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19 February 2010

Super System Review  
GPO Box 9827  
MELBOURNE VIC 3001

Email: [info@supersystemreview.gov.au](mailto:info@supersystemreview.gov.au)

Dear Sir

## **Review into Australia's Superannuation System - Phase Three: Structure (Including SMSFs)**

### **1. Introduction**

#### **1.1. Scope and structure of our submission**

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide its comments in response to the issues paper for the *Review of Australia's Superannuation System, Phase Three: Structure (including SMSFs)* (**Phase Three Issues Paper**).

The Taxation Institute has limited its comments to focus specifically on issues under Part B of the Phase Three Issues Paper relating to SMSFs.

The Taxation Institute's submission is not intended to provide an exhaustive response to all of the SMSF-related issues raised by the Phase Three Issues Paper, but rather focuses on the following range of key issues, discussed below:

- SMSF governance;
- SMSF operation and efficiency;
- SMSF investments;
- SMSF sector participants;
- SMSF structure;
- Early release issues; and
- Life insurance

#### **1.2 Preparation**

The Taxation Institute's submission has been prepared by the Taxation Institute's Superannuation Subcommittee, whose brief encompasses the operation of the superannuation legislation and regulations in the context of Australia's retirement income system.

The members of the Taxation Institute's Superannuation Subcommittee are respected experts and leaders in their field with extensive experience in advising on all facets of superannuation both in the public and private sectors.

A number of the Taxation Institute's Subcommittee members have represented the Taxation Institute in consultations with the Australian Taxation Office (**ATO**) and the Treasury on a broad range of superannuation issues both at the administrative and policy levels.

The current membership of the Taxation Institute's Superannuation Subcommittee is appended to the submission.

### **1.3 Summary of recommendations**

As requested by the Phase Three Issues Paper the Taxation Institute has set out below a summary of the key recommendations made in this submission (our reasons appear in the body of our submission):

- the Taxation Institute supports a continuation of the trust model for SMSFs, including for single-member funds;
- the Taxation Institute supports a continuation of the requirement for all members of SMSFs to also act as trustees (or directors of the trustee company);
- the Taxation Institute does not support compulsory training, education or accreditation for trustees of SMSFs, though the Taxation Institute is not opposed to it being encouraged;
- the Taxation Institute supports simplification of the regulatory environment for SMSFs, particularly in relation to investment and in-house asset rules and suggests that consideration be given to allowing or incentivising SMSFs to opt-in to a simpler regulatory model on the basis that they will not engage in any related party dealings – reduced supervisory fees may then operate for these funds with a higher fee for those that do not opt-in;
- the Taxation Institute would support stand-alone legislation for regulation of SMSFs;
- the Taxation Institute supports extending the jurisdiction of the Superannuation Complaints Tribunal to deal with death and disability benefits in SMSFs and potentially to the payment of any kind of benefit from an SMSF;
- the Taxation Institute has recommended a review of the penalty regime for SMSFs with the top marginal tax rate merely applying to an SMSF's taxable income during the financial years that the fund remains non-complying; and if an extra monetary penalty above this needs to be imposed then the Taxation Institute has suggested that it be in line with having a deterrent effect, but not a punishment so large that wipes out almost half of a taxpayer's retirement savings - this monetary amount could be in the order of, say, \$10,000 to \$20,000 – or based on a scale of the assets in the fund;
- the Taxation Institute does not support any moves towards requiring an independent custodian to be appointed to hold an SMSF's assets – nor does the Taxation Institute support prescribing the asset classes into which an SMSF might choose to invest;
- the Taxation Institute would welcome improvements to investment platforms and technological advances that would improve the operation and efficiency of SMSFs, but notes that a considerable cost factor for SMSFs over the past decade or so has been the constant changes in the regulatory environment;
- the Taxation Institute agrees that there are important issues to be addressed in dealing with elderly participants in the superannuation industry, but suggests that these issues are industry-wide and do not only affect SMSF participants – accordingly, the Taxation Institute does not support any proposal to encourage SMSF participants to move away from the self managed sector after a particular age;
- the Taxation Institute tentatively supports an increase to the maximum number of members who may participate in an SMSF, though further consideration will be required to determine how an SMSF would then be defined and whether there is an

- alternative to imposing a maximum limit on the number of members or whether there might be some requirement for additional members of the fund to be “related”;
- the Taxation Institute does not support any minimum fund amount as being required to establish an SMSF;
- the Taxation Institute supports some form of independent assessment for determining the release of monies from SMSFs on hardship grounds;
- the Taxation Institute supports the work being done in relation to minimising the occurrence of illegal early release schemes; and
- the Taxation Institute does not support any requirement for minimum insurance to be provided in SMSFs.

## **2. Brief remarks on “Choice Architecture Model”**

The Taxation Institute supports the views stated in the Government’s preliminary report on *‘Australia’s Superannuation System – Clearer Super Choices: Matching Governance Solutions’*. As the Taxation Institute understands it, the report sets out a ‘choice architecture’ model pursuant to which members are classified into three categories: “Universal”, “Choice” and “SMSFs”. The Taxation Institute agrees with the classification of members into the “self managed” fund model as those who will be “self reliant” and not dependent upon the regulatory system to operate in a paternalistic way. In turn, this means that a simplified approach to regulation should operate without extensive prudential controls which currently give rise to onerous disclosure and reporting obligations that are largely unnecessary in the SMSF sector.

The Taxation Institute has made further reference to the “Choice Architecture Model” throughout the submission.

The remainder of the submission addresses some particular issues raised by the Phase Three Issues Paper.

## **3. SMSF Governance**

### **3.1. Trust Model**

The Taxation Institute supports the continued use of the trust model for SMSFs. It should not be assumed that all trustees and members of SMSFs will be related parties as many SMSFs are established by unrelated business colleagues, friends or parties who may become unrelated through marriage break-downs and death.

A trust structure brings innate protections for investors that would be difficult to replicate in any alternative contractual or statutory vehicles for retirement savings. Whilst it is possible for trust deeds governing an SMSF to alter and even “water down” some of these protections, they nevertheless operate as an appropriate back-drop or starting point to the establishment of an SMSF and to the operation of the regulatory environment. The separation of legal and beneficial ownership of assets is also important in the context of protecting retirement savings in the case of insolvency of a member.

Even single member funds are appropriately served by the trust structure, particularly in light of the potential for death benefits and superannuation splitting to apply.

### **3.2. SMSF Trustees**

The Taxation Institute supports to continuation of the requirement for all members to be trustees (or directors of the trustee company) and vice versa. Such arrangements seem consistent with the “choice architecture” outlined in the preliminary report for phase one of the Review where the “SMSF” category would be at the highest end of connectivity to their

superannuation and being largely self reliant.

The Taxation Institute considers that member notification and disclosure requirements for SMSFs should be less onerous than for Small APRA funds where an independent trustee is involved. For example, the PDS requirements seem largely irrelevant for SMSFs. Also, the application of the investment strategy statutory covenant would seem less relevant to an SMSF where the members are making their own investment decisions in their capacity as trustees.

### **3.3. Trustee Education**

The Taxation Institute does not support “compulsory” education for trustees of SMSFs. Such a requirement would be a departure from the position that exists for other private investment vehicles used by the community, such as companies and trusts – there is no requirement nor any suggestion for company directors to have compulsory education.

Further, a compulsory education requirement may be particularly burdensome and discriminatory for older trustees or those in regional communities who may find it difficult to attend or otherwise participate in a compulsory education programme.

The key factor for members/investors is that they have chosen to take control of their own superannuation savings and it follows that they will make decisions with a view to improving their retirement savings and not diminishing those savings (with only a relatively small component assisted by taxation concessions). If there is a policy concern about “uneducated” members/investors being persuaded to establish an SMSF by operators who will inappropriately benefit from charging SMSF fees then this issue should be addressed with a focus to those operators – rather than compulsory education for the investors/members.

The Taxation Institute does not support the ATO’s powers being broadened to require compulsory training or accreditation for trustees of SMSFs. Such a power may be more appropriate for a prudential regulator and not the ATO. However, for the reasons already mentioned, the Taxation Institute is not satisfied that any form of compulsory training is appropriate for trustees of SMSFs. The Taxation Institute supports a change to the current penalty regime applicable to SMSFs (see below).

### **3.4. Complexity**

Any proposal for current regulatory complexity being maintained as a “useful barrier of entry to the sector” is not supported. Regulatory complexity should not be supported in any sense. It would be an abuse of legislative power for regulatory complexity to be used for the purpose of discouraging participants to enter any industry.

The Taxation Institute suggests greater regulatory complexity for SMSFs exists in relation to investment rules and, in particular, the application of the in-house asset test. These complexities are not generally faced by the non-SMSF sector. There are many transitional rules that have added to this complexity.

Accordingly, the Taxation Institute would strongly support efforts to simplify these arrangements, though any such simplification would need to protect current complying investments. The Taxation Institute expects any legislative simplification of this area would be difficult to achieve and would be pleased to provide further input into this process.

In relation to any such simplification consideration might be given to providing an incentive (which might of itself largely be a simplified regime) for existing SMSFs to opt-in to a simplified regulatory environment for which related party investments would not be permitted and perhaps lower annual supervisory fees were applied (with higher supervisory

fees being applied to the “legacy” funds). Presumably audit and other costs of running a fund with unrelated investments might also be reduced. Care would need to be taken to ensuring that the “opting-in” or “accreditation” for the simpler fund tier did not of itself become an additional burden for auditors – perhaps it could operate in a similar way to self-assessment with significant penalties for those that “abuse” the system.

### **3.5. Regulatory Framework**

#### **3.5.1. Regulation**

The Taxation Institute would support a separate suite of simplified regulation applicable to SMSFs only. There are many parts of the SIS legislation and the Corporations Act that are not applicable to SMSFs and add to the complexity for advisors and auditors, as well as members/investors themselves, in understanding and complying with the regime.

#### **3.5.2. Role of the ATO and other Regulators**

The Taxation Institute does not consider that the ATO is an appropriate regulator of prudential matters. There are currently inconsistencies between the ATO’s and APRA’s approach to regulation. An example of this might currently be seen in relation to the regulators dealing with mistaken contributions.

The Taxation Institute would generally support amendments to the SIS legislation to enable the ATO to deal directly with “agents” or other intermediaries on behalf of SMSFs.

The Taxation Institute would also be very supportive of the ATO being empowered to issue binding rulings on SMSF matters.

#### **3.5.3. Dispute mechanisms**

The Taxation Institute would support an extension of the Superannuation Complaints Tribunal’s jurisdiction to handle complaints relating to the distribution of death benefits from an SMSF. Consideration might also be extended to a complaint regarding a payment of any benefits from an SMSF on the basis that there is potential for disputes to be unresolved in this arena – for example, a refusal by one of the trustees to liquidate an investment to allow a member to withdraw their superannuation following a dispute between business partners or a marriage separation. Where external disability insurance has been arranged via an SMSF it would also make sense for the SCT to have jurisdiction to hear complaints regarding disability benefits in respect of which the insurer may be joined.

The Taxation Institute supports the rationale behind the continuing exclusion of SMSF members from access to industry-funded financial assistance and agree that access to this regime should not be extended to SMSF members. In our view this is in keeping with SMSF members/investors taking responsibility for the operation of their fund and the outcome of their decisions.

#### **3.5.4. Penalties**

The Taxation Institute considers that the penalty regime, as it operates in relation to SMSFs, is inappropriate.

If a superannuation fund becomes a non-complying fund (typically this will only occur for SMSFs), in relation to the immediately following financial year for that fund its assessable income will be taken to include, broadly, an amount referable to the market value of the fund’s assets (less any tax free component) (see sections 295-320 and 295-325 of *Income Tax Assessment Act 1997*). This means that all of the tax concessions that were previously available to the fund whilst it was a complying fund are effectively recouped and, in effect,

the entire asset base of the fund becomes subject to taxation at the rate of 45% (together with an additional amount of 15% tax already paid in respect of concessional contributions). There is no discretion given to the ATO to impose a lesser rate of tax.

This seems to be the key penalty which the ATO seeks to impose in the circumstances where there are breaches of the SIS legislation. There are other options available to the ATO for dealing with breaches including disqualifying, suspending or removing trustees, instituting court proceedings to seek penalties in respect of offences under the SIS legislation and freezing the assets of a fund. However, these kinds of options are typically used in addition to the ATO making the fund a non-complying fund.

The Taxation Institute has recognised a recent increase in the number of SMSFs that the ATO is making non-complying. Given that the Taxation Institute understands the average SMSF now has a net asset base of in the order of \$900,000 the imposition of a 45% tax appears draconian. Further, the imposition of such taxation has a deleterious effect on the retirement savings of members of a fund who are affected by such a finding. The Taxation Institute accepts that there needs to be a significant penalty to deter trustees from breaching the SIS legislation, however, the Taxation Institute considers that the removal of the taxation concessions available to complying funds (and those contributing to them) is of itself a significant deterrent in addition to the other penalties available to the ATO. In any event, the Taxation Institute seeks consideration to be given to reducing the 45% tax on the asset base of a fund if it is found to be non-complying.

The Taxation Institute recommends that the top tax rate merely apply to the fund's taxable income during the financial years that the fund remains non-complying and that alone will generally be sufficient to penalise funds. If an extra monetary penalty above this needs to be imposed then it should be in line with having a deterrent effect, but not a punishment so large that wipes out almost half of a taxpayer's retirement savings. This monetary amount could be in the order of, say, \$10,000 to \$20,000 – or based on a scale of the assets in the fund.

#### **4. SMSF Operation and Efficiency**

The Taxation Institute notes the comments regarding economies of scale and the apparent lack of access by SMSFs generally to wholesale pricing, however, the Taxation Institute feels that subsidised wholesale pricing would be difficult to achieve without distorting normal market forces.

The Taxation Institute would welcome the development of technology platforms that would make the operation of an SMSF more efficient, but again consider this should be in the context of normal market forces and pricing unless provided under the umbrella of a government agency or statutory authority.

The Taxation Institute does not support the tightening of SMSF reporting deadlines merely to enable the collection of more timely data. Most SMSFs already have access to various real time data to enable appropriate decision making by trustees.

The Taxation Institute supports the introduction of mandatory market valuation of all assets of an SMSF, but not the extension of reporting requirements to include mandatory preparation of general purpose financial statements. Such a requirement would be contrary to the existing accounting framework universally adopted in Australia for end users who have access to all necessary financial information (ie trustee/members).

The variances in costs in operating an SMSF are in accordance with our understanding of what is occurring in practice. The higher costs at the lower end are not surprising, but should perhaps be analysed further. In many cases, an SMSF is established with a lower initial net asset level on the basis that sufficient contributions are likely to be made in the next



couple of years to enable the fund to reach a more cost effective level of assets. Many trustee/members are happy to operate at a less cost efficient basis in the short term on the expectation that their choice of investments and overall contribution strategy will result in a cost effective arrangement over the longer term.

The Taxation Institute submits that all SMSFs, regardless of size, must invariably comply with a mandatory base level of statutory requirements. These base requirements, and hence costs, have increased in recent times as a result of further regulatory requirements and complexity despite the 2007 “Better Super” changes (for example, changes to contributions caps and reporting requirements, revised regulatory annual returns, S104A declarations for new trustees, significant increase in pronouncements from the ATO after many years of little activity). In our opinion, the “fixed compliance cost component” of running an SMSF has increased in proportion to the increase in complexity of the overall regulatory regime. This in turn has a greater impact on SMSFs with an overall lower net asset value. The Taxation institute would welcome any future simplification of the SMSF regulatory regime and long term bi-partisan stability.

## **5. SMSF Investments**

As a preliminary comment, the Taxation Institute notes that investment expertise is a key issue in the defined contribution environment and is a concern for the superannuation industry as a whole – not just for SMSFs. Historically, the Taxation Institute suggests that SMSF investment performance has been relatively favourable when compared with the remainder of the industry, though the Taxation Institute accepts that collection of accurate and relevant data to conclusively support this is at present unavailable.

The Taxation Institute does not support a third party custodian being compulsorily required to hold SMSF assets either on establishment of an SMSF or universally. This would add considerably to the costs of operating an SMSF and any perceived benefit to be gained would be significantly outweighed by the cost.

The Taxation Institute does not consider that such a requirement would be an effective or appropriate penalty in response to a breach of the SIS legislation – refer to our comments above for our recommendations in relation to the penalty regime.

If, as the Taxation Institute has suggested above, a broad and new legislative approach were adopted to simplifying SMSF legislation such that funds with unrelated investments operated under a simplified and possibly cheaper regime, then consideration might be given to enhanced regulation over funds with related party dealings – perhaps directed at special certification or audit requirements around compliance with regulations for related party dealings.

As mentioned above, the Taxation Institute would support the removal of the requirement for SMSF trustees to have an investment strategy.

The Taxation Institute does not support any prescription of asset classes, such as “financial assets”, for investments made by SMSFs. Investors/members of SMSFs are ultimately responsible for the investments made and it follows that they will be motivated to invest so as to maximise their retirement savings without exposing their savings to significant risk. Prescribing asset classes for investment would potentially force SMSFs to compete with large funds for the same kinds of investments without access to the same economies of scale. Simplification of administration and audit should not be a reason to compel SMSFs to invest in particular asset classes.

The Taxation Institute supports SMSFs (and superannuation funds generally) being able to borrow albeit with constraints over the loan to valuation ratios that must apply. Sensible borrowing to invest in growth assets has been a traditional method of increasing wealth.

Whilst the Taxation Institute accepts that some individuals will suffer increased losses as a result of their superannuation fund borrowing, to preclude superannuation funds from borrowing altogether will result in generally smaller retirement incomes within Australia.

However, the current regime (as described in section 67(4A) of SIS) is too cumbersome and should be simplified in order to provide greater clarity of when and where superannuation funds are allowed to borrow.

## **6. SMSF Sector Participants**

The Taxation Institute considers that there is significant confusion around the current exemption for accountants and the extent to which it operates. The Taxation Institute considers it would be useful to have clarification around the application of this exemption. However, care should be taken to ensure that any restrictions or requirements around the activities of an accountant do not erode their ability as professionals to advise their clients in a productive way.

The Taxation Institute considers that there is scope for audits to be conducted on a triennial basis for funds that opt-in to a simplified regulatory regime (as described above) where there are no related party dealings. This would simplify the audit process for these funds.

## **7. SMSF Structure**

The Taxation Institute strongly rejects any suggestion that SMSFs become purely a creature of statute or that there be a standard trust deed similar to the “replaceable rules” under the Corporations Act. It is important for the trust structure to be maintained in a pure sense – rather than a statutory creature with unknown parameters. One can see the difficulties that have arisen with the interpretation and application of statutory covenants under the SIS legislation – the Taxation Institute suggests the same kinds of difficulties would arise if the SMSF became purely a statutory creature or a statutory trust deed could be applied. This kind of approach does not recognise the peculiarities and design features of various SMSFs and would be inconsistent with the general thrust of the “SMSF” fund model architecture.

## **8. Other SMSF Issues**

### **8.1. SMSFs in later life**

The Phase Three Issues Paper suggests that it might be appropriate for older members of SMSFs to be encouraged to move their retirement income arrangements out of their own hands or at least into simpler products needing less active management. The Taxation Institute does not support this suggestion; such changes may cause older members to liquidate SMSF investments at an inappropriate time or to be convinced by advisers (with government policy backing) to move to a retail or industry fund without any real or tangible benefit. The suggestion that a member/investor who has chosen to be self directed in the management of their retirement savings should upon reaching a particular age be encouraged or required to divest themselves of that arrangement is counter intuitive for the self managed “fund model”.

That said, the Taxation Institute considers that further work is required to determine the scope of issues likely to be faced by the industry as a whole in dealing with an increasing number of elderly participants in the superannuation industry. This is an industry-wide issue because an elderly participant in a “choice” fund model may make an equally poor decision concerning their superannuation as a trustee member managing their own SMSF under the “self managed” model. Ensuring that members (and trustees for SMSFs) have appropriate enduring power of attorney arrangements in place only goes part way to addressing the issues likely to be faced by this growing phenomenon.



## **8.2. Number of members**

The Taxation Institute would support increasing the potential number of members in an SMSF to a number above four. The Taxation Institute accepts that if the rule that all members must be trustees remains then there would be difficulties in management and control of an SMSF that had a larger number of members – for example, ten.

One option might be to permit an increase in the number of members so long as the members are “related” (which concept would need to be by reference to “Part 8 Associates” or some other existing concept of “associate” or “relative”). At present, a family of five must establish two SMSFs in order for all family members to participate – increasing the number above four in circumstances where family members are related would seem to have the benefit of cost savings without any obvious downside. This approach would allow many Australian families to have one SMSF instead of two SMSFs.

Of course, an SMSF with eight members who must also act as trustees or directors of the trustee may be considered cumbersome – though the Taxation Institute expects that there would be few SMSFs that would fall within this category. One way to address this issue would be to allow for representative trustees to be nominated by family groups within an SMSF.

## **8.3. Barriers to entry**

The Taxation Institute does not support the imposition of any barriers to entry for joining or establishing an SMSF. There are no barriers to entry for other investment products such as, listed shares or real property. The SMSF is a vehicle through which investments are made and the relevant underlying investment market is the appropriate point at which to place any limitations or requirements – for example, financial products in which an individual or an SMSF may invest are regulated by Chapter 7 of the Corporations Act.

## **8.4. Minimum monetary balance**

The Taxation Institute does not support a minimum monetary balance being required to establish an SMSF. Such a restriction is contrary to the concept of those investors/members making their own choices about their retirement savings. It also ignores the fact that investment by making contributions to a SMSF is intended to take place over a longer timeframe as opposed to being a one-off contribution. Such a limit would pre-suppose an investor’s future capacity to contribute to superannuation and only adds further complexity to regulation of the sector. It also has the potential to cause members who would not for any other reason choose to pool their superannuation to do so in order to enter the self managed fund sector.

## **8.5. Early release on hardship grounds**

The Taxation Institute would support some form of independent decision being made to permit the release of SMSF monies to a member on the grounds of hardship. It is difficult to envisage how trustees might otherwise overcome the inherent conflict they would face for these decisions.

## **8.6. Illegal early release schemes/registrations process/Super Fund Lookup**

The Taxation Institute supports the ATO’s recent changes to the recognition of new SMSFs on ‘Super Fund Lookup’ coupled with the regulatory encouragement given to large funds to be more vigilant regarding rollovers to SMSFs.

## **8.7. Life insurance default**

The Taxation Institute does not support any minimum level or type of compulsory cover for SMSFs. Consistent with the choice architecture a person participating in an SMSF should have a right to determine whether or not they have life cover and, if they do, what level of cover they wish to have.

## **Appendix – the Taxation Institute’s Superannuation Committee**

Set out below are the current members of the Taxation Institute’s Superannuation Subcommittee:

**Daniel Butler**  
DBA Butler Pty Ltd

**Neal Dallas**  
McCullough Robertson Lawyers

**Elizabeth Goddard**  
Chartered Accountant

**Greg Rowsell**  
Deloitte Touche Tomhatsu

**Suzanne Mackenzie**  
DMAW Lawyers

**Shayne Carter**  
Greenwoods & Freehills

**Neil Howard**  
HLB Mann Judd

**Mark Payne**  
Hall & Wilcox

**Martin Heffron**  
Heffron Consulting

**Graeme Halperin**  
Halperin & Co Pty Ltd

**Gabrielle Teys**  
UBS Wealth Management

\* \* \* \* \*

Should you have any queries with respect to any of the matters raised above, please do not hesitate to contact David Williams on (02) 9958 3332 or the Taxation Institute’s Tax Counsel, Angie Ananda on 02 8223 0011.

Yours faithfully



David Williams  
President