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Tax compliance behaviour in Australian self-managed superannuation funds

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Abstract

The rapid growth of self-managed superannuation funds (SMSFs) in Australia over the past two decades has been mirrored by a host of legislative and taxation rulings regulating the sector. The need for trustees to remain compliant with the relevant regulations is of paramount importance given the severity of the penalties they face for contraventions. We review the main rules governing SMSF compliance along with several notable legal cases of non-compliance. We then provide a comprehensive quantitative analysis of compliance outcomes in 321 SMSFs from across Australia.

This research paper focusses only on SMSF trustee behaviour in respect of funds where the auditor has reported a breach. It does not refer to SMSF funds that are technically non-compliant as that term is defined in s 42A of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act). Therefore, in terms of this paper, whenever a SMSF is referred to as non-complying regard is only had to a SMSF where an auditor has reported a breach of any of the regulatory rules.

The results of our research suggest that trustee literacy is positively associated with fund compliance, whereas trustee overconfidence cannot be linked with compliance outcomes for the sample. Moreover, compliant funds also appear more likely to allocate a greater share of their superannuation portfolios to conservative asset classes (cash and domestic equities), typically linked with under-diversification in SMSFs. Our findings therefore suggest that the financial risks borne by under-diversified SMSFs may at least in part be offset by a lower compliance burden for these funds.

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1. INTRODUCTION

Australia's retirement savings regime has been part of the tax reform agenda for many decades and is still a part of current tax reform debate.[5] This retirement savings regime was also addressed in detail in the final report of the AFTS review with seven of the 138 recommendations specifically relating to retirement incomes.[6]

In theory, Australia's retirement income system is designed to encourage individuals to self-fund their retirement through a voluntary and compulsory contributions scheme with a government pension scheme acting as a safety net for those who are unable to fully self-fund their retirement incomes. This regime is collectively known as the 'three-pillar' structure of the retirement income system. These three pillars are; the age pension; compulsory superannuation and voluntary superannuation.

It is the second and third pillars (the superannuation pillars) that receive the current tax concessions concerning contributions to a 'complying superannuation fund'. These include a lower tax rate of 15% that applies to earnings of complying superannuation funds and various other tax concessions surrounding superannuation such as the nil or reduced rates of tax that apply when members withdraw their benefits from a superannuation fund.[7]

2. WHAT IS A SELF-MANAGED SUPERANNUATION FUND (SMSF)?

Section 17A of the *Superannuation Industry (Supervision) Act* 1993 (**SIS Act)** sets out the basic conditions that must be satisfied for a superannuation fund to be a self-managed superannuation fund (**SMSF).** Section 17A provides that in order for a superannuation fund to be a SMSF it must have fewer than five members and that if the trustees are individuals that each individual trustee is also a member of the fund and that individual members must also be trustees of the fund.

If the trustee is a body corporate then each director of the body corporate must be a member of the fund and each member of the fund must also be a director of the body corporate. This essentially means that members of an SMSF must take responsibility for the assets managed by the self-managed superannuation fund.

Subsection 17A (3) of the SIS Act does provide that other persons who are not members of the fund can be a trustee in specified circumstances, such as when the member is under a legal disability or when the member has died. In both cases the Legal Personal Representative of the member under a legal disability or the deceased member will also be regarded as a trustee of the SMSF. For ease of reference, in the rest of this paper the term 'trustee of an SMSF' will be used for both individual trustees and corporate trustees.

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[5] K Sadiq, 'Prescriptions for reform of Australia's superannuation tax concessions' (2012) 27 *Australian Tax Forum* 372.

[6] *Australia's Future Tax System, the Retirement Income System Report on Strategic Issues,* May 2009.

[7] A complying superannuation fund is defined under the *Superannuation Industry (Supervision) Act 1993* (Cth). The concessions that a complying superannuation fund are eligible for include a flat rate of taxation of 15% on fund income and deductible contributions and superannuation benefits paid to a member aged at least 60 are generally tax-free, whether paid as a lump sum or as an income stream.

According to the Australian Prudential Regulation Authority (APRA) and its *Quarterly Superannuation Performance (interim edition)* for September 2014, there were 539,375 SMSFs in Australia with more than 1 million members and some $558.6 billion of assets invested. This comprises about 30% of assets invested in superannuation in Australia.[8] The SMSF portion is therefore a very large part of Australia's superannuation sector and statistics indicate the SMSF portion is growing by about 7–8% per annum.[9]

3. RULES GOVERNING THE OPERATION OF SMSFS IN AUSTRALIA

The obligation on SMSF trustees to comply with the stringent regulatory requirements contained in the SIS Act, SIS Regulations and the *Financial Sector (Collection of Data) Act 2001* (Cth) is designed to ensure that SMSF assets are kept in accordance with a sole purpose test as set out in s 62 of the SIS Act.

The sole purpose test requires each trustee of a SMSF to ensure the SMSF is maintained solely for the benefit of the members for their retirement and is pivotal to the SMSF maintaining its compliance under the SIS Act and retaining the tax concessions available to superannuation funds.[10] Essentially, the sole purpose test requires the assets of the SMSF to be solely used for the purposes of providing retirement benefits for members; benefits for each member of the fund upon reaching 65 years of age and the provision of death benefits for the Legal Personal Representative or the member's dependants in the event of the member's death. The definition of dependant includes not only financial dependants but also the spouse and children of the deceased member even where they may not be a financial dependant. It also includes a person with whom the member has an interdependency relationship. If the sole purpose test is breached then not only may the SMSF be reported by an auditor as a non-complying fund but the trustees may also be subject to penalties.[11]

A non-complying fund is defined in s 995-1 of the *Income Tax Assessment* Act *1997* (Cth) as a superannuation fund that is not a complying fund. A SMSF is not a complying fund if it has received a notice from the ATO stating that it is a non-complying fund. The consequences of being a non-complying fund are that the SMSF loses access to the various tax concessions available to complying funds. Specifically, this means that the non-complying SMSF is subject to tax at 47% for the relevant financial year (not 15%), on not only on its earnings (assessable income less deductions) but also on unrealised capital gains based on the amount by which the market value of its total assets exceeds the amount of any un-deducted (non-

[8] APRA, *Quarterly Superannuation Performance* (interim edition) September 2014 (issued 20 November 2014) at page 9.

[9] Ibid.

[10] SMSFR 2008/2 explains in more detail and provides examples of what the Commissioner of Taxation considers to be the sole purpose test and also when it is likely to be contravened. Broadly the sole purpose test is taken to mean that the trustees of a SMSF are prohibited from maintaining an SMSF for purposes other than those set out in subs 62(1). The core purposes specified in that subsection essentially relate to providing retirement or death benefits for, or in relation to, SMSF members.

[11] In *DFC of T v Fitzgeralds and Anor* [2007] FCA 1602 civil penalties were imposed upon fund trustees for contravening the sole purpose test. Penalties were also imposed on trustees for breaching the sole purpose test in other more recent cases such as *Olesen v MacLeod* [2011] FCA 229 and also *Triway Superannuation Fund and Shail Superannuation Fund v FC of T* [2011] AATA 940.

concessional) contributions. There are further implications of being declared a non-complying fund such as the loss of access to the 33 1/3% Capital Gains Tax (CGT) discount and a loss of tax deductibility for member and employer contributions made to the fund.

The other major test that SMSFs are subject to is the in-house assets test. The purpose of this test is to ensure that the fund is not used for personal consumption purposes or to benefit members before these members are eligible to access their superannuation benefits.[12] The operation of both the sole purpose test and the in-house asset tests is discussed in more detail later on in this paper under the topic 'research study'.

4. RESEARCH STUDY

As there is a lack of available data on compliance issues facing self-managed superannuation funds a research study was arranged by the authors to consider a wide range of issues relating to the financial performance, corporate governance and fund compliance outcomes of Australian SMSFs. Specifically, with respect to fund compliance, the resulting draft questionnaire was targeted at capturing trustee knowledge and attitudes toward SMSF management along with trustee circumstances and overall fund compliance outcomes. The purpose of this was to investigate the potential relationships between SMSF compliance and various other fund and trustee characteristics, including but not limited to, the level of asset diversification, trustee over-confidence and trustee knowledge.

The data analysed for the research study in this paper originates from a survey administered to SMSF trustees in 2012. The survey was initially developed in consultation with the SMSF Association (previously known as SPAA). The final questionnaire was refined through a workshop held in late 2011 with a pilot group of trustees and via several interviews with professional SMSF advisors. The survey included a range of compliance related questions examining the financial investments and decisions of trustees, SIS Act knowledge and trustee satisfaction with various support professionals servicing the industry. The questions were specifically designed to encourage trustees of non-complying funds to respond, ensuring that we captured variation across funds, trustees and their corresponding compliance outcomes.

In order to further ensure a viable response rate the survey was widely distributed. The questionnaire was made available online through the Qualtrics® research platform allowing us to access responses from trustees across Australia. The survey was also publicised through a number of media outlets including *The Australian Financial Review*, and by the SMSF Association to its members. Various incentives were offered to participants including guaranteed gift cards and prize draw entries for the successful completion of the survey. The survey was further separately co-branded with two of the largest SMSF service providers, *SuperConcepts* and *SuperGuardian*, to be independently and privately advertised to their members. The survey was open for six months, closing at the end of June 2012. Of 595 attempting

[12] Superannuation benefits may only be accessed after a member has met a condition of release as defined in the various SIS Regulations such as in Parts 1A and 6 in for example reg 1.06 (regarding pensions) and reg 6.17 (on restriction on payment).

respondents 321 were able to provide complete answers to the full questionnaire, with 93% completing the survey on the same day.

The full survey comprised 20 questions with 96 individual inputs throughout. A total of 23 of these distinct inputs were used in this paper. These included one Likert question with seven categories, five numerical questions requiring the investor to consult their financial reports, nine dummy and three count variables on fund and trustee demographics, and five test questions examining the SIS Act understanding and knowledge of trustees.[13]

We measured SIS Act literacy through five questions relating to what SMSFs are permitted to do in Australia. We discuss the main rules governing the compliance of SMSFs in Australia elsewhere in this paper. The final set of questions was chosen from a much larger set of possible questions, all specific to the SIS Act. The questions were carefully designed to be of varying difficulty through several pilot studies which were assisted by professional advisors and the SMSF Association. They concurrently covered aspects of regulatory knowledge and financial understanding and formed the basis of both our SIS Act literacy and overconfidence measures.[14]

The **first question** of the survey tested trustee knowledge on the use of leverage and the borrowing restrictions set out in s 67 of the SIS Act to fund asset purchases. Trustees were asked if their SMSF can 'Borrow money from a bank to buy residential property for purely investment purposes that [they] have never owned' while remaining compliant with the SIS Act and regulations.

This question sought to examine understanding of this compliance issue implicitly assuming that it is similar to broader regulations imposed on other superannuation fund types, which are also limited in their usage of debt for the purpose of purchasing assets.[15] In compliance terms this issue focused on the question of whether an SMSF can borrow and also what affect the level of borrowing has on compliance. Prior to 24 September 2007 regulated superannuation funds were not permitted to borrow other than in very narrow circumstances and only for a temporary purpose.[16] However, with amendments made in September 2007, superannuation fund trustees could borrow money on a limited recourse basis providing certain conditions were met.[17] However, due to prudential concerns about the use of limited recourse borrowing arrangements, particularly with respect to instalment warrants, and the subsequent risks SMSFs were exposed to, this provision was repealed and replaced with ss 67A and 67B with effect from 1 July 2010.[18] Borrowing which meets the

[13] The questionnaire is available upon request.

[14] Table 2 provides a list of the variables, their derivation and the five specific questions which form the basis of our SIS Act literacy and overconfidence measures.

[15] We acknowledge recent legislative changes relating to limited recourse borrowing arrangements (discussed elsewhere in this paper) which were not in place and therefore not considered at the time of this study. This remains a potential avenue for future research on SMSF compliance.

[16] Section 67 of the SIS Act.

[17] Subsection 67(4A) of the SIS Act.

[18] The amendments were introduced to reduce the risks for superannuation funds investing in limited recourse borrowing arrangements such as instalment warrants and this specific risk was outlined in para. 1.1 of the Explanatory Memorandum to the Superannuation Industry (Supervision) Amendment Bill 2010 (Cth).

requirements of these new sections is referred to by superannuation industry experts as a 'complying loan'.[19]

On 29 July 2010 the ATO released a general guidance document, *Limited recourse borrowing arrangements by self-managed superannuation funds—questions and answers*, in response to the aforementioned July amendments on issues such as whether improvements materially alter the character of the original asset and so create a replacement asset for the purposes of s 67A of the SIS Act.[20]

The **second question** of the survey concerned the types of transactions which are permitted between a trustee and their fund. This is quite a complicated issue requiring trustees to understand a range of SIS Act regulations, including on arm's length transacting, the sole purpose test and restrictions on acquiring and holding in-house assets. A SMSF must keep the assets and money of the fund separate from the members[21] and an SMSF cannot lend money to a member or provide any financial assistance to a member.[22] SMSFR 2008/1 indicates what the ATO's view is on what constitutes providing financial assistance. Section 66 of the SIS Act provides that, with some exceptions, an SMSF cannot acquire assets from related parties.[23]

In the **third question** of the survey trustees were asked to demonstrate their understanding with regard to the types of assets which can be held within their portfolios. While there are no restrictions placed on investing in most of the major asset classes, in order to minimise risk and maximise returns, trustees should understand asset valuation techniques for unlisted assets as well as portfolio allocation and weighting strategies. This question also raised the compliance issue related to understanding the in-house asset allocation rules.

5. IN-HOUSE ASSET ALLOCATION TEST/RULES

The in-house asset allocation rules require that the fund hold no more than 5% of the market value of all its assets as in-house assets.[24] In-house assets are assets such as loans, or an investment, in a related party or an asset of the fund subject to a lease or lease arrangement between a trustee of the fund and a related party.[25] A 'related party' means a member or a standard employer-sponsor of a fund and their associates.[26] The rules regarding in-house assets are quite complex and a breach can

[19] The term 'complying loan' is an industry term describing limited recourse borrowing arrangements that meet the requirements of ss 67A and 67B. The term was first identified as used by Daniel Jenkinson in his article 'Self-managed superannuation funds and real property—changes to the borrowing rules' (2011) 45(9) *Taxation in Australia*, at 527. Subsection 67(4A) of the SIS Act was repealed with effect from 7 July 2010 with the effect that the requirements of this former section are now referred to as 'instalment warrant' borrowing arrangements.

[20] For further discussion on the effect of the ATO's guidance document please refer to Jenkinson, note 19 above, 527–533.

[21] Section 52 of the SIS Act.

[22] Section 65 of the SIS Act.

[23] The exceptions contained in s 66 of the SIS Act 1993 provide that a SMSF can acquire assets from members where those assets are business real property or listed securities acquired at market value. SMSFR 2009/1 provides more clarification of when an asset is business real property.

[24] Sections 82–85 of the SIS Act.

[25] Section 71 of the SIS Act.

[26] SIS Regulations 1994, reg 13.22C.

also result in the superannuation fund being reported, potentially endangering the finds's complying fund status and therefore entitlement to the various tax concessions available only to complying superannuation funds.[27]

SMSF trustees are required to formulate and regularly review as well as give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the risk profile of the fund; the composition of the fund's assets including the holding of any in-house assets; the liquidity of the entity's investments; the ability of the SMSF to discharge its liabilities; and whether the trustees should hold a contract of insurance over any member or members.[28]

A case where the in-house asset restriction was breached was the case of *Deputy Commissioner of Taxation v Lyons*.[29] The case involved the trustee (Mr Lyons) of a SMSF lending money (about $190,000) through six loans to Mr and Mrs Lyons to help them with their struggling retail business. These loans were made just one month after the SMSF was established. None of these loans were ever repaid with the result that the fund had no assets. The Federal Court (Bennett J) ruled that the trustee breached the in-house asset rule (and the sole purpose test) with the result that the fund was declared non-compliant (the ATO having made this decision in 2012). Mr Lyons was further fined $32,500 and ordered to pay legal costs to the Commissioner of Taxation of $5,000.

The **fourth question** of the survey covered the extent to which fund assets could be used for private purposes before the member is of retirement age. SIS Act regulations only allow for a narrow range of specialised exemptions allowing early access to fund assets before retirement age and trustees are expected to be knowledgeable of these exemptions and timing restrictions under the Act. This fourth survey question therefore explored compliance issues related to the fund being held for the sole purpose of financing the retirement of its members.

6. SOLE PURPOSE TEST

The sole purpose test[30] provides that the fund be used solely for the provision of retirement benefits to the members or to provide benefits to each member of the fund on the member reaching the age 65 or to provide benefits for the Legal Personal Representative or the member's dependants[31] in the event of the member's death. The test therefore ensures that the assets held by a SMSF are maintained for the sole purpose of funding the retirement benefits of its members. However, the trustee of a SMSF is allowed to maintain the fund for other purposes (not specifically for the purpose of retirement benefits or the other grounds for paying benefits noted above). These ancillary purposes are recognised whenever a member meets a condition of release, such as termination of employment with an employer or associate who had

[27] As occurred in the case of *Re QX971 v APRA* 99 ESL 1.

[28] The requirement to set out and maintain and review an investment strategy is set out in SIS Regulations 1994, reg 4.09.

[29] *Deputy Commissioner of Taxation v Lyons* [2014] FCA 1353.

[30] The sole purpose test is set out in s 62 of the SIS Act.

[31] The term dependant includes not only a financial dependant but also the spouse or children of the deceased member even where the spouse and children are not financially dependant. It also includes a person with whom the member has an interdependency relationship.

contributed to the fund, thereby allowing the otherwise early payment of benefits to a member. This includes provision of benefits to a member where the member terminates employment as a consequence of ill-health.[32]

Paragraph 5 of SMSFR 2008/2 indicates the ATO approach to the sole purpose test and states that 'determining the purpose for which an SMSF is being maintained requires a survey of all the events and circumstances relating to the SMSF's maintenance. This enables an objective assessment of whether the SMSF is being maintained for any purposes other than those specified by s 62(1).' Superannuation tax expert, Bryce Figot, has concluded that the 'sole purpose test' is likely to be passed whenever the trustees are dealing with any transaction at 'arm's length'.[33]

7. CASES ON SMSFS AND THE SOLE PURPOSE TEST

The *Swiss Chalet* case[34] is the most obvious example of a case where a fund was found to have failed the sole purpose test. In this case the fund had purchased shares which enabled access to a golf club for one of the members in clear breach of the sole purpose test which requires that the fund assets be maintained for the sole purpose of providing for the retirement of the members.

More recently, the AAT has stated in *Montgomery Wools* that 'whether a fund complies with the sole purpose test will depend upon the facts of each case and will be assessed by objective facts, not the subjective views of trustees or, in the case of corporate trustees, the directors'.[35]

The very recent decision in *Deputy Commissioner of Taxation (Superannuation) v Graham Family Superannuation*[36] seems to confirm the views of Figot noted earlier in this paper in that Buchanan J emphasised that the sole purpose test was contravened in the case (where the SMSF rented residential property it owned to their son who did not pay any rent at all for its use) as the SMSF provided 'rental accommodation on non-arm's length terms (to the son)'.

The case of *Pabian Park Pty Ltd Superannuation Benefits Fund and FCT*[37] showed that in order to avoid being declared a non-complying fund and all the negative implications and tax consequences that would attach to the trustees of an SMSF,[38] the

[32] SIS Regulations 1994—reg 1.06(9A) deals with the grounds under which benefit payments can be made and reg 6.17 sets out the grounds under which a member may meet a condition of release.

[33] B Figot, 'The Sole Purpose Test- a new way to answer an old problem' (2013) *Professional Planner*, November, 39.

[34] *AAT Case 43/95; No 10,301* (1995) 95 ATC 374.

[35] *Montgomery Wools Pty Ltd and FCT* [2012] AATA 61.

[36] [2014] FCA 1101.

[37] [2012] AATA 375 at [72].

[38] As discussed earlier but also including the loss of the various tax concessions available only to complying superannuation funds. These losses would include such outcomes as a higher tax rate (47% in 2014/15 rather than the 15% rate) and the loss of the 33 1/3rd CGT discount. In addition, member contributions to a non-complying superannuation fund are not tax deductible and any employer contributions would not satisfy the employer's obligations for superannuation guarantee purposes and also, amongst other things, a non-complying superannuation fund cannot deduct current and prior year losses.

trustees should adopt a proactive approach to rectify contraventions by offering enforceable undertakings or agreeing to wind up the fund.

Consistent with other recent cases was the decision that failure to adopt a proactive approach is likely to increase the risk of a notice of non-compliance being issued and will also be a factor in considering whether the notice of non-compliance be set aside or revoked in any subsequent review proceeding.[39]

Re The Trustee for the R Ali Superannuation Fund and FCT[40] (*Ali case*) also demonstrated the need for proactive action on the part of SMSF trustees. Without this proactive action by the trustees of the SMSF to quickly rectify any contraventions and put in place procedures to ensure ongoing compliance with the superannuation legislation and ensuring there is written documentation to support the arm's length nature of the transactions with related parties, then it is likely the SMSF will be issued with a non-compliance notice under s 40 of the SIS Act.

The *Ali case* involved a number of serious breaches of the SIS Act such as the sole purpose test under s 62; the prohibition against giving financial assistance to a member under s 65 and the arm's length test under s 109. The case facts involved one of the trustees using all of the SMSF assets to give a loan to a related party that never paid any interest or indeed repaid any of the principal of the loan. The breaches in the *Ali case* were deemed very serious: (1) as they were carried out by someone who was a tax professional and so should have known better, (2) because they also exposed all of the fund's assets to risk of a type not permitted, and (3) were multiple in nature, attempted to be disguised and were only corrected after the Commissioner's audit activities commenced.

The **fifth and final** question in the survey again considered permissible investment types. The focus here was on the use of invested funds and in particular on understanding the sole purpose test for making investments or purchasing assets. Trustees of funds that have been found to have contravened any of the regulatory requirements (as reviewed in the five survey questions) can be charged with significant financial penalties.

8. CONSEQUENCES FOR NON-COMPLIANCE

The SIS Act provides a number of mechanisms, depending upon a number of factors such as the seriousness of the contravention, the attitude of the trustee to compliance generally and the ability to restore the SMSF to the position it would have been in but for the contravention, to address SMSF contraventions and breaches of the regulatory provisions.

[39] *Montgomery Wools Pty Ltd and FCT* [2012] AATA 61 at [126]; [140]–[141] and also *Re JNVQ and FCT* [2009] AATA 522.

[40] [2012] AATA 44.

Where there has been a contravention of the SIS Act the ATO may:

1. Accept an enforceable undertaking from the trustees to rectify the contravention;[41]
2. Seek civil or criminal penalties against the trustee;[42]
3. Disqualify individuals from acting as trustees;[43]
4. Suspend or remove a trustee of the superannuation fund;[44] or
5. Make the fund a non-complying fund by giving the fund a notice of non-compliance.[45]

The civil penalty provisions in the SIS Act include provisions which prohibit:

1. Making loans to or providing financial assistance to members;[46]
2. Acquiring assets from related parties of the SMSF (some limited exceptions);[47]
3. Borrowing money (subject to a specified limited recourse borrowing rule);[48]
4. Using the SMSF assets to benefit members before their retirement;[49]
5. Entering into non-arm's length investments unless both parties are dealing with each other at arm's length with respect to the transaction or if the parties are not dealing at arm's length but the terms and conditions are no more favourable than would be expected had the parties been dealing with each other at arm's length.[50]

Any intentional or reckless refusal or failure to comply with the civil penalty provisions is also an offence.[51] Reviewing the statistics reveals that the most commonly reported contravention is an entry into a loan with, or providing financial assistance to, a member.[52] Accordingly the ATO announced that for the 2012–13 financial year it was going to focus its SMSF audit activities on suspected arrangements that entered into non-arm's length investments and allowed for the early

[41] Section 262A of the SIS Act.
[42] Part 21 of the SIS Act.
[43] Section 126A of the SIS Act.
[44] Section 133 of the SIS Act.
[45] Section 40(1) SIS Act.
[46] Section 65 SIS Act.
[47] Section 66 of the SIS Act.
[48] Section 67 of the SIS Act.
[49] Section 62 of the SIS Act.
[50] Section 109 of the SIS Act.
[51] Section 285 of the SIS Act.
[52] M Bishop and R Jeremiah, 'SMSFs- responding to non-compliance warnings and notices' (2012) 47(3) *Taxation in Australia* at 163, quoting from the published ATO reported contraventions for the period 2005 to 30 June 2011 in the Australian Taxation Office, *Self-managed superannuation funds: a statistical overview 2009–10*, April 2012 at 36.

release of assets.[53] The ATO has also warned that late lodgement or non-lodgement of income tax returns by SMSFs will likely trigger an SMSF to be audited.[54]

A review of recent ATO annual reports reveals that the number of funds that had enforceable undertakings increased from 2010, when only 94 funds entered into enforceable undertakings, to 2014 where 329 funds entered into enforceable undertakings.[55]

9. NON-COMPLIANCE NOTICES

Subsection 42A(5) of the SIS Act confers on the ATO a discretion to issue a notice of compliance to an SMSF which has contravened one or more of the regulatory provisions of the SIS Act. Where the 42A(5) SIS Act discretion is not exercised in favour of the SMSF, the SMSF is issued with a non-complying fund notice and then loses the benefit of the concessional tax treatment afforded to SMSFs.

When determining whether to issue a notice of non-compliance to a SMSF the Commissioner must consider the taxation consequences of issuing such a notice; the seriousness of the contravention; and any other relevant circumstances.[56] The AAT has held that the subs 42A(5) discretion should be given 'a construction that allows the fullest relief which is open on a fair reading' of its terms.[57]

In addition, the Commissioner must have regard to considerations of unfairness but also apply the discretion 'in a manner consistent with the objects of the relevant Act'.[58]

The consequences of being declared a non-compliant fund are likely to be devastating to the trustees and members of the SMSF due to the loss of concessional tax treatment, taxation on all fund assets at their market value and taxation being payable at the highest tax rate applicable for that particular financial year. As a matter of administrative practice, the ATO therefore generally allows trustees the opportunity to either wind the fund up, roll it over to another independently managed superannuation fund, or enter into enforceable undertakings to rectify the defect discovered.[59]

In the 2010/11 financial year approximately 2% of SMSFs were reported to the ATO as having contravened requirements of the SIS Act or the SIS Regulations with the number of SMSFs issued with non-compliant fund notices being much lower.[60] The number of funds made non-compliant in 2014 was 129 which represented an increase from the 83 funds made non-compliant in 2012.[61]

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[53] Australian Taxation Office, *Compliance Program 2012–13*, July 2012 at 57.

[54] Ibid at 13.

[55] Australian Tax Office annual reports for 2010, 2011, 2012, 2013 and 2014.

[56] Section 42A(5) SIS Act.

[57] *The Trustee for the R Ali Superannuation Fund and FCT* [2012] AATA 44 at [64].

[58] *Re JNVQ and FCT* [2009] AATA 522 at [41].

[59] PS LA 2006/19 at paragraphs 16–17.

[60] Australian Tax Office, *Self-managed superannuation funds*, note 52 above.

[61] Australian Tax Office annual reports for 2012 and 2014.

10. REVIEW RIGHTS IF SMSF DECLARED NON-COMPLIANT

If a SMSF is declared non-compliant then the trustee has some review rights. These start with an internal review which allows the trustee 21 days, from the date of the non-compliance notice, to request a review of the non-compliance notice in writing setting out the reasons for the request.[62] The ATO then has 60 days from the date of such a request being made to reconsider the non-compliance notice decision and must provide the trustee reasons for confirming, revoking or varying the decision.[63]

If a decision is not made by the ATO within this 60 day period then any decision made by the ATO will be ineffective.[64] If the trustee is dissatisfied with the ATO's internal review decision then the trustee may apply to the AAT for an independent review of the decision.[65] This application must be made within 28 days of the receipt of the ATO review decision.[66] The AAT is the only independent forum for review of the decision to issue a non-compliance notice and it is not restricted to the reasons or grounds considered by the ATO.[67] There is no longer a right to privacy in AAT hearings unless the SMSF can demonstrate that some harm would result in their matter being heard in public.[68] An appeal can then be made from the decision of the AAT to the Federal Court but only on a question of law.[69]

11. DISQUALIFICATION OF TRUSTEES FROM MANAGING A SMSF

Another severe implication of a fund being declared non-compliant can also attach to the trustees of the fund who can then be declared disqualified. In the Commissioner of Taxation's annual report for 2013–14 585 persons were declared disqualified persons and this represented a significant increase on prior years.[70]

Being declared disqualified can have substantial adverse consequences quite apart from the person no longer being able to act as a trustee as there is also likely to be a substantial impact on the disqualified person's professional, business and personal reputation, more so due to the accessible impact of social media. This negative affect on reputation can cause a significant decline in future business income.

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[62] Section 344(1) and (2)–(4) of the SIS Act.

[63] Section 344(6) of the SIS Act.

[64] Section 344(5) of the SIS Act and *Re the Taxpayer and FCT* [2006] AATA 84.

[65] Section 344(8) of the SIS Act.

[66] Section 344(9) of the SIS Act and s 29 *Administrative Appeals Tribunal Act* 1975 (Cth) (AATA 1975).

[67] *Re Montgomery Wools Pty Ltd and FCT* [2012] AATA 61 at [60].

[68] Section 35(2) of the AATA 1975.

[69] Section 44 AATA 1975.

[70] For example in the 2010 tax year only 94 persons were declared disqualified; in 2011, 330 persons were declared disqualified; in 2012, 295 persons were declared disqualified whilst in in 2013, 440 persons were declared disqualified. This is in part explained by the greater ATO focus on promoters of illegal early access schemes.

12. RESULTS OF RESEARCH STUDY

We are of the view that SIS Act compliance and literacy are intrinsically linked with the long term financial goals of individual trustees and the wider industry objectives for compulsory and voluntary superannuation contributions as major pillars of the Australian retirement income system. Table 1 presents summary and comparative statistics of trustees who manage compliant funds (265 or 83% of our sample) versus those whose funds are non-compliant (56 or 17% of our sample).[71]

Table 1: Descriptive statistics showing mean values and mean difference tests

	Compliant	Non-Compliant	Difference## (C – NC)	Full Sample
Fund age (years)	12.59	11.48	1.11	12.40
Trustee age (years)	65.05	64.95	0.10	65.03
State (%)				
New South Wales	22.35	21.43	0.92	22.19
Queensland	12.88	17.86	–4.98	13.75
South Australia	14.02	21.43	–7.41	15.31
Victoria	43.94	32.14	11.80*	41.88
Other#	6.82	7.14	–0.32	6.87
Occupation (%)				
SMSF professional	18.26	5.66	–12.60**	15.81
Other professional	25.57	28.30	–2.73	26.10
Non professional	6.39	16.98	–10.59**	8.46
Retiree	49.77	49.06	0.71	49.63
Members per fund	1.95	1.86	0.09	1.93
Total assets (M AUD)	1.23	0.95	0.28*	1.18
SIS act literacy (correct responses)	2.66	2.11	0.55***	2.56
Overconfidence (%)	24.24	26.79	–2.55	24.69
Listed shares (K AUD)	691.51	405.44	286.07***	643.07
Other managed investments (K AUD)	17.73	56.55	–38.82	24.30
Cash and term deposits (K AUD)	295.52	363.65	–68.13	307.06
Loans (K AUD)	5.51	5.70	–0.19	5.54

Western Australia, Northern Territory, Tasmania and Australian Capital Territory.
Statistical significance for variation between groups is calculated based on the applicable two sample univariate test for differences in mean (assuming unequal variances) or proportion for each category.
Statistical significance is denoted as *** for $p < 0.01$; ** for $p < 0.05$; and * for $p < 0.10$.

We examined whether compliance outcomes were related to (1) experience with running an SMSF (fund age), (2) occupational knowledge of the SMSF sector (occupation), (3) the number of investors per fund (members) and (4) the dollar value of the fund (total assets). We also include in Table 1 the age of the responding trustee

[71] In determining whether a fund was non-compliant a question was asked in the survey as to 'whether the audit report for the fund was qualified for the year ended 30 June 2010?'

and the location of the fund by State. Of these demographic features, only fund size, occupation and location dummies seem to differentiate between funds that are compliant with their obligations under the SIS Act and those that are not. Specifically, compliant funds appear to have significantly larger total assets while also having a higher incidence of SMSF-related professionals among their trustees.

In terms of the above demographic features our sample was fairly representative of the general SMSF population at the time of this research.[72] The mean number of members per fund in the general population was 1.91, slightly below that of our sample (1.93 members). The general population mean investor age was between 55 and 64 years of age, also only marginally below that of our sample (65.03 years). Average fund size (by total assets) in the general population was approximately $917,000 as at June 2012.[73] This is below the sampled average of roughly $1.18m. Geographically, New South Wales and Victoria account for the largest proportion of SMSFs across Australia and these cohorts are also the largest constituents of our sample.

There is, however, an over-representation for South Australia, which is expected given the assistance we received from the SMSF Association (which is based in South Australia) in distributing the survey. The only other key deviation which exists between our sample and the general population of SMSFs relates to the compliance rate of constituent funds. The rate of non-compliant funds within the sector is quite small at approximately 2%.[74] The incidence of non-compliant funds in our sample is much higher (approximately 17%). This deviation is not surprising since the survey was geared toward capturing a larger number of non-complying funds in order to provide a sufficiently representative cohort for the statistical analysis which follows.

The described demographics constituted a set of control variables that were used in the subsequent regression analysis. The rationale for including both trustee- and fund-level demographics is to control for factors which can potentially influence the likelihoods of compliance and non-compliance respectively. Occupation and age measures were used to proxy for the experience level of the leading fund member.[75]

It was expected that fund size and fund age could also impact on compliance outcomes by influencing investment opportunities and through life-cycle effects.[76]

We further captured differences in the levels of SIS Act literacy and overconfidence with respect to SIS Act knowledge across the two groups. We expected that compliant funds were, *a priori*, likely to consist of trustees that are more knowledgeable (or literate) with regard to their regulatory and legal obligations under the SIS Act. If this was indeed the case, we should have seen a statistically significant difference in this level of technical knowledge between the two groups. Furthermore, we examined the attitude of SMSF trustees toward SIS Act compliance by comparing

[72] Australian Prudential Regulation Authority. 'Statistics: Annual Superannuation Bulletin – June 2012', Sydney (9 January 2013) and Australian Taxation Office. *Self-managed superannuation funds*, note 52 above.

[73] Australian Taxation Office. *Self-managed superannuation funds*, note 52 above.

[74] Australian Tax Office Annual Report for 2012.

[75] MCJ Van Rooij, A Lusardi and R.JM Alessie, 'Financial literacy and retirement planning in the Netherlands' (2011) 32(4) *Journal of Economic Psychology* 593–608.

[76] G Bhandari and R Deaves, 'Misinformed and Informed asset allocation decisions of self-directed retirement plan members'(2008) 29(4) *Journal of Economic Psychology* 473–490.

their self-assessed ability to ensure SIS Act compliance with their actual attainment on five key compliance-based questions with the results of these questions shown on the next few pages (also refer to the results for SIS Act literacy shown in Table 2). This provided a proxy measure for the level (or lack thereof) of trustee overconfidence in relation to compliance. Our expectation was that increasingly overconfident trustees would be associated with poorer compliance outcomes.

The results summarised in Table 1 suggest that the trustees of compliant SMSFs have a significantly higher rate of SIS Act knowledge than their counterparts who are managing non-compliant funds (SIS Act literacy = 0.55, $p < 0.01$).

Our measure of overconfidence is a dummy variable that compared a respondent's answer to each technical question with a corresponding supplementary question that asked how knowledgeable they think they were for each of the topics covered.

This is akin to treating overconfidence as a measure of the tendency to overestimate one's own knowledge as described by Lambert et al.[77]

The supplementary self-assessment questions corresponded directly to the theme of each SIS Act literacy question. That is, they were matched to consider the borrowing, related party transaction, asset investment, benefit payment and asset use permissions applicable to SMSFs under the SIS Act.

If an investor self-assesses their technical knowledge as being at least three Likert points (representing a 40% differential) better than their actual achievement (in the SIS Act literacy questions) we record a value of one by that fund and zero otherwise. This implies that the overconfidence level of any trustee can be reduced either through increases in their level of SIS Act knowledge or through reductions in their self-assessed proficiency with SIS Act compliance.

The Table 1 results also suggest that there are no statistically significant differences in compliance knowledge overconfidence between trustees of compliant and non-compliant SMSFs (Overconfidence = –2.55, $p > 0.10$).

Table 1 also shows differences in investment levels between the two cohorts for four asset classes.

Sampled trustees of compliant SMSFs appear to be slightly under-invested in: (1) cash and term deposits; (2) other managed investments; and (3) loans in comparison to their non-compliant counterparts, with none of these differences being statistically significant.

Compliant funds are however, significantly over-investing in Australian listed shares relative to non-compliant funds (difference in listed shares = 286.07, $p < 0.01$). This univariate result may also be an artefact of the dataset we are using since compliant funds are also on average much larger than non-compliant funds. Therefore, a more formal regression analysis was necessary to control for demographic differences

[77] J Lambert, V Bessière and G N'Goala, 'Does expertise influence the impact of overconfidence on judgment, valuation and investment decision?' (2012) 33(6) *Journal of Economic Psychology* 1115–1128.

between the cohorts while examining the relationships between SIS Act literacy, overconfidence, investment holdings and compliance outcomes.[78]

We ran probit regressions to evaluate the associations between SIS Act literacy, overconfidence and investment holdings, and compliance outcomes.

The probit model is most readily interpreted as a latent variable specification for binary data such that:

$$y_i^* = x_i' \beta + \varepsilon_i \qquad (1)$$

where x_i' is a transposed vector of independent variables (including controls), β is a vector of estimated coefficients and ε_i is a random disturbance term. The observed y_i are then determined from y_i^* using the following rule:

$$y_i = \begin{cases} 0 & if \quad y_i^* \leq 0 \\ 1 & if \quad y_i^* > 0 \end{cases} \qquad (2)$$

We made use of the demographic factors previously highlighted in Table 1 to generate a control variable set. The full variable list with descriptions is provided in Table 2.

[78] The results of this regression analysis are shown in Table 3.

Table 2: Variable list

Variable	Description/ Calculation
Study	
Compliance	Compliant fund dummy variable equal to 1 if the SMSF audit opinion is unqualified and 0 otherwise
SIS act literacy	Count variable ranging from 0 to 5 gauging trustee technical understanding based on correct/incorrect responses to five SIS compliance questions. Namely, can your SMSF do the following and still comply with the SIS Act and regulations: • Borrow money from a bank to buy a residential property for purely investment purposes that you have never owned? • Purchase business premises that you currently own? • Buy from you as a member, an unlisted managed investment that is widely held? • Pay a pension to a member who is over 55 but under 60 years of age, as part of a transition to retirement strategy? • Own a trading business?
Overconfidence	Dummy variable for trustee overconfidence with respect to compliance compares Likert self-assessment of regulatory and technical understanding to actual achievement in SIS Act literacy questions and is equal to 1 if the difference is greater than 3 Likert points and 0 otherwise
Listed shares	Quantitative variable (AUD) for direct investment in locally listed shares (Item H, Section H 2014 ATO SMSF annual return)
Other managed investments	Quantitative variable (AUD) for investment in local non-trust managed investments (Item D, Section H 2014 ATO SMSF annual return)
Cash and term deposits	Quantitative variable (AUD) for direct investments held in cash or term deposits (Item E, Section H 2014 ATO SMSF annual return)
Loans	Quantitative variable (AUD) for direct investment in loans (Item G, Section H 2014 ATO SMSF annual return)
Control	
Fund age	Count variable for fund age in whole years
Trustee age	Count variable for trustee age in whole years
SMSF professional	Dummy variable equal to 1 for professionals who are employed in SMSF-related fields (i.e. accountants, brokers, financial planners and auditors) and 0 otherwise
Non-professional	Dummy variable equal to 1 for non-professionals and 0 otherwise
Victoria	Dummy variable equal to 1 if the responding trustee lives in the state of Victoria and 0 otherwise
Members	Count variable ranging from 1 to 4 for the number of fund members
Total assets	Quantitative variable (AUD) for fund size in total assets

In order to link compliance outcomes with trustee features and demographics we show in Table 3 the output from two regressions where the probability of compliance is a function of SIS Act literacy, overconfidence, investment holdings and a number of controls.

Model 1[79] showed that trustees with increased levels of SIS Act literacy manage SMSFs which are associated with a greater likelihood of being compliant (SIS Act literacy = 0.1722, $p < 0.05$). This result is consistent with our prior expectations, suggesting that the level of SIS Act knowledge that trustees possess is linked with their eventual compliance outcomes.

However, we found no link between the level of compliance overconfidence exhibited by trustees and the compliance outcomes of their funds (overconfidence = 0.0501, $p > 0.10$). This result does not lend support to our expectation that increasingly overconfident trustees will be associated with SMSFs which have poorer compliance outcomes.

Model 2[80] demonstrated links between the investment holdings and compliance outcomes of SMSFs. The results suggest that as trustees increase their investment in Australian listed shares (0.0598, $p < 0.01$) and cash and term deposits (0.0525, $p < 0.10$), the probability of their SMSF being compliant also improves. Conversely, as trustees increase their investment in other managed investments (–0.0552, $p < 0.05$) and loans (–0.0812, $p < 0.10$), the probability of their SMSF being compliant deteriorates. Taken together, these findings put forward the idea that various investment classes may not be equal with respect to how they predispose trustees for their compliance obligations. It appears more likely that trustees will manage compliant funds if they follow the mainstream investment allocations to Australian shares and fixed income securities. Diversifying into less popular asset classes appears to be associated with increased probabilities of non-compliance. These results highlight a potentially fruitful avenue for future research—the interface between standard investment theory (favouring diversified holdings) and the legal and taxation requirements for regulatory compliance, which seem to be enhanced by reductions in the level of diversification for SMSFs.

Our controls also hold the right signs where they are significant.

Specifically, trustees who are employed in SMSF-related fields (e.g. employed as auditors or accountants or financial planners) are significantly more likely to be managing compliant SMSFs than other professionals, non-professionals and retirees. We found no other statistically significant demographic differences between trustees of compliant and non-compliant funds.

[79] Model 1 is represented by the first column of regression results shown in Table 3.

[80] Model 2 is represented by the second column of regression results shown in Table 3.

Table 3: SMSF compliance

	(1)	(2)
SIS Act literacy	0.1722**	
	(0.0747)	
Overconfidence[#]	0.0501	
	(0.2394)	
Log (listed shares)		0.0598***
		(0.0219)
Log (other managed investments)		–0.0552**
		(0.0258)
Log (cash and term deposits)		0.0525*
		(0.0297)
Log (loans)		–0.0812*
		(0.0487)
Constant	–1.6633	–1.0468
	(1.4517)	(1.5150)
Fund age	–0.0038	–0.0057
	(0.0136)	(0.0139)
Trustee age	0.0125	0.0049
	(0.0122)	(0.0127)
SMSF professional	0.7907**	0.9520**
	(0.3637)	(0.3934)
Non-professional	–0.4154	–0.2993
	(0.2994)	(0.3214)
Victoria	0.2188	0.1388
	(0.1998)	(0.2077)
Members	–0.0095	–0.0024
	(0.1586)	(0.1622)
Log (total assets)	0.0908	0.0329
	(0.1065)	(0.1177)
McFadden R^2	7.27%	12.34%
Likelihood ratio prob.	0.0312	0.0010

Table 3 results are generated from probit regressions where the dependent is the binary *Compliance* variable, equal to 1 if the SMSF audit opinion is unqualified and 0 if it is qualified.

As a robustness check for our measure of *overconfidence*, a second variable was created from the question '*Who is in the best position to prevent a possible breach of the SIS Act and regulations?*' Respondents were given a number of choices relating to using a stock broker, financial planner, accountant, auditor, lawyer, specialised SMSF administrator or themselves. Those respondents who selected themselves had to record the strength of their conviction, as measured on a scale from 1 to 7. This measure of confidence is related to a person's belief, whether correct or not, that they are best equipped to ensure SIS Act compliance relative to specialists in the field. We consider it a more direct measure of overconfidence when compared to the first measure capturing the differential between actual and perceived SIS Act literacy. Using trustee self-assessed ability to prevent a regulatory breach (measured as a Likert score ranging from 1 to 7) instead of *overconfidence* in model 1 above resulted in no changes in the significance or signs of any of the independent variables.

Statistical significance is denoted as *** for $p < 0.01$; ** for $p < 0.05$; and * for $p < 0.10$. Standard errors are in parentheses.

13. CONCLUSION

SMSFs continue to grow in number and size and so are becoming a larger and larger part of Australia's superannuation sector, already accounting for 30% of the sector by assets under management. One of the reasons for this growth is the freedom given to trustees to manage their own superannuation. Greater control, flexibility and choice are attractive but with this freedom comes increased responsibility. In the words of Bennett J 'responsible officers or trustees of self-managed superannuation funds are placed in a special position of trust because they can allocate a fund's assets without supervision and without seeking another's authority to do so'.[81]

This special positon of trust exposes trustees to many compliance issues. As discussed in this paper, these include the need to maintain fund assets for the sole purpose of providing retirement benefits to the members, as well as to satisfy the various other regulatory rules contained in the SIS Act and Regulations.

This paper has discussed some recent cases involving breaches of these compliance obligations and has therefore sought to highlight the significant challenges facing trustees managing SMSFs.

Statistical results of a research study into SMSF trustee compliance (as previously mentioned in this paper in terms of whether or not an auditor has reported a breach) revealed interesting insights on which trustees manage these challenges most effectively. We find that trustees with increased levels of SIS Act literacy manage SMSFs which are associated with a greater likelihood of being compliant. This result was even stronger for trustees who are employed in SMSF-related fields (such as in auditing, accounting or financial planning) who also appear significantly more likely to be managing compliant SMSFs than other professionals, non-professionals and retirees.

However, the survey also produced results which were not expected in that no statistically significant differences were observed between trustees of compliant and non-compliant SMSFs in terms of their compliance knowledge overconfidence.

The results of this survey also suggest that SMSFs, at least empirically, appear more likely to be compliant if they follow mainstream investment allocations to Australian shares and fixed income securities, and are correspondingly less likely to be compliant if they invest in international shares, loans and other managed investments. Our findings therefore reinforce the view that SMSFs are generally managed conservatively and counter to finance theory on diversification. Notably, the results seem to suggest that the need for compliance with regulatory requirements may be at the heart of why so many SMSFs are departing from standard finance theory and concentrating their investment allocations.

This last observation opens up potentially fruitful avenues for future research exploring the interface between standard investment theory (favouring diversified holdings) and the legal and taxation requirements for regulatory compliance.

[81] *Deputy Commissioner of Taxation v Lyons* [2014] FCA 1353 at para 35.