

## **SELF MANAGED SUPER FUNDS**

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## **INTRODUCTION**

**By Pauline Hammer**

Welcome investors.

The end of the financial year is near and for most practitioners in the finance industry, there is time for little else but assisting clients with their end of financial year strategies.

In this issue we provide you extracts from the “Self Managed Super Solutions Phase Three — Preliminary Report” of the Review into the Governance, Efficiency, Structure and Operation of Australia’s Superannuation System. The report is of some 60 pages long so in each issue we will provide extracts from the report until we have covered all areas considered by Jeremy Cooper especially in the SMSFs area.

The Phase Three Preliminary report intends to provide stakeholders a clear picture of the likely shape of the final recommendations on SMSFs to be made by 30 June 2010.

In this issue, we provide the following extracts:

- Ten Guiding Principles for SMSFs
- Trustee Structure (Corporate v Natural Person Trustees)
- SMSF Trustees — Education and Competency

A common issue this financial year has been solvency problems with asset test exempt pensions in SMSFs due to the global financial crisis. We provide a brief explanation of the issue and the treatment of such a pension which does not meet the high probability test, by Centrelink.

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# TEN GUIDING PRINCIPLES FOR SMSFS

On 29 May 2009, the Government announced a comprehensive review of Australia's superannuation system: the Super System Review (Review).

It has been charged with examining and analysing the governance, efficiency, structure and operation of Australia's superannuation system. The Review is focused on achieving an outcome that is in the best interests of members and which maximises retirement incomes for Australians.

On 14 December 2009, the Review Panel released an Issues Paper titled 'Phase Three:

Structure' calling for submissions by 19 February 2010 on a range of issues relating to Self-Managed Superannuation Funds (SMSFs) and small APRA funds (SAFs).

This Preliminary Report contains the Panel's views on the issues raised in Phase Three insofar as they relate to SMSFs only. The Panel has done this to assist in the process of articulating and refining the recommendations that will ultimately be made to the Government. The Panel believes that there is a reasonably high degree of consensus on many of the issues if the numerous, high quality submissions received in response to the Phase Three issues paper are indicative.

The Panel also notes the Future of Financial Advice package of financial advice reforms announced by The Hon Chris Bowen MP, the Minister for Financial Services, Superannuation and Corporate Law, on 26 April 2010.<sup>2</sup> The Panel believes that this SMSF Preliminary Report is consistent with the Government's Future of Financial Advice reform package; in particular, in areas such as adviser competency and remuneration and the removal of the accountants' licence exemption.

As a starting point, the Panel has articulated ten guiding principles that it believes should underpin the regulation of SMSFs. The principles have informed the Panel's preliminary recommendations and could have a longer term role in guiding policy-making in the SMSF sector.

## **Principle 1 — Ultimate responsibility**

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.

## **Principle 2 — Freedom from intervention**

Given that SMSF members are entirely responsible for their own decisions (principle 1), the Panel sees the ability to be genuinely self directed and self sufficient as an important feature of SMSFs. The Panel believes that trustees should not lightly be exposed to administrative and other burdens that are not directly relevant to building their retirement savings through sound investment practices.

## **Principle 3 — ... but not complete absence of intervention**

All superannuation funds, including SMSFs, benefit from valuable tax concessions that are designed to encourage and help members to save for retirement. In addition, the government underwrites the risk of SMSF failure via the social security system. The Panel believes that this justifies some intervention in the way SMSFs are managed and that the community also has a right to a certain level of information about them. That intervention is currently reflected in a range of rules and restrictions in the SIS Act and associated regulations.

## **Principle 4 — Service providers**

Consistent with the first three principles, trustees are not required to use a service provider when running an SMSF, other than the annual audit, which must be carried out by an approved auditor. SMSFs might also choose to use a range of other service providers (for example, administrators, platform providers and accountants) and these service providers also play an important 'gatekeeper' role in the SMSF sector. As a result, the Panel believes that government policies should be directed at ensuring service providers maintain a high standard of competency and

compliance as part of the overall regulatory framework. Where appropriate, licensing should be used to achieve this, but only in a way that demonstrably adds value to the sector.

### **Principle 5 – Gatekeeper on establishment**

The Panel believes that the viability of the SMSF sector is strongly dependent on the composition of its population. An influx of trustees who were less well equipped to cope with the responsibilities and disciplines inherent in running an SMSF could lead to serious public policy concerns for the sector. Such a development could see a call for more severe regulatory restrictions on all SMSFs which would be to the detriment of all existing members and the sector as a whole. The Panel recognises that this Review could create an interest in SMSFs from people who would, in fact, be better off remaining in an APRA regulated fund.

The Panel therefore favours a mechanism that allows new entrants to the SMSF sector to assess whether they would be suited to its unique features and responsibilities and understand the need for a certain size of fund to make an SMSF cost competitive with an account in an APRA regulated fund. The Panel has not made any preliminary recommendation, but decided to leave open for further discussion the way this could be achieved by proposing a number of options. The various options it has looked at are canvassed in section 7.2.1 ‘SMSF Establishment – gatekeeper mechanism’.

### **Principle 6 — Consistent treatment with APRA regulated funds where appropriate**

The Panel believes that the norm should be that all superannuation funds are treated in the same way. For example, notwithstanding that outcomes might differ because of fund size, scale and other individual fund circumstances, the same tax legislation, sole purpose and preservation rules should apply across all sectors. This suggests that many rules for SMSFs will be the same as those applicable to APRA regulated funds and that is in fact the case.

However, there is no escaping the fact that SMSFs are different and that they call for different rules in a number of areas. It is not always appropriate or desirable that all superannuation funds should operate under precisely the same legislative framework. The Panel recognises that this runs counter to many submissions that argued their particular position on the basis of a ‘level playing field’. However, the Panel has specifically taken the view that consistency with APRA regulated funds will not always be appropriate for SMSFs.

This position also reflects the distinct supervisory approach necessarily applied by the ATO and APRA to their respective superannuation populations.

### **Principle 7 — Recognition of special risks in an SMSF environment**

Extending principle 6, the Panel recognises that the SMSF environment creates some particular tensions in appropriately managing the personal preferences and lifestyle choices of the members (and their related entities). While trustee decisions for all funds are made within the framework of the sole purpose test, the Panel believes that it is appropriate to impose some additional restrictions on SMSF trustees (over and above the restrictions imposed on funds with an external trustee) given those tensions.

### **Principle 8 — Leverage**

Leverage should not be a core focus for SMSFs. While views will differ on this issue, the Panel believes that there is room for leverage in SMSFs, but it should be ancillary to the main strategies employed to build retirement savings over the longer term.

### **Principle 9 — Compliance, rather than prudential, regulatory focus**

An important element in the supervision of APRA regulated funds is ensuring that trustees are acting in members’ best interests at all times.

In the Panel’s view, a different regulatory focus is appropriate for SMSFs. The role of the regulator and key industry participants (such as auditors) for this sector should be legislative compliance, rather than a prudential objective.

## Principle 10 — Pursuit of excellence

Given that SMSFs are widely dispersed and non-institutionalised, and that many SMSF service providers are also fragmented and lack scale, there is a challenge for the sector in investing in improvements such as technology, governance and investor education. The Panel believes that a sector that has such a large proportion of Australia's retirement savings needs an aggressive agenda aimed at pursuing excellence across all its activities.

The Panel believes that it might be worthwhile for government to consider measures to support, promote and champion the development of best practice among SMSF trustees.

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## TRUSTEE STRUCTURE (CORPORATE V NATURAL PERSON TRUSTEES)

The number of SMSFs with natural person (member) trustees is much greater than those with corporate trustees and this trend appears to have been increasing in recent years. As at 30 June 2009, around 29 per cent of all SMSFs had a corporate trustee. However, for the 2008 and 2009 financial years, nearly 90 per cent of new SMSFs were established without a corporate trustee.<sup>17</sup>

The Panel and various stakeholders have expressed their surprise at this trend in various consultations and submissions. It is widely accepted by professionals and the ATO that a corporate trustee is superior. Some of these benefits, outlined in submissions, include:

- perpetual succession — the corporate entity cannot die, so it enables better control in the event of member death or incapacity;
- greater administrative efficiency;
- greater flexibility to pay benefits as lump sums or pensions;
- greater estate planning flexibility;<sup>18</sup> and
- reduced risk of deliberate or accidental intermingling of fund and personal assets, in breach of the covenant in section 52(2)(d) of the SIS Act.<sup>19</sup>

The trend towards individual member trustees could be due to limited advice or understanding of the benefits and the higher establishment costs of the corporate trustee option over the member trustee option.

Some submissions, recognising the benefits of corporate trustees, supported the use of a sole purpose corporate trustee (SPCT).<sup>20</sup> One submission recommended that the ASIC company registration fee be reduced to \$100 and the \$40 ASIC annual review fee be removed.<sup>21</sup> A number of submissions also suggested that all SMSFs should be required to have a corporate trustee.<sup>22</sup>

The Panel is attracted to the potential benefits provided by the corporate trustee structure and is concerned about the large proportion of new SMSFs choosing not to use a corporate trustee. However, consistent with principle 2 regarding freedom from intervention, the Panel believes that the solution here is a better standard of advice, an aim which is addressed by other recommendations. The Panel therefore does not intend recommending any change on this issue.

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## SMSF TRUSTEES — EDUCATION AND COMPETENCY

Risks associated with a trustee's lack of financial literacy or understanding of longevity risk is potentially magnified in an SMSF. While SMSF members face complexity in relation to their funds, complexity affects every superannuation member in one way or another.

The Panel does not believe that SMSF trustees should be expected to become superannuation experts; that is simply not realistic. Increasing trustee knowledge and competency is desirable and was mentioned in many submissions. This is, of course, a view shared by the Panel.

The Panel, however, believes that increased knowledge and competency can be achieved through other methods rather than by requiring trustees to undertake compulsory education.

The Panel believes that improvements in SMSF trustee knowledge can be realised through:

- Increasing the minimum competency and knowledge levels of participants that service the SMSF sector, given that the majority of trustees engage some form of service provider. The overwhelming majority of submissions were of a similar view.<sup>23</sup> This is further discussed in section 7 'Service providers'.
- Increasing the provision of SMSF orientated information and education to enable voluntary education. This is further discussed in section 9.4 'Online SMSF resource centre'.

The private sector is already starting to produce this type of education. Accounting professional bodies are in the process of developing an 'on line self paced training package for SMSF trustees' which will be available free of charge for trustees in the second quarter of 2010.<sup>24</sup>

While, in principle, the Panel does not favour compulsory trustee education, it is attracted to the idea of compulsory education for those who breach their SIS Act obligations. This is further discussed in section 6.1 'ATO Penalties'.

The Panel does not believe that any particular academic, professional or other qualifications requirement should be imposed on SMSF members. The Panel does not believe SMSF trustees should be mandated to undergo any form of initial or ongoing formal education, training or accreditation. Such decisions should be voluntary.

17 Super System Review, 'Statistical Summary of Self-Managed Superannuation Funds,' 10 December 2009.  
Self-managed super solutions Page | 7  
18 DBA Lawyers, Phase Three Submission, appendix 1; Outlook Tax and Accounting Solutions Pty Ltd, Phase Three Submission, page 6.  
19 Section 52(2)(d) SIS Act.  
20 SPAA, Phase Three Submission, page 22; DBA Lawyers, Phase Three Submission, page 4.  
21 DBA Lawyers, Phase Three Submission, page 4.  
22 J. and V. Mahon, Phase Three Submission, page 6; DBA Lawyers, Phase Three Submission, page 4; K. Bailey, Phase Three Submission, page 1.  
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23 SPAA, Phase Three Submission, page 14; Dixon Advisory, Phase Three Submission, page 14.  
24 CPA Australia, Phase Three Submission, page 9.

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# **SOLVENCY PROBLEMS WITH ASSET TEST EXEMPT PENSIONS IN SMSFS**

If a SMSF has a 100% asset test exempt lifetime or term pension, they are required to meet a 'high probability' actuarial test that verifies that the SMSF can continue to meet their pension obligations. Due to the global financial crisis, it has become more difficult for a SMSF to pass the high probability actuarial test. If a SMSF fails this test, the pension must be commuted to purchase a new retail asset test exempt income stream or market linked term allocated pension (which may be available within the same SMSF).

## **Continuation of the asset test exemption for social security**

Where the 100% asset test exempt lifetime or term pension is commuted to commence another income stream, the new income stream will only be asset test exempt if it retains the features of the original income stream. Hence, a lifetime or term asset test exempt income stream that is commuted to a new market linked term allocated pension will lose its asset test exemption. Usually this would result in a social security debt being created.

## **New exemption from raising a debt**

The Government has introduced new relief measures to waive the creation of any social security debt. The relief is available where a 100% asset test exempt lifetime or term pension fails to meet the high probability test and is restructured into a new market linked term allocated pension, within the same SMSF. This relief measure is available until 30 June 2010. However, the new market linked term allocated pension is 100% asset tested.

## **Temporary debt relief measures for 100% ATE income streams**

The temporary debt relief measures include the original relief and the enhanced relief.

### **1. Original relief**

The Minister for FaHCSIA agreed to provide temporary relief for income support recipients with 100% ATE income streams who provide an actuarial certificate to Centrelink that does not specify a high probability opinion, or where the income support recipient does not provide an actuarial certificate. The income stream will be re-assessed as an asset-tested income stream (long term) but a debt will not be raised. This initial relief measure is available until 30 June 2010, and applies to the 2008-09 and 2009-10 actuarial certificate reviews.

While actuarial certification is no longer required, the now asset-tested income stream is still subject to the characteristics of an income stream under SSAct section 9(A) or 9(B). For example, a debt will be raised if a non-allowable commutation is made from the now asset-tested income stream or where the gross income is reduced. A non-allowable commutation happens in the following circumstances:

- the asset-tested income stream is commuted to a lump sum,
- the asset-tested income stream is commuted and rolled over to an allocated income stream,
- the asset-tested income stream is commuted and rolled over to a market-linked income stream prior to 27 November 2009 (SMSF) and 5 February 2010 (SAF) under the enhanced relief.

### **2. Enhanced relief**

From 27 November 2009 and until 30 June 2010, it is permissible for income support recipients with 100% ATE income streams paid from SMSFs who provide an actuarial certificate that does not specify a high probability opinion to restructure the income stream by a full commutation (including reserves) and rollover to an asset-tested market-linked income stream within the fund. The market-linked income stream cannot be purchased from a retail provider. A debt will be raised



but will be waived according to the legislative instrument Social Security (Waiver of Debts - Self Managed Superannuation Funds) (FaHCSIA) Specification 2009.

Similarly, from 5 February 2010 and until 30 June 2010 it is also permissible for income support recipients with 100% ATE income streams paid from SAFs who provide an actuarial certificate that does not specify a high probability opinion to restructure the income stream by a full commutation (including reserves) and rollover to an asset-tested market-linked income stream within the fund. The market-linked income stream cannot be purchased from a retail provider. A debt will be raised but will be waived according to the legislative instrument Social Security (Waiver of Debts - Small APRA Funds) (FaHCSIA) Specification 2009.

Note: Enhanced relief is not available to income support recipients who do not provide an actuarial certificate to Centrelink that does not specify a high probability opinion.

The new asset-tested market-linked income stream is still subject to the non-commutability requirement for market-linked income streams. A debt will be raised if the now asset-tested market-linked income stream is subsequently commuted to a lump sum or rolled over to any other income stream.

Exception: If the SMSF is forced to wind up in the future on the grounds of the administrative responsibilities of the fund becoming too onerous due to the age or incapacity of a trustee, the asset-tested market-linked income stream from the SMSF can be commuted and rolled over into an asset-tested market-linked income stream from a retail provider, or into a lifetime or life expectancy asset-tested income stream from a retail provider. The retail asset-tested income stream is also subject to the non-commutability requirement.

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