



What Is A "Self-Managed Superannuation Fund"?

Introduction

This memorandum explains what self-managed superannuation funds are, how they are regulated, what laws apply, who sets them up and what their advantages are.

A SMSF is a superannuation fund with less than five members that is managed by its members. Up to 1 July 1999 most SMSFs were known as "excluded superannuation funds" and were supervised by the Australian Prudential Regulations Authority. From 1 July 1999, responsibility for SMSFs has been with the Australian Taxation Office ("ATO"). The ATO has largely continued the APRA's emphasis on education and information and has not turned out to be the draconian ruler some thought it would be.

At least one commentator referred to the transfer of power to the ATO as the equivalent of "putting Dracula in charge of the Blood Bank". So far it looks like he is wrong.

For simplicity, in this memorandum we assume the ATO is the responsible authority and use the term "Regulator" to denote the government body responsible for SMSFs.

The terms "ATO" and "APRA" are used where a more specific reference is required. The members, or a company owned and controlled by the members, act as the trustees. The trustees control the investments and are generally responsible for the SMSF's administration and its compliance with the law. A SMSF is controlled by a deed. The deed sets out the rules the SMSF has to follow. It also sets out the obligations and responsibilities of the people connected to the SMSF, i.e. the members and the trustees. The rules for paying contributions on retirement or death, investing assets, holding meetings, appointing trustees, paying benefits to members and the other matters affecting the SMSF are also found in the deed.

What is a SMSF?

A SMSF is a special type of trust. It is special because the trust assets are held and managed by a trustee for the purpose of providing retirement income and other benefits to members. This means it qualifies for special income tax concessions under the tax law.

The three essential parts of a trust are present in a SMSF. These are a trustee, trust property and beneficiaries, in this case called "members". The trust deed must have special rules if the SMSF is to be a complying superannuation fund and be eligible for tax concessions. However, it is the trustee's year-to-year conduct that ultimately determines the SMSF's eligibility for tax concessions.

The auditor must certify to the Regulator that the SMSF complied with the superannuation law in the relevant year. The Regulator then accepts the SMSF is a complying fund and it is taxed on the concessional basis set out in the Income Tax Assessment Act 1936 ("the Tax Act"). If the auditor does not certify the SMSF complied with the superannuation law the tax concessions are withdrawn and the values of the SMSF's assets, less any undeducted contributions, are taxed at 45%.

What other laws are relevant?

Trustees are subject to a wide range of laws. These include the general law, the special body of law developed over centuries that applies to trustees, the Superannuation Industry (Supervision) Act and six related pieces of legislation ("the SISA") and the Tax Act. These laws must be complied with if the SMSF is to be eligible for tax concessions and the trustees are to avoid penalties under the SISA.

Who supervises SMSFs?

As far as it applies to SMSFs, the SISA is now enforced by the ATO. Up to 1 July 1999 it was enforced by the APRA. If the deed is drafted properly and the trustees comply with the law, the SMSF will be eligible for tax concessions. These concessions include a deduction for contributions and concessional tax on the SMSF's income. These tax concessions drive the SMSF's enhanced investment performance.

It is the tax concessions that make superannuation such an attractive investment medium and allow it to outperform alternative investment vehicles. Although these rules are theoretically onerous, the trustees are normally able to satisfy those rules without difficulty. It is important to not overstate the risk of breaching the law. In virtually all cases SMSFs run smoothly and no difficulties are encountered. Except for cases of extreme culpability, if a SMSF that has inadvertently breached the superannuation law will be deemed by the Regulator to have complied with the law.

The Superannuation Industry (Supervision) Act

The ATO enforces the SISA as it applies to SMSFs. This, and the regulations made under it, is the major source of regulation of SMSFs, although other laws, including the Tax Act, have to be considered. The SISA is part of a seven Act parcel of legislation. The SISA is the pivotal Act and is generally referred to the most. In this memorandum the term "SISA" describes the full parcel of superannuation legislation as well as the SIS Act.

Objects of the SISA

The SISA is intended to increase the security of benefits held for members and ensure the special tax concessions (i.e. tax rates of 15%, 10% and sometimes nil %) are only available to SMSFs that are conducted properly. The ATO ensures SMSFs comply with the SISA and other relevant laws. The SISA is a complex piece of legislation.

Many of its provisions relate to non-excluded funds and are therefore outside the scope of this memorandum.

Who can set up a SMSF?

There is no restriction on who can establish SMSFs. They are set up by people of all ages from all walks of life. Normally people with higher incomes or who have significant wealth set up SMSFs. Older people predominate, since they are able to pay larger deductible contributions and are more aware of their ultimate retirement.

Younger people who want to use the SMSF to set themselves up for later life are becoming increasingly common.

The list of people setting up SMSFs typically includes:

- self-employed professionals, tradesmen and others in small/medium-sized business;
- employees, particularly those on higher salaries and who have flexible remuneration options or who work for smaller firms;
- people who have managed superannuation and who are able to transfer these to SMSFs. This includes retirees and people temporarily out of the workforce; and
- people who run businesses through companies or trusts.

This boils down to a large proportion of the adult population of Australia.

Who should join a SMSF?

Generally those inclined to control their investments and be responsible for their lives. Professional people, small businessmen and retired people who have done well in their former employment are well represented in the SMSF ranks.

How much do you need to set up a SMSF?

Some say a person should have \$100,000 of super before setting up SMSF. They say below \$100,000 the costs of running SMSFs outweigh the benefits. The threshold of \$100,000 is in many cases too high. It significantly overstates the cost of setting and running a SMSF and significantly understates the various commissions and fees connected to managed funds.

We believe a more accurate figure is \$50,000. This is also the figure quoted by the Australian Society of CPA's as the "break even point" for a SMSF. Some people use SMSFs with less than \$50,000, confident that over time the enhanced returns coupled with a robust contributions strategy, will make up for any cost inefficiencies in the early days.

The figure of \$50,000 comes with two caveats: these are that the SMSF has a simple investment strategy and does not have a large number of small value transactions. It is the number of transactions that determines the cost of running a SMSF, not its size.

One good strategy for a SMSF is to have all of its assets in investments like managed funds. These are extremely easy investments to account for and to audit and this means these costs are kept to a bare minimum.

Do you need more for a SMSF paying an income stream?

The figure is closer to \$100,000 for a SMSF that is paying an income stream. This is because most members would be better off taking a lump sum benefit if they have any less than this. Plus the accounts and audit for a SMSF paying an allocated pension are more complicated when a SMSF is paying a pension.

Any investment will do better in a SMSF

Where the member faces tax of 39.5% or 46.5% (which is virtually everyone) any investment will perform better in a SMSF.

This is because:

- the tax deduction for contributions means up to 31.5% more cash is available for investment at the beginning of the investment's life (i.e. 46.5%, being the member's tax rate, less 15%, being the SMSF tax rate);
- because more money can be invested, investment earnings are greater; and
- income is taxed at 15% (and sometimes 0%) and capital gains are taxed at 10% (and sometimes 0%), so the after tax rate of return on the investment is always greater than for a 46.5% taxpayer.

This is deliberate government policy. The old age pension is being replaced by a system of private pensions. It is a mathematical certainty that an investment in a super environment will do better than, in a non-super environment.

Increased information

A SMSF means you don't have to wait for months after 30 June each year to find out how your investment performed (or even what it has invested in). The information is always available. Most trustees can access information on their SMSF on virtually a daily basis.

The rapid growth in Internet trading is increasing the amount of information. Most etraders provide free portfolio tracking software, which means clients get immediate reports on the state of their portfolios at any time.

Synergy with other investment and business strategies

SMSFs can create synergies with the member's other investment and business activities. The SMSF's investment strategy should be prepared as part of an overall investment strategy reflecting the member's attitudes and overall financial profile. The member's will and estate planning should be considered as part of this strategy.

It can make good sense for a SMSF to minimise property investments if the member's family trust has invested heavily in property. Overall, the investment portfolio is balanced, even if the SMSF invests solely in Managed Funds. It's hard to see how a managed Super fund with thousands of members of all ages, from all walks of life and with vastly different financial profiles can be as efficient as a self-managed fund. One fund cannot be all things to all people.

Tax free death benefits

In most cases eligible termination payments paid direct to dependants are tax-free in the dependant's hands. This applies to all superannuation funds, not just SMSFs.

Asset protection

SMSF assets are generally protected from bankruptcy. This means the trustee in bankruptcy cannot access the benefits and the benefits are held for the member. Benefits paid out during a bankruptcy, say, on the member reaching a specified age, or before bankruptcy may not be protected.

Capital gains tax efficiencies

Most people know most SMSF income is taxed at 15% and capital gains are taxed at no more than 10%. Few are aware SMSF income is taxed at nil % if used to pay an allocated pension or a complying pension, and capital gains only face tax in the year the gain is realised, not in the year the gain accrues. SMSFs allow you to control the timing of asset disposals. This means the realisation of gains (and, in many cases, other income) can be deferred to a year when the SMSF pays nil tax, i.e. when the members are being paid pensions from the SMSF. With planning most capital gains can be derived tax-free using this method.

This significantly increases the after tax rate of capital gain, often virtually doubling the return on the investment. Try getting a managed fund to do this for you!

Retirement planning for children

SMSFs can be used to obtain retirement benefits for spouses, children and even grand children. SMSFs are a sophisticated method of cross-generational wealth transmission.

Ethical investments

SMSFs can choose to only hold investments they believe are ethical.

It's a pleasure: SMSFs as an enjoyable way to spend your time

Most people who run SMSFs enjoy it. SMSFs do not have to take up a great deal of time. Some people get by with just a few hours a year. They select quality blue chip shares and Managed Funds they never sell. This strategy worked well recently and has the added benefit of lower administration costs since there are fewer transactions to record. This strategy is common with younger people with smaller funds and larger work and family commitments.

Running a SMSF is a valid and interesting occupation: ten years ago many managed funds did not have as much in them as some SMSFs do today. Their size and cash flow means the trustees enjoy the time spent on SMSF activities.

Tax deductible life insurance premiums

Life insurance premiums paid through a SMSF can be tax deductible. This can halve the cover's cost and is the cheapest way to arrange life insurance. Often the tax benefit connected to deductible premiums more than covers the cost of running the SMSF.

Roll-over of taxable capital gains

Small businesses, including businesses run through companies and trusts, can roll over taxable capital gains on the sale of their businesses into their SMSF. This special rule acknowledges that businesses are often the main retirement asset for many people. This concession is limited to businesses with a combined value of less than \$6,000,000, which includes most small and medium sized businesses.

Other reasons

Other reasons for SMSFs are:

- increased information: you don't have to wait for months after 30 June each year to find out how your investment is performing. The information is always at hand. Most trustees can access information on a daily basis;
- synergies with the member's business activities (e.g. ownership of business premises) or other investment activities. This means the SMSF's investment strategy makes sense as part of an overall investment strategy. For example, it can make good sense for a SMSF to minimise property investments if the member's family trust has invested heavily in property;
- control over the investment and a confidence you won't find out the trustees have done a "Robert Maxwell" when you open the paper tomorrow morning. This is perhaps the most important advantage. Control and security appeal to self-employed or professional people;
- tax-free death benefits. Benefits paid to a deceased member's dependants are tax free in the dependant's hands;
- Generally, SMSF assets are protected from bankruptcy;
- control over the timing income: capital gains and, in many cases, other types of income, can be deferred to a year when the SMSF pays nil tax;
- retirement benefits for spouses and children. SMSFs can be even used to create retirement funds for spouses and children. They can be used to help grand-children: SMSFs as a sophisticated method of cross-generational wealth creation and transmission is a growth area at the moment;
- tax-effective savings. The deduction for contributions and the low rate of tax (15%, 10% or nil %) means virtually any investment will do better in a superannuation fund compared to other holding vehicles; and
- tax deductible life insurance premiums. Running life insurance cover through a SMSF means the cost of the cover is effectively halved.

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