, DOL Advisory Opinions are published on the DOL website and elsewhere without any modification to protect the anonymity of the subject of the opinion (which protection is very firmly adhered to by the ATO).

⁶⁶⁷ Income Tax Regulations, RSC, c 945, s 4900-4901.

⁶⁶⁸ SISA s 66 (current exceptions are listed securities and business real property).

⁶⁶⁹ Defined in US Code Title 26, s 4975(c).

⁶⁷⁰ As the result of Reorganization Plan No 4 of 1978, 1979-1 CB 480.

Depending on whether the plan is an IRA or a 401(k), the tax treatment following a 'prohibited transaction' differs. For an IRA, such a transaction results in the plan itself becoming fully taxable as well as subjected to penalties; for a 401(k) plan, the result is that tax is payable only on the prohibited transaction amount and no penalty is imposed. Losses cannot be written off against taxes and cannot be replaced in the plan (to make up losses annually against the contribution limits).

7.2.3 Loans by the fund

All Australian regulated superannuation funds are prohibited by SISA s 65 from making loans to members or their relatives. In the United Kingdom SIPPs may not make loans to any party.⁶⁷¹ In contrast, personal pension scheme arrangements that are not SIPPs may make loans to other than members or associates.⁶⁷² In both Canada and the United States self-directed personal pension plans are permitted to lend money to members under certain circumstances, discussed below.

7.2.3.1 Canada

Although real property is not a 'qualified investment' for an RRSP, it may invest in a mortgage on real property including in the case where the mortgagor is the holder of the RRSP provided that:⁶⁷³

- the amount of the mortgage interest rate and other terms reflect normal commercial practice; and
- the mortgage is administered by an approved lender under the *National Housing Act*⁶⁷⁴ and insured under that Act.⁶⁷⁵

⁶⁷¹ Inland Revenue SPSS, *Personal Pension Schemes Guidance Notes: IR76* (2000) <<http://webarchive.nationalarchives.gov.uk/20110615130158/http://hmrc.gov.uk/pensionschemes/ir76.pdf>> paragraph 11.23; *The Personal Pension Schemes (Restriction on Discretion to Approve) (Permitted Investments) Regulations 2001* (UK) no 117, regulation 8.

⁶⁷² Inland Revenue SPSS, *Personal Pension Schemes Guidance Notes: IR76* (2000) <<http://webarchive.nationalarchives.gov.uk/20110615130158/http://hmrc.gov.uk/pensionschemes/ir76.pdf>> paragraph 11.33.

⁶⁷³ Income Tax Regulations, RSC, c. 945, s 4900(1)(j.1).

⁶⁷⁴ *National Housing Act*, RSC, 1985, c N-11.

⁶⁷⁵ Income Tax Regulations, RSC, c 945, s 4900(1)(j.1).

This concession is in addition to the allowable loan to the RRSP holder under the *Home Buyer's Plan*, discussed below. A TFSA interest may be used as security for a loan at arm's-length terms and conditions, so long as the loan's purpose is not tax avoidance.⁶⁷⁶

Home Buyer's Plan

While the original purpose of RRSPs was to help Canadians save for retirement, it is possible to use RRSP funds to help purchase one's first home under what is known as the *Home Buyer's Plan*.⁶⁷⁷ Canadians can borrow, tax-free and interest-free, up to \$25,000 from their RRSP (and another \$25,000 from a spousal RRSP) towards buying their residence. This loan must be repaid within 15 years after two years of grace. Amounts not repaid are included in the individual's income for the year.⁶⁷⁸ This plan can be used more than once per lifetime, as long as the borrower did not own a residence in the previous five years, and has fully repaid any previous loans under this plan.

Interest on money borrowed to make repayments of amounts withdrawn under the Home Buyers' Plan is not deductible in computing taxable income.⁶⁷⁹

Post-secondary education

The 'Lifelong Learning Plan' allows withdrawal from RRSPs to finance training or education in a qualifying educational program⁶⁸⁰ for the account holder, or their spouse or common-law partner, but not for their children's training or education. There is no tax withheld from such withdrawal, which is limited to \$10,000 per annum and \$20,000 over the life of the plan.⁶⁸¹ The annuitant must repay all withdrawals within 10 years but no interest is payable; amounts not repaid are included in the individual's income for the year.⁶⁸²

⁶⁷⁶ *Income Tax Act*, RSC, 1985, s 146.02(4).

⁶⁷⁷ *Income Tax Act*, RSC, 1985, s 146.01.

⁶⁷⁸ *Income Tax Act*, RSC, 1985, s 56(1).

⁶⁷⁹ Canada Revenue Agency, *Bulletin IT-124R6: Contributions to Registered Retirement Savings Plan* (1995) <<http://www.cra-arc.gc.ca/E/pub/tp/it124r6/it124r6-e.html>>

⁶⁸⁰ Either post-secondary school or a technical or vocational program: *Income Tax Act*, RSC, 1985, s 146.02(1).

⁶⁸¹ *Income Tax Regulations* (CRC, c 945), s 104.1; *Income Tax Act 1985* (Canada) s 146.02.

⁶⁸² *Income Tax Act*, RSC, 1985, s 56(1).

7.2.3.2 United States

First home loans

Traditional 401(k) and IRA monies can be withdrawn as deposit for a first home (Roth 401(k) plan monies may not). Early withdrawal of up to \$10,000 is allowed for the costs of buying, building, or rebuilding a first home plus any usual or reasonable settlement and financing costs. The first home can be bought by the account holder, their spouse (up to \$20,000 for a couple who are both first home buyers),⁶⁸³ or a descendant of either.⁶⁸⁴ The loan must be repaid within 30 years.

General loans

Apart from home deposit loans, loans are not permitted from IRAs. If the owner of an IRA borrows from the IRA, the IRA is no longer an IRA, and the value of the entire IRA is included in the owner's income.⁶⁸⁵ If part of the IRA is pledged as security for a loan, the part of the IRA that is pledged is treated as distributed.⁶⁸⁶

However, loans are permitted from 401(k) plans under certain conditions – generally that the loan is set up formally, short-term with market interest rates. A loan from a 401(k) plan to a participant or beneficiary is not treated as a distribution from the plan if the conditions are met, but defaults in repayment mean the borrowed amount is added to the borrower's assessable income.⁶⁸⁷ The IRS publishes the following warning.⁶⁸⁸

Loans from 401(k) plans. Some 401(k) plans permit participants to borrow from the plan. The plan document must specify if loans are permitted. A loan from your employer's 401(k) plan is not taxable if it meets the criteria below.

⁶⁸³ Defined as someone who has had no present interest in a main home during the 2-year period ending on the date of acquisition of the home the distribution is being used to buy, build or rebuild.

⁶⁸⁴ United State Internal Revenue Service, *Publication 575: Pension and Annuity Income* (2011) <<http://www.irs.gov/pub/irs-pdf/p575.pdf>> 54.

⁶⁸⁵ IRC § 408(e)(2) and (3).

⁶⁸⁶ IRC § 408(e)(4).

⁶⁸⁷ IRC § 72(p).

⁶⁸⁸ United State Internal Revenue Service, *401(k) Resource Guide - Plan Participants - General Distribution Rules* (2011) <<http://www.irs.gov/retirement/participant/article/0,,id=151787,00.html>>

Generally, if permitted by your plan, you may borrow up to 50% of your vested account balance up to a maximum of \$50,000. The loan must be repaid within 5 years, unless the loan is used to buy your main home. The loan repayments must be made in substantially level payments, at least quarterly, over the life of the loan.

You must reduce the \$50,000 amount, above, if you already had an outstanding loan from the plan (or any other plan of your employer or related employer) during the 1-year period ending the day before the loan. The amount of the reduction is your highest outstanding loan balance during that period minus the outstanding balance on the date of the new loan...

Before you borrow from your 401(k) plan!

Have you considered other loan sources? Borrowing from your plan may have a negative impact on the earnings of your account and reduce the money you will eventually have available for your retirement.

The advantage of a 401(k) loan is that the individual paying interest is contributing that interest into their own retirement savings, rather than to a commercial lender. A disadvantage to borrowing from a 401(k) plan is that most plans have a provision prohibiting the holder from making additional contributions until the loan balance is repaid.

In general, US pension plans are designed to allow greater flexibility for participants in their use of retirement funds than in Australia. Average loans amount to just over 10% of the account balances of those who take advantage of the ability to borrow from their plans. Together with the ability (and tendency) of employees to cash out their pension plans when changing employment, these leakage features make it more difficult for participants to fund an adequate retirement.⁶⁸⁹

The US Senate is currently considering a Bill attempting to reduce 'leakage' or non-repayment of loans from 401(k) plans.⁶⁹⁰ It would, inter alia, reduce to three the number

⁶⁸⁹ Josh Cohen, Don Ezra and Tim Furlan, 'Australia's Defined Contribution System: Lessons We Can Learn (and Teach)' (2011) 27(4) *Benefits Quarterly* 26.

⁶⁹⁰ S 1020: *Savings Enhancement by Alleviating Leakage in 401(k) Savings Act of 2011*.

of loans that participants may take at one time and ban products that promote 'leakage' such as the '401(k) debit card'.⁶⁹¹

7.2.4 Borrowing by the fund

In Australia superannuation has always been viewed as a safe harbour in which aspiring retirees could accumulate money without the risk that would otherwise be created by borrowing against the assets in their SMSFs. In fact, this substantially risk-free approach to investment was legislatively codified for many years. Borrowing (and lending) by SMSF trustees was a serious breach of the law, often leading to loss of tax concessions and substantial fines, though recent amendments to SISA have allowed borrowing by SMSF under limited recourse arrangements (see 6.5.2.3 **Borrowing**). This is currently subject to government review, with *Exposure Draft - Corporations Amendment Regulations 2012 - Limited Recourse Borrowings by Superannuation Funds (Instalment Warrants)* requiring all parties to an SMSF borrowing arrangement to be financial planning licensees.

In other jurisdictions borrowing by the retirement fund is permitted in a range of circumstances.

7.2.4.1 United Kingdom

SIPPs may borrow for any legitimate purpose intended to further the aims of the scheme, albeit limited to 50% of the value of the scheme's net assets at that time. In practice SIPP trustees are only likely to permit this for commercial property purchase and/or development, or to pay the VAT liability arising from such a purchase or development. The borrowing must not exceed 75% of the purchase price or the development and may only be undertaken during the accumulation phase or until the member reaches 65 years of age.⁶⁹²

⁶⁹¹ United States Government Accountability Office, '401(k) PLANS: Policy Changes Could Reduce the Long-term Effects of Leakage on Workers' Retirement Savings (Report to the Chairman, Special Committee on Aging, U.S. Senate)' (2009).

⁶⁹² *Personal Pension Schemes (Restriction on Discretion to Approve) (Permitted Investments) Regulations 2001*, (UK) No. 117, s 6.

A SIPP can borrow funds from any individual, company or financial institution whether or not they are connected to the scheme. The transaction must be made on an arm's length basis and the borrowing may be secured on the property or on any other asset of the scheme. If not, or the borrowing is greater than 50% of net assets, this may create an unauthorised payment.⁶⁹³

7.2.4.2 Canada

Although borrowing by an RRSP is not specifically prohibited, adverse income tax consequences may occur if a plan trust borrows money or uses or permits its property to be used as security for a loan.⁶⁹⁴ If an RRSP carries on a business, income so earned will also be taxable.⁶⁹⁵ These prohibitions do not apply where the RRSP acquires a 'qualified investment' that is payable on an instalment basis, because an obligation to pay instalments does not constitute a loan or borrowed money with a relationship of lender and borrower between the parties.⁶⁹⁶

7.2.4.3 United States

Whilst the IRC does not prohibit borrowing of money from within an IRA or 401(k) plan (generally for the purpose of purchasing property), income from a debt-financed property directly held within a retirement plan is likely to be categorized as 'unrelated business taxable income' and the plan consequently required to file a tax return and pay income tax on income arising from the debt-financed portion of the asset purchased.⁶⁹⁷

⁶⁹³ In which case the scheme will be subject to a sanction charge of currently 40% on the amount of borrowing over 50%: Inland Revenue SPSS, *Personal Pension Schemes Guidance Notes: IR76* (2000) <<http://webarchive.nationalarchives.gov.uk/20110615130158/http://hmrc.gov.uk/pensionschemes/ir76.pdf>>

⁶⁹⁴ *Income Tax Act*, RSC 1985, c 1, ss 146(4), 146(7).

⁶⁹⁵ *Income Tax Act*, RSC 1985, c 1, s 146(4)(b).

⁶⁹⁶ Canada Revenue Agency, *Qualified Investments -- Trusts Governed by Registered Retirement Savings Plans, Registered Education Savings Plans and Registered Retirement Income Funds* (2002) <<http://www.cra-arc.gc.ca/E/pub/tp/it320r3/>>, 6.

⁶⁹⁷ Refer Internal Revenue Service, *Publication 598: Tax on Unrelated Business Income of Exempt Organisations* (March 2010) <<http://www.irs.gov/pub/irs-pdf/p598.pdf>>

7.2.5 *In specie* contributions

Although *in specie* contributions of listed securities and business real property to SMSFs in Australia are currently permitted,⁶⁹⁸ the circumstances under which it is allowed are to be significantly reduced by the government's 'Stronger Super' measures whereby, from 1 July 2013, such related party transactions must be conducted through the market where one exists. If no market exists, the transaction must be supported by a valuation from a suitably qualified independent valuer. This measure was to take effect from 1 July 2012, but in mid-June 2012, in the absence of draft legislation, the Treasury announced it had been delayed for a year.

7.2.5.1 *United Kingdom*

The acquisition by a SIPP of a member's commercial property or portfolio of stocks and shares is prohibited, as is the acquisition by the member of any of the SIPP's assets. All transactions in UK or overseas securities must take place through a recognised stock exchange.⁶⁹⁹

7.2.5.2 *Canada*

There is no provision in the Canadian *Income Tax Act* or Regulations dealing with *in specie* contributions, nor any material on the CRA website. Such contributions do not appear to be contemplated, possibly because of the complication the requisite third party custodian would pose. However, cash transfers from US IRAs are permitted.⁷⁰⁰

⁶⁹⁸ Via exemptions contained in SISA s 66(2).

⁶⁹⁹ Inland Revenue SPSS, *Personal Pension Schemes Guidance Notes: IR76* (2000) <<http://webarchive.nationalarchives.gov.uk/20110615130158/http://hmrc.gov.uk/pensionschemes/ir76.pdf>> paragraph 11.13.

⁷⁰⁰ Canada Revenue Agency, *RRSPs and Other Registered Plans for Retirement* (2010) <<http://www.cra-arc.gc.ca/E/pub/tg/t4040/t4040-10e.pdf>> 25.

7.2.5.3 United States

Except in the case of certain rollover contributions (whereby securities may be accepted as 'in-kind' contributions), no contribution to an IRA or 401(k) plan is accepted unless it is in cash.⁷⁰¹

7.3 Asset title and custody arrangements

One of the most important differences between self-managed retirement savings in Australia and the other jurisdictions under examination is the requirement in all jurisdictions except Australia for a pension 'provider' and third party custodian for pension plan assets.

7.3.1 United Kingdom

In order to qualify for the tax relief from HMRC, an authorised provider must be used. Depending on the type of provider, the scheme will have at least a provider, administrator and, under trust-based schemes, a trustee. These roles may be filled by one company, or a combination of companies and individuals. The scheme administrator carries out the day-to-day running of the SIPP, collecting and recording the individual's contributions to the SIPP, as well as reporting to HMRC, for example, when claiming tax relief on contributions to the SIPP.

It is permissible for a scheme to be set up such that each member has a separate trust holding the member's fund. The member may be a co-trustee (but not sole trustee) with the other trustees/scheme administrator of the individual trust.⁷⁰² Actual investment decisions can be made by the policyholder or by an investment manager. But it is the trustee/scheme administrator who ultimately decides whether or not to make a certain investment, notwithstanding any particular direction from the member. Normally, the member has no legal ownership over the investments. The trustee owns the assets in

⁷⁰¹ Internal Revenue Service, *Traditional IRAs: Rollovers* (2011)

<http://www.irs.gov/publications/p590/ch01.html#en_US_2010_publink1000230420>

⁷⁰² Inland Revenue SPSS, *Personal Pension Schemes Guidance Notes: IR76* (2000)

<<http://webarchive.nationalarchives.gov.uk/20110615130158/http://hmrc.gov.uk/pensionschemes/ir76.pdf>> paragraphs 11.4-11.5.

the SIPP; purchases and sales are made in the trustee's name, so that these transactions enjoy the tax protection of the SIPP.⁷⁰³

SIPPs can make and accept transfers to and from most types of UK pension plan as well as overseas plans. Because of the interposed administrator/trustee, illegal early release is not the risk it represents in Australia in the case of transfers to SMSFs.

In addition to establishment and annual administration charges, it is common for a SIPP provider to impose a charge for transferring benefits both in and out of a SIPP, as well as investment transactions and for setting up an annuity. This adds to the cost in ways an SMSF is able to avoid.

7.3.2 Canada

Most RRSPs are governed by a trust deed, however there are depositary RRSPs and insurance contract RRSPs. RRSPs and TFSAs are all offered through an institution, so there is third party involvement. The regulators consider this facilitates compliance by the funds:

The vast majority accepting these funds [RRSP and TFSA] would be banks and we educate them and make sure they understand the rules. RRSP compliance would generally be very, very high due to cooperation by the issuers. (Interview C6)

There is matching between the contribution slips from institutions and the deductions that are on the taxpayer's T1.⁷⁰⁴ (Interview C5)

All qualified investments of a plan trust must be owned by the trustee of the plan trust and not by the annuitant,⁷⁰⁵ beneficiary or subscriber under the plan trust.⁷⁰⁶

⁷⁰³ The Pensions Advisory Service, *Self Invested Personal Pension (SIPP) Plans* (2011)

<[http://www.pensionsadvisoryservice.org.uk/personal-and-stakeholder-pensions/self-invested-personal-pension-\(sipp\)-plans](http://www.pensionsadvisoryservice.org.uk/personal-and-stakeholder-pensions/self-invested-personal-pension-(sipp)-plans)>

⁷⁰⁴ Canadian Income Tax and Benefit Return for Individuals.

⁷⁰⁵ The individual or their spouse for whom a retirement plan provides retirement income: Canada Revenue Agency, *RRSPs and Other Registered Plans for Retirement* (2010) <<http://www.cra-arc.gc.ca/E/pub/tg/t4040/t4040-10e.pdf>> 4.

7.3.3 United States

Truly self-directed IRAs and 401(k) plans are marketed by some companies, allowing the individual to have 'chequebook control' over their retirement savings. In each case, though, a third party custodian must hold title to the plan assets. The custodian is not responsible for ensuring compliance and cannot give legal or tax advice. Notwithstanding the typical involvement of custodians, facilitators and administrators, the plan trustee retains ultimate responsibility for avoiding prohibited transactions.⁷⁰⁷

An IRA is a separate entity from the individual owner. It is a trust and the trustee is a bank or such other person who demonstrates to the satisfaction of the IRS that the manner in which such other person will administer the trust will be consistent with the requirements of the IRC.⁷⁰⁸ Most IRAs are self-directed, which allows the saver to make a wide range of investment decisions, albeit against the backdrop of a custodian/trustee who owns the assets and is IRS approved. Title to an IRA asset is held as follows: *'Equity Trust Company [or other custodian company] Custodian for the benefit of [individual's name] IRA'*. The custodian has responsibility for reporting the fair market value and contributions (including rollovers) to the IRA annually.⁷⁰⁹ However, the IRA owner signs contracts on behalf of the IRA. There is usually also a third party administrator (who performs record-keeping and tax reporting functions), which can be the same entity as the custodian.⁷¹⁰

By contrast, in a 401(k) the trustee is the same individual who has the 401(k) plan. There is no need for separate reporting from a third party entity, and annual filing of an employee plan return may not be necessary if the plan is 'maintained solely for:

⁷⁰⁶ Canada Revenue Agency, *Qualified Investments -- Trusts Governed by Registered Retirement Savings Plans, Registered Education Savings Plans and Registered Retirement Income Funds* (2002) <<http://www.cra-arc.gc.ca/E/pub/tp/it320r3/>> 2.

⁷⁰⁷ John Park, 'Self-Directed IRAs/401(k)s ' (2010) <<http://bawldguy.com/self-directed-iras401ks-the-maze-of-custodians-administrators-and-facilitators/>>

⁷⁰⁸ IRC §408(2).

⁷⁰⁹ For the IRA the fair market value must be reported annually (using IRS Form 5498); for the 401(k) this need not be done until assets reach \$250,000.

⁷¹⁰ The private Equity Trust Company is the largest custodian in the US and allows non-traditional investments, especially real estate.

- (1) an individual or an individual and his or her spouse, who wholly own a trade or business, whether incorporated or unincorporated, or
- (2) partners or the partners and the partners' spouses in a partnership, as they are not deemed 'employees'.⁷¹¹

There is currently a contentious issue in the US about the *selection* of an IRA or 401(k) plan provider being a fiduciary function, with the liability that imposes (explored in more detail at 7.5.4 **Fiduciary duties**). Because employers are understandably uneasy making such a selection, regulators are seeking a solution that will encourage (voluntary) participation by employers on behalf of their employees.⁷¹²

This is not an issue facing SMSFs in Australia, since members and trustees are the same individuals. Selecting an administrator, accountant or other professional is thus done directly by the members, who are also directly responsible for the investment decisions. As Senator Vanstone pointed out in the Second Reading Speech to the *Superannuation Legislation Amendment Bill (No 3) 1999*, which amended SISA to incorporate changes relating to SMSFs, members of SMSFs are expected to protect their own interests:

... the new definition will require that all members of the fund are trustees of the fund. The Financial Systems Inquiry found that under the present system there is little protection of the interests of beneficiaries who are at arm's length from the trustees in an excluded fund. In addition, that there is little practical scope for effective prudential regulation of such funds. As such, the inquiry concluded that excluded funds should not have beneficiaries who are at arm's length from the trustees. Under the new definition, members of self managed superannuation funds will be able to protect their own interests.

7.4 Taxation treatment

Australia is the only OECD country that taxes at all three points: contributions, benefits and investment income and capital gains accruing to the superannuation fund.

⁷¹¹ See Code of Federal Regulations (US) - Title 29, 2510.3-3(b)

⁷¹² Interview C13.

Deductions against ordinary income for contributions to superannuation are available only to the substantially self-employed.⁷¹³

7.4.1 Taxation treatment of contributions

In common with Australia's regime, there are contribution limits to all self-directed personal pension plans under examination, imposing a limit on the taxation concessions enjoyed by the holder and consequent tax expenditure by the government.⁷¹⁴

Australia imposes a 15% contribution tax on pre-tax amounts⁷¹⁵ and contributions above the age-related limits are subject to excess contributions tax.⁷¹⁶ In the other jurisdictions contributions to pension schemes are not subject to contributions tax and deductions against ordinary income are available.

7.4.1.1 United Kingdom

Contributions to a SIPP are post-tax, but the pension provider claims tax back from the government at the basic rate of 20%, which amount is credited to the SIPP⁷¹⁷ (an individual cannot claim tax relief, only the pension provider can do so).

There are limits to the annual relief for contributions (in addition to any relief recovered by the individual's employer).⁷¹⁸ The Annual Allowance is the mechanism by which HMRC restricts tax relief on large contributions. The Annual Allowance is the total of all contributions to registered pension schemes by or on behalf of an individual and was £255,000 for 2010/11. A tax charge of 40% applies to the excess.⁷¹⁹

Those who do not pay tax can also benefit from the 20% basic rate tax relief on the first £2,880 a year they contribute, so that the contribution can be enhanced by government co-contribution up to £3,600. There is no tax relief for contributions above this amount.

⁷¹³ ITAA 1997 s 290-160.

⁷¹⁴ In Australia this was estimated at \$26.6 billion in the 2010 income year: Australian Treasury, *Tax Expenditures Statement 2010* (2011) <http://www.treasury.gov.au/documents/1950/PDF/2010_TES_consolidated.pdf> at 238

⁷¹⁵ ITAA 1997 s 295-160.

⁷¹⁶ ITAA 1997 Div 292.

⁷¹⁷ *Finance Act 2004* (UK) c 12, s 188.

⁷¹⁸ The limits are the amount of the individual's relevant UK earnings which are chargeable to income tax for the tax year, or the difference between those earnings and £3600 (the basic amount): *Finance Act 2004* (UK) c 12, s 190.

⁷¹⁹ *Finance Act 2004* (UK) c 12, s 227.

Contributions to the SIPP of a husband, wife, civil partner, child or grandchild will also attract tax relief, without affecting the contributor's taxable income.

7.4.1.2 Canada

In Canada, contributions to an RRSP up to a limit are deductible against ordinary income and thus are not taxed in the individual's hands. RRSPs were not heavily used until the 1970s, when the *Income Tax Act* was amended to increase the dollar limits up to which tax deductible contributions could be made to equal that of other plan types, after which there was a rapid growth in RRSP usage.⁷²⁰ The limits are noted below.

Registered Retirement Savings Plan

A taxpayer who contributes to an RRSP any time during the year, or no later than 60 days after year end, is eligible to deduct RRSP contributions from income, as long as the taxpayer or the taxpayer's spouse is the annuitant. The 'RRSP deduction limit', which is in effect a contribution limit, is generally equal to 18% of the taxpayer's earned income for the previous year (less any amounts contributed to employer-sponsored pension plans), subject to an annual limit, which has been rising steadily since 2004. It was \$22,450 for 2011,⁷²¹ thereafter to be indexed to the annual increase in the average wage. The limit applies regardless of the contributor's age, except that no contributions may be made after 72 years of age.⁷²²

A taxpayer who contributes less than the amount allowed in a year may be able to make up for the missed contributions in later years. Similarly, if the deduction for the whole of the allowable contribution was not claimed in an income year, the unclaimed portion can be claimed in a later year. Whilst it is possible to contribute more than the deduction limit, as in Australia the excess amount is subject to a penalty tax, namely 1% per month on the excess amount, with a lifetime \$2,000 'grace' amount that must be used before any

⁷²⁰ Bob Baldwin, 'Research Study on the Canadian Retirement Income System: Final Report (Prepared for the Ministry of Finance, Government of Ontario)' (November 2009)

<<http://www.fin.gov.on.ca/en/consultations/pension/dec09report.pdf>> 11.

⁷²¹ *Income Tax Act*, RSC, 1985, s 146(5).

⁷²² *Income Tax Act*, RSC, 1985 subsections 146(2) and (3) set out the conditions for registration of a retirement savings plan. One condition is that no contributions may be made to an RRSP after its maturity. Paragraph 146(2)(b.4) provides that maturity must occur before the year in which the annuitant becomes 72 years of age.

new contributions are applied.⁷²³ The taxpayer may withdraw the excess contributions out of the RRSP on a tax-free basis if the withdrawal is made within a specified time.⁷²⁴ In common with other jurisdictions, contribution limits are unpopular, an interviewee remarking that ‘everybody wants higher contribution limits’ (Interview C5).

Tax Free Savings Account

The Tax Free Savings Account (‘TFSA’) allows individual Canadians to contribute up to \$5,000 per annum into it. There is no deduction for the contribution, but the amounts grow tax-free while in the account, can be withdrawn tax-free at any time and the additional ‘contribution room’ is restored the following year.⁷²⁵

Even though TFSAs are not designed for retirement savings per se, they are another way individuals can help supplement their retirement savings.⁷²⁶ TFSAs are attracting retirement savings away from RRSPs, as TFSAs have the advantages of withdrawals allowable at any time and withdrawals adding to the individual’s ‘limit room’ the following year.⁷²⁷ RRSPs have the advantage of income tax deduction for contributions, making them attractive to high income earners. The funds are taxed when they are paid out as benefits (TFSA withdrawals are not), at which time the individual’s marginal tax rate is likely to be lower.

The distinction between the taxation of RRSPs and TFSAs is similar to that between traditional and Roth versions of 401(k) plans and IRAs in the United States.

Australia would do well to examine the feasibility of the Canadian system of contributions into RRSPs which has a level of flexibility to account for delays in bank, fund and employer processing of contributions. Allowing 60 days grace from the end of the financial year for contributions to be applied to the previous year would avoid Excess

⁷²³ *Income Tax Act*, RSC, 1985, s 204.1.

⁷²⁴ *Income Tax Act*, RSC, 1985, s 146(8.2).

⁷²⁵ *Income Tax Act*, RSC, 1985, s 146.2(1).

⁷²⁶ Interview C4.

⁷²⁷ There were approximately 6.2 million RRSP contributors and 5 million TFSA contributors in 2009: Interview C4, quoting Statistics Canada reports.

Contributions Tax being levied on many fund members where contributions have been delayed and eliminate a great deal of reverse workflow for both regulator and regulatee.

7.4.1.3 United States

Contribution limits apply as follows:

- For a 401(k) plan: US\$16,500 per annum for contributors aged less than 50, \$22,000 per annum for 50 and over in 2010; these limits are a total of traditional 401(k) and Roth 401(k) contributions.
- For an IRA: US\$5,000 per annum for age 49 or below; \$6,000 per annum for age 50 or above in 2010; these limits are a total of traditional IRA and Roth IRA contributions.

Contributions to a traditional IRA cannot be made after the account holder has attained age 70½, but no such limit applies to Roth IRAs.⁷²⁸ Rollovers into IRAs significantly outpace IRA contributions and account for most assets flowing into IRAs.⁷²⁹

The Internal Revenue Code places the onus on the issuer to reject contributions over the limit. For IRAs, contributions will not be accepted for the taxable year on behalf of any individual in excess of the amount in effect for that year.⁷³⁰

Taxation treatment of contributions differs for Roth plans and traditional plans. Put simply, traditional plans receive pre-tax (deductible) contributions but benefits paid from them are taxable as ordinary income, whereas Roth plans receive post-tax contributions and benefits are tax-free. The Exempt/exempt/taxable⁷³¹ version is thus the traditional and the Taxable/exempt/exempt version the Roth. Conversion is permitted from traditional to Roth accounts upon immediate payment of tax on converted balances. The choice of which retirement vehicle to use will therefore depend upon whether an

⁷²⁸ IRC § 408A(4).

⁷²⁹ United States Government Accountability Office, *Individual Retirement Accounts: Government Actions Could Encourage More Employers to Offer IRAs to Employees* (2008) <<http://www.gao.gov/products/GAO-08-590>>

⁷³⁰ IRC § 408(a).

⁷³¹ That is, contributed amounts are tax-exempt; plan earnings are tax-exempt; benefits paid are taxable.

individual is likely to be in a higher tax bracket in the future (in which case a Roth plan is better) or a lower tax bracket in the future (in which case a traditional plan is better).

7.4.2 Taxation treatment of plan/fund earnings

So far as capital gains, dividends, and interest within a self-managed retirement plan are concerned, in the United Kingdom, Canada and the United States these generate no taxable consequence, in contrast to Australian SMSFs in the accumulation phase (SMSFs are taxed at 15% on their income from all assets not supporting a pension,⁷³² but can claim imputation credits from dividends they receive).

7.4.2.1 United Kingdom

Income from assets within the scheme is untaxed (although it is not possible to reclaim imputed dividend tax). Growth is free from capital gains tax.⁷³³

7.4.2.2 Canada

An RRSP is exempt from income tax except if in an income year:

- it holds a non-qualified investment;⁷³⁴
- it borrows money;⁷³⁵
- it pledges plan property as security for a loan;⁷³⁶ or
- it carries on a business.⁷³⁷

If an RRSP acquires a non-qualified investment or uses or permits its property to be used as security for a loan, the fair market value of the property must be included in computing the annuitant's income for the year.⁷³⁸

⁷³² ITAA 1997 s 295-385.

⁷³³ *Finance Act 2004* (UK) c 12, s 186.

⁷³⁴ *Income Tax Act*, RSC, 1985, s 146(10.1).

⁷³⁵ *Income Tax Act*, RSC, 1985, s 146(4)(a).

⁷³⁶ *Income Tax Act*, RSC, 1985, s 146(2)(c.3).

⁷³⁷ *Income Tax Act*, RSC, 1985, s 146(4)(b).

⁷³⁸ *Income Tax Act*, RSC, 1985, s 146(10).

7.4.2.3 United States

For both traditional and Roth versions of 401(k) plans and IRAs any capital gains, dividends and interest accruing within the account incur no tax liability.⁷³⁹

7.4.3 Taxation treatment of benefits

In Australia, there is no age at which an SMSF member is forced to begin receiving benefits (the compulsory withdrawal provision was abolished with effect from 10 May 2006⁷⁴⁰), but once a pension is begun there are minimum annual payments based on a percentage of the individual's account balance and increasing with their age.⁷⁴¹ Benefits paid to people over 60 are tax-free, except for those paid from an untaxed fund (generally a defined benefit fund) and benefits paid to fund members between preservation age and 60 attract a tax offset, meaning in many cases no tax is payable. Superannuation death benefits to dependents are tax-free, however death benefits to non-dependents are taxable.⁷⁴²

By contrast, in the other jurisdictions under examination, benefits are generally assessable income to the recipient and, apart from Roth IRAs, there is a compulsory age at which they must begin to be taken.

7.4.3.1 United Kingdom

Payments can be made into a SIPP until the age of 75; at this point an annuity must be purchased or the fund must be transferred into an Alternatively Secured Pension and pension payments begun.⁷⁴³

Benefits paid from a SIPP count as taxable income. At any time after the SIPP holder reaches age 55 they may elect to take benefits from some or all of their fund, either having retired or whilst continuing to work.⁷⁴⁴ After taking up to 25% (as of 2010) of the

⁷³⁹ Wikipedia, '401(k) IRA matrix' (2011) <[http://en.wikipedia.org/wiki/401\(k\)_IRA_matrix](http://en.wikipedia.org/wiki/401(k)_IRA_matrix)>

⁷⁴⁰ With the enactment of the *Tax Laws Amendment (Simplified Superannuation) Act 2006* (Cth).

⁷⁴¹ Contained in SISR 1994, Sch 7.

⁷⁴² See in general Divisions 280 and 302 of ITAA 1997.

⁷⁴³ *Finance Act 2004* (UK) c 12, s 166.

⁷⁴⁴ *Finance Act 2004* (UK) c 12, s 279: 'Normal minimum pension age' has been 55 since 6 April 2010, previously it was 50.

plan balance as tax-free Pension Commencement 'lump sum',⁷⁴⁵ the remaining money must be moved into drawdown (and continue to be invested) or an annuity purchased.⁷⁴⁶ Drawdown income is limited (by the provider) to approximately 7% of the drawdown fund value (this is reviewed every five years). There is no minimum level of drawdown, so the member can elect to receive a 'nil' pension.⁷⁴⁷ The provider withholds the income tax payable by the member and remits it to HMRC.

Rules exist to prevent the Pension Commencement 'lump sum' being 'recycled' back into the SIPP (and neither drawdown nor annuity payments count as 'earned income' for the purpose of making SIPP contributions).

If the fund value exceeds the 'Lifetime Allowance' of £1.8 million (tax years 2010/11 and 2011/12) at retirement, then the amount above £1.8 million is taxed at 55% if paid as a lump sum and 25% if paid as a pension.⁷⁴⁸ From April 2012 the 'Lifetime Allowance' fell to £1.5 million but there is grandfathering provisions for those previously relying on the higher limit.

7.4.3.2 Canada

According to the Canadian *Income Tax Act*, an RRSP holder *must*, upon turning 71, withdraw the funds.⁷⁴⁹ Transfers from registered employer-sponsored pension plans into RRSPs create a 'locked in' portion (similar to Australia's 'preserved benefit'⁷⁵⁰), meaning that benefits cannot be cashed out either before or after maturity.⁷⁵¹ Separate accounts may be necessary for locked-in and non- locked-in portions of an RRSP. There are no restrictions on withdrawals from the non- locked-in portion of an RRSP, but tax is payable on the amount withdrawn.

⁷⁴⁵ *Finance Act 2004* (UK) c 12, s 166

⁷⁴⁶ A lifetime annuity involves passing the value of the SIPP to an insurance company of the member's choice to provide a regular, taxable, income, and the member ceases to have any involvement with the investment of the pension fund.

⁷⁴⁷ General pension rules: *Finance Act 2004* (UK) c 12, s 165.

⁷⁴⁸ *Finance Act 2004* (UK) c 12, s 215.

⁷⁴⁹ *Income Tax Act*, RSC, 1985, c 1, s 146(2)(b.4).

⁷⁵⁰ Preserved benefits are benefits that must be retained in a superannuation fund until the member reaches 'preservation age' and either retires or begins a transition to retirement income stream.

⁷⁵¹ The Canadian Revenue Agency targets schemes aimed at illegal early release of locked-in funds, however 'RRSP compliance would generally be very, very high due to cooperation by the issuers': Interview C6.

When the account holder retires, they can transfer their RRSP funds to a registered retirement income fund (RRIF) or use their RRSP funds to purchase an annuity. The RRSP issuer will not withhold tax on amounts that are transferred directly to a RRIF or that are used to purchase an annuity. The total of all amounts received by a taxpayer from an RRSP, RRIF or annuity is included in computing their taxable income (except those received as loans under a Homebuyers' or Lifelong Learning Plan: see 7.2.3).⁷⁵²

Withdrawals from an RRSP can be made at any time before retirement, but the trustee financial institution will withhold tax, depending on the account holder's residency and the amount withdrawn.⁷⁵³

RRIFs, once begun, have a minimum annual withdrawal amount calculated by a formula based on the total fair market value of all the fund assets and the age of the 'annuitant' or their spouse.⁷⁵⁴

7.4.3.3 United States

Compulsory distributions from 401(k) plans and IRAs begin in the year the account holder turns 70½,⁷⁵⁵ other than for Roth IRAs, which have no mandatory distribution⁷⁵⁶ and thus represent an advantage for estate planning purposes. The required minimum distribution for each year is calculated by dividing the IRA account balance as of December 31 of the prior year by the applicable distribution period or life expectancy.⁷⁵⁷ The tax penalty for non-distribution is 50% of the minimum distribution.

A gift to a qualified charity from a traditional or Roth IRA (not to exceed \$100,000 per year) may count towards the minimum distribution but is not included in the taxable

⁷⁵² *Income Tax Act*, RSC, 1985, s 146(8).

⁷⁵³ Withholding is as follows: 10% (5% in Quebec) on amounts up to \$5,000; 20% (10% in Quebec) on amounts over \$5,000 up to including \$15,000; and 30% (15% in Quebec) on amounts over \$15,000. For funds held in the province of Quebec provincial tax is also withheld. The account holder receives a T4 RRSP receipt from the plan administrator for any funds withdrawn during the year showing the amount to be included in their taxable income and the credit for the withholding tax.

⁷⁵⁴ *Income Tax Act*, RSC, 1985, c 1, s 146.3.

⁷⁵⁵ IRC §401(a)(C)(i).

⁷⁵⁶ IRC §408A(5).

⁷⁵⁷ United State Internal Revenue Service, *Publication 575: Pension and Annuity Income* (2011) <<http://www.irs.gov/pub/irs-pdf/p575.pdf>>

income of the IRA owner. Non-profit organisations, being tax exempt, pay no income tax on the money they receive.

401(k) plans also allow 'in service' withdrawals whilst the owner is still contributing (similar to Australia's Transition to Retirement Income Streams)⁷⁵⁸

For traditional 401(k) plans and IRAs plans distributions are taxed as ordinary income and can begin at age 59½ or if the owner becomes disabled. Qualified distributions from a Roth 401(k) or IRA are tax-free. Distributions from any of these plans before age 59½ are subject to an early distribution penalty of 10% in additional tax unless an exception applies.⁷⁵⁹

7.4.4 Early Access to benefits

In Australia early access to retirement savings in all types of superannuation fund is available on compassionate grounds. Since 1 November 2011 administration of claims for early release of superannuation benefits on compassionate grounds is the responsibility of the Department of Human Services (the Chief Executive, Medicare).⁷⁶⁰ Superannuation funds themselves decide applications for access to superannuation on grounds of severe financial hardship, total and permanent disability, temporary incapacity, terminal illness or permanent departure from Australia.

In the UK, Canada and the US, early access to retirement savings in the case of financial hardship or disability is also generally permitted. However, in the United States early access to retirement savings is allowed in two further circumstances: to fund higher education and medical expenses, both of which can be prohibitively expensive in that country.⁷⁶¹ This is effected, for higher education, via a provision that exempts from the 10% additional tax an early distribution from an IRA to pay qualified higher education

⁷⁵⁸ As defined in SISR 6.01, constituting a condition of release.

⁷⁵⁹ Wikipedia, '401(k) IRA matrix' (2011) <[http://en.wikipedia.org/wiki/401\(k\)_IRA_matrix](http://en.wikipedia.org/wiki/401(k)_IRA_matrix)>

⁷⁶⁰ *Superannuation Legislation Amendment (Early Release of Superannuation) Act 2011* (Cth).

⁷⁶¹ James Banks et al, 'Disease and Disadvantage in the United States and in England' (2006) 295(17) *Journal of the American Medical Association* 2037; D. Bruce Johnstone, *Sharing the Costs of Higher Education. Student Financial Assistance in the United Kingdom, the Federal Republic of Germany, France, Sweden, and the United States* (1986).

expenses for the account owner, spouse or a descendant of either.⁷⁶² And medical expenses exceeding 7.5% of the participant's adjusted gross income or not more than the cost of the participant's medical insurance for the year are likewise exempt from the 10% early distribution tax (except in the case of Roth 401(k) plans).⁷⁶³

7.5 Challenges for overseas regulators

Challenges for the regulators in the jurisdictions examined in this chapter share many similarities with those faced by the ATO in regulating SMSFs, most notably resourcing, legislative delay and lack of graduated penalty powers. These are illustrated by extracts from Canadian interviews.

7.5.1 Resourcing

The problem is public versus private pay levels – it's very difficult at times for us maintaining expertise. I could hire an investment expert today but in a year or two they're probably a little out of touch with the marketplace. There's just so much evolving in the markets – strategies, alternative investments; it's really tough to keep up with the marketplace and globalization, money flows so quickly. (Interview C4)

The Australian regulator must also compete for talented employees with the private sector, where pay levels in some professions tend to be higher.⁷⁶⁴ There is also the challenge of keeping pace with developments in the marketplace.

7.5.2 Legislative delay

Our legislation was really lagging behind the environment ... we've had some major legislative reforms go through – in the Ontario *Pension Benefits Act* – and we're still waiting for the regulations and we won't see them until after the election in October [2011], which, if it's a new government, a different party gets in, what they're going to do in the regs we

⁷⁶² United State Internal Revenue Service, *Publication 970: Tax Benefits for Education* (2011) <<http://www.irs.gov/pub/irs-pdf/p970.pdf>> 58; United State Internal Revenue Service, *Publication 575: Pension and Annuity Income* (2011) <<http://www.irs.gov/pub/irs-pdf/p575.pdf>> 54.

⁷⁶³ United State Internal Revenue Service, *Publication 575: Pension and Annuity Income* (2011) <<http://www.irs.gov/pub/irs-pdf/p575.pdf>> 31 and 53.

⁷⁶⁴ Although across the entire workforce public sector salaries exceed private sector: Australian Bureau of Statistics, *Average Weekly Earnings, Australia, Aug 2011* <<http://www.abs.gov.au/ausstats/abs@.nsf/mf/6302.0>>

don't know. The real detail goes into the regulations and we still don't have that. (Interview C4)

In Australia, the SMSF regulator – the ATO – is currently grappling with the need to prepare for 'Stronger Super' legislative reforms to regulate the SMSF sector without knowledge of what the final changes will be. The 29 SMSF proposals arising from the Super System Review are in the Exposure Draft stage, after which the final legislation must be drafted, debated in both Houses, then implemented by the regulator. However, since 2010, the ATO has deployed several 'super reform' project teams to prepare for the likely changes.⁷⁶⁵

7.5.3 Lack of graduated penalty powers

Sometimes we don't have some of the graduated powers. We try moral suasion but it really comes down to a fight. Our only power might be to order the plan terminated, which isn't necessarily in the best interest of the member. Is that a victory or not? It'd kill their pension plan. Maybe there [should be] some administrative monetary penalties that don't require laying charges. (Interview C10)

In Australia, the ATO faces the same issues with the 'blunt instrument' of declaring an SMSF non-complying.⁷⁶⁶

7.5.4 Fiduciary duties

A further challenge for US regulators, which appears to be confined to that jurisdiction, is the impact of fiduciary duties. There is legal uncertainty surrounding the question of which party bears which fiduciary duty in relation to IRAs and 401(k) plans (and other pension plans as well), for instance, what fiduciary duties are owed by those who select retirement plans for their employees or associates and those who select the investments entered into by those plans. This issue currently preoccupies regulators and legislative bodies:

⁷⁶⁵ Researcher's personal knowledge from employment at the ATO.

⁷⁶⁶ Pursuant to SISA s 42A.

As we speak, our Assistant Secretary is testifying on our agency's proposal to expand the definition of 'fiduciary' so that more people who provide advice to plans would be accountable under ERISA and subject to the prohibited transaction rules. A premise of her speech is that a portion of the underperformance of IRAs relative to 401(k) type plans is due to the fact that IRAs have no fiduciary acting on their behalf and therefore have less protection vis-à-vis financial service providers since the individuals who direct the investments of their own IRAs tend to be less sophisticated than the people who operate 401(k) plans and more susceptible to people selling them things that may not be appropriate just to get a commission or a profit. (Interview C12)

It's unclear whether or not the selection of annuity provider is a fiduciary violation – do I become a fiduciary by selecting M's company over B's company to provide annuities, what type of due diligence and research do I have to do – there are questions that need to be answered. (Interview C13)

A big issue for us is the need for more disclosure and clarification of the fiduciary standard. (Interview C15)

Such preoccupation with fiduciary duties does not appear to be a concern to either APRA or the ATO, due most likely to the greater litigiousness faced by those making decisions about retirement savings in the US and, more significantly, the fact that in Australian SMSF members align with trustees, without the interposition of third party custodians.

7.6 Major differences between other jurisdictions and Australia

What appears from the foregoing account of the salient features of the each country's regulation of self-managed superannuation is that the most significant differences between other jurisdictions and Australia are:

- the requirement for a third party custodian in other jurisdictions.
- the availability of loans/early access to members to purchase real estate and for other purposes in other jurisdictions.
- the ability for members to make *in specie* contributions to SMSFs.
- the ability for SMSFs to invest in collectables.
- taxation treatment.

Further examination of these differences, all of which are legislatively founded, appears below.

7.6.1 Third party custodian

Canada, US and the UK each require third party custodians for pension plan assets, in whom legal title to those assets resides, an expensive exercise for the account holder, as it would be for an SMSF if it were required in Australia. This requirement does, however, mean the retirement savings industry in those countries is very tightly regulated. This has spawned a perception amongst regulators in these countries that account holders are compliant for this reason. Consider the following observations in the Canadian context:

RRSP compliance would generally be very, very high, due to cooperation between the issuers ... when you make a contribution you get your contribution slip, when you make a withdrawal you get a slip. The vast majority accepting these funds would be banks and we educate them and make sure they understand the rules. There's no reason to believe that the non-compliance rate is any higher than any other sector or any other tax reporting. There's always a segment of the population that look for ways to circumvent the rules but because of all the reporting that's done on RRSPs and the players that are involved it's a fairly tightly-regulated industry. They are all offered through an institution so there's third party involvement. (Interview C6)

The only question of compliance at the individual level is with the taxation and that's pretty hard to get around. I guess you could not report it, but they do a matching, so that not reporting it from a tax perspective is probably pretty low. The financial institutions – unless you get your RRSP from some rinky-dink little financial institution – I think all the big institutions have large compliance groups that make sure that all the documentation lines up with the requirements and that's really the only thing you have to look at. (Interview C7)

In Canada, the self-directed retirement savings accounts are financial products, and the contract between issuer and participant must be approved by the CRA.

In order to be able to market a product the institution comes to us for us to review the 'specimen' contract and if everything is according to the conditions of registration we approve their contract and they go out and sell it. (Interview C5)

It is made explicit neither in the legislation nor extrinsic materials why a third party custodian was not considered necessary for SMSFs in Australia. As Part 15 of SISA sets standards for trustees, custodians and investment managers of superannuation entities (including SMSFs), it is envisaged that SMSFs may have custodians, though it is not mandated. SISA s 123 requires that a custodian must be a body corporate, but this requirement is specifically excluded for an SMSF.⁷⁶⁷

SISA s 10 defines 'custodian' in a way that makes it clear that a custodian cannot be a trustee of the fund:

'*custodian*', in relation to a superannuation entity, means a person (other than a trustee of the entity) who, under a contract with a trustee or an investment manager of the entity, performs custodial functions in relation to any of the assets of the entity.

An inkling why third party custodians and administrators are not compulsory for SMSFs can be found in the Explanatory Memorandum to the *Superannuation Legislation Amendment Bill (No 3) 1999*. The EM gives sets out a general rationale for requiring all SMSFs members to be trustees and any fund with arm's-length members to appoint an APRA-approved trustee:

Few, if any, existing excluded fund trustees are likely to apply to become approved trustee themselves [thereby enabling arm's-length members to remain in the SMSF]. The requirements involved in becoming an approved trustee are quite extensive and the costs likely to be prohibitive (for example, normally the trustee company must have \$5 million in net assets) ... [A]necdotal evidence suggested an overall belief by trustees that excluded funds were generally family or business oriented funds and should not contain arm's length members.

By excluding from SMSFs arm's-length members whose interests would be served by third party custodians and administrators, the Parliament conveyed an expectation that SMSFs are family-oriented investment vehicles, the members of which are expected to protect their own and each others' interests.

⁷⁶⁷ Neither the Explanatory Memorandum nor the Second Reading Speech to the *Superannuation Legislation Amendment Bill (No 3) 1999*, which amended SISA to deal with SMSFs explains why SMSFs were explicitly excluded.

The price to be paid for the freedom from custodian/administrator requirements enjoyed by SMSFs may be the erosion of privacy rights, as in the absence of third party custodians, government regulators must use indirect means of control and surveillance to combat illegal early release. For example, from 1 July 2015 employers and funds will be enabled to check SMSF, trustee, ABN and bank account details online against a register of 'Proof of Identity Supplied Accounts'. The 'SuperStream Data Standards', part of the government's 'Stronger Super' measures, require that in order to rollover funds to an SMSF, an APRA fund must determine whether the SMSF is complying, whether the bank account for the receiving SMSF is valid and whether the initiating member is a member of the SMSF, using data maintained by the ATO.

TFN protection legislation⁷⁶⁸ must be weakened in order for SuperStream to be implemented (for example, the contributions of any member not quoting their TFN to a fund will be redirected to the ATO as unclaimed). The ATO is currently working through issues with the Privacy Commissioner prior to legislative drafting.⁷⁶⁹

The requirement for a third party custodian for fund assets, although it would introduce a layer of cost and complexity, has the advantages of largely preventing illegal early release and preserving retirement assets for retirement, as well as avoiding the intrusive measures and invasion of privacy deemed necessary in Australia by a regulator seeking, by indirect means, to combat illegal early release. On the other hand, introduction of third parties introduces questions of fiduciary duty, as in the US.

7.6.2 Allowable loans to account holders

Although loans to members by SIPP in the UK and by SMSFs in the Australia are strictly prohibited, in both Canada and the US loans to members by self-directed pensions plans are allowed under certain circumstances. The US is particularly liberal in

⁷⁶⁸ Tax File Number Guidelines 2011 issued under the *Privacy Act 1988 to regulate the collection, storage, use, disclosure, security and disposal of individuals' TFN information*.

⁷⁶⁹ Australian Taxation Office, *SuperStream Rollover Message Implementation Guide* (2011) <<http://www.ato.gov.au/content/downloads/spr00286878guide.pdf>>

this respect, allowing loans from 401(k) plans for any purpose. Both Canada and the US allow members to borrow from their retirement savings to fund the purchase of a home.

Why are loans to plan members for home purchase allowed in Canada and the United States but not in Australia? There have been suggestions that allowing plan members to use retirement savings to purchase housing will have a stimulating effect on moribund property markets, particularly in the US.⁷⁷⁰ This suggests the obvious question as to the extent to which superannuation law should be directed solely towards retirement savings, ignoring consideration of economic societal benefits.

In Australia there was a submission to the Commonwealth Government Budget 2009/10 by the Real Estate Institute of Australia that allowing first home buyers access to their superannuation for the purchase of a home would address the fact that the overall level of home ownership in Australia has fallen and first homebuyers currently account for only 19% of the market, down from the long term historical average of 21%.⁷⁷¹ Then there were suggestions at the October 2011 Tax Forum that first home buyers should be allowed to use their superannuation as a deposit for a home loan.⁷⁷² Housing affordability is at near all-time lows⁷⁷³ and many younger workers, particularly in the major capital cities, despair of ever owning a home of their own. Access to their superannuation savings to fund the deposit for a first home could be one means of addressing this problem, but for now, retirement savings remain quarantined by the 'sole purpose' test.⁷⁷⁴ The current (unresolved) debate in Australia concerning the possibility of investment by superannuation funds in government infrastructure projects is also relevant here.⁷⁷⁵

In Australia there is no compelling reason against allowing loans from SMSFs for the purchase of first homes or post-secondary education expenses. Although it is unlikely

⁷⁷⁰ See for example Jenny Ivy, 'Retirement bill aims to stir housing markets' (April 19, 2011) *benefitspro* <<http://www.benefitspro.com/2011/04/19/retirement-bill-aims-to-stir-housing-markets>>

⁷⁷¹ Real Estate Institute of Australia, *Commonwealth Government Budget Submission 2009/10* (2009) <http://www.reia.com.au/userfiles/REIA_PreBudgetSubmission.pdf>

⁷⁷² Bianca Hartge-Hazelman, 'Super fix for housing', *Australian Financial Review* 8 October 2011, 8

⁷⁷³ Judith Yates and Mike Berry, 'Housing and Mortgage Markets in Turbulent Times: Is Australia Different?' (2011) 26(7-8) *Housing Studies* 1133.

⁷⁷⁴ SISA s 62.

⁷⁷⁵ Benjamin Levy, 'Government stifling infrastructure investment' (11 November, 2011) *SuperReview* <<http://www.superreview.com.au/news/superannuation/government-stifling-infrastructure-investment>>

that the average SMSF member would be a first home buyer or in need of further education (in general this population is relatively wealthy and highly-educated), if this were extended to children of members, it would constitute a significant economic stimulus.

It is not the purpose of this thesis to investigate the societal, economic and political aspects of the possibility of use of retirement savings for housing (or infrastructure development or any other private or public good). However, as a general comment, the historical Australian focus on superannuation being directed solely to fund retirement, and the allied sole purpose test, would require a quantum shift in policy to encompass housing, whether for first home buyers or others. Moreover, Australia already has some of the most favourable tax treatment of residential housing in the world, and first home buyers have received benefits in recent times at both a Federal (first home owner grant) and State (for example stamp duty concessions) level. Indeed, the greater the concessions and favourable tax treatment of residential housing, the greater the pressure on prices, and so it may well be queried whether releasing superannuation to fund first home owners' deposits would ultimately assist affordability.

7.6.3 *In specie* contributions

Australia is the only jurisdiction under consideration here that allows *in specie* contribution to superannuation, limited by SISA s 66 to listed securities and business real property. All assets must be transferred at market value on the date of transfer and capital gains tax liability may accrue to the transferring member. In practice, the contribution is only possible to SMSFs and SAFs, as larger funds generally accept only cash contributions.

Why did the government of the day consider *in specie* contributions to self-managed funds to be acceptable and, further, why did it limit such contributions in this manner? Some insight may be gained from the Senate debates on the passage of SISA, along with six related bills, in 1993. In essence, *in specie* contributions were allowed for

reasons of cost to the fund of requiring sale on the open market or liquidation of the asset before contribution, which deserve lengthy citation.⁷⁷⁶

Senator Ferguson: I would like to draw the Senate's attention to my major area of concern—clause 64 [which became section 66 in the final SISA]. Under this clause the government is seeking to prohibit funds from intentionally acquiring assets from members or their relatives and from providing any other financial assistance to members; attempting to resolve the sole purpose test, which is to determine whether a super fund is operating solely as a fund to provide retirement benefits; and aiming to prevent abuses of current legislation where members sell personal assets such as houses, boats, cars, et cetera, to super funds. This legislation proposes a penalty of two years gaol for breaching this clause ...

Of all the issues raised during the hearings and in most of the evidence that we received, this was the most controversial, the most troublesome and, I believe, the most difficult to come up with a meaningful resolution for...

Those decisions of the committee were taken only after a lot of discussion and deliberation. I am sure Senator Chris Evans, who is in the chamber, will remember that there was a considerable amount of discussion on these issues, and it was probably the only area where there was any disagreement of any major proportion in the committee.

The proposed amendment has been drafted so that, if the asset is classified as 'business real property', the acquisition of that property, together with any other business real property previously acquired, does not exceed 40 per cent of the total value of assets of the fund for excluded superannuation funds [that is, SMSFs].

Equally ridiculous is the situation where, under the amended SIS legislation, fund members and their relatives will be forced into selling assets like investment property to a company, which can then sell the property to the fund in order for the member to gain access to cash.

All this does is add another personal company to the equation, at a cost to the fund member because of the added costs involved in going through another party — extra stamp duty fees, costs of selling, et cetera. For what purpose? It will only put more money in the pockets of brokers and state commissioners for stamp duty.

⁷⁷⁶ Commonwealth of Australia, *Parliamentary Debates*, Senate, 16 November 1993, page 2938 (Senator Martin Ferguson).

We are here to make laws for the benefit of Australian people and I personally cannot see the benefit to the Australian people of their not being able to sell that property to their super fund when they can sell it to a company which then sells it to their super fund, or when they can sell it to somebody else's fund ...

What are we trying to prevent? We are trying to prevent, firstly, bodgie investments going into super and, secondly, this happening at unreal prices. These are the only two issues.

Section 66 of SISA has already been amended eleven times since originally enacted. The Explanatory Memorandum to the *Superannuation Legislation Amendment Act (No 4) 1999*, which introduced the major amendment,⁷⁷⁷ states:

For a fund with fewer than 5 members, the previous 40% limit on acquisition of business real property from a member has been increased to 100% of fund assets. The exception for listed securities remains ... While there are risks involved in providing exceptions to the general rules, these exceptions have the benefit of allowing small business owners to use their superannuation savings to invest in their own business premises. The exceptions recognise that land and buildings generally have an underlying value independent of the employer-sponsor's business ... The definition for listed securities is being expanded to include securities listed on approved overseas stock exchanges, and domestic exempt stock markets.

In specie contribution to SMSFs has been a concern of the regulators and the Government since the original enactment of SISA. The ATO's Taxpayer Alert 2008/12 *Non-cash contributions to superannuation funds* highlights concerns with using *in specie* payments or arrangements designed to allow a member of a superannuation fund to avoid the superannuation contribution caps. And finally it appears *in specie* contributions are to be severely limited. The government's 'Stronger Super' proposals contain the following.⁷⁷⁸

⁷⁷⁷ Via amendment of SISA s 66(5) definition of 'listed security'.

⁷⁷⁸ Commonwealth of Australia, *Stronger Super Information Pack* (21 September 2011)

<http://strongersuper.treasury.gov.au/content/publications/information_pack/downloads/information_pack.pdf> at 18.

The Government will legislate to require related party transactions to be conducted through the market where one exists. If no market exists, the transaction must be supported by a valuation from a suitably qualified independent valuer.

... [During the Super System Review] [c]oncerns were raised in consultation that requiring related party transactions to be conducted through a market could involve transaction risk and result in increased costs. However, non-market transactions are not transparent and are open to abuse. Abuse can occur through transaction date and asset value manipulation to achieve more favourable outcomes in terms of contributions caps and capital gains tax.

The ATO's publication of valuation guidelines, which was also recommended by the Super System Review, will provide guidance for obtaining valuations for related party transactions where there is no underlying market.

Thus, the ability of SMSF members to make *in specie* contributions of business real property remains largely intact, although off-market transfer of securities will not be possible after 1 July 2013.

7.6.4 Collectables

Australia is the only jurisdiction under consideration here that allows self-directed personal pension plans to invest in collectables and personal use assets. Such assets offer the same potential for manipulation of valuation as *in specie* contributions, as well as the lure of current use and enjoyment by members. The Super System Review recommended this freedom of investment choice be removed because:⁷⁷⁹

... the cumulative regulatory and compliance complexities outweigh the potential benefits of allowing such a liberal investment menu to a sector that is not directly prudentially regulated ... Collectable investments pose particular issues in relation to the application of the sole purpose test. These assets lend themselves to personal enjoyment and a range of 'non-investment' factors and therefore can involve significant current day benefits being derived by those using or accessing the assets.

⁷⁷⁹ Commonwealth of Australia, above n 175, 246.

However, the Government did not adopt this recommendation because 'it would restrict investment choice for SMSF trustees'.⁷⁸⁰ Instead it amended SISA and SISR to impose additional restrictions on SMSF trustees investing in collectables and personal use assets.⁷⁸¹ The regulations list the particular assets affected and relate to how a personal use asset is acquired, stored and used while in the SMSF and disposed of, effective from 1 July 2011.⁷⁸² Treasury noted that 'the amendments in their current form will require additional ATO clarification and guidance on the new SISA section and SIS Regulation'.⁷⁸³ Thus the freedom of investment in collectables and personal use assets enjoyed by SMSF trustees remains largely intact.

7.6.5 Taxation treatment

The taxation treatment of contributions, fund earnings and benefits to and from self-directed personal pension plans differs significantly between jurisdictions. In particular, in Australia deductions for contributions into superannuation are allowed only to the self-employed and fund income is tax-free only in the pension phase. In other jurisdictions employees may deduct contributions to superannuation and fund income is always tax-free. Another important difference is the absence in Australia of a mandatory age at which distribution from superannuation must begin.

It is not proposed to examine in detail the reasons for such taxation treatment, this being an extensive field of research in its own right. However, it is noteworthy that despite Australia being the only country under examination to tax at all three points, present-value estimates of overall budgetary cost of tax-favoured contributions to superannuation funds places Australia highest of any OECD country, with over 1.7% of GDP.⁷⁸⁴ A partial

⁷⁸⁰ Australian Treasury, 'Stronger Super: Government Response to the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System' (2011) <http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/recommendation_response_chapter_9.htm>

⁷⁸¹ Contained in the new SIS Act section 62A and SIS Regulation 13.18AA (inserted by *Tax Laws Amendment (2011 Measures No 2) Act 2011* (Cth)).

⁷⁸² Explanatory Memorandum, *Tax Laws Amendment (2011 Measures No 2) Act 2011* (Cth).

⁷⁸³ Commonwealth of Australia, *Stronger Super: SMSF Consultation Summary* (2011) <http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/outcomes_of_consultation_process/smsf.htm>

⁷⁸⁴ See in general Kwang-Yeol Yoo and Alain De Serres, 'Tax Treatment of Private Pension Savings in OECD Countries' (2005) *OECD Economic Studies* No. 39, 2004/2 <<http://www.oecd.org/dataoecd/19/0/35663569.pdf>>

explanation may stem from the fact that benefits paid to people over 60 are tax-free, except for those paid from an untaxed fund (generally a defined benefit fund), and so the tax collected from superannuation benefits is relatively negligible.

7.7 Other legislative features of overseas jurisdictions

Apart from the major differences between the regulation of SMSFs and self-directed pension plans elsewhere, what follows is a description of a number of noteworthy legislative and supervisory features of the other systems. Some may be practical to adopt in Australia, others may not.

7.7.1 Ability to carry over unused contribution allowance, calculation of unused contribution allowance by tax authority: CANADA

During the income year, the CRA calculates an RRSP Room statement, so that unused contributions carry over from one year to the next, indefinitely.⁷⁸⁵ An RRSP deduction limit is the maximum amount of RRSP contributions that can be claimed on a tax return for a given tax year. An individual's 'unused RRSP deduction room'⁷⁸⁶ is calculated as the unused limit from the prior year, plus the allowance for that individual for the current year, and since 1990 it is printed on every Notice of Assessment or Reassessment, provided the taxpayer is 71 years or younger.

An individual can find out their deduction limit (and thereby avoid excess contributions tax) by registering with the CRA, being given a password and accessing their RRSP Deduction Limit Statement online.⁷⁸⁷ TFSA 'contribution room' information can also be found on the individual's latest Notice of Assessment or Notice of Reassessment. Contributions and benefits paid are tracked through an individual's Social Insurance Number and reported by the financial institution to the CRA.

There is an argument that carrying forward unused contribution room is counter-productive:

⁷⁸⁵ Interview C4.

⁷⁸⁶ Defined in *Income Tax Act*, RSC, 1985, s 146(1).

⁷⁸⁷ Canada Revenue Agency, *RRSPs and Other Registered Plans for Retirement* (2010) <<http://www.cra-arc.gc.ca/E/pub/tg/t4040/t4040-10e.pdf>> 12.

The carrying it forward indefinitely makes it a bit easy just to say 'I'll deal with it next year'. There's always another spending priority that seems more important. (Interview C8)

In fact, only 31% of eligible tax filers made an RRSP contribution in 2007 and contributions represented only 6% of the total RRSP room available to tax-filers (and contributions are skewed towards individuals in the top level of income distribution).⁷⁸⁸

Another new initiative in Canada is that the deduction limit is to be indexed to the annual increase in the average wage from the 2011 income year onward.

In Australia the possibility of encouraging contributions by allowing carry-forward of unused allowance is under consideration. SISFA has included in a submission to the Minister for Financial Services and Superannuation the proposition that either lifetime contributions caps or a 'rolling period cap'⁷⁸⁹ (similar to Canada's system) should be adopted to encourage saving in superannuation towards a goal of retirement income adequacy.⁷⁹⁰ This measure could be combined with indexation of the concessional contribution cap (say, to Average Weekly Ordinary Time Earnings or the Consumer Price Index) and some means whereby the ATO advised individuals of their annual superannuation contributions. However this notification would necessarily be one year in arrears, given that the due date for Member Contribution Statements is later than the due date for individual Income Tax Returns.

The Canadian system of online access for taxpayers to a running balance of their contributions appears to be the standard of best practice. Advice by the ATO of what contributions have been made during the year, both employer and personal, as part of the income tax assessment or, ideally, via an online portal facility as in Canada would have the advantage of assisting individuals to be more aware of their retirement saving, engaged with superannuation and retirement planning and help them avoid inadvertently incurring excess contributions tax.

⁷⁸⁸ Steering committee of Provincial/Territorial Ministers on Pension Coverage and Retirement Income Adequacy, 'Options for increasing pension coverage among Private sector workers in Canada' (2010) <http://www.fin.gov.bc.ca/pension_plan_options_paper.pdf> 8.

⁷⁸⁹ Whereby contributions in any given year which are less than the cap limit can be 'caught up' in a later year(s).

⁷⁹⁰ Small Independent Superannuation Funds Association, 'SISFA News' (October 2011) <<http://www.sisfa.com.au/news-media.html>> 1.

Carry-forward of unused 'contribution room' ideally coupled with indexation of contribution limits would be advantageous for Australia to adopt. This has the benefit of encouraging saving for retirement at a steady rate, allowing contribution whenever the money is available, but avoiding excessive diversion of otherwise taxable income into superannuation.

7.7.2 Incentives for annuitisation

In other jurisdictions, government policy has encouraged the conversion of retirement savings to an annuity⁷⁹¹ when an individual attains preservation age and retires. This is done either by legislative mandate (as in the UK) or tax incentives as levers to prevent depletion of retirement savings and access to government pension. After all, if the annuity purchased is sufficient to support the individual for the rest of their life, they will have no need to access government age income support.

In Australia there is no annuitisation requirement and no government program for making annuities widely available. The Henry Review⁷⁹² proposed that further consideration be given either to provision of a government vehicle for annuitisation or to measures to facilitate development of the private annuity market, but stopped short of any recommendation requiring that all or part of superannuation balances be annuitized at or during retirement.⁷⁹³ Some commentators have made public statements supporting a voluntary system of annuities provided by government:⁷⁹⁴

... because it would be able to supply the income streams cheaper than the private sector ... 'We should at least be having the debate on annuities', Mr Cuffe [Chairman of UniSuper retirement fund] said. 'At the moment we have nothing that puts people in the mindset of taking an income stream'.

⁷⁹¹ An annuity is an insurance product that pools risk between people. In the event of an person's early death, the unused part of their fund helps pay the pension of those who live longer than expected: Djuna Thurley, *Pensions: 'requirement to annuitise'* (8 November 2011) <www.parliament.uk>

⁷⁹² Commonwealth of Australia, *Australia's future tax system: Report to the Treasurer, December 2009* <http://taxreview.treasury.gov.au/content/downloads/final_report_part_1/00_AFTS_final_report_consolidated.pdf>

⁷⁹³ Alan J Auerbach, 'The Taxation of Savings and Superannuation' in Chris Evans, Richard Krever and Peter Mellor (eds), *Australia's Future Tax System: The Prospects After Henry* (2010) 93, 97.

⁷⁹⁴ Sally Patten, 'Cuffe puts the case for annuities', *Australian Financial Review* 18 November 2011, 48.

Critics of annuities point out that not only do holders lose liquidity by entering into an annuity arrangement but there is ‘counter-party risk’ where the annuity is issued by an insurance company.⁷⁹⁵ Should the company fail, the annuity-holders’ assets are gone and they may then have recourse to government income support. For this reason, critics favour government-issued annuities.⁷⁹⁶

7.7.2.1 United Kingdom

In the UK at age 75 an annuity must be purchased or the fund must be transferred into an Alternatively Secured Pension and pension payments begun.⁷⁹⁷ Upon purchasing an annuity (from an insurance company) an individual is ‘locked’ into the annuity rates offered at that time.

However, the requirement for compulsory annuitisation at 75 has been removed effective April 2011 via the *Finance Act 2011*.⁷⁹⁸ This initiative dictates that, provided that an individual has a ‘secured income’ of £20,000 per annum from an occupational scheme, SIPP or state pension (and thus is unable to access government income support), the drawdown of the entire fund as cash is allowed, which is subject to taxation. As explained by an interviewee:

This has come in because the government knows people are not very happy with annuity rates because they’re so low – 6.5% for a 65-year-old, increasing as you get older. You’re locked into that rate once you’ve started. It’s designed to stop people depleting their retirement savings and going on the government pension – a carrot and stick approach. (Interview C1)

⁷⁹⁵ Private markets for annuities offered by insurance companies are also beset by a problem known as ‘adverse selection’, making optional annuities unnecessarily expensive. If the insurer cannot distinguish individuals with above- and below-average life expectancies, the annuities need to be priced uniformly for all buyers. Purchasers often have better knowledge of their life expectancy, so that those who expect to live longer than average tend to buy annuities; this process, in turn, pushes up the price of annuities, thus discouraging purchases by those with shorter expected lives. As a result, many individuals choose rationally not to purchase annuities but to bear the risk of outliving their savings or leaving an unintended estate. One study estimates that adverse selection accounts for half of the excess price of an annuity over its ‘fair’ value, which is the present value of the payments it guarantees: Jonathan R. Kesselman, ‘Expanding Canada Pension Plan Retirement Benefits: Assessing Big CPP Proposals’ (October 2010) 3(6) *University of Calgary School of Public Policy SPP Research Papers* 1.

⁷⁹⁶ Victoria Tait, ‘Annuities play increasing role in retirement solutions’ (7 November 2011) *Independent Financial Adviser* 8.

⁷⁹⁷ *Finance Act 2004* (UK) c 12, s 166.

⁷⁹⁸ The relevant provisions are in cl 65 and Sch 16.

Annuities were designed to act as a cap on withdrawal to ensure that people did not exhaust savings prematurely. This concern has no currency vis-à-vis persons who can show that they have secured a sufficient minimum income to prevent them from 'falling back on the state'. It also aims to ensure that people do not use pension saving as a 'tax-privileged means for passing on wealth', any unused funds remaining on death being taxed at a rate designed to reflect the value of tax relief received.⁷⁹⁹

7.7.2.2 Canada

In Canada an RRSP must be 'collapsed' by the end of the calendar year in which the holder turns 71. There are three basic options:

1. Take the entire amount in cash, all of which is subject to tax.
2. Purchase an annuity and begin receiving a regular income, subject to tax.
3. Roll over the RRSP into a RRIF, which can be composed of different investment types. A minimum amount of income must be withdrawn from the RRIF annually,⁸⁰⁰ also subject to tax and no contributions can be made.⁸⁰¹

With the annuity option, the annuity payment is fixed for the term of the individual's life, based on a formula that includes age, gender, the term of the annuity, the frequency of the income payments and the size of the single premium (lump sum). With the RRIF option, there is longevity risk – the RRIF may not last the individual's lifespan – but any remainder can be paid to a beneficiary, earnings continue to be tax-free and the individual can control the timing and the amount of withdrawals, subject to the minimum. Thus in Canada there is no requirement or incentive to annuitize.

⁷⁹⁹ Djuna Thurley, *Pensions: annuities and income drawdown* (15 March 2012) <<http://www.parliament.uk/briefing-papers/SN00712>>

⁸⁰⁰ The minimum depends on the account holder's age or the age of their spouse: *Income Tax Act*, RSC, 1985, s 146.3.

⁸⁰¹ Michael Baker and Kevin Milligan, 'Government and Retirement Incomes in Canada (paper produced for the Research Working Group on Retirement Income Adequacy)' (2009) <<http://www.fin.gc.ca/activity/pubs/pension/ref-bib/baker-eng.asp>>

7.7.2.3 United States

In the United States there is draft legislation to encourage annuitisation of retirement savings by means of tax incentives.⁸⁰² The apparent cost to the revenue comes at an inopportune time in the country's economic cycle and it is therefore unlikely to pass both Houses. As observed by an interviewee:

There are proposals to give differentiated tax concessions favouring annuities, there's legislation which would give an X percentage tax-free from the disbursement if you [buy an annuity], but given the current economic situation in America ... the pension policy sometimes is driven by revenue considerations. (Interview C12)

In fact, one of the US interviewees in this study had published a recent OECD paper on policies to encourage annuitisation.⁸⁰³ However, in the jurisdictions under examination, only the UK has adopted serious legislative measures to encourage annuitisation.

Australia could introduce incentives for annuitisation for SMSFs, as in the United Kingdom. This is a measure that would apply to members of all types of fund. For example, if an individual withdraws a lump sum to purchase an annuity (from an insurance company) guaranteeing them a lifetime income (and sufficient to disentitle them to the Age Pension) they could be automatically entitled to a government Seniors Card/Health Care Card.

7.7.3 Charitable donations count towards minimum pension payments: USA

In the US, a qualified charitable distribution from an IRA is a charitable gift and counts towards the minimum distribution. This may be an option for Australian retirees who struggle to meet the pension standards for minimum percentage of account balance

⁸⁰² The *Lifetime Income Disclosure Act* (S 267) to amend the *Employee Retirement Income Security Act* of 1974 (US) 1974 was reintroduced in the US Senate February 3, 2011, read twice and referred to the Senate Committee on Health, Education, Labor, and Pensions, from which it has not emerged to date.

⁸⁰³ Organisation for Economic Co-operation and Development, 'Annuities in Pension Plans: Policies to Encourage Annuitization' (2010) <<http://www.oecd.org/dataoecd/56/38/48130111.pdf>>

annual withdrawal (based on account holder age).⁸⁰⁴ The advantages of this would be two-fold.

1. Charitable institutions (or deductible gift recipients) would be facilitated in their work.
2. Superannuation income stream recipients not in need of the full minimum payment amount in any income year could direct any shortfall to some altruistic purpose and avoid penalty.

Charitable giving to make up the annual minimum payment from a superannuation income stream, as in the United States, is an idea that could be adopted in Australia. This has the advantages of avoiding the dire consequences of breaching the minimum payment amount provisions⁸⁰⁵ and contributing to social capital.

7.8 Supervisory features of overseas jurisdictions

Some features of the regulatory supervision of self-managed retirement savings in other jurisdictions, particularly the United States, may have merit in encouraging voluntary compliance and improving the relationship between regulator and regulatee. Some may be practical to adopt in Australia, others have either been abandoned or, for various reasons, are not applicable in this context. An explanation of these follows.

7.8.1 Resolution of non-compliance

In the United States the IRS publishes an extensive 401(k) plan checklist with potential compliance shortcomings, along with methodology to correct and avoid each of them.

There exists what is known as the IRS's Employee Plans Compliance Resolution System (EPCRS), with guidance to trustees to remedy mistakes and avoid the consequences of

⁸⁰⁴ See in general Australian Taxation Office, *Changes to pension standards for self managed super funds* (2010) <<http://www.ato.gov.au/superfunds/PrintFriendly.aspx?ms=superfunds&doc=/content/00120916.htm> >

⁸⁰⁵ According to draft Taxation Ruling TR 2011/D3 *Income tax: when a superannuation income stream commences and ceases*, failure of an SMSF to meet the minimum payment amount will deem the income stream to cease from 1 July of that year, with potential major negative taxation impact on both fund and member for that income year.

plan disqualification. When a retirement plan meets the requirements of the IRS in form and operation, it is 'qualified' and entitled to tax concessions. If it fails to remain in compliance it is 'disqualified', which can result in harsh income tax penalties, since a disqualified plan may lose all the tax benefits it has received from the date of its inception.

The EPCRS encourages plan administrators to 'address potential violations of the law proactively, rather than try to hide violations and take their chances playing "audit roulette"'.⁸⁰⁶ A correction for a mistake must be 'reasonable and appropriate'. There are three components of EPCRS:

1. *Self-Correction Program* (SCP), which permits a plan sponsor to correct certain plan failures without contacting the IRS.
2. *Voluntary Correction Program* (VCP), which permits a plan sponsor to, any time before audit, pay a limited fee and receive IRS approval for correction of plan failures.
3. *Audit Closing Agreement Program* (Audit CAP), which permits a plan sponsor to pay a sanction and correct a plan failure while the plan is under audit.

The VCP cannot be used once an IRS audit⁸⁰⁷ has been initiated.⁸⁰⁸

Though this may be a useful service for the ATO to offer SMSF trustees, there are several relevant distinctions between an SMSF and a 401(k) plan. A 401(k) plan 'sponsor' is usually an employer, whereas an SMSF trustee is seldom an employer; and an SMSF has an independent auditor whose role includes verification of compliance with SISA. It would normally be the auditor's function to detect non-compliance and offer the trustees the opportunity to correct that non-compliance.⁸⁰⁹

⁸⁰⁶ Neil Sandhu and Paul T Schultz, 'The US Pension System and The Role of the IRS' 44(June 2003) *International Pension Lawyer* 33, 36.

⁸⁰⁷ Under IRS Code §7605(b).

⁸⁰⁸ As set forth in Revenue Procedure 2008-50, 2008-35 I.R.B. 464 on the IRS website.

⁸⁰⁹ Neither the legislation itself nor eSat and other ATO guidance to auditors deals with pre-ACR opportunities for rectification by SMSF trustees. This issue, however, is outside the scope of this thesis.

Certainly the ATO could offer an SMSF self-correction program with advice on the website of common breaches and what trustees can do to correct them, coupled with a requirement for the auditor to acknowledge that a breach has been corrected *before* the audit.

7.8.2 Publicised outcomes of compliance projects

In the United States there are summaries of outcomes of compliance projects on the IRS website under the banner *Employee Plans Compliance Unit – Completed projects with summary reports*.⁸¹⁰ The ATO does not share such information publicly, beyond brief mention of selected compliance project outcomes in speeches by the Commissioner, Deputy and Assistant Commissioners, which are published on the ATO website.⁸¹¹ The ATO's Compliance Program is published each year, describing the tax and superannuation compliance risks it is most concerned about and what is being done to address them.⁸¹² 'In doing so', the ATO has stated, 'it reflects our corporate value of openness and accountability'.⁸¹³ Making public the outcomes of compliance projects in the SMSF sector is a logical next step in open regulation.

The IRS Director of Employee Plan Examinations also releases a newsletter quarterly (similar to the ATO's *SMSF News*), as well as ad hoc bulletins concerning specific compliance concerns (similar to the ATO's *Taxpayer Alerts*). The difference is that the newsletter and bulletins are under the banner of a specific individual IRS employee and have an email contact within the IRS for readers' feedback and suggestions for future articles. This enables two-way communication and gives the impression of a more open, less monolithic organisation with a human face.

⁸¹⁰ <<http://www.irs.gov/retirement/article/0,,id=218636,00.html>>

⁸¹¹ For example: *Super funds and taxation: working together for effective compliance*, Stuart Forsyth, Assistant Commissioner Superannuation, 17 Sept 2010; <http://www.ato.gov.au/corporate/PrintFriendly.aspx?ms=corporate&doc=/content/00256592.htm> *Who is in the driver's seat of the SMSF car?*, Neil Olesen, Deputy Commissioner of Taxation, 12 November 2010; <http://www.ato.gov.au/corporate/content.aspx?doc=/content/00261824.htm>

⁸¹² For the first time in 2011-12, the ATO is inviting feedback via email on its Compliance Program.

⁸¹³ Australian Taxation Office, *Compliance program 2011-12*

<<http://www.ato.gov.au/corporate/PrintFriendly.aspx?ms=corporate&doc=/content/00284023.htm>>

In Australia, the ATO could enhance its reputation for openness and transparency by publicising the outcomes of its SMSF compliance projects and introducing senior staff members as spokespeople for the organisation in its communications to the sector.

7.8.3 Model plan documents

In the US, the IRS has created model plan documents for the simplest plans that employers can use for their retirement plans, together with instructions, as a variety of IRS form.⁸¹⁴ In contrast, in the United Kingdom, HMRC has stated that '[f]rom 6 April 2006⁸¹⁵ HMRC will not be issuing model rules as it does now. It will be up to schemes to design their own rules'.

Australia's Super System Review considered but did not adopt a recommendation to offer model trust deeds for SMSF use, reasoning as follows:⁸¹⁶

... the time, effort and cost involved in creating, hosting and maintaining a standard deed could not be justified. The Panel therefore believes that some of the pressure to update trust deeds regularly (especially where there is a change in the law) could be reduced by introducing, into the SIS Act, provisions which would automatically deem anything permitted by the SIS Act to be permitted by SMSF trust deeds.

It seems, therefore, that there is neither the will nor any convincing example from overseas experience for the development of model trust deeds by the regulator in Australia.

7.8.4 Regulator with financial literacy mandate

At a global level, financial education has had renewed focus. The G20 Financial Inclusion Experts Group has emphasised the relevance of financial education as part of a wider attempt to mitigate future financial crises.⁸¹⁷ None of the regulators of self-

⁸¹⁴ For example Form 5304-SIMPLE, <http://www.irs.gov/pub/irs-pdf/f5304sim.pdf>.

⁸¹⁵ A-Day: the day the UK government's pension taxation simplification rules came into effect.

⁸¹⁶ Commonwealth of Australia, above n 175, 258.

⁸¹⁷ Ross Jones, *Promoting Confidence in the Industry: Speech to ASFA 2011 National Conference*

directed pension plans discussed in this chapter have a financial literacy mandate including responsibility for educating plan holders about prudent and life-stage-appropriate asset allocation. However, the legislative regime in other jurisdictions is much more prescriptive about allowable assets than is Australia's (see 7.2) and can thus be expected to impose some deterrent to unsuitable investments. Nevertheless, it is certainly open to the ATO to provide general guidance to SMSFs on suitable asset allocation.

In jurisdictions where there is a regulatory body with financial literacy responsibility, it does not appear to address specifically the investment decisions that must be made by self-directed retirement plan holders. In the United States the Financial Literacy and Education Commission has been established by the US Government to develop a national strategy to improve consumer education and financial literacy. In the United Kingdom, the Financial Services Authority, the UK financial regulator, is responsible for promoting public understanding of the financial system.

No Canadian regulator has a financial literacy mandate. This has been decried by interviewees, who remark as to retirement savings account participants' inertia and overly conservative asset allocation. For example:

I think the biggest issue in Canada is probably [that] most people put a lot of mutual funds in their RRSPs and the MERs [Management Expense Ratios] are extremely high and so they're probably not getting the investment gains that one would hope they would be getting from those savings because they're paying such high fees to the mutual fund companies. The fees in Canada are some of the highest in the world. (Interview C7)

It must be understood, though, that in Canada constitutional issues prevent financial literacy being promoted through the education system, education being a provincial responsibility. The Financial Services Commission of Ontario is currently developing guidelines for prudence in investments for publication on their website.⁸¹⁸

(11 November 2011)

<http://www.apra.gov.au/Speeches/Documents/Ross%20Jones_ASFA%20Speech_Nov%202011.pdf> 3.

⁸¹⁸ Interview C7.

In Australia, following Treasury's Consumer and Financial Literacy Taskforce key recommendation in 2004 of the establishment of a national financial literacy body,⁸¹⁹ ASIC has what amounts to a financial literacy mandate via its Money Smart website,⁸²⁰ launched 15 March 2011, which has a brief section on Self-managed super with links to ATO SMSF publications. The only guidance provided by APRA on investments for superannuation funds is its *Superannuation Circular No II.D.1: Managing Investments and Investment Choice*, which is somewhat dated. As in Canada, there is a distinct lack of guidance by the ATO on asset allocation for SMSFs.

7.8.5 Supervisory levy on a cost-recovery basis

The Financial Services Commission of Ontario has adopted an interesting method of imposing a supervisory levy on a cost-recovery basis, with each regulatee billed annually in arrears for the cost of its regulation. Its incidents appear from the following interviewee comments:

One of our problems is if we charge a company and they get fined, we don't get that money. We spend all the money on our investigation, our lawyers and any fines would go to the City of Toronto because they administer the local court. So we work on a cost-recovery basis from the industry; we charge all of our costs back to the pension plans we regulate. Lawyers and court cases get very expensive. Every year we send out an assessment to them, towards the end of the fiscal year when we've got a pretty good idea what our final costs for the year will be. Our year end is in March. And we will send out an assessment in January or February in which there's a formula for allocating our total expenditures to all the plans. (Interview C9)

An additional cost of running a pension plan is to pay the regulator's cost – they have to pay directly for their own regulation. If they want better service they have to pay for it. Like the police – you do that through your taxes – we just do it direct. (Interview C10)

The ATO collects and expends the SMSF levy directly. By contrast, the Financial Institutions Supervisory Levy to fund APRA's operations passes through the

⁸¹⁹ The Treasury, *Preliminary Recommendations to Government* (2004)

<<http://cfltaskforce.treasury.gov.au/content/home.asp>>

⁸²⁰ <<https://www.moneysmart.gov.au/>>

Consolidated Revenue Fund, a net amount being allocated annually to APRA by the Minister for Revenue and Assistant Treasurer as a Special Appropriation.⁸²¹

As at June 2008, the ATO had incurred total costs of \$69 million in administering and regulating the SMSF sector for the 12 month period ending June 2008.⁸²² For the same period, the ATO collected \$18.5 million from the SMSF supervisory levy. More recent data is not available, but it is reasonable to assume that regulatory costs to the ATO will have significantly increased due to the increased numbers of those being regulated and the increased level of ATO-initiated compliance activity targeting both trustees and auditors. If the cost of regulation is to be fully recovered, the levy is likely to significantly increase. If not, the cost must be met by general taxpayers.

7.8.6 Advisory committees

Interviewees from the Financial Services Commission of Ontario suggested that confidentiality of proceedings within advisory committees enhances communication and trust between stakeholders and regulator. For instance, one said the following:

In order to remain close and communicate with industry, we have six advisory committees – one for lawyers, one for investment managers, one for auditors, actuaries, plan administrators and one for multi-employer pension plans. The advisory committees all have terms of reference and confidentiality agreements and the members are there to give confidential advice as individuals, not as representatives of any organisation. And there's no attribution of comments back to them either, and that's very effective ... We don't even publish the minutes of the meetings. We don't want them to be afraid of anything. (Interview C4)

On the other hand, the ATO publicly releases minutes of advisory committee meetings, attributing comments and questions, not to a named member, but distinguishing between

⁸²¹ Leslie Nielson, 'Benchmarking Australian Superannuation Regulation and Practice' (2006) <http://www.apf.gov.au/Senate/committee/corporations_ctte/completed_inquiries/2004-07/superannuation/library_research_paper.pdf> at 12 December 2011.

⁸²² Commonwealth of Australia, 'A Statistical Summary of Self-Managed Superannuation Funds' (10 December 2009), 18. This figure includes both direct and indirect costs. Direct costs include labour and supplier expenses, while indirect costs are overhead-type costs attributed to the activity.

'industry' and ATO participant. This is likely to enhance transparency and protect against regulatory capture.

The same Canadian interviewees also pointed out that twice yearly their agency hosted speakers drawn from their advisory committees to speak to their staff from the regulatee's perspective.

Whilst the ATO has hosted a speaking tour of ATO sites by the Chief Executive Officer of SPAA, a wider and more frequent program of speakers from industry to educate ATO staff on superannuation industry issues and concerns would prove beneficial for staff understanding.

In addition a program of visits by senior ATO managers to groups of SMSF professionals in three capital cities was undertaken in 2011 with the aim of sharing insights about emerging issues and trends.⁸²³ It is to be continued in 2012 in four capital cities, however it is a somewhat exclusive exercise, as the ATO has announced that 'invitations to participate will be issued to a small group of superannuation advisers'.⁸²⁴

Despite their limitations, such initiatives should enhance mutual understanding and trust between the regulator and the SMSF sector. The problem here is that such groups, as well as membership of ATO advisory committees, is very restricted. A better way to communicate may be the webinar.

7.8.7 IRS webinars

The ATO in 2011 converted from the traditional face-to-face tax practitioner seminars delivered in venues across Australia to a wholly electronic non-interactive format. On the other hand, in the United States the IRS delivers free, interactive webinars, for example

⁸²³ Australian Taxation Office, *SMSF Newsletter - Edition 18* (August 2011)

<<http://www.ato.gov.au/superfunds/PrintFriendly.aspx?ms=superfunds&doc=/content/00284835.htm&pc=001/149/030/003/002&mnu=49150&mfp=001/149&st=&cy=>>

⁸²⁴ Australian Taxation Office, 'Self-managed super funds: A statistical overview 2008-09' (2011)

<<http://www.ato.gov.au/content/downloads/SPR00301485n74068.pdf>> ; Australian Taxation Office, 'SMSF Newsletter - Edition 21' (2012)

<<http://www.ato.gov.au/superfunds/PrintFriendly.aspx?ms=superfunds&doc=/content/00310323.htm&pc=001/149/030/003/002&mnu=49150&mfp=001/149&st=&cy=>>

to assist small businesses and sole practitioners to choose a suitable low-cost retirement plan, set it up and ensure it complies with the IRS Code.

The advantages of webinars include:

- they can be viewed anywhere in the world with internet access at a specific time
- they are low or no-cost
- participation can be controlled via a registration process
- groups can register and participate
- they are interactive, so that written or verbal questions can be responded to in real time or compiled, with responses disseminated at a later date through a variety of methods.⁸²⁵

Webinars by the ATO would doubtless be welcomed by the SMSF sector, as they are interactive and more widely accessible than discussion at ATO forums (which have very limited membership and minutes which are not available until months after meetings), or the visits by senior ATO managers to small groups of hand-picked SMSF professionals in major capital cities. Webinar invitations could be extended via the *SMSF News* recipient email list.

7.9 Conclusions

Australia's SMSF sector appears to enjoy a level of freedom unparalleled in the Western world. Whether this lightness of regulation will continue, and whether the sector will remain as well supported, will depend upon its attractiveness vis-à-vis other sectors and in public confidence in the superannuation system as a whole. As APRA's Deputy Chairman pointed out last year, in many countries there is recognition that the retirement income models of the past decade have lost some degree of public support. In extreme

⁸²⁵ Grant Abbott, arguably Australia's most prominent SMSF 'guru', has commenced a series of SMSF webinars in 2011, offering Continuing Professional Development points for financial planners, accountants, their staff and SMSF trustee clients.

cases, for example Argentina, the private pensions industry has effectively been nationalised.⁸²⁶

Although Australia's retirement income system ranks second only to the Netherlands in terms of adequacy, sustainability and integrity and well ahead of the UK, Canada and the US,⁸²⁷ a number of features of the regulation of self-directed personal pensions in those countries have been identified that may be worthy of consideration in the Australian landscape. Some would require legislative amendment and in examining their feasibility, the threshold consideration will be the extent to which Australia's superannuation laws should be directed solely towards retirement savings, ignoring consideration of economic and societal benefits.

Other identified features from overseas are purely administrative measures that the ATO might usefully examine for feasibility in its task of regulatory supervision of SMSFs.

⁸²⁶ Ross Jones, *Promoting Confidence in the Industry: Speech to ASFA 2011 National Conference* (11 November 2011)

<http://www.apra.gov.au/Speeches/Documents/Ross%20Jones_ASFA%20Speech_Nov%202011.pdf> 2.

⁸²⁷ According to Mercer, 'The Melbourne Mercer Global Pension Index' (2011)

<<http://www.mercer.com/articles/global-pension-index-australia>> and *OECD(2011), Pensions at a Glance 2011: Retirement-Income Systems in OECD and G20 Countries* (www.oecd.org/els/social/pensions/PAG).

CHAPTER 8

CONCLUSIONS

Ultimately, a theme underscoring this thesis is that there has to be a balance between trust and regulation. The ATO has adopted self-regulation as the dominant paradigm in dealing with the taxpayers it regulates, trusting those taxpayers to do the right thing until they demonstrate otherwise.⁸²⁸ Similarly the regulation of SMSFs relies on trusting them to efficiently and prudently manage their own retirement savings without heavy-handed intrusion. Their performance, as measured by average return on assets, demonstrates that, generally, that trust has been warranted.

As noted in Chapter 2, it is worth emphasizing that, as the largest sector by numbers of funds and assets, SMSFs are an established part of the Australian financial, retirement and business environment. They attract continuing policy focus from government and are increasingly marketed to by service providers and product developers. Engagement of individuals in the SMSF sector tends to be high, with members actively involved in their retirement savings.⁸²⁹ The annual audit, in particular, serves to engage trustees with their superannuation. Were the category of SMSFs removed from the industry, there would likely be an overall reduction in saving for retirement, which would be undesirable.⁸³⁰

This thesis has drawn together historical and statistical information about SMSFs, their members and trustees. It has reviewed and analysed the results of various surveys of SMSF trustees, seeking to explain why the SMSF has become such a popular retirement savings vehicle despite the regulatory and investment challenges it presents the non-professional member. It has presented the views of senior officials within the principal supervisory regulator, as well as professional advisers, each representing numbers of

⁸²⁸ In fact this has been mandated via the *Taxation Laws (Self Assessment) Act 1992*.

⁸²⁹ Russell Investments, 'Intimate with Self Managed Superannuation: An inaugural annual study of Self-managed Superannuation Funds' (2011) <http://www.russell.com/AU/_pdfs/market-reports/spaa/R_EVE_SPAA_Report.pdf> reported that 40% of SMSF trustees surveyed review their fund more often than fortnightly and 51% review their investments more often than three monthly.

⁸³⁰ Tom Valentine, 'Regulation of DIY Superannuation Funds' (2004) 37(2) *The Australian Economic Review* 215, 220.

SMSFs. Finally, it has compared the regulation of Australian self-directed retirement savings with that of Canada, the UK and the USA.

As defined at the outset, 'to regulate' is to control, govern, or direct by rule or regulations; to subject to guidance or restrictions. This thesis examined the regulation of SMSFs in Australia, in both legislative and supervisory senses, with the aim of identifying improvements in both legislative and supervisory aspects. The evaluation of the appropriateness and effectiveness of the supervisory regulation of the SMSF sector and the legislative regime within which it operates has in fact uncovered some areas where improvements could be made. Some aspects from the overseas experience may also be worthy of adoption in this country.

8.1 Recommendations:

A number of the deficiencies highlighted throughout this thesis could be ameliorated by measures that have been categorised below into:

- supervisory measures, which the ATO could take unilaterally; and
- statutory measures, which would require drafting by Treasury and enactment by the Federal Parliament.

More generally, comment is made on what are perceived as deficiencies in Australia's retirement income system, made significantly manifest within the SMSF sector.

Despite being so grouped, recommendations 3, 4, 5, 6, 9, 10, 11, 14, 15, and 16 are relevant only to the SMSF sector; the remainder are potentially applicable to the superannuation system as a whole.

8.1.1 Supervisory measures

The SMSF is a unique Australian retirement vehicle which gives its members unparalleled freedom of investment and control but places them in a position of some vulnerability without prudential regulation, access to government financial protections or tribunal review.

The effectiveness of the ATO as supervisory regulator will continue to improve as the government enacts the Stronger Super measures which give the ATO the power and flexibility to tackle minor regulatory breaches, prosecute scheme promoters, issue directions to trustees and more closely scrutinise SMSF auditors.

To enhance SMSF compliance, a number of measures are suggested:

1. The ATO should address the dearth of appreciation and understanding in the community of the government's retirement income policies, and the reasons for the trustee obligations and prohibitions contained in SISA and SISR (see 3.9.2).
2. The outdated MOUs between the ATO, APRA and ASIC need updating and strengthening with respect to information-sharing (see 5.3).
3. A number of aspects of the SMSF registration process require closer scrutiny, specifically:
 - identity verification and bankruptcy checks of trustees;
 - SMSF bank account checks;
 - naming conventions for SMSFs; and
 - capture of adviser details (see 5.4.6).
4. The ATO could institute some type of reward or incentive for SMSFs that lodge on time and without contravention of their statutory obligations over a period of time (see 5.4.10).
5. The ATO could provide general guidance on its website to SMSFs about suitable asset allocation (see 5.3.5).
6. The ATO could facilitate transition from SMSF to SAF by providing information on its website explaining how this may be accomplished, with links to the relevant forms and SAF trustees' websites (see 6.9).
7. ATO personnel representing the organisation in industry forums, should be regularly rotated to avoid the possibility of regulatory capture (see 5.4.11).

From the overseas experience:

8. The ATO, in conjunction with APRA, should provide advice to the individual of what contributions have been made during the year, both employer and personal, as part of the income tax assessment or, ideally, via an online portal facility as in Canada. This has the advantage of assisting individuals to be more aware of their retirement saving, engaged with superannuation and retirement planning and possibly helping them avoid inadvertently incurring excess contributions tax (see 7.7.1).
9. An SMSF self-correction program should be instituted by providing advice on the website of common breaches and what trustees can do to correct them, coupled with a requirement for the auditor to acknowledge that a breach has been corrected *before* the audit (see 7.8.1).
10. Publicise outcomes of SMSF compliance projects (see 7.8.2).
11. Introduce webinars for SMSF trustees (see 7.8.7).
12. Implement a wider and more frequent program of speakers from industry to educate ATO staff on superannuation industry issues and concerns (see 7.8.6).

8.1.2 Statutory measures

13. Statistical collection for the superannuation industry should be centralised with the Australian Bureau of Statistics. This would have the effect of forcing harmonisation of reporting and data collection between the ATO and APRA and enhance comparability between superannuation fund sectors (see 2.6.4).
14. A separate SMSF Act should be enacted, or at a minimum a simpler set of regulations specific to SMSFs (see 6.9).
15. A standard SMSF trust deed should be attached to the Regulations, as a schedule to the Act, or, optimally, developed and updated by the ATO and made available on its website (see 6.10).

From the overseas experience:

- 16.** Third party custodians for fund assets could be introduced, possibly as a non-mandatory alternative to penalties such as disqualification of trustees or the SMSF being declared non-complying. Although this introduces a layer of cost and complexity to the SMSF, it has the advantages of largely preventing illegal early release and preserving retirement assets for retirement, as well as avoiding the intrusive measures and invasion of privacy deemed necessary in Australia by a regulator seeking, by indirect means, to combat illegal early release (see 7.6.1).
- 17.** Carry-forward of unused 'contribution room' ideally coupled with indexation of contribution limits. This may encourage saving for retirement at a steady rate, allowing contribution whenever the money is available, but avoiding excessive diversion of otherwise taxable income into superannuation (see 7.7.1).
- 18.** A grace period from the end of the financial year for application of contributions to a member's account, as for the Canadian RRSP, would prevent Excess Contributions Tax and reverse workflow in many cases of delay (see 7.4.1.2).
- 19.** Charitable giving to make up the annual minimum payment from a superannuation income stream, as in the United States. This has the advantages both of contributing to social capital and, for the member, avoiding the dire consequences of breaching the minimum payment amount provisions (see 7.7.3).
- 20.** Introduce incentives for annuitisation for SMSFs, as in the United Kingdom. This measure could apply to members of all types of fund. For example, if an individual withdraws a lump sum to purchase an annuity (from an insurance company) guaranteeing him or her a lifetime income (and sufficient to disentitle them to the Age Pension), he or she could be automatically entitled to a government Seniors Card/Health Care Card (see 7.7.2).

8.1.3 More generally

Some important aspects of the superannuation system are not specific to the SMSF sector, but nonetheless deserve mention. What is observed today is inadequacy in retirement savings, although SMSFs are arguably the sector most approaching adequacy. In the words of one commentator:

The Baby Boomers around the world have written into law rich benefits for themselves, which have to be financed by tax dollars from future generations ... There are insufficient numbers of young people paying into the system to support the social security payments for those who have retired. Pension schemes, or forced retirement savings, should have protected workers from the problems associated with aging demographics. Unfortunately, low contributions, high costs, and poor governance and institutional design have generally led to poor funding and adequacy ratios.⁸³¹

In Australia, a number of legislative features of the retirement savings system are disincentives for the Boomer generation to provide for their own retirement, at the expense of Generations X and Y. This was explored in Chapter 5 in the context of an inquiry into the effectiveness of SMSF regulation. Currently the law allows fund members to access their superannuation in a lump sum at preservation age and deplete it between that time and the age at which, their lives having been circumscribed by frailty or infirmity and their financial requirements greatly reduced, they can access the government Age Pension. This is a rational course, maximising utility for the individual who does it, but detrimental to the wider community and inequitable to younger generations.

The superannuation system was introduced to encourage (or force) people to provide financially for their own retirement, but two principal legislative features currently frustrate that purpose – the misalignment of preservation and Age Pension ages and unreasonably low contribution caps. Two recommendations addressing these features follow.

⁸³¹ Jason Hsu, 'The 3-D Hurricane and the New Normal' (2011)

<http://www.investorsinsight.com/blogs/john_mauldins_outside_the_box/archive/2011/06/27/the-3-d-hurricane-and-the-new-normal.aspx>

21. The preservation age should be aligned to the Age Pension age to prevent deliberate depletion of superannuation savings and accessing government Age Pension.⁸³² The Age Pension is not pre-funded but is paid from consolidated tax revenue each year and, as the population continues to age, more retirees will require funding from a shrinking tax base.⁸³³ Despite this, the government appears reluctant to take this necessary step, possibly because it will discourage voluntary saving for retirement. The federal government has vetoed suggestions that the superannuation preservation age should rise to track the Age Pension age,⁸³⁴ a decision that is both inefficient (given longevity increases) and inequitable (since it advantages richer superannuants over poorer pensioners).⁸³⁵
22. Contribution caps should be raised, possibly via annual indexation, to address the longevity risk faced by the superannuation system.⁸³⁶ A possible outcome will be to implement a lifetime cap for everyone. This lifetime cap will differ from the previous system of reasonable benefits limits as it is not based on a lump sum or pension benefits approach.⁸³⁷

The Superannuation Guarantee will not fully mature until the late 2030s.⁸³⁸ Even then it may not meet the needs of workers living as long after retirement as they worked pre-retirement. The freedom to invest is one of the features attracting large sums into retirement savings held in SMSFs and available evidence indicates SMSFs are achieving better returns than professionally managed APRA-regulated superannuation funds.⁸³⁹ As

⁸³² See David Crowe, 'Call to lift super age to ease pension pressure', *The Australian* 3 August 2012, 6.

⁸³³ Rice Warner Actuaries, 'Touchstone: Reforming the Age Pension' (2012), 12.

⁸³⁴ Indexation of upper age limits in all laws, ensuring they rise together as lifespans increase. Indexation could apply to laws that provide benefits (age pensions, veterans' pensions, superannuation) and to laws that impose additional requirements (for example mandatory annual driver testing): Andrew Leigh, 'You're only as old as they feel', *Australian Financial Review* 6 October 2009, 64.

⁸³⁵ Nick Sherry, 'Some Challenges Facing Australia's Defined Contribution Superannuation System' (Paper presented at the 20th Annual Colloquium of Superannuation Researchers, University of NSW, 2012).

⁸³⁶ This has now been enacted for the concessional cap as of the 2014-15 income year (refer Appendix 2).

⁸³⁷ Sylvia Villios, 'Australia: Impact of Tax Review Report and the Henry Review on Self-Managed Superannuation Funds' (2011) 18(1) *The Business Review, Cambridge* 41.

⁸³⁸ Australian Treasury, *Retirement Income Strategic Issues Paper: 4. Assessment of the retirement income system* (2009)

<http://www.taxreview.treasury.gov.au/content/StrategicPaper.aspx?doc=html/Publications/Papers/Retirement_Income_Strategic_Issues_Paper/Chapter_4.htm>

⁸³⁹ SMSFs having out-performed the institutional funds since 1997: refer 5.3.6.

the government is attempting to combat longevity risk by encouraging retirement saving, government regulation should not interfere with freedom of asset allocation by SMSF trustees; such attractions must be retained.

8.2 Scope for future research

Throughout this thesis a number of unanswered questions have arisen, providing rich scope for further research. Answers to those questions will aid regulator (and community) understanding of SMSF members' behaviour and compliance and this is important as the sector takes control of an increasing proportion of the country's retirement savings, and the taxation expenditure it represents.

Some of those questions are:

- whether there is any evidence of SMSF members gaining access to their retirement savings at preservation age, depleting them and subsequently accessing the government Age Pension;
- the proportion of funds which have been subject to an ATO audit and the characteristics of funds that have been audited;
- the reason(s) why SMSFs are wound up;
- how often SMSFs accept Super Guarantee contributions, whether this introduces employers as SMSF stakeholders and the implications if it does; and
- whether evidence exists linking level of auditor independence⁸⁴⁰ and rate of contravention reporting.

Then there are sociological questions such as:

⁸⁴⁰ Differentiating levels of auditor independence such as:

1. none (the SMSF accountant and auditor being the same individual)
2. the auditor being a different director of the same accounting firm
3. the auditor being a person from a completely unrelated firm.

- the relationship between SMSF members (whether parents and children, other family members or unrelated individuals);
- whether all of the trustees in an SMSF are regularly involved in its day-to-day running or if there is generally one main controller;⁸⁴¹ and
- the demographic characteristics of SMSFs that invest in collectibles or have other unusual asset allocation patterns, for example 100% of their assets in business real property.

8.3 Evaluation

This research has, for the first time, attempted a documentation of the genesis of the SMSF, the sociology of the SMSF member, the legislative landscape within which SMSFs operate and a comparison of the Australian SMSF with other self-directed pensions schemes internationally.

Its aim was to identify improvements in the regulation of SMSFs in Australia, beginning with the assumption that such regulation, either in a legislative or supervisory sense, is not ideal or complete. A number of recommendations have been made above for the improvement of SMSF regulation.

No final conclusion is drawn as to whether an appropriate balance has been struck between trust and regulation in the SMSF sector. A great deal of further research into this sector is needed. In the interim:

Good people do not need laws to tell them to act responsibly, while bad people will find a way around the laws. Plato (427-347 B.C.)

⁸⁴¹ This is of concern particularly where death benefits are payable. A quote from Jacquie Hayes, 'Waves on the will pond', *Australian Financial Review* 16 June 2012, 40:

"When people tell me they don't need to worry about estate planning and the decisions a trustee of their SMSF will make because they've got members of their family [in the role], alarm bells ring for me," says Louise Biti, whose company, Strategy Steps, provides sophisticated research and technical support for top-tier financial services groups. "I'd be more confident about them getting things right if they thought of family members as hostile parties."

APPENDIX 1 - KEY TO INTERVIEWS

Only those interviewees who have consented to be quoted are named

	NAME	ORGANISATION/POSITION	DATE OF INTERVIEW
A. Australian SMSF professionals			
1	David Shirlow, Executive Director Macquarie Adviser Services	Macquarie Bank	7/5/09
2	Warren Chant, Principal	Chant West	16/6/09
3	Jeff Bresnehan, Managing Director	Super Ratings	31/7/09
4		Financial lawyer	15/9/09
5		SMSF Auditor	11/8/10
6		SMSF Administrator	12/8/10
7		Accountant	20/8/10
8		SMSF advisor	27/8/10
9		SMSF auditor	1/9/10
10		SMSF accountant/administrator	23/11/10
11		Accountant	2/3/11
12		Actuary	22/3/11
13		Actuary	23/3/11
14		SMSF auditor	29/3/11
15		Retired accountant	18/12/12
B. Australian Public Officials			
1	Jeremy Cooper, Chair	Super System Review	27/7/09
2	Craig Blair, Director SMSF Regulatory	Australian Taxation Office	1/10/09
3	Stuart Forsyth, Assistant Commissioner, SMSF Regulatory	Australian Taxation Office	1/10/09
4	Stuart Forsyth, Assistant Commissioner, SMSF Regulatory	Australian Taxation Office	16/4/10
5	Nathan Burgess, Director Illegal Early release, SMSF Regulatory	Australian Taxation Office	31/3/10
6	Stuart Forsyth, Assistant Commissioner, SMSF Regulatory	Australian Taxation Office	15/7/11

7	Nathan Burgess, Director Illegal Early release, SMSF Regulatory	Australian Taxation Office	5/10/11
8	Jeremy Cooper, Chairman, Retirement Income	Challenger	1/8/12
C. Overseas Public Officials			
1	Chris Masterton	Financial Services Authority, London	18/7/11
2	Andrew Bennett, Press Office	Her Majesty's Revenue & Customs, Waterloo, London	19/7/11
3	Kelly Greenwood Associate of Pensions Management	The Pensions Advisory Service, London	19/7/11
4	Mike Godwin, Director, Registered Plans Directorate	Canada Revenue Agency, Ottawa	22/7/11
5	Lorraine Bayeau, Manager, Registered retirement plans, health and education savings plans Group	Canada Revenue Agency, Ottawa	22/7/11
6	Jean D'Alon, Manager, General Enquiries and Compliance Group	Canada Revenue Agency, Ottawa	22/7/11
7	Judy Cameron, Managing Director, Private Pension Plans Division	Office of Supervisor of Financial Institutions, Ottawa	22/7/11
8	Chris Eccles	Office of Supervisor of Financial Institutions, Ottawa	22/7/11
9	David Gordon, Deputy Superintendent, Pension Division	Financial Services Commission of Ontario, Toronto	23/7/11
10	Matthew Ng, Technical Consultant, Training – Pensions Plans Branch	Financial Services Commission of Ontario, Toronto	23/7/11
11	Bernie Robins, IRS Public Relations	Internal Revenue Service, Washington DC	25/7/11
12	Mark Greenstein, Senior Pension Benefit Specialist	Department of Labor, Washington DC	26/7/11
13	Brian Buyniski, International Benefit Law Specialist	Department of Labor, Washington DC	26/7/11
14	Charlie Jeszeck, Director Security Team	Government Accountability Office, Washington DC	26/7/11
15	Tamara Cross	Government Accountability Office, Washington DC	26/7/11
16	Melinda Bowman	Government Accountability Office, Washington DC	26/7/11

APPENDIX 2 - SIGNIFICANT LEGISLATIVE EVENTS AFFECTING SMSFs

SIGNIFICANT EVENTS FOR SMSFs ⁸⁴²	
Effective Date	Event
December 1992	Introduction of allocated pensions
1 July 1994	<i>Superannuation Industry (Supervisions) Act 1993</i> replaced the <i>Occupational Superannuation Standards Act 1987</i>
1996-97	Introduction of lifetime complying pensions
16 October 1997	Introduction of eligible spouse contributions
20 September 1998	Introduction of life expectancy complying pensions
31 May 1999	Introduction of binding death benefit nominations (BDN)
8 October 1999	Introduction of Section 17A which includes the member/ trustee rules
1 July 1999	ATO replaced APRA as the regulator of SMSFs

⁸⁴² Tranzact Super, *Significant Events for SMSFs* (2012)
<<http://www.tranzacttotalsuper.com.au/Deed%20Significant%20Events.html>> accessed 15/6/12.

Mid-2001	Internal roll-overs of super pensions now treated as ETPs and taken into account for RBL purposes
1 July 2002	Introduction of greater flexibility with regards to contributions and compulsory cashing
1 July 2003	Introduction of Government co-contributions
11 March 2002	Introduction of product disclosure statements (PDS)
12 May 2004	Restrictions placed upon defined benefit pensions (DBP)
1 July 2004	Removal of work test for persons under age 65; Changes to work test for persons aged 65-70
20 September 2004	Introduction of market linked pensions
1 July 2005	Introduction of transition to retirement benefits
1 July 2005	Abolition of the superannuation surcharge
31 December 2005	Cessation of DBPs in SMSFs
1 January 2006	Introduction of super contributions splitting
10 May 2006	Relaxation of member benefit cashing rules at age 65

10 May 2006	Limits placed on making contributions
1 July 2007	Introduction of 2006 Budget Super Reforms including account based pensions
September 2008	Fund Borrowing via Instalment Warrants became available
November 2008	Non-lapsing Binding Death Benefit Nominations receive official ATO endorsement
Stronger Super measures enacted to date:	
June 2012	Superannuation data and payment regulations and standards applying to transactions undertaken by superannuation entities ⁸⁴³
June 2012	Indexation of concessional contributions cap (from 2015) and refund of excess concessional contributions ⁸⁴⁴

⁸⁴³ *Superannuation Legislation Amendment (Stronger Super) Act No. 91, 2012.*

⁸⁴⁴ *Tax and Superannuation Laws Amendment (2012 Measures No. 1) Act No. 75, 2012*

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