THE RISE AND RISE OF SELF-MANAGED SUPERANNUATION IN AUSTRALIA

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Prior to the major reforms of the superannuation system in the 1980s, less than 40% of workers were covered by superannuation, which was, in practice, largely restricted to public servants and long time employees of major corporations. Following the 1986 national wage case decision, many workers became entitled to a 3% productivity superannuation contribution under industrial award provisions. This was subsequently extended to almost all employees by the Superannuation Guarantee (Administration) Act 1992. Compulsory employer contributions under the Superannuation Guarantee rose to 9% of total income in 2002-03.1

For most of its history, superannuation in Australia has been intrinsically linked with the contractual employment relationship. For the self-managed superannuation fund (SMSF) this is not the case, although SMSFs are generally able to accept compulsory employer contributions (since the ‘choice’ legislation was introduced) and a significant minority in fact do accept such contributions. An enquiry into the reasons people set up SMSFs will be part of my PhD, however at this stage employer contributions are not considered to be important amongst those reasons.

The history of the self-managed superannuation fund is described in the 2007 Australian National Audit Office report The Australian Taxation Office’s Approach to Regulating and Registering Self Managed Superannuation Funds2, partly excerpted below.

Excluded Funds
Up to 30 June 1999, the Australian Prudential Regulation Authority (APRA) and its predecessor, the Insurance and Superannuation Commission (ISC) had responsibility for regulating all small superannuation funds. Until this time, all small funds were known as ‘excluded funds’, which were superannuation funds with fewer than five beneficiaries.

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2 Australian National Audit Office, Audit Report No. 52 2006-07 Performance Audit
They were established to allow the self-employed and small business to maintain their own cost-effective superannuation vehicles.

The Superannuation Industry (Supervision) Act (SISA) had been enacted in 1993, a manifestation of the ‘old-age pensions’ power of the Constitution.\(^3\) When funds elected to become regulated under the SIS regime they were asked to complete a short statistical questionnaire to provide the ISC with selected statistics of the fund as at June 1994. The ISC (in its submission to the 1997 Wallis Inquiry) noted that:

> While a minor part of the growth in the excluded fund sector can be explained by small corporate funds converting to excluded funds, a more significant proportion of excluded fund growth has been due to high net worth individuals opting out of their current employer sponsored superannuation fund and directing contributions into their own personally managed excluded fund.\(^4\)

In April 1997 the Wallis Inquiry recommended, amongst other things, a significant change to Australia’s superannuation regulatory framework. In particular it recommended:

- **the establishment of a new agency known as the Australian Prudential Regulation Commission\(^5\).** This agency was to be responsible for the regulation of all deposit taking institutions as well as for life companies, friendly societies, general insurers and superannuation funds; and
- **new responsibilities for excluded funds.** The inquiry recommended that the Australian Taxation Office be made responsible for regulating excluded funds, and that all members of these funds be trustees.

Importantly the *Wallis Inquiry* recommendations included the following:

> The Inquiry considers that self-managed funds provide a worthwhile and competitive option for superannuation investors. However, as self-managed funds, they should not be subject to prudential regulation. To apply prudential regulation in such circumstances is impracticable. Moreover, it should be made clear that such schemes are conducted entirely at the risk of the

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\(^3\) ISC Submission to the Wallis Inquiry, contained in APRA Insurance and Superannuation Bulletin June 1996

\(^4\) Ibid 12

\(^5\) Later renamed the Australian Prudential Regulation Authority (APRA).
beneficiaries – in relation to financial safety, there should be no regulatory assurance attaching to such schemes.\(^6\)

**Excluded funds become SMSFs/SAFs**

In June 1999 the *Superannuation Legislation Amendment Act (No.3)* (the *Amendment Act*) was enacted to give effect to the government’s 1998-99 budget announcements of 12 May 1998 (contained in budget paper no. 2). This Act re-categorised excluded funds into two new categories of small funds: SMSFs and small APRA Funds (SAFs)\(^7\) by means of amendments to SISA. The term “self managed superannuation fund” was substituted for “excluded superannuation fund” in the consequential amendments in Schedule 2 of that Act.

According to the budget papers, there were no revenue implications involved in the changes affecting excluded funds except that reducing the superannuation supervisory levy was expected to have a budget revenue cost of around $19 million in each of the following two years.

There had been concern in the Senate Economics Legislation Committee about the following matters in relation to the Amendment Bill:

- the addition of a third regulator to those regulating superannuation funds and the potential for inconsistencies in the application by the three of the same legislative provisions
- the fear that the ATO would be more concerned with revenue collection than promoting self-regulation
- the maximum number of members of a self-managed fund being 4 (Committee members and witnesses proposed alternatives ranging up to 14)
- the need for a family or business link between each member of the fund

\(^6\) Wallis Report at 333

\(^7\) SAFs are similar to SMSFs in most respects, except for the following:
- SAFs are regulated by APRA;
- SAFs have a trustee that holds an extended public offer licence;
- SAFs are subject to the Registrable Superannuation Entity (RSE) licensing regime;
- members have access to the Superannuation Complaints Tribunal;
- members have the protection of the culpability test which is designed to protect arm’s length members who are not involved in trustee decision making; and
- the regulatory levy for SAFs ($500 minimum) is higher than the levy for SMSFs.
provisions for non-resident members of self-managed funds.\textsuperscript{8}

In relation to the fourth dot point, approximately 16\% of the 180,000 excluded funds at the time of this legislation contained arm's-length members. It was considered that some arm's-length members of excluded funds would not be able to represent their interests under the former framework, particularly employees who were members of employer sponsored excluded funds because of the often unequal nature of the relationship between employees and employers. Therefore the Bill required all members of a self-managed fund to be family members or business relations, on the assumption that these parties would be able to look after their own interests. However this disentitled same-sex couples and friends from continuing their excluded funds as self-managed funds, necessitating transfer of the arm's-length member out of the fund or the appointment of an approved trustee and regulation by APRA, either of which would result in increased costs for the fund.

An opposition amendment, supported by the Australian Democrats, removed the family or business linkage requirement while ensuring that employees cannot be a member of their employer's self-managed super fund, except where they are relatives.

The explanatory memorandum to the \textit{Amendment Act} clarified the Tax Office's regulatory role, where it was stated that:

\begin{quote}
As members of self managed superannuation funds will be able to protect their own interests, these funds will be subject to a less onerous prudential regime under the SIS Act.\textsuperscript{9}
\end{quote}

Self managed super funds are exempted from such onerous requirements of SISA as the requirement to establish internal complaints resolution systems, the requirement to have a registered company auditor and many other detailed requirements for reporting to members.


\footnotesize{\textsuperscript{9} The Parliament of the Australian Government, House of Representatives 1998–99, Superannuation Legislation Amendment Bill (No.3) 1999, at 1}
Another key change instituted by the *Amendment Act* was the reduction of the SMSF superannuation supervisory levy from $200 to $45. This levy was reduced ‘to better reflect expected Tax Office regulatory costs and to recognize the past cross subsidization of larger fund regulatory costs by small funds’¹⁰.

Since 8 October 1999, SMSFs have been regulated by the Tax Office, and at that date they accounted for approximately:
- 98 per cent of the total number of excluded funds; and
- 90 per cent of the total value of excluded fund assets.

The ANAO report states the following in respect of the transfer of responsibility for SMSFs¹¹:

> In September 2000, approximately 187,000 SMSF records were transferred across from APRA to the Tax Office. The Tax Office considered that some of these records were of poor quality and required rectification. The Tax Office also suspected that prior to the *Amendment Act* coming into effect, compliance by a large proportion of these funds had been poor¹² and that ISC and APRA had undertaken a limited amount of compliance work on these funds in comparison to larger funds.

**Subsequent events affecting SMSFs**

*Disqualification of trustees by the ATO*

Significant changes were made to the Tax Office’s role as regulator when the *Financial Sector Legislation Amendment Act* was passed in January 2001, allowing the Tax Office to disqualify persons that they considered not to be ‘fit and proper’ to manage a fund. Previously only APRA had been able to disqualify individuals from being a trustee or investment manager of any superannuation entity.

*Auditor contravention reports*

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¹⁰ Second Reading speeches, *Superannuation Legislation Amendment Act (No.3) 1999* (Sen Joe Hockey)
¹¹ ANAO, above n 1, at 122
¹² In 1997, the ISC undertook a survey of the compliance practices of 1 000 funds. Approximately 20 per cent were investing in unit trusts controlled by the members or the employer sponsor, and about half of these unit trusts were involved with geared investments (see the Explanatory Memorandum to Superannuation Legislation Amendment Bill (No.4) 1999: Attachment F). The ANAO in its report *The Australian Taxation Office’s Approach to Regulating and Registering Self Managed Superannuation Funds* (supra) notes that there were industry criticisms of the ISC’s approach and the conclusions of the survey.
In September 2001, the then Senate Superannuation and Financial Services Committee produced the last of three reports into the prudential supervision of superannuation, banking and financial services. The report recommended that changes be made to section 16 of the SISA. This recommendation related to approved fund auditors being required to inform relevant regulators of funds breaching their obligations under the SISA.

In July 2004, the Superannuation Safety Amendment Act 2004 came into effect. This Act required fund auditors (including approved auditors) and actuaries to lodge auditor contravention reports with fund regulators. Specifically, it requires approved auditors to notify the Tax Office of any major breaches of the SISA by SMSFs, regardless of whether SMSFs take action to resolve the breaches.

**Supervisory levy increase**

In April 2003 the Productivity Commission released a report into the SISA. The report recommended that the costs of administering SMSFs should be fully cost recovered. This was consistent with the Government’s cost recovery policy as well as funding arrangements for APRA and the Australian Securities and Investment Commission (ASIC) regarding the regulation of superannuation funds.

In October 2003, the Department of the Treasury released a report into financial sector levies relevant to APRA, ASIC and the Tax Office. The superannuation supervisory levy relating to SMSFs was not examined as part of this report, suggesting that the levy does not operate on a cost recovery basis. The SMSF levy increased to $150 from 1 July 2007.

**Fund choice**

In July 2005, the Superannuation Choice legislation came into force. This gave many employees the right to choose the superannuation fund to receive their superannuation contributions. The Tax Office prepared for the possibility of significant increases in the number of SMSFs due to the Superannuation Choice legislation. Numbers of SMSFs had been increasing at a relatively consistent rate since 1999–2000\(^{13}\), however no

\(^{13}\) The percentage increases have been 11% in 2000-01, 7% in 2001-02, 11% in 2002-03, 10% in 2003-04, 5% in 2004-05, 7% in 2005-06, 13% in 2006-07 and 9% in 2007-08.
significant increases in SMSF numbers occurred in the short term after the introduction of Superannuation Choice legislation.

‘Simplified Super’
In March 2007, the Tax Laws Amendment (Simplified Superannuation) Act 2007 and related legislation received Royal Assent. This legislation implemented the Government’s Simplified Superannuation reforms, which include changes to the reporting arrangements for SMSFs, clarification of SMSF trustee and approved auditor requirements and the application of administrative penalties to SMSFs.

Instalment warrants
In September 2007 amendments to SISA permitted superannuation funds to borrow money of a limited recourse nature for investment purposes in certain circumstances. Section 67(4A) of the SISA now provides an exception to the general prohibition from a regulated superannuation fund borrowing money. The intent of the amending legislation is to permit a SMSF to invest in instalment warrant arrangements such as those in respect of ASX listed shares. The amending legislation extended the borrowing exception beyond the acquisition of ASX listed shares and allowed a SMSF to borrow money to acquire any asset which a SMSF is permitted by law to acquire directly. This has potentially made SMSFs even more attractive for those who wish to purchase real property or collectibles through their super fund.

Characteristics of SMSFs
The APRA Superannuation Survey Methodology Overview in March 1999 noted three important defining characteristics of SMSFs (then called excluded funds):

- **equity per member** - excluded funds have significantly higher average equity per member than other superannuation funds.
- **propensity to directly invest in the market** - the decision to establish an excluded fund is often based on an intention by individuals to exert increased control over their superannuation investments. This control is illustrated by the fact that 85 per cent of excluded fund assets are directly invested in the market, with only 15 per cent

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invested through investment managers and life offices. This compares with 26 per cent directly invested for all other superannuation funds. The high degree of direct investment by excluded funds is also consistent with the fact that excluded funds acting individually have limited market power to gain cost effective access to wholesale investment products.

- **Contributions per member** - excluded funds have extremely high contribution rates per member.

The average assets per SMSF as at 2006-07 income year were $938,315, with average assets per member of $489,247\(^\text{16}\). This is considerably higher than the assets held by public offer fund members, indicating that SMSFs are primarily a vehicle for the wealthy. Tax Office data reveal that at the end of the March 2009 quarter there were 406,577 registered SMSFs, up from 187,000 in September 2000 when the Tax Office took over APRA’s SMSF records. Latest reports from APRA show that whilst numbers of corporate, industry, public sector and retail funds decreased between June 2007 and June 2008, SMSF numbers rose 9% in the same period.\(^\text{17}\)

**Future growth in SMSF numbers**

There is a view by some researchers in the industry that there will be an imminent and severe downturn in the SMSF market-share because many people have been inappropriately advised to start up an SMSF and the costs and work involved can be wearing for those without significant investment funds ($1-2 million) and good tax and/or estate planning reasons to have an SMSF.

Rice Warner Actuaries’ Superannuation Market Projections Report\(^\text{18}\), based on data as at June 2008, predicts over the next 15 years that the SMSF segment of the superannuation industry will decline to 26% (from 30.4% of total superannuation assets, being currently a bigger sector than retail, industry, public sector and corporate funds).

\(^{16}\) ATO Self-managed super fund statistical report - December 2008
\(^{17}\) Australian Prudential Regulation Authority, Superannuation industry overview, APRA Insight, Issue Two 2009, 2-10
\(^{18}\) Accessed online at <http://www.ricewarner.com/index.php?option=products&action=listpage&id=64>
The broader informal view in industry is that this projection is incorrect.\textsuperscript{19}

New SMSF establishments,\textsuperscript{20} net of wind-ups, have been as follows (ATO data extracted 6 April 2009):

**Quarters:**

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Establishments</th>
</tr>
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<tbody>
<tr>
<td>December 2006</td>
<td>6,149</td>
</tr>
<tr>
<td>March 2007</td>
<td>8,963</td>
</tr>
<tr>
<td>June 2007</td>
<td>19,878*</td>
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<tr>
<td>September 2007</td>
<td>7,971</td>
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<tr>
<td>December 2007</td>
<td>5,772</td>
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<tr>
<td>March 2008</td>
<td>6,568</td>
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<tr>
<td>June 2008</td>
<td>9,404</td>
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<tr>
<td>September 2008</td>
<td>8,788</td>
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<tr>
<td>December 2008</td>
<td>7,127</td>
</tr>
<tr>
<td>March 2009</td>
<td>4,489**</td>
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</tbody>
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\* The spike in registrations in the June 2007 quarter was due to the well-publicised, once-only opportunity for each member to contribute up to $1 million in non-concessional contributions between 6 December 2006 and 30 June 2007. Many would have made \textit{in specie} contributions into SMSFs, particularly of business real property, in order to take advantage of this opportunity.\textsuperscript{21}

\** Although it appears that the March 2009 quarter establishments have reduced compared to previous quarters, the data was extracted in April and there will be a number of funds that were established in the March quarter but did not register until April, May or June. So the next quarterly report from the Tax Office will include all the funds that were established in the March quarter but were registered after the data extract was taken in April.

\textsuperscript{20} Establishment date is the date when an SMSF is deemed by the super law to come into existence and is not necessarily the date of registration
\textsuperscript{21} After 1 July 2007, contributions caps existed to replace the repealed reasonable benefit limits. These caps were $50,000 for concessional ($100,000 for over-50s) - which has been temporarily halved in the 2009 budget - and $150,000 non-concessional (with the ability of under-65s to bring forward two years' worth of contributions and make $450,000 in one year). Contributions in excess of the caps are subject to punitive rates of taxation.
New registrations this financial year are up approximately 9% on the same period last year. The growth in fund numbers has been generally steady, with a consistent increase each year – apart from the 2006-07 year. Logically a saturation point must exist where there are few new registrations but at this time there is still room for penetration in the market. For example, many public servants in defined benefit funds are approaching retirement age and can be expected to take a lump sum and, having time and interest in closely monitoring their retirement savings, put it into a SMSF.

The global financial crisis may stimulate a further spike, as SMSFs appear to have survived it better than public offer funds so far, although it can be difficult to source accurate, comparable figures in this area. According to University of Adelaide Professor Ralf Zurbrugg, the average SMSF posted a gross loss of just over 11% in the 12 months to June 2008, beating the S&P/ASX 100 which lost 12.8% over the same period. Selecting Super, a statistical research division of Rainmaker Group, reported the average loss for balanced portfolios in public offer funds (retail, industry and government funds) was 18.2%.

Now may be an opportune time for people to start a SMSF: the sharp falls in share and property values mean transferring unlisted shares and real estate (including business premises) into concessionally taxed new SMSFs will result in less capital gains tax and stamp duty with the change of ownership than before the global financial crisis because of the eroded values of those assets.

Members may resent paying fees to public offer funds which are losing their superannuation and this may have psychological effects that prompt movement to SMSFs. Taxation Commissioner Michael D’Ascenzo drove home this bear market point recently, saying that, ‘[g]rowth in [SMSF] registrations is consistent with economic

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22 Australian Taxation Office SMSF newsletter - Edition 9, 26 June 2009  
23 Anecdotal comment from ATO  
24 Bryce, Jason 'DIY has Super Form', Herald Sun (Melbourne) 6 June 2009, 29  
downturns. The reason for this is not chiselled, but it is thought that people seek to be more self reliant in difficult economic times.\textsuperscript{27}

Apart from disaffection with public offer funds, other perceived advantages of SMSFs include:

- control over asset allocation
- scope to make direct investments and borrow via instalment warrants
- withdrawal and re-contribution strategies
- access to transition to retirement pensions (not available through all public offer funds)
- scope to acquire premises from which a small business operates
- highly-controlled estate planning (for example, use of indefinitely continuing binding death nominations).

Contrasting with this, another circumstance that will increasingly confront husband-and-wife SMSFs with the ageing of the population is when one spouse dies, leaving the other perhaps less willing or able to continue as a trustee.

The Rice Warner report comments that another factor that will encourage members of SMSFs to return to large funds is that the Australian Taxation Office, in its role as regulator of self-managed funds, is continually toughening its stance against trustees who breach superannuation law. And Superannuation Minister Chris Bowen is presently conducting a review into the sector and how its standards can be improved\textsuperscript{28}, illustrating ever-present legislative risk.

The Assistant Treasurer in the second reading speech to the Amendment Bill stated:

The ATO has developed a compliance model on which its regulation of self-managed superannuation funds will be based. There are four stages to the model: education communication and service, self-regulation, assisted regulation and enforced regulation. The ATO expects to spend most of its time and effort at the first two stages to assist self-managed superannuation funds to regulate through education and communication. This

\textsuperscript{27} ‘Self-managed superannuation funds and the global recession: an ATO perspective’, speech delivered at the SPAA Annual Conference, 11 March 2009

\textsuperscript{28} Review into the governance, efficiency, structure and operation of Australia’s superannuation system is to report to the Government by 30 June 2010
reflects the ATO’s belief that the vast majority of self-managed funds wish to comply with the law or would comply if made fully aware of the rules.

However, recent speeches by Tax Office senior officers\(^{29}\) and the previous Minister for Superannuation\(^{30}\) reveal continuing unease about SMSF trustees’ understanding of their obligations.

In conclusion it is worth emphasizing that, as the largest sector by numbers of funds and assets, SMSFs are a very well-established part of the Australian financial, retirement and business environment. They attract continuing policy focus from government and are increasingly marketed to by service providers and product developers.

No matter who turns out to be correct about the future direction of the SMSF sector, it will remain a formidable force and provide intense competition for much of the superannuation industry. Public offer funds considering how to counter loss of members to the SMSF sector could go to the extent of offering SMSFs access to wholesale versions of their diversified investment options and possibly access to the super funds’ group insurance deals, as well as attempting to mimic some of the more attractive options available to SMSFs such as direct shares and real property.\(^{31}\)

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\(^{29}\) For example Neil Olesen, Deputy Commissioner of Taxation speeches ‘Regulatory issues emerging from self-managed super fund cases’ delivered at the SPAA Annual Conference 11 March 2009 and ‘Regulating the self-managed super fund market’ delivered at the ICA SMSF Conference, 27 February 2009.

\(^{30}\) The Hon Nick Sherry, ‘Putting You in the Professional Spotlight’ speech delivered at the SPAA Annual Conference 13 March 2009, including the following comment: ‘With superannuation being compulsory, supported by significant tax concessions and with the Government responsible (in the form of age pensions) for those for whom the SMSF experience may turn sour, I am sure you can see my interest.’

\(^{31}\) Michael Laurence, above n 19, 36