AUDIT OF SELF-MANAGED SUPERANNUATION FUNDS

EXTRACT

BE HEARD.
BE RECOGNISED.
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1. INTRODUCTION

1.1 KEY CHARACTERISTICS OF SUPERANNUATION FUNDS

Superannuation funds are trusts with a pool of assets invested for the benefit of members and their beneficiaries. Contributions into the fund are paid by members and/or the members’ employers. Benefits are paid out when a member meets one of the defined release conditions (such as on death, disability or retirement, or when they are moved to another superannuation fund).

Superannuation funds must have a trustee and there are special rules in the Superannuation Industry (Supervision) Act 1993 (SISA) about who can be a trustee. The trustee must be a corporation unless the fund has the sole or primary purpose of providing old age pensions. In these circumstances the trustee(s) can be individuals.

Superannuation funds may pay lump sums or pensions, depending on the specific rules of each fund as set out in the trust deed. There are special requirements for pension-paying funds. There are also restrictions about whether a fund can pay a pension.

Funds may manage their own investments or may have a custodian which holds the assets on behalf of the fund and also provides investment accounting services by providing reports that show the assets held, income earned, taxation position, and realised and unrealised gains/losses. The audit implications will be considered later in this course.

1.2 KEY SMSF STATISTICS

Every quarter the ATO releases statistical reports for the SMSF market. This information includes the total number of SMSFs, the number of members, average fund balances, average member balances and member demographics.

The following information is as per the September 2015 data:

<table>
<thead>
<tr>
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<th>September 2015</th>
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<tbody>
<tr>
<td>Total number of SMSFs</td>
<td>562,466</td>
</tr>
<tr>
<td>Total members of SMSFs</td>
<td>1,067,934</td>
</tr>
<tr>
<td>Establishments (for quarter)</td>
<td>7,464</td>
</tr>
</tbody>
</table>

1.2.1 Other key SMSF statistics

Some of the other interesting statistics include:

Distribution of the size of SMSFs as at 30 June 2014

<table>
<thead>
<tr>
<th>Asset range</th>
<th>Proportion of funds (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0–$50,000</td>
<td>6.2%</td>
</tr>
<tr>
<td>&gt;$50,000–$100,000</td>
<td>4.4%</td>
</tr>
<tr>
<td>&gt;$100,000–$200,000</td>
<td>9.7%</td>
</tr>
<tr>
<td>&gt;$200,000–$500,000</td>
<td>24.1%</td>
</tr>
<tr>
<td>&gt;$500,000–$1m</td>
<td>23.8%</td>
</tr>
<tr>
<td>&gt;$1m–$2m</td>
<td>18.4%</td>
</tr>
<tr>
<td>&gt;$2m–$5m</td>
<td>10.8%</td>
</tr>
<tr>
<td>&gt;$5m</td>
<td>2.6%</td>
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</table>
Member age ranges

- 29.8% of all SMSF members are aged 55–64 (based on June 2015 data).
- 32.8% of all SMSF members are aged 65+ (based on June 2015 data).
- 42.7% of members of new SMSFs established in the June 2015 quarter were aged under 45.
- 13.2% of members of new SMSFs established in the June 2015 quarter were aged under 34.

It is interesting to note the number of younger Australians now starting their own SMSF, particularly in the under 35 age bracket. However, with nearly 1 in 3 members now aged over 64, it may take some time for these overall age statistics to significantly change.

1.3 LEGISLATIVE BACKGROUND

Superannuation funds are governed by the SISA and the Superannuation Industry (Supervision) Regulations 1994 (SISR). The main object of the SISA and the SISR is to provide prudential supervision for the superannuation industry. It includes restrictions on contributions, benefits and the use of the assets of the fund to ensure assets are accumulated for retirement benefits. This supports the Federal Government’s policy of providing tax concessions to superannuation.

Superannuation funds also need to comply with trust law and the relevant tax legislation.

There are two categories of small superannuation funds. SMSFs are regulated by the ATO. Small funds which do not meet the definition of an SMSF are regulated by the Australian Prudential Regulation Authority (APRA).

Two of the key definitions that SMSFs need to meet on an ongoing basis are:

<table>
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<tr>
<td>An SMSF</td>
<td>Defined in section 17A of the SISA. A fund needs to meet this definition in order to be treated as an SMSF.</td>
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Both definitions are discussed below.

1.3.1 Definition of an Australian Superannuation Fund

The fund must satisfy all of the following three tests to be called an Australian Superannuation Fund:

- The fund was established in Australia, or any asset of the fund is situated in Australia; and
- The central management and control of the fund is ordinarily in Australia; and
- The fund has no ‘active members’, or at least 50% of:
  - the market value of the fund assets are held by active members resident in Australia; or
  - the total amounts payable to active members if they left the fund are residents in Australia.

Australian establishment or assets situated in Australia

The first element to be satisfied is that the fund was either established in Australia, or any asset of the fund is situated in Australia.

Australian central management and control

The second element is that the central management and control of the fund must ordinarily be in Australia. This involves a focus on the ‘who, when and where’ of the strategic and high level decision making processes and activities of the fund. These include:

- formulating the investment strategy for the fund;
- reviewing and updating or varying the fund’s investment strategy as well as monitoring and reviewing the performance of the fund’s investments;
• (if the fund has reserves) formulating a strategy for their prudential management; and
• determining how the assets of the fund are to be used to fund member benefits.

The central management and control of a superannuation fund is ordinarily in Australia at a given time, even if that central management and control is temporarily outside Australia for a period of not more than two years – see ITAA 97 s. 295-95(4).

Where the two-year time frame is exceeded then the central management and control will not ordinarily be in Australia and issues can arise. The two-year rule is really an ‘intention based test’: what are the intentions of the trustee when they depart Australia? If the period of absence is to be less than two years then the central management and control may still be ordinarily in Australia. If the period of absence that was initially to be less than two years is extended beyond the two-year period, then the central management and control may in fact still be deemed to be ordinarily in Australia but will ultimately depend on each case. A regulator’s opinion should be sought by trustees where the two-year limit may be exceeded or extended.

**Australian active member assets**

The final requirement is that the fund must have no active member (see below), or at least 50% of:

• the total market value of assets attributable to the interests of resident active members; or
• the sum of the amounts that would be payable to or in respect of active members, if they voluntarily ceased to be members, amounts to at least 50% of the total market value of assets attributable to interests held by all active members.

An ‘active member’ is a current contributor, or a member in respect of whom contributions have been or are to be made in respect of the current year of income, but excluding non-residents whose support during the current year has related only to a period when they were residents – see ITAA 97 s. 295-95(3).

For a large superannuation fund with many resident members and with a trustee based in Australia, the above requirements pose few difficulties. It is for SMSFs that pitfalls can arise, because of the requirements for Australian management and control, and for 50% of the asset value supporting active members’ entitlements to relate to the entitlements of residents.

**EXAMPLE 1**

Active membership

Chris, a member of the Smith SMSF, a single member fund, ceases to be a resident and heads overseas. Whilst overseas he continues to make contributions to the fund. The active member test is failed as more than 50% (in this case 100%) of the fund’s assets are held by non-resident active members. In turn, the super fund will fail the definition of an Australian Superannuation Fund.

**EXAMPLE 2**

Active membership

Helen, one of four members of the Sharpe SMSF, heads overseas on 31 March 2016 and becomes a non-resident. Prior to departing Australia Helen worked for a local business which made contributions to the Sharpe SMSF on her behalf. The fund received a contribution on 20 April 2016 for the third quarter Superannuation Guarantee for Helen. As the contribution related to a period when Helen was a resident, the fund, by virtue of accepting this contribution, would not fail the active member test.
Active membership

Lisa is a member of the Rose Superannuation fund, a two-member SMSF. Lisa’s benefit is 50% of the fund’s balance and the remaining 50% represents her husband’s balance. Lisa ceases to be a resident and also ceases to make contributions to the fund. Her husband, who is still a resident continues to make contributions to the fund.

The Rose Superannuation Fund would continue to meet the active member test as at least 50% of the fund’s balance is attributable to resident active members.

If Lisa’s husband did not make contributions whilst she was away, the fund would of course still meet the definition of an Australian superannuation fund.

Audit considerations for fund residency

In an income year when a fund fails to meet the residency requirements, ITAA 97 s. 295.320 causes ordinary income and statutory income from previous years to be included in assessable income for that year at normal marginal tax rates as well as the income for the current year. The formula for working out the amount is in ITAA 97 s. 295.325.

The tax consequences for the fund becoming a non-complying fund by failing to meet the residency test may be significant.

If a fund fails to meet the residency test and the tax expense of the fund has been based only at the concessional 15% rate, the audit risk will be that an unmodified opinion is given at Part A of the audit report in relation to the financial audit of the fund. The audit opinion should be modified as the tax expense and income tax payable will be materially understated given that the market value of all fund assets, less undeducted contributions that have been made, should have been reported as taxable income at the marginal tax rate.

Consider the situation where the member or trustee/s depart overseas on temporary assignment. The hazards are:

• Extension of trustees’ planned overseas absence of under two years, to a period exceeding two years (breach of central management and control requirement).
• Continuing contributions in respect of a member or members residing overseas (potential breach of active member test where 50% or more of the entitlements of the fund do not relate to the resident active member).

SMSF auditors need to be aware of certain strategies that can be utilised to overcome these potential difficulties. Auditors should focus on:

• Trustee residency: it may be necessary to appoint a professional trustee to the fund, or to provide a power to another person (a Legal Personal Representative) under an Enduring Power of Attorney (EPOA). Matters surrounding this and the requirements to meet the SISA rules are found in the Self-Managed Superannuation Fund Ruling SMSFR 2010/2.
• Contributions to the fund: generally it is prudent to cease all contributions while overseas, unless the member who is to spend time overseas has a balance that is lower than the aggregate balances of active members who are remaining resident. Note that changes can occur, or the situation can be overlooked, and it is better to be safe than sorry.
• Some SMSF trustees may decide that the situation is too difficult to monitor and may decide to roll their balances into a larger fund and wind up the SMSF.

To ensure that the appointment of the Legal Personal Representative is allowed and that the required process has been carried out effectively, the auditor must review the fund’s trust deed and the constitution of the corporate trustee where relevant.
Further guidance on the meaning of ‘Australian superannuation fund’ used in ITAA 97 s. 295.95(2) can be found in the ATO Taxation Ruling TR 2008/9.

Further information on the use of a Legal Personal Representative to act as a trustee in place of an SMSF member can be found in the ATO Self-Managed Superannuation Funds Ruling SMSFR 2010/2.

1.3.2 Definition of an SMSF – SISA s. 17A

There are a number of requirements that need to be met for the definition to be satisfied and all of these requirements need to be met on an ongoing basis. The requirements include:

- There are less than five members.
- Where the fund has individual trustees, then all individual trustees are members of the fund.
- Where the fund has a corporate trustee then each director of the corporate trustee is a member of the fund.
- Each member of the fund is a trustee of the fund (individual trustees) or a director of the corporate trustee (corporate trustees).
- No member of the fund can be an employee of another member of the fund unless the members concerned are relatives.
- No individual trustee of the fund receives any remuneration from the fund or any other person for their trustee duties.
- No director of the corporate trustee receives any remuneration from the fund or any other person (including the body corporate) for any duties or services performed by the director in relation to the fund.

Where the fund is a single member fund, there are additional requirements which include:

- Where there is a corporate trustee:
  - the single member is either the sole director of the corporate trustee; or
  - the member is one of only two directors of the corporate trustee and the member and the other director are relatives; or
  - the member is one of only two directors of the corporate trustee and the member is not an employee of the other director.
- Where there are individual trustees:
  - the member is one of only two trustees of whom one is the member and the other is a relative of the member; or
  - the member is one of only two trustees and the member is not an employee of the other trustee.
- No individual trustee of the fund receives any remuneration from the fund or any other person for their trustee duties.
- No director of the corporate trustee receives any remuneration from the fund or any other person (including the body corporate) for any duties or services performed by the director in relation to the fund.