

SUPER SYSTEM REVIEW SUBMISSION COVER SHEET

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Governance

Operation & Efficiency

Structure



Association of Independent Retirees (A.I.R.) Limited
ACN 102 164 385

Super System Review

Phase 3 Structure (including SMSFs)

February 2010

SUMMARY

The Association of Independent Retirees (A.I.R.) Limited welcomes the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation Industry. The Association is the peak body representing the views of fully and partly self-funded retirees with over 12,000 members Australia wide. The Association's policies endeavour to achieve dignity, independence, and freedom of choice for retirees, recognising a diverse range of individual circumstances.

A.I.R. members understand the issues arising in the superannuation system because they are retirees actually applying their assets to manage their retirement income—the ultimate purpose of the system. They understand the issues involved in both the accumulation of assets and also the drawdown of assets for retirement purposes. The superannuation system must accommodate both aspects.

A.I.R. supports the Choice Architecture Model contained in the Review Panel's Preliminary Report. The Universal category, providing for those who do not wish to be engaged in managing their superannuation, should be supported by a simplified structure and operation. The SMSF sector should be seen as a Choice category with an even greater emphasis on member choice and self direction than can be exercised in a large superannuation fund.

People tend to become more conservative as they age because they find it more difficult to cope with stress. A competent, conservative, and ethical approach to investment by superannuation funds is a primary requirement to try to recover the standing of the industry in the eyes of retirees following major company collapses and the global financial crisis.

This submission sets out recommendations focused on the following Sections of the Issues Paper:

- Super in the Retirement Phase (Section 11 Part A)
- SMSF Issues (Part B)

The comments and recommendations should be read in the context set out above. Numbers in brackets refer to the individual section in the Issues paper.

Summary of Recommendations

Recommendation 1

That a consistent and conservative investment strategy should be required for all superannuation funds, whether in the accumulation or the drawdown phase.

Recommendation 2

That the powers of trustees of superannuation funds should be changed by legislation to require trustees to honour the estate wishes of a member.

Recommendation 3

That the possibility of a totally new structure created by legislation should be examined for SMSFs.

Recommendation 4

That a standard Trust Deed should be established by the ATO, as the regulatory body, for use by trustees.

Recommendation 5

That the focus of compliance improvement should be on developing an expert and robust accounting and auditing system to support the advice, administration and reporting needs of trustees.

Recommendation 6

That mandated education and continuing education should be required and strengthened for accountants, independent auditors, and ATO auditors supporting SMSFs because of the structure of the system which relies heavily on accountants and auditors for detailed compliance.

Recommendation 7

That trustees should be able to recover their costs of appealing non-compliance charges subsequently withdrawn by the ATO or successfully appealed through the Administrative Appeals Tribunal

Recommendation 8

That the focus on regulation in SMSFs in this Review should be on simplification and reviewing the need for existing regulations in terms of meeting the objectives of the SIS Act.

Recommendation 9

That the definition of a pension should be changed to allow additional contributions to an existing pension for the reasons set out in detail in the A.I.R. Phase 2 submission.

Recommendation 10

That the SIS Act and regulations relating to instalment warrants and to investment in real property should be changed to remove the complexity and excess costs associated with the legal processes required to allow such investments. The changes should allow the ability to borrow at acceptable levels for investment in real property by way of non-recourse loans.

Recommendation 11

That the regulations relating to GST as it applies to SMSFs should be radically altered to simplify the system even if this means some reduction in revenue to governments.

Recommendation 12

That the Annual Regulatory Return should be changed to provide a simple and understandable return for funds in the drawdown phase recognising the rapid increase in number of SMSFs entering this phase.

Recommendation 13

That trustee responsibilities should not be able to be delegated to professional advisers.

Recommendation 14

That existing dispute mechanisms should remain unchanged. The drive should be to minimise incorrect advice by ensuring that service professionals, including ATO auditors, are expert and ethical in carrying out their responsibilities. A more effective approach would be for stronger penalties to be applied to professionals where they are deficient in their services.

Recommendation 15

That the graduated scale of penalties applied by the ATO for non-compliance should be maintained. However, the ATO should be required to take into account the extent and quality of professional advice provided to the trustee in determining any trustee penalty. Where there has been incorrect advice, the ATO should have the power to refer non-compliance issues arising from bad professional advice to the appropriate body.

Recommendation 16

That the ATO supervisory levy should remain at \$150.

Recommendation 17

That the ATO, as the regulatory body, should prepare a minimum number of model sets of accounts as a guide for accountants and trustees. The Regulatory Return should be consistent with these accounts.

Recommendation 18

That the principle purpose of forming an SMSF to allow trustee control of the management of the trustees' assets should be recognised in determining the appropriate degree of regulation applied to SMSFs. There should be no compulsory requirement for involvement by third parties in any of the aspects of administering and managing SMSFs.

Recommendation 19

That the intent of the Parliamentary Joint Committee recommendation to reduce the frequency of auditing funds be adopted but limited as follows:

- funds totally in the drawdown phase
- funds that have been audited without serious compliance breaches over the previous three years
- no further auditing unless a serious compliance breach is detected by the ATO, in such case the fund should be audited annually thereafter.

Recommendation 20

That there should be no limiting regulations governing the manner in which older people manage their financial affairs.

Recommendation 21

That the minimum withdrawal rules should be removed.

INTRODUCTION AND CONTEXT OF THE SUBMISSION

The Association of Independent Retirees (A.I.R.) Limited welcomes the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation Industry. The Association is the peak body representing the views of fully and partly self-funded retirees with over 12,000 members Australia wide. The Association's policies endeavour to achieve dignity, independence, and freedom of choice for retirees, recognising a diverse range of individual circumstances.

A.I.R. members understand the issues arising in the superannuation system because they are retirees actually applying their assets to manage their retirement income—the ultimate purpose of the system. The A.I.R. 2006 Survey of members shows that 64% of members between 65 and 74 years of age received taxed-fund superannuation pensions, and 15% were trustees of SMSFsⁱ. They understand the issues involved in both the accumulation of assets and also the drawdown of assets for retirement purposes.

The Review Panel's Phase 1 Preliminary Report recognises that:

- Australia's superannuation system is predominantly a compulsory fully-funded investment system with all investment and longevity risk carried by individual members. In this respect it is unique among other nations.
- Because of its compulsory nature, Government has a responsibility to ensure that members' interests are protected and investment risk is minimised through enforcement of a conservative investment strategy by superannuation fund trustees on behalf of members. It has a responsibility to ensure that superannuation funds are operated in accordance with the highest governance and prudential standards, including accountability and transparency to their members.
- Conceptually, the superannuation system should be member-based and not account-based, product based or industry specific. Although this concept is important in the accumulation phase, it is even more important in the drawdown phase when members come to gather together their accumulated superannuation assets and to use their entitlements over a normally lengthy retirement span. The superannuation system must accommodate both the accumulation and drawdown phases.
- Direct engagement in superannuation is not a high priority for a large proportion of the population. Nevertheless, choice is important for a significant proportion of the population.

A.I.R. supports the Choice Architecture Model contained in the Review Panel's Phase 1 Preliminary Report. The Universal category, providing for those who do not wish to be engaged in managing their superannuation, should be supported by a simplified structure and operation. The SMSF sector should be seen as a part of the Choice category; it is simply a different way of exercising Choice to that exercised through a large superannuation fund.

The SMSF Statistical Summary prepared for the Super Systems Review states that: "SMSF members are on average older, earn a higher income and have larger superannuation balances compared to members of APRA regulated superannuation funds"ⁱⁱ. Many SMSF trustees are, or were, sole traders or small family business owners, including farmers"ⁱⁱⁱ.

The global financial crisis has had an extreme effect on many retirees. This is far from a trivial matter. The proposition that markets will recover in due course may be relevant during the early part of the accumulation phase but has little relevance to a person approaching retirement age or to a retiree with only a relatively short and uncertain span of life remaining.

Loss of income arising from reduction in assets has far broader repercussions than simply requiring retirees to 'pull their belts tighter'. A healthy retirement depends fundamentally on maintaining social relationships and activities with a group of peers with similar standards of living and retirement expectations^{iv}. Insufficient income to maintain social relationships leads to stress, breakdown in health, and reduced individual quality of life. Insecurity arising from investment trauma also leads to breakdown in health. Reduced personal income leads to greater reliance on age pensions. These pressures ultimately add to the cost to government of health and welfare services

Because many retirees have been accustomed to a third party managing their superannuation, they expect to have confidence that their assets will continue to be managed properly into retirement. Hence, they expect the superannuation industry to act responsibly and ethically during the accumulation and the drawdown phase. They expect operators to be suitably qualified and of good character. They expect the industry to be regulated and monitored in an efficient, effective, and conservative manner.

People tend to become more conservative as they age because they find it more difficult to cope with stress. A competent, conservative, and ethical approach to investment by superannuation funds is a primary requirement to try to recover the standing of the industry in the eyes of retirees following major company collapses and the global financial crisis.

A community-wide compulsory superannuation system is a relatively recent phenomenon in Australia, although many corporations and public services have provided superannuation for many years. Consequently, the accumulation phase has attracted most attention, despite the fact that only 6% of super benefits in retirement will be sourced from contributions during a person's working life and nearly two-thirds will be sourced from post-retirement investment returns^v. Compared to the amounts being accumulated in the compulsory Superannuation Guarantee system, the amount being withdrawn as pensions has been relatively small, but is growing rapidly as the number of members retiring increases. Superannuation policies and operations must increasingly recognise the different circumstances that apply during the drawdown phase, when living needs are very different, when the ability to accumulate funds reduces, and when security of assets assumes particular importance.

Many issues have emerged as experience has been gained in administering the compulsory superannuation system. Some of these have emerged because of fragmentation within the industry. Some have emerged because of a difficult to manage interface between contributors, employers, funds, and APRA and the ATO. It is imperative at this stage of development of the system that these issues are considered and major changes made to ensure a cost-effective future system for both the superannuation funds and their members.

The financial return to members depends on investment returns less costs. This Inquiry has been established because of the concern that costs are not constrained through competition between superannuation funds. One of the few factors exerting pressure for

better investment returns and reduced costs is competition from the SMSF sector, which should be retained and supported.

This submission sets out recommendations in answer to a number of the Issues raised in the Phase 3 Issues paper including SMSFs. The comments should be read in the context set out above. Numbers in brackets refer to the individual section in the Issues paper.

RESPONSE TO THE ISSUES RAISED

A. STRUCTURAL ISSUES

1. SUPER IN THE POST-RETIREMENT PHASE (Part A Section 11)

The Issues Paper suggests that the risk profile, tax treatment, and liquidity needs of those drawing a pension are all likely to be different from those of members in the accumulation phase. However, nearly two-thirds of super benefits in retirement will be sourced from post-retirement investment returns and only 6% will be sourced from contributions during a person's working life. Hence, superannuation funds investment strategies should be based on the post-retirement expectations of members, and the present emphasis on investment strategies during the accumulation phase should be put in this context.

The three Issues Papers have relied on the assumption that over the long term, short term investment losses will be recovered and investment returns will be positive. This assumption allowed a culture that fund managers can undertake more risky investment strategies to provide returns greater than the average; where these fail, the funds will be recovered over the long term. High returns become the driver for investment fund manager remuneration. This approach is unacceptable to the majority of retirees. It is wrong in principle for superannuation funds and is not accepted in the majority of superannuation regulations of other nations.

Not only is excessive investment risk unjustified but there are periods in a member's life when the risk is particularly unacceptable. For example, the investment risk profile of a member who is within one or two years of retirement will often be highly conservative; a member does not wish to see the assets available at retirement dramatically reduced by a global financial crisis just before retirement. The proposition that the lost funds will be recovered over the retirement life span has little credibility - it is the assets at hand that are important. Similarly, excessive investment risk is unacceptable to a retiree if the result is to catastrophically reduce assets to pay an account-based pension while preserving sufficient assets to cover the retirement life span, recognising that it is these assets that will provide the majority of superannuation benefits during retirement.

The Phase 3 Issues papers clearly acknowledges that Australia currently adopts a higher risk investment model than other nations. It states that the OECD argues that governments should encourage retirees to take out annuities that offer a guaranteed retirement benefit to reduce the vulnerability of retirement income to financial market turmoil.

A.I.R. supports development of annuities as an option for retirees. However, it argues that the same conservative investment risk strategy should be adopted during accumulation and retirement. **There is no need to have a more conservative risk strategy for retirement assets over accumulation assets.** It would be almost impossible to monitor different strategies defined by regulation in a meaningful way.

Recommendation 1

That a consistent and conservative investment strategy should be required for all superannuation funds, whether in the accumulation or the drawdown phase.

Trust rules place the power for all decision making in the hands of the trustees. However, individual members must have the power to define the distribution of their estate. The present system, which tries to ensure that trustees do not override the personal estate allocation decisions of a member are cumbersome and require renewal of intention at three-year intervals. The administration of this process can lead to error, abuse, and incorrect decisions by default.

All superannuation funds (including SMSFs) should be required to hold a binding death nomination from all members clearly nominating how they wish their benefits to be distributed. This should not require renewal at defined intervals. Where circumstances change such that the trustees are unable to distribute the benefits as nominated then the benefits should by default be paid into the member's estate. Under no circumstances should the distribution be at the trustees' discretion unless explicitly agreed to by the member in the binding death nomination. It should also be noted that in the past a number of the public funds have omitted to make it clear to joining members that the option for a binding nomination was available.

Recommendation 2

That the powers of trustees of superannuation funds should be changed by legislation to require trustees to honour the estate wishes of a member.

B. SMSF ISSUES (Part B)

1. SMSF OVERVIEW (15)

The SMSF Statistical Summary prepared for the Super Systems Review states that: "SMSF members are on average older, earn a higher income and have larger superannuation balances compared to members of APRA regulated superannuation funds"^{vi}. Many SMSF trustees are, or were, sole traders or small family business owners, including farmers^{vii}.

One reason given for trustees adopting an SMSF is that they wish to maintain control of their assets. In this sense, SMSFs are similar to, but different from, the Choice model in the 'Choice Architectural Model'. It is likely that many sole traders and small family business owners choose an SMSF because they, and their advisers, have little experience or confidence with large superannuation funds.

Trustees (apart from the few with intent to circumvent the regulations) do not wish to have regulations imposed on them that remove their flexibility of decision-making without good reason. The majority of questions in the Phase 3 Issues Paper focus on the need for greater regulation and systems that require conformity; the questions imply that the drafters assume that greater regulation is required. The questions do not address ways in which regulation can be *minimised* and flexibility of decision making by trustees *maximised*. A.I.R. is disappointed in the approach taken.

The Phase 3 Issues Paper (Section 15) lists a number of potential risks in SMSFs which do not exist within the large superannuation funds sector. A number of these risks relate to compliance. However, compliance levels have been shown to be high and serious breaches are at very low levels (Auditor Contravention Reports (APRs) were provided on approx. 1.6% of funds in 2009, of which half were rectified prior to the ATO receiving

them). Financial or regulatory significant non-compliance levels are consistent with APRA regulated funds. Further, only 276 funds, of a total of 410,000 had significant sanctions applied in 2009^{viii} There is no substantive evidence that further regulation is required to improve compliance beyond the present adequate level for those non-compliance issues that have an impact on tax avoidance, or on improper financial structures and performance.

2. SMSF GOVERNANCE (17)

A.I.R. believes that the current structure of the system is reasonable (17.1, 17.2) and that change can create further confusion and enhance the perception that the system is complex and over-regulated. However, A.I.R. believes that further work needs to be done to simplify the system and reduce complex regulations, particularly where the benefit/cost of these regulations is very small. The existing complexity undoubtedly leads to excessive costs. If a completely new structure could be legislated along the lines set out in the Phase 3 Issues Paper (21.1) with the intent of reducing the administrative/accounting/compliance burden then this would be a worthwhile endeavour.

A key issue in establishing and maintaining an SMSF is to have a suitable Trust Deed. A farcical aspect of the current situation is the pressure from many professional advisers on trustees to continually upgrade their Trust Deed, at additional cost, even when this is unnecessary. Standard Trust Deeds are available for purchase on legal websites. Many professional administrators use these standard Trust Deeds but charge clients excessive additional fees on the basis that were prepared by them. There have been sufficient years of experience with SMSFs to enable the development of a standard Trust Deed (such standard Trust Deeds are readily available through websites) with the authority of the SMSF regulator, to satisfy the needs of the great proportion of SMSFs (21.1), with a suitable caveat for special cases.

Recommendation 3

That the possibility of a totally new structure created by legislation should be examined for SMSFs.

Recommendation 4

That a standard Trust Deed should be established by the ATO, as the regulatory body, for use by trustees.

2.1. SMSF Trustees (17.2)

A feature of the SMSF system is that the great majority of trustees rely on accountants for administration and advice on compliance, on which they do not wish to become expert but desire confidence that their funds comply (the increasing complexity of SMSF regulation is illustrated by the ATO issuing one Interpretative Decision and one Private Ruling on SMSF issues approximately every six weeks). The issue of compliance is but one of the reasons for trustees choosing to use accounting services. The basic issue is that many trustees have higher priorities on their time, wish to concentrate on financial management of the fund, and are comfortable to pay for administrative and advice services (17.3, 20.1). For the same reasons, there is no evidence that mandated trustee education would improve compliance or that trustees would be interested in undertaking such education (17.2.1).

Over 80% of all SMSFs are registered with a tax agent. Only 11% self-administer and do not pay for any professional services^x. All SMSFs are audited annually and approximately

6,500 APRs were reported in 2009. There is no data on the proportion of non-compliance issues reported by auditors from funds which rely on accountants for the preparation of financial accounts, regulatory returns and other audit information. However, there is anecdotal evidence that the majority of non-compliance issues, either reported by auditors or discovered by the ATO are from funds which rely on accountants. A.I.R. is aware of a number of cases where accountants have not advised clients correctly and the auditor has not detected the non-compliance. The accountant/auditor system is far from robust.

Reasons for the very high percentage of SMSFs that use accountants for the preparation of financial accounts and regulatory returns are not available. There are at least three related reasons:

- The desire of SMSF trustees to focus their interest on the financial conduct of the SMSF leaving the detailed preparation of accounts, regulatory returns and other compliance documentation to professionals who they believe understand the compliance issues.
- Fear that trustees will be unable to understand and keep up with the high degree of complexity and rapidity of change of the taxation and compliance regulations.
- A belief engendered by the SMSF support industry and the ATO that the complexity involved in the preparation of accounting and compliance documentation is beyond the capabilities of trustees. In all cases trustees pay for, and expect, expert advice on compliance issues from their accountants.

Trustees are reported to have medium to high understanding of the principle requirements for SMSFs (17.2). A.I.R. acknowledges that there will always be a proportion of SMSFs established with intent to operate outside the regulations. However, for the very high percentage of SMSFs set up with good intent, the very small percentage of serious compliance issues are derived, not because of lack of understanding by trustees, but because of lack of knowledge, lack of care, or even criminal intent by accountants and auditors.

A fundamental weakness of the structure is that many accountants are not expert or do not intend to become expert in SMSFs. Consequently, incorrect or careless advice is often provided. The same issue of lack of care or lack of knowledge applies with respect to auditors (20.2.2). Mandated basic and continuing education should be strengthened and required for all professional groups supporting SMSFs, including ATO auditors.

While A.I.R. accepts that trustees should be ultimately responsible for compliance it cannot stress strongly enough that the focus on achieving compliance must be on the knowledge, expertise, and honesty of accountants and auditors. The data shows that 60% of tax agents registered less than 10 SMSFs and 20% registered only one SMSF. About half of all auditors audited less than five SMSFs^x. There is no data provided by the ATO as to the link between serious non-compliance and the expertise of accountants and auditors, but A.I.R. has evidence that there is a strong link between the two. A.I.R. supports the statement in the Phase 3 Issues Paper (20.2.2) questioning the ability of auditors servicing small numbers of SMSFs to maintain an appropriate level of expertise in superannuation matters. However, A.I.R. maintains that it is at least as important to question the expertise of accountants servicing small numbers of SMSFs.

The lack of expertise of ATO auditors is also questioned. A.I.R. is aware of cases where ATO auditors have only examined financial accounts and totally disregarded compliance matters properly minuted. The ATO has withdrawn its penalties when such cases have

been taken to the Administrative Appeals Tribunal. It is necessary to examine the data for poor decisions by ATO auditors to obtain a complete picture of the appropriateness and efficiency of the present compliance process.

Improvement in the robustness of the accountant, independent and ATO auditor support system for SMSFs is of the highest priority. The issue is more important than any of the governance, administrative, and regulatory issues raised in the Issues paper, or the issues raised with respect to accountants (20.1.1). The SMSF system fails despite all the compliance regulatory inputs if supporting professionals, whether accountants, auditors or lawyers, cannot provide accurate and honest advice. The ATO has a clear responsibility to correct this problem. Correction might include licencing (20.1.1).

Whilst A.I.R. supports the present appeals process and does not recommend any change (17.4.3), it must be recognised that most SMSFs, when faced with a non-compliance charge by the ATO, have to expend funds on professional services to argue their case. If the case is subsequently withdrawn or lost, there is no recovery of the costs of the appeal. Recovery of such costs from the ATO should be possible.

Recommendation 5

That the focus of compliance improvement should be on developing an expert and robust accounting and auditing system to support the advice, administration and reporting needs of trustees.

Recommendation 6

That mandated education and continuing education should be required and strengthened for accountants, independent auditors, and ATO auditors supporting SMSFs because of the structure of the system which relies heavily on accountants and auditors for detailed compliance.

Recommendation 7

That trustees should be able to recover their costs of appealing non-compliance charges subsequently withdrawn by the ATO or successfully appealed through the Administrative Appeals Tribunal

2.2. Regulatory Framework (17.4)

2.2.1 Appropriateness of Regulation and Reporting Requirements

A.I.R. acknowledges that a degree of regulation is appropriate for SMSFs. The issue is not the need for regulation but the appropriateness of that regulation and its administration. The SMSF sector has been in existence for over eighteen years. Major changes were made from 1 July 2007 aimed at simplifying the system. However, there is still opportunity for further deregulation and simplification.

Regulation should be the minimum necessary to ensure that the objectives of the SIS Act for SMSFs are met. The evidence is that less than 1% of funds have demonstrated non-compliance with the principles of the SIS Act (as distinct from non-material breaches). This small group should be dealt through a policy of exception management; the majority should not have to comply with rigid and complex regulation because of this small group.

The principles of compliance are not complex; it is the detailed regulations that cause complexity. However, government, press, and professional publicity emphasises

complexity and acts as a barrier to entry. A.I.R. believes that publicity should be balanced and should not be used as a means of creating a barrier to entry (17.3).

Issues of unclear, complex and unnecessary regulation and administration often reported to A.I.R. include:

1. *Regulations that add unnecessary complexity and cost.* Examples include:
 - the definition of Pension which prohibits adding contributions to an existing pension. The restriction has led to a high degree of complexity, and substantial increased costs for SMSFs.

Because of Regulation 1.06, a retiree with a pension who wishes to make further contributions has three options: (a) commence an additional pension immediately following the contribution, (b) roll back the original pension and commence a new pension with the total amount, or (c) have the contribution placed into an accumulation component of the fund.

Each option adds to fees charged and costs of administration in superannuation funds. The lack of a supportable rationale for contributors to have to go through the administrative complexity of adopting one option over another, and the fee charged by superannuation funds to make a contribution, leads to disenchantment and confusion with the system. In the case of an SMSF, each option adds to complexity in understanding the requirements of the Act for the member and the trustee and the risk of breaching the Regulation. This issue has been discussed in detail in the A.I.R. Phase 2 submission^{xi}.

- the regulations relating to instalment warrants, including the complexity of borrowing for investing in real property. It is not appropriate in this submission to argue the case for leveraging in SMSFs despite the issue being raised in the questions in Section 19.3.2. This is not a structural issue, but a policy issue. The policy issue is the extent of leveraging that should be permitted. This submission is concerned with the fact that leveraging is possible through instalment warrants, whether rightly or wrongly, and can be applied to leveraging direct investment in real property if complex processes are followed which require expert advice and substantial cost to set up.

Many young people building their retirement assets outside the superannuation guarantee scheme commence by borrowing to purchase investment property, residential or commercial. They feel more confident about this type of investment because they see it as a longer-term more secure type of investment than equities. They are encouraged by the ability to negatively gear the property. They lack the experience and the time to gain experience in equities but they perceive a better return and capital gain from property than investment in fixed interest securities. Their understanding of investment in property increases with the length of time they invest. Yet, they are unable effectively to continue an active interest in direct investment in property in retirement through superannuation. Their investment risk is increased because of the limited range of options available in SMSFs. The result is that experience built up through property is lost and continued management of their personal retirement assets must be built on inexperience in another investment class.

The demand to be able to invest in residential and non-residential property is clearly demonstrated from the ATO SMSF Statistical Report for June 2009 which shows investment (as a percentage of total investment) in residential and non-residential property now standing at 13.7% compared with Australian listed shares at 27.7% and cash and term deposits at 30.1%^{xii}. These figures demonstrate that investment in real property is becoming a significant class of investment despite the restrictive regulations.

Borrowing, as a means of leveraging in SMSFs, became possible from September 2007 normally to acquire listed securities, provided the borrowing is structured as an instalment warrant (19.3.2). Borrowing is now available to provide non-recourse loans for residential property investment provided certain conditions are met and the purchase of the property is suitably structured. Hence, leveraging is now possible in SMSFs through complex mechanisms, which incur a high cost to set up. These mechanisms require a totally different structure to that experienced by the group of people described above and incur much higher fees than those pertaining to normal direct investment in property. These structures and fees could easily be avoided if the legislation was amended to allow simple non-recourse loans to SMSFs for property purchases with perhaps some limitations on the proportion of the SMSFs total assets allowed for this type of investment (18.1).

The ability to borrow circumvents a number of the SMSF regulations, for example, it can become a mechanism for circumventing contribution caps. At this time the ATO has not provided any definitive information on the issues involved for SMSFs to invest directly in property and the conditions for leveraging such investments through instalment warrants or other mechanisms. It is clear that the regulations regarding borrowing are now excessively complex, are inconsistent with the original intent of the SIS Act, and favour high value SMSFs who can afford the cost of establishment and advice to effectively circumvent the intention of the Act. The regulations relating to borrowing need to be simplified and rewritten to allow direct investment in property. The regulations should include appropriate limitations on borrowing for all classes of investment to reflect the intention of the SIS Act.

2. *Regulations that increase complexity, are not complied with accurately, and have little economic benefit.* An example is the regulation relating to recovery of GST on inputs for SMSFs. GST on some inputs is completely recoverable (e.g. some aspects of property costs), some is recoverable at 75% (e.g. some elements of accountant's fees) and some is not recoverable (e.g. auditors fees). Most trustees and many accountants and auditors are unfamiliar with the regulations or interpret them in different ways. Some trustees receive different interpretations from different accountants, many auditors do not check compliance. The principle policies supporting the regulations should be provided to allow people to make a more informed judgement of the effect of the regulations (e.g. what is the interpretation of the output from an SMSF as it applies to GST). The regulations should be simplified even if the result does not apply in fine detail to the principles of the GST. The cost to government will be no more using simple GST regulations because government is not receiving the correct amount of GST because of the present complex and confusing

regulations. The ATO fact sheet (NAT71512) for SMSFs covering GST is infamous for being completely incomprehensible and is an unfortunate example of how the ATO has failed to adequately inform the SMSF community.

3. *Regulations that cannot be justified but add cost.* An example is the requirement for auditing funds in the drawdown phase. This matter is addressed in the following Section 5.
4. *Administrative and reporting requirements that are difficult to understand.* An example is the structure of the Annual Regulatory Return for funds in the drawdown phase. This return is focused on tax collection, probably because of the terms of reference of the ATO as a tax collector. It is designed for the accumulation phase where income tax is payable on the earnings in the fund. However, the ATO has a wider responsibility including compliance with respect to SMSFs.

A Fund in the drawdown phase and paying no income tax on the earnings in the fund is required to complete the form as though it were in the accumulation phase and then deduct the amount which is tax free. Whilst this arrangement may be regarded as manageable by accountants preparing the Regulatory Return, it adds unnecessary confusion and uncertainty for trustees who are required to sign off the Return. For example, the Return contains a capital gains tax line item, which has no significance for a fund in the drawdown phase and paying no tax. Consequently, a trustee must consult the separate Instructions to determine if the line item applies, causing confusion. It is acknowledged that the ATO has worked hard to simplify the Regulatory Return to meet the needs of funds following the introduction of the major changes to superannuation in July 2007. However, the Mercer estimates show that over 60% of all investment income will be obtained during the drawdown phase. Hence, the majority of fund earnings will be tax free and the present Regulatory Return increasingly less appropriate.

Recommendation 8

That the focus on regulation in SMSFs in this Review should be on simplification and reviewing the need for existing regulations in terms of meeting the objectives of the SIS Act.

Recommendation 9

That the definition of a pension should be changed to allow additional contributions to an existing pension for the reasons set out in detail in the A.I.R. Phase 2 submission.

Recommendation 10

That the SIS Act and regulations relating to instalment warrants and to investment in real property should be changed to remove the complexity and excess costs associated with the legal processes required to allow such investments. The changes should allow the ability to borrow at acceptable levels for investment in real property by way of non-recourse loans.

Recommendation 11

That the regulations relating to GST as it applies to SMSFs should be radically altered to simplify the system even if this means some reduction in revenue to governments.

Recommendation 12

That the Annual Regulatory Return should be changed to provide a simple and understandable return for funds in the drawdown phase recognising the rapid increase in number of SMSFs entering this phase.

2.22 Other Regulatory Matters

A.I.R. does not support the concept of delegating trustee responsibility for some actions to service providers (17.4.2). Ultimate responsibility should continue to be vested in trustees. It is more important that trustees receive proper professional advice to allow them to accept their responsibility with confidence. There is no question that many trustees would be happy to pass responsibility to their professional advisers, but A.I.R. believes this would be detrimental to the quality of the SMSF system and would lead to great difficulty for the regulatory body to achieve compliance and would provide an avenue for transfer of blame.

For the same conceptual reasons, A.I.R. does not believe that there should be any change to existing dispute mechanisms. The drive should be to minimise incorrect advice by ensuring that service professionals, including ATO auditors, are expert and ethical in carrying out their responsibilities (17.4.3). A more effective approach would be for stronger penalties to be applied to professionals where they are deficient in their services

The graduated scale of penalties applied by the ATO for non-compliance is appropriate and should be maintained (17.4.4). However, the ATO should be required to take into account the extent and quality of professional advice in determining any trustee penalty. Where there has been incorrect advice, the ATO should have the power to refer non-compliance issues arising from bad professional advice to the appropriate professional body.

A.I.R. does not support an open-ended approach to compliance oversight leading to a higher supervisory levy. The argument that greater compliance activity leading to a higher supervisory levy is necessary because of the significant amount of funds held by an increasing number of SMSFs (17.4.5) is totally rejected. To the contrary, the levy should be based on a sliding scale down from a maximum value of \$150. For example, SMSFs fully in the drawdown phase paying no tax on earnings are likely to have few compliance issues. Any misuse would have little monetary effect and in any case should be detectable through monitoring of the Annual Regulatory Return. A supervisory levy of \$150 for such funds is excessive. The present system has checks and balances on trustees, accountants, and auditors with independent ATO compliance imposed over the top. This is extreme and unjustified.

The operating expense for the one-quarter of SMSFs with less than \$200,000 in assets is approximately \$5,700 and is increasing as a percentage of assets. The present supervisory levy is about 3% of this cost. Data on the number of non-compliance issues for SMSFs in this range is unavailable but would be expected to be small and minimal in total monetary terms. Without data to the contrary there is no argument for increasing the supervisory levy and adding further to the operating expense ratio for this group.

Recommendation 13

That trustee responsibilities should not be able to be delegated to professional advisers.

Recommendation 14

That existing dispute mechanisms should remain unchanged. The drive should be to minimise incorrect advice by ensuring that service professionals, including ATO auditors, are expert and ethical in carrying out their responsibilities. A more effective approach would be for stronger penalties to be applied to professionals where they are deficient in their services.

Recommendation 15

That the graduated scale of penalties applied by the ATO for non-compliance should be maintained. However, the ATO should be required to take into account the extent and quality of professional advice provided to the trustee in determining any trustee penalty. Where there has been incorrect advice, the ATO should have the power to refer non-compliance issues arising from bad professional advice to the appropriate body.

Recommendation 16

That the ATO supervisory levy should remain at \$150.

3. SMSF OPERATION AND EFFICIENCY (Section 18)

User-friendly administration and investment software is available for trustees to use for managing their funds and providing information to accountants for the preparation of returns. However, in many cases this software is not compatible with the accountant's software causing them to re-enter data into their own software to simplify the preparation of annual returns and reports. The cost of data entry can be high and has led some trustees to prepare their own accounts with some thousands of dollars in savings. Low cost compatible software for use by trustees could effect significant cost savings. Some auditors have standardised electronic forms for obtaining compliance information as a means of containing costs (18.2).

Many auditors require accounts, which are essentially in the form of general-purpose financial reports but usually containing less information as Notes supporting the accounts. Auditor requirements vary between auditors. Trustees interested in preparing their own accounts and annual returns are put off by the lack of a model set of accounts. Some accountants prepare a set of accounts that contain insufficient information, for example, not including the treatment of contributions in the drawdown phase. A limited number of standard sets of accounts should be prepared by the ATO under the same conditions as for the proposal for standard Trust Deeds set out in Section A1 above:

- to provide a method of comparison for trustees to ascertain if their own accounts meet audit requirements,
- to provide a model for trustees to use in preparing their own accounts;
- to reduce the cost of accountants preparing unnecessarily complicated sets of accounts.

Recommendation 17

That the ATO, as the regulatory body, should prepare a minimum number of model sets of accounts as a guide for accountants and trustees. The Regulatory Return should be consistent with these accounts.

4. SMSF INVESTMENTS (19)

A.I.R. is opposed to the imposition of conditions, such as third-party custody of assets, (19.1) for the purpose of preventing breaches of the regulations. Early release schemes

and roll-overs from super funds on retirement allegedly into SMSFs but taken illegally from the system are examples. Inevitably, imposition of such conditions reduces the flexibility of the SMSF system (a major reason for trustees establishing an SMSF) and increases bureaucratic delay and cost. A.I.R. believes, as a principle, that regulatory control of matters such as incorrect roll-over should be managed by exception within the large fund superannuation administrative system by suitable use of technology and not managed by imposition on the majority of unaffected SMSFs.

The same principle should be applied with respect to investment decisions. The facts show that SMSFs overall obtain a return at least as good as APRA regulated funds. There is no evidence that poor returns are any greater as a percentage than in APRA regulated funds. The fact that some SMSF members do not access professional asset allocation and investment advice is totally irrelevant (19.2). The questions in the Issues paper imply that all funds should access such advice. This concept is totally rejected. It ignores the expertise of trustees and supports the pressure applied by professionals dominating the SMSF industry for increased business adding to administrative costs, the very antitheses of the objective of the superannuation system.

Regulation of the time period in which funds must be invested again ignores the very reason for trustees establishing SMSFs, namely, to give them control of their investments, which they have managed successfully elsewhere in their lives. The concept of such limiting regulation is totally rejected (19.3).

Investment restrictions should be the same as for APRA regulated funds. In addition, a simple method of investing directly in property, including reasonable leverage (19.3.2), should be available to SMSFs because of the more individual nature of SMSFs and the background of many trustees.

The matter of leveraging particularly for direct property investment has been raised in other sections of this submission. A simple mechanism to allow this without the uncompetitive costs associated with complex legal arrangements should be developed (19.3.2).

A.I.R. does not believe there should be any change to the regulations relating to In-house assets (19.3.3), Acquisition of assets from related parties (19.3.4) or the requirements for investment strategies (19.4).

Recommendation 18

That the principle purpose of forming an SMSF to allow trustee control of the management of the trustees' assets should be recognised in determining the appropriate degree of regulation applied to SMSFs. There should be no compulsory requirement for involvement by third parties in any of the aspects of administering and managing SMSFs.

5. SMSF SECTOR PARTICIPANTS (Section 20)

The Joint Committee on Corporations and Financial Services Inquiry into the structure and operation of the superannuation industry report August 2007 (PJC)^{xiii} recommended that SMSFs, with accounts prepared by qualified accountants be audited annually for three years from their commencement, and subject to no irregularities, thereafter every five years (20.2.1).

This recommendation arose from an A.I.R. submission made to that Inquiry which was directed to the those SMSFs in the drawdown phase where there is no income tax payable

on the earnings and where there is no upper limit on withdrawals, only on the minimum withdrawal amount. The only opportunities for non-compliance lie in excess contributions or in non-arms length operations to improperly maintain the tax benefit on some proportion of the assets. The submission recognised that the audit fee was significant for the majority of funds with assets in the range up to \$200,000 (one quarter of all funds).

The Senate Inquiry recommendation was that funds then be audited every five years. The Phase 3 Issues paper (states that this would require “multiple years at a time instead of a single year” (20.2.1). A.I.R. categorically refutes the argument that multiple year auditing would be required as a consequence. It is completely and reasonably possible to do an audit for a particular year based on the accounts and inputs for that year.

A.I.R. is conscious of the need to maintain the integrity of the fund compliance system. Its submission to the PJC Inquiry was that if a breach of compliance was detected at a later time the exemption would be revoked and the fund would be audited annually thereafter.

The requirement for auditing over the immediate previous three-year period prior to being exempt from the annual audit allows the provision to be applied to existing funds as they move from the accumulation phase to the drawdown phase.

Contributions may be made which breach the regulations, either in terms of the amount or in terms of the age requirements. These may not be detected by an accountant. However, the Annual Return now contains contribution information. The ATO also has a mechanism for checking for contribution breaches.

It is worth pointing out that a high proportion of members of funds in the drawdown phase do not pay income tax on their ‘taxable income’ (which excludes their pension income). There would be only a marginal number of funds where maintaining assets in the fund for the purpose of minimising tax would be attractive enough to be worth breaching the regulations. In any event, ATO compliance checks provide a brake on breaching regulations, just as in the preparation of personal Income Tax returns.

A.I.R. estimates that there would be a significant saving in administrative costs for ‘simple’ SMSFs, which in turn would become available as pension income, or as retention in the asset base for providing future pension income.

Recommendation 19

That the intent of the Parliamentary Joint Committee recommendation to reduce the frequency of auditing funds be adopted but limited as follows:

- funds totally in the drawdown phase
- funds that have been audited without serious compliance breaches over the previous three years
- no further auditing unless a serious compliance breach is detected by the ATO, in such case the fund should be audited annually thereafter.

6. SMSF STRUCTURE (21)

6.1. SMSFs in later life (21.3)

A.I.R. as the peak body representing self-funded retirees is concerned with their well being in later life.

It is obvious that there is tremendous variation in personal capability as people age with some in their nineties quite capable of operating independently and others seeking extensive assistance in their seventies. There is no specific age at which all people suddenly become incapable of managing their financial affairs. Models that force all people into one mould such as requiring assets to be managed by third parties, or limiting the range of products in which people can invest, are unacceptable. It is nonsense to suggest that as people age they will somehow be protected by being forced to put their superannuation assets into the hands of professionals. If they are incapable of making investment decisions within an SMSF structure there is nothing to suggest that they will be capable of selecting suitable products from the multitude professionally offered unless these are restricted by regulation, with all the duty of care issues this would raise.

People choose from among a range of options that suit them personally, In many cases they can manage their affairs satisfactorily until they die. In other cases, delegation through Powers of Attorney to relatives or professional associates, or to younger SMSF trustees, are available options. Decisions as to the appropriate time to make changes in how a retiree member of an SMSF organizes their financial affairs is entirely a matter for them. Government interference would be unreasonable and impossible to administer in a way that maximized the individual's potential for a full independent life.

As detailed in Section 17 of this submission A.I.R. is concerned to see that changes are made to the SIS regulations to ensure that the difference between an SMSF in the accumulation phase and in the drawdown phase is reflected in a reduction in the administrative burden on SMSFs, reflecting the change from the compliance emphasis to reduce the taxation risk to Government by way of revenue loss. .Once an SMSF is in the drawdown phase members have little incentive and little opportunity to abuse the system. One exception lies with the minimum withdrawal rules. The recent decision by government to halve the minimum withdrawal requirement over two financial years because of the global financial crisis is an indication of the artificiality of the minimum withdrawal rules as a means of control. As experience has been built with the superannuation system, it has become clear that the minimum withdrawal rules themselves are a hindrance to good management of an SMSF as they effectively interfere with a member's ability to manage assets in a way that maximizes the effective life of the SMSF. Experience has also shown that the average size of an SMSF is not large enough to encourage the majority of members to retain funds unnecessarily, or for estate purposes, in the fund. Further, other taxation concessions mean that few members would pay tax on the minimum amount withdrawn. The compliance cost of administering the rule hardly justifies the marginal increase in overall tax revenue. It is increasingly apparent that individuals should have the right to determine how much they need to draw down as pension to support their lifestyle and to maximize the period in which they can rely on their assets to remain self supporting.

Recommendation 20

That there should be no limiting regulations governing the manner in which older people manage their financial affairs.

Recommendation 21

That the minimum withdrawal rules should be removed.

ⁱ A.I.R. National Survey 2006.

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- ⁱⁱ Commonwealth of Australia. A Statistical Summary of Self-Managed Superannuation Funds. 2009. Executive Summary www.supersystemreview.gov.au-
- ⁱⁱⁱ Commonwealth of Australia. A Statistical Summary of Self-Managed Superannuation Funds. 2009. Member Income. www.supersystemreview.gov.au
- ^{iv} Vaillant G., *A Rewarding Life*. The Australian Financial Review, 21 August 2009, Review p 1
- ^v Commonwealth of Australia. Phase 3 Structure - Issues Paper Section 11. www.supersystemreview.gov.au
- ^{vi} Commonwealth of Australia. A Statistical Summary of Self-Managed Superannuation Funds. 2009. Executive Summary www.supersystemreview.gov.au-
- ^{vii} Commonwealth of Australia. A Statistical Summary of Self-Managed Superannuation Funds. 2009. Member Income. www.supersystemreview.gov.au
- ^{viii} Commonwealth of Australia. A Statistical Summary of Self-Managed Superannuation Funds. 2009. Section 11 Compliance. www.supersystemreview.gov.au
- ^{ix} Commonwealth of Australia. A Statistical Summary of Self-Managed Superannuation Funds. 2009. Section 4.2 Service Providers. www.supersystemreview.gov.au
- ^x Commonwealth of Australia. A Statistical Summary of Self-Managed Superannuation Funds. 2009. Section 4.2 Service Providers. www.supersystemreview.gov.au
- ^{xi} A.I.R. Phase 2 submission to the Super Systems Review, Dec. 2009
- ^{xii} ATO, Self-managed super fund statistical report - June 2009, <http://www.ato.gov.au/superfunds/content.asp?doc=/content/00214157.htm&page=8&H8>
- ^{xiii} Parliamentary Joint Committee on Corporations and Financial Services 2007, The Structure and Operation of the Superannuation Industry, August 2007.