

SMSFs – Keeping the Concessions

Too much attention on the details can mean forgetting about the fundamentals. Here we trace the convoluted eligibility rules applying to SMSFs and the consequences of not meeting those rules.

There are many ways in which to save for retirement – from complex structured investments to keeping cash under the mattress. Superannuation is one of the most popular retirement savings vehicles due to two main drivers:

- It comes with significant taxation concessions; and
- Employers have superannuation obligations to meet in relation to their employees.

In each case, a key requirement is that a "complying superannuation fund" is involved.

So just when will a superannuation fund be (or, of more concern – not be) a complying superannuation fund? Let's take a look at how the process works for a typical new superannuation fund wanting to qualify as a self managed superannuation fund ("SMSF"). While this article will look solely at SMSFs, similar (but not identical) rules apply to other classes of superannuation funds.

Qualifying as an SMSF

A good starting point is to determine whether our fund is an SMSF.

To be an SMSF our fund must:

- be a "superannuation fund";
- have fewer than 5 members; and
- have each member as either an individual trustee of the fund or the director of a corporate trustee (and vice versa). Somewhat surprisingly, only about 30% of SMSFs have corporate trustees.

Further, a member cannot be an employee of another member (unless they are related) and no trustee or trustee director may be remunerated for acting in that role.

Most of these requirements are relatively easy to understand and monitor. However, if our SMSF failed to meet those requirements then it would (after a 6 month grace period) revert

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to being a "standard" superannuation fund – with a number of different regulatory provisions to comply with.

But what technically is a "superannuation fund"?

Superannuation Funds

A superannuation fund is defined in the *Superannuation Industry (Supervision) Act 1993* ("SIS Act") as an indefinitely continuing fund that is a "provident, benefit, superannuation or retirement fund".

These terms are not defined further and, therefore, take their ordinary and natural meaning in the context in which they appear. There were a number of Court cases that considered these terms back in the 1960's and 70's when they were being used in the taxation legislation applying to superannuation funds in those times.

However, as long as our SMSF has the "sole purpose" of providing retirement or death benefits then there is not much doubt that it will, at least, be a "superannuation" or "retirement" fund.

Our SMSF will be indefinitely continuing as long as it is not established for a fixed term. The fact that the trust deed has a termination or perpetuities clause in it does not prevent the fund being indefinitely continuing. As an aside, it should be noted that the legal rules against perpetuities do not actually apply to regulated superannuation funds (section 343 of the SIS Act).

So, we have a superannuation fund that meets the SMSF requirements. How do we ensure that it is "complying"?

Being a complying superannuation fund

Becoming a complying superannuation fund actually involves much more than merely complying with the operating standards.

Our SMSF will be complying for tax purposes (and hence for SG contribution purposes) if it is a "complying superannuation fund" for the purposes of section 45 of the SIS Act. Under that section, our SMSF is complying if it has received a notice under section 40 of the SIS Act stating that it is a complying superannuation fund and has not subsequently received a notice stating that it is non-complying.

Under section 40 of the SIS Act the ATO may give a notice that our SMSF is a complying superannuation fund. However, under section 42A of the SIS Act our SMSF can only be a complying superannuation fund if it is a "resident regulated superannuation fund" for a particular year of income and has not contravened a compliance test.

So, how do we make sure that our SMSF is a resident regulated superannuation fund?

Resident Regulated Superannuation Fund

To be a resident regulated superannuation fund our SMSF needs to be both a "regulated superannuation fund" and an "Australian superannuation fund" – which means that we need to drill down even further.

Regulated Superannuation Fund

To be a regulated superannuation fund section 19 of the SIS Act requires our SMSF to have either a corporate trustee or have a sole or primary purpose as the provision of old age pensions. One or both of these requirements would be reflected in the trust deed for our SMSF.

Further, our SMSF's trustee must have elected to the regulator that the SIS Act is to apply to the fund. Making this election is a relatively straightforward form filling exercise that must occur within 60 days of establishment of the fund.

Assuming that our fund's trust deed is worded appropriately and the election made then we need to consider whether our SMSF is an Australian superannuation fund.

Australian Superannuation Fund

Although the criteria is complicated (see section 295-95(2) of the ITAA 1997) being an Australian superannuation fund essentially means that our SMSF continues to be managed in Australia, have assets in Australia and a majority of its assets or benefit entitlements are held by active members who are Australian residents.

It is possible to lose this status relatively easily if the members (or a majority of them) leave Australia for an extended period. Accordingly, the trustee should be wary if any members of our SMSF express a desire to leave Australia for an extended period.

Having made sure that our SMSF is a resident regulated superannuation fund we need to consider the compliance test.

The compliance test

To meet the compliance test our SMSF must not have contravened certain regulatory provisions during the year of income. It is beyond the scope of this article to consider these compliance requirements themselves.

However, if our SMSF did contravene an applicable requirement then it can still be complying if the ATO is prepared to overlook the contravention.

Failing that, the ATO would issue a notice of non-compliance and our SMSF would cease to be a complying superannuation fund. Such a notice can apply to one or more financial years.

The issuing of a notice of non-compliance is actually a fairly rare occurrence – only 185 notices were issued by the ATO in 2009-10, up from 99 in 2008-9. Given the severe consequences of being made non-complying and the ATO's ability to overlook contraventions (either because they are trivial or have been rectified) the ATO seems to issue a non-compliance notice only as a last resort in serious cases.

Interestingly, the Cooper Review has recommended that the ATO be given the power to issue administrative penalties against SMSF trustees on a sliding scale reflecting the seriousness of the breach. The penalties would be payable by the trustees personally and not from the assets of the fund. This would give the ATO a range of penalties to impose on SMSF trustees who contravened the regulatory requirements rather than the existing "all or nothing" nature of the non-compliance notice. The Government has indicated that it supports this recommendation and it is likely that such a system will be introduced at some point in the future.

However, for the time being, assuming that our SMSF does not receive a notice of non-compliance then it will receive a notice of compliance and will, therefore, be a complying superannuation fund.

The effect of losing complying status

As mentioned above, once our SMSF has received complying status it will generally continue to have that status until the ATO notifies it that it is non-complying.

Keep in mind, though, that our SMSF could also lose its complying status if it ceased to be a "superannuation fund" or if it lost its status as an "Australian superannuation fund".

The consequences of becoming non-complying are quite onerous. Obviously, our SMSF will no longer be eligible to receive SG contributions (although there are "safe harbour" provisions for employers affected by this situation) and will lose its tax concessional status (so that, for example, its income will be taxed at 45% rather than 15%).

Further though, our SMSF will upon becoming non-complying have to pay additional tax equal, in effect, to all of the tax concessions that it has received in the past. This amount can be quite large for a fund that has been in operation for some time. There is also the possibility that the ATO may impose interest charges and other penalties depending on the nature of the contraventions that occurred.

One non-consequence of being non-complying is that our SMSF is still regulated under the SIS Act and must still comply with the requirements of that Act.

Room for improvement?

Tracing our way through the legislative provisions above reveals a fairly convoluted and, in the author's opinion, unnecessarily technical process for establishing an SMSF (when compared with establishing a company, for example). Further, this article has not even touched on the actual operating standards that regulate the activities of our SMSF and which create their own set of issues.

The Cooper Review recognised this issue and recommended that the legislation covering SMSFs be included in a separate division of the SIS Act or even given its own legislation. With the long term decline in corporate funds the superannuation industry is increasingly dividing between public offer funds and SMSFs and the time might soon come when it makes sense to recognise an SMSF as a unique type of entity rather than just a small version of the generic superannuation fund.