Self Managed Super Funds

A Big Win for DIY Investors

On Monday, 5th July 2010, the Super System Review final report was released. The report sets out the Panel's final recommendations on the whole superannuation industry including self-managed superannuation funds (**SMSFs**).

The Cooper Review findings represent a big win for the SMSF. The panel has described the SMSF sector as as "largely successful and well-functioning". Certainly, the review's final report gives a big tick to self-managed super funds (SMSFs) in general, describing the $400 billion-plus sector. Certainly, the changes recommended to the Government for self-managed funds are much lighter than for the rest of the super industry. This represents a win for the SMSF and will surely result in an explosion of SMSF start-ups.

When the Cooper Review was first announced in 2009 by Senator Nick Sherry, there were real fears that the retail and industry super funds would seek to destroy the SMSF sector. Industry experts feared that resulting legislation would favour the interests of the large funds at the expense of the SMSF. Trustees feared they would be bound with unbearable red tape and investment restrictions. The end-game was to destroy the SMSF!

Fortunately, this has not occurred. The Cooper review has given the big super funds a “big smack in the teeth”. Retail funds have been heavily criticized for mismanaging client’s funds, high fees & charges, the persistent conflicts of interests and the use of costly antiquated financial systems. The industry funds have not fared much better. They’ve been put on notice by the Cooper Review that their “gravy train” no longer exists. Their captive market of union members can no longer be taken for granted and they now have to compete in the market on a level playing field. The MySuper plan will introduce much needed competition into the sector. Not surprisingly, the big end of town is pretty upset with the Cooper Review.

In my submission to the review, I made the following points:

1. The Cooper Review must recognize that SMSF trustees are conservative investors and fund managers. Self interest is very important to SMSF trustees simply because they are managing their own money. Our plea is that the Cooper Review gives SMSF a "fair go" and not to go down the path of stifling SMSF growth…through increased regulation and restrictions!
2. Significantly reduce the amount of SMSF administration required for audit. Make the end of year multi-purpose reporting more "trustee friendly' so that they can better understand and use them... the current system is more auditor and accountant friendly;
3. Eliminate the current serious "conflict of interest" in the financial planning industry by banning commissions and enforcing a "fee for service model". This conflict of interest encourages the financial planner to sell high risk insurance policies and managed funds that deliver the highest commissions to the financial planner;
4. Eliminate the practice of the industry where the direct cost of commissions is not properly disclosed. The actual costs of administration of the policy are a fraction of this cost. In comparison, we use the services of an online broker to invest funds where the brokerage fees are just $20 per trade;
5. No further restrictions should be imposed on SMSF investment strategies including age-based restrictions. The SMSF environment is subject to too many changes in legislation; and
6. Ensure that people who aggressively market non compliant schemes are met with the full force of the law;

In the end, the Cooper Review key recommendations relating to SMSF met many of the demands made by SMSF trustee submissions. The recommendations are:

1. prohibit investment in collectables and personal-use assets (such as artworks, wine collections, exotic cars and yachts);

2. strengthening the competence and independence of approved auditors;

3. an online SMSF resource centre to help SMSF trustees build skills and make better decisions. In particular they are looking at streamlining laws and reducing the amount of redundant paperwork;

4. making the ATO's penalty regime more flexible to enable more effective and equitable regulation;

5. tightening the SMSF registration process, including the introduction of member identity requirements, to reduce instances of fraud and illegal early release schemes;

6. Reducing the potential to benefit illegally from related party transactions by prohibiting the acquisition of in-house assets and imposing restrictions on the way in which an SMSF can transact with related parties;

7. A sliding scale of penalties that the Tax Office could use for infringements; and

8. Higher standards for advisers and other service providers and more educational resources for trustees.

There are some important changes to the running of the SMSF that the trustees will need to implement. SMSFs will need to be run more professionally so that we can justify the considerable tax concessions afforded to us.

Here are our four tips for SME owners with their own funds:

1. Business premises are held in your SMSF are OK.

The Cooper review makes no recommendations about business real estate held in SMSFs…. even if they are rented to the members' own businesses. This should be seen as a key win for many SME owners.

Business real estate is expressly excluded from being classified as in-house asset. A common strategy is to hold business premises in their self-managed funds and receive a commercial rent. The rental income is concessionally taxed within the funds. This practice is acceptable under the Superannuation Industry (Supervision) Act.

Business premises are broadly untouchable to creditors if the fund members later fall into personal financial difficulties. However, be sure that governments will keep a close watch on gearing by SMSFs.

2. Refocus your SMSFs investment portfolio away from related-party investments.

In future SMSFs will be barred from holding even a small percentage of in-house assets. This means that all-related party investments with the exception of business real estate will be banned.

Many SME owners have some related party assets in their self-managed funds. They include loans, investments or leases involving related parties of the fund. Related parties include fund members and entities (including trusts) that are majority-owned or controlled by members, their partners and relatives.

Under prevailing superannuation law, a SMSF cannot hold more than 5% of its assets as in-house assets. The Cooper review recommends that the SMSFs be prohibited from acquiring new in-house assets. Further, funds with existing in-house assets will be given five years to either get rid of them or become a small APRA fund with a professional, APRA-approved trustee.

The Cooper review says one of the purposes of the in-house asset maximum is to limit the "extent to which business funding arrangements can be distorted, particularly in the small business sector, through access to relative cheap, tax-advantaged working capital from a related SMSF".

And the report adds: "...the current exemptions still provide an avenue for potential abuse, which is inconsistent with Government policy, and whose regulatory compliance costs across the superannuation system outweigh the benefits they bring to individual funds."

If the Government accepts this recommendation, more SMSFs will need to focus on more conventional assets such as listed shares and bonds.

3. Be careful when using gearing strategies in your DIY fund.

The Cooper review states emphatically that "leverage should not be a core focus for SMSFs".

In 2007, the Superannuation Industry (Supervision) Act was amended to unequivocally allow self-managed funds to borrow to buy investments. This change was only intended for instalment warrants… provided strict conditions are met. However, the unintended consequence was that it also allows borrowing to invest in residential real estate.

The level of borrowing by funds under this amendment began modesty, but appears to have gathered pace. Investment researcher Super Trends found that more than 5% of SMSFs are now borrowing to invest in instalment warrants.

The Cooper review called for greater regulation of borrowing by SMSFs. The report recommends that the Government review in two years time the 2007 relaxation of the borrowing rules. It also recommends that consumer protection measures be implemented to ensure that borrowing does not become a significant focus of SMSFs.

This recommendation has implications for some SME owners:

1. the self-managed funds of many SME owners borrow heavily to buy their members' business premises.
2. the marketing of self-managed fund gearing products directed at SME owners because they have their own SMSFs.

The Cooper review's concern about borrowing by SMSFs largely echoes a widespread concern about the degree of SMSF gearing. Extensive borrowing by a fund can upset its asset allocation and expose the fund to the investment losses.

The 2007 borrowing amendment to superannuation law stipulates that a SMSF loan is non-recourse. This means that in the event of a fund's default in loan repayments, any losses must be limited to the asset itself…. not to the other assets of a fund. A defaulting fund can lose its initial deposit on the geared investment and any payments made.

The government will tighten of the SMSF borrowing provision sometime in the future. Be prepared.

4. If you have paintings, antiques or classic cars, you will have to sell them and rebalance your investments

The Cooper review recommends the prohibition of self-managed funds owning collectables and personal-use assets. Funds that already own these investments will be given five years to sell them or to convert the fund to a small APRA fund.

There are entrepreneurs who mark their success by acquiring collectables as "investments" for their SMSFs. However, the Cooper review does not see them as an asset that is suitable for SMSFs

"While the panel recognises and supports the freedom of investment choice that SMSFs afford their members," the Cooper review states, "it believes there are certain types of assets that should generally not be regarded as investments that build retirement savings..."

In Summary

Some members will be unhappy with some of the recommendations but the outcome for do-it-yourselfers is largely positive. Cooper has eschewed calls to dictate who should run their own fund or to be overly proscriptive in how they should go about it. The reforms will help self-managed funds grow, not strangle them.

If you have any comments or would like further information then you can contact me on allencummings@bigpond.com

ABOUT ALLEN CUMMINGS

Allen Cummings is a qualified accountant BBus, AASA with a total of 30 years experience. He has been employed with large companies such as Australian Paper Ltd, Greater Pacific Life and government bodies such as Brisbane City Council and Queensland Government.

Allen has also had 10 years experience working as an independent contractor and understands the taxation and superannuation needs of independent contractors.

Allen is a trustee and has managed his own SMSF for 12 years.