

'SELF-MANAGED SUPER FUNDS IN THE POST-REFORM LANDSCAPE'

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OPENING

Thank you for inviting me to speak today.

Although we've come a long way since the first step to universal super coverage in 1985 and the introduction of the Superannuation Guarantee Charge 20 years ago, the goal of lifetime income security for Australians remains as important as ever – even more so as we face the challenges of an ageing population.

Self-managed super funds (SMSFs) play an important role in securing Australians' retirement incomes so it's pleasing to note, as I did at this forum last year, that the SMSF sector is in good shape. It continues to flourish and most trustees and auditors are doing a good job. As a dominant force in the super industry, it's vital that SMSFs are managed in the best interests of their members.

We at the ATO share responsibility for the health of this segment with trustees, professional advisers and with Treasury and the government, but ultimately the onus is on trustees. Our work with the industry, including SISFA, is vital as it keeps us in touch with the issues that are important to you.

Reforms

After a milestone period of consultation and review into Australia's tax and super system we are now well into the reform stage. These reforms comprise three main

elements: Stronger Super, reforms arising from the Henry Review and changes to the super system announced as election commitments.

As of 1 July this year, three measures are already in place: the increase in the SMSF supervisory levy from \$150 to \$180 (the 2010-11 SMSF annual return has been updated to reflect this); tightening the legislative standards for investing in collectables and personal use assets; and the use of tax file numbers (TFNs) as primary locators for super accounts.

Stronger Super is probably of most interest to this audience. The proposals include: curbing illegal early access to super through new proof of identity and rollover processes and greater powers to penalise promoters of illegal schemes; collecting and producing SMSF statistics to greater understand the sector and its performance; new regulatory powers to prevent and penalise breaches of super legislation; and providing registration, knowledge and competency provisions for approved auditors of SMSFs.

Following on from the conclusion of the government's Stronger Super consultative process, we've recently established an ATO SMSF reform working group to work with us on implementation and administration design issues. SISFA are on this group and we value your input.

The new regulatory powers we will have will help us to deal with non compliance. We're really looking to use these new powers in a graduated way so that we're still focused on helping people to comply but we will have more flexibility and ability to deal with situations where circumstances don't warrant disqualifying a trustee or making a fund non-complying, but where some sanction is still appropriate.

Collectables and personal use assets

New regulations include:

- the prohibition on leasing these assets to related parties
- any use of these assets by related parties
- the requirement that the asset not be stored in a private residence of a related party
- the requirement to document the reason for the decision to store the asset appropriately
- the requirement to insure these assets in the fund's name
- the requirement for an independent valuation for any transfer of these assets to a related party.

Where there are existing holdings of these assets before 1 July 2011, trustees must ensure they comply with these regulations by 1 July 2016 or alternatively, dispose of the asset/s.

TFNs and reuniting people with their super

To help super funds operate more efficiently, super fund trustees and retirement savings account providers can now use their members' TFNs as a primary locator to link contributions and rollovers with member accounts and to locate member accounts.

By 1 January 2012, TFNs may also be used by super fund trustees and retirement savings account providers to help consolidate super accounts whether they are in the same fund or across multiple funds.

Registration of approved auditors and competency standards

Auditors play an integral role in the regulation of the SMSF sector and, consequently, it's critical that SMSF approved auditors have a high standard of competency.

However, our compliance results indicate that this level of competency does not yet exist across the approved auditor population. In fact, ATO compliance cases initiated in 2009-10 found that the quality of the audit was poor or unsatisfactory in 15% of cases, with reasons for this including: little or no evidence that an audit was performed; failing to adequately deal with independence obligations; and lack of knowledge about super legislation and the professional obligations of approved auditors.

It is with these thoughts in mind that we've invested quite heavily in supporting approved auditors through our publications, the eSAT tool and piloting the Superannuation Professional 2 Professional support service. This year we will be extending this support service to the Top 100 approved auditors who together cover over 25% of the SMSF population.

We expect that the introduction of mandatory auditor registration will help improve standards. While the Australian Securities and Investments Commission (ASIC) is responsible for introducing and administering the registration system, including setting competency and independence standards, we'll be working closely with them as we continue to have a role in monitoring and assessing auditor compliance. This will naturally include sharing information to ensure that the whole registration framework is operating effectively.

Also under consideration is whether there should be a transitional registration period. This whole measure reinforces the importance of the role of the SMSF auditor in the system.

We've also been in discussion with both ASIC and the professional associations to develop a framework for auditor competencies as well as independence standards for SMSF auditors. Some of the concepts considered through the government's SMSF consultative working group included eligibility criteria based on tertiary qualifications, experience and examination and continuing professional development requirements.

We continue to have close discussions with ASIC, Treasury and the professional associations on these issues.

Changes to the SMSF annual return

A number of minor changes were made in relation to the SMSF product in the current (2011) SMSF annual return (SAR). However, the only change directly attributable to the Stronger Super initiative was the increase in the levy from \$150 to \$180.

Several changes are likely to the 2012 SAR but the full extent of these is yet to be determined.

Compliance and rectification of contraventions¹

We continue to focus on monitoring compliance of SMSF trustees with the SIS Act and Regulations via the Notice of Compliance strategies and lodgment of auditor/actuary contravention reports (ACRs). A major component of our compliance activities involves the examination of unrectified contraventions reported in ACRs.

The trend has continued towards a higher proportion of contraventions being reported as rectified, with 52% of 2008-09 audit year contraventions rectified.

Current compliance activities focus on:

- ACRs lodged for SMSFs that are less than 15 months old (new funds are required to report all identified contraventions)
- related-party investments including lending to members (section 65)
- breaches of the 5% in-house asset (IHA) limit (section 82).

Contraventions related to lending and IHAs continue to be significant in terms of both number and value. There's been little change in the top contraventions reported over the past 12 months. There has been a continued upward trend of borrowing contraventions (section 67) which account for close to 8% of all contraventions reported and 6.4% of rectified contraventions.

Trustees are responsible for running their funds in accordance with the strict requirements for attracting concessional tax treatment. They should ensure they are fully aware of the relevant provisions.

Illegal early release

Illegal early release (IER) of super benefits undermines the integrity of the super system.

Any benefits trustees access illegally will form part of their assessable income, and as a result, they are likely to face higher taxes and additional penalties. This was highlighted by an Administrative Appeals Tribunal (AAT) decision on 16 August which involved a taxpayer who took money out of her SMSF to prop up her and her husband's real estate business. The amounts withdrawn were included as assessable income to her, in accordance with s304-10(4). The AAT upheld the ATO decision.

Trustees can also be disqualified when super benefits are accessed early. An SMSF may be treated as non complying and the fund's assets taxed at the highest marginal tax rate, currently 45%.

We've taken steps to mitigate SMSF IER risks:

- registration processes – we've implemented more robust risk assessment processes, thoroughly reviewing registration for all those who enter the SMSF industry, including those who enter an existing SMSF
- member verification – this allows Australian Prudential Authority (APRA)-regulated super funds to confirm SMSF membership when processing rollover requests. The service strengthens existing controls to protect super savings
- working with ASIC and APRA – we've taken a whole-of-government approach towards IER and ID fraud. We've collaborated with APRA to provide APRA-regulated funds with guidance to assist them address risks around non-legitimate rollovers. ASIC has successfully prosecuted promoters and individuals who organise these criminal activities
- working with state authorities on related fraud matters including assisting them with prosecuting promoters and their associates
- working with the community – to ensure promoters and scheme participants are aware that the Commonwealth is active in addressing IER and that heavy penalties apply for those who are involved.

Trustees should be aware that there are limited circumstances where super savings can be accessed before retirement. They should seek professional advice from either their SMSF advisor or the ATO.

Excess contributions tax

Contributions caps are a key integrity design element of the super system. Identifying those who have exceeded the caps will continue to be a priority for us and we will issue assessments for excess contributions tax (ECT) where appropriate.

We've identified and taken action on a number of cases of inappropriate re-reporting of contributions information by SMSFs that have led to a reduction of an individual's ECT liability. This is an area that we'll continue to focus on this year. We plan to undertake 100 reviews of SMSF re-reporting in 2011-12.

From cross-checking contributions information with income tax information, we're concerned that in some cases the lifetime super capital gains tax cap is being used incorrectly or inappropriately to exclude amounts from the non-concessional cap. This is an area that we will be looking at closely.

Income tax issues

Non-arm's length income

We've found that some SMSFs are not reporting non-arm's length income (NALI) at the correct income tax return label and are therefore not paying the correct amount of tax. Some other funds are declaring NALI at the correct label but not taxing it at the correct tax rate. You need to ensure that you have correctly calculated the fund's tax.

Taxation Ruling 2006/7 confirms our view of what is considered NALI. Funds must declare income that is considered as such and pay tax on that income at the highest marginal rate, currently 45%.

Losses incurred by an SMSF

The income tax laws provide that a loss or outgoing may be deducted from an SMSF's assessable income to the extent that it is incurred in gaining or producing assessable income. However, a loss or outgoing of capital, or of a capital nature, is not deductible.

There are ATO Interpretative Decisions that provide guidance on gains and losses from exchange traded options and the tax treatment of losses realised by a complying super fund from the disposal of shares.

Exempt current pension income

Exempt current pension income (ECPI) continues to be a significant area of concern for compliance risk. Trustees need to be mindful of the requirements for the method they use to calculate ECPI. There are two: segregated and proportional (also referred to as unsegregated).

Under the segregated method the trustee must set aside certain assets so that the income from these can be identified as having the sole purpose of paying a super income stream benefit.

We've found a number of SMSFs are using the proportional method and claiming ECPI and still not meeting the actuarial certificate requirements. Under the proportional method an actuarial certificate must be obtained *before* lodging the annual return as failure to do so may see the deduction claim for ECPI disallowed.

Other important considerations for calculating ECPI are to:

- ensure that the SMSF's assets are re-valued to their current market value before the commencement of the pension

- comply with the minimum payment standards. If the minimum pension standard hasn't been met in a year of income, the pension doesn't meet the definition of a super income stream and ECPI provisions don't apply.

For more information refer to *Draft Taxation Ruling TR 2011/D3 Income tax: when a superannuation income stream commences and ceases*.

Lodgment

Too many funds continue to have a poor record in the area of lodgment. We know that many of these SMSFs remain active but despite a number of reminder notices from us, they've still not lodged their annual return. Failure to lodge by the due date can result in penalties and/or loss of an SMSF's complying status.

On time SMSF lodgment stands at 70%, a decrease from 2008-09 and new registrants (established in 2009-10) is at 63%. The fall can largely be attributed to a system error resulting in a large number of new registrant funds being incorrectly given a 15 May due date. Natural disasters in early 2011 also had an impact on lodgment rates.

Conclusion

In terms of SMSFs, this period of reform is all about improving integrity in the sector. With nearly a third of all super assets held in SMSFs we can't afford to be complacent about standards. As Minister Shorten said at the launch of Stronger Super, 'We are today at a kind of middle stage in our national story'.² It is up to all of us to ensure that we continue in the right direction. At the ATO, we look forward to working constructively with SMSF stakeholders to build improved governance and greater efficiencies into an already robust sector.

¹ Contravention data sourced from ACRs lodged to 31 March 2011

² Formal remarks at the launch of 'Stronger Super' (Government response to the Cooper Review), Moonee Ponds Bowls Club, 16 December 2010, Assistant Treasurer and Minister for Financial Services and Superannuation, the Hon Bill Shorten

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