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### **The Productivity Commission**

On line lodgement:

<http://www.pc.gov.au/inquiries/current/superannuation/make-submission#lodge>

Dear Sir/Madam,

### **Opportunity for further comment: How to Assess the Competiveness and Efficiency of the Superannuation System: Productivity Commission Draft Report August 2016**

#### **Introduction**

I refer to the Productivity Commission Draft Report August 2016: How to Assess the Competiveness and Efficiency of the Superannuation System. ("Draft Report") and welcome the opportunity to provide comments on some of the issues outlined in the Draft Report and, also, very much welcome the opportunity to contribute to consideration of the competiveness and efficiency of Australia's superannuation system.

Given my recent experience (see below), my comments are, in the main, restricted to the SMSF sector of the superannuation system. Specifically, with respect to:

1. Structural differences of SMSF compared with other types of superannuation funds relevant to selecting analytics,

2. Incentives for SMSF members to integrate business assets with their SMSF,
3. Licencing conditions which impact on the use of service providers to SMSFs,
4. Four specific tax aspects, and, finally,
5. Some observations about the role of the ATO as regulator.

## **Background**

However, by way of background I am currently Lecturer in Charge of three superannuation subjects (Taxation of Superannuation, SMSF Law and Taxation Strategies in Financial Planning), which are part of our Masters programs at the UNSW Business School.

In addition, I am Convener of the Master of Tax (Financial Planning and Tax) and the Master of Tax (Applied).

I am Director of the UNSW SMSF Specialization Program for both the Chartered Accountants Australian and New Zealand (CA ANZ) and CPA Australia, which is the educational component for both those organisations' SMSF Specialist membership. To date, 600+ accountants from both organisations who service the SMSF sector have completed that Program.

I have just completed a research project on the underlying principles for the regulation of SMSF, which involved a cross-country comparison with SMSF-equivalent pension funds in USA, UK and Canada.

In addition, in conjunction with Professor Margaret McKerchar, in 2014 research funded by CA ANZ was completed into the way that Chief Investment Officers of large public offer superannuation funds account for tax when investing (referred to further below).

Full details of my research can be seen here

<https://www.business.unsw.edu.au/our-people/gordonmackenzie>

In terms of superannuation industry experience, prior to becoming an academic I was Global Tax Director at AMP Ltd and prior to that was a superannuation lawyer at AMP Ltd having established the first master trust deeds for superannuation funds, drafted the trust deeds for the first industry superannuation funds, as well as establishing a superannuation administration company to service that sector of the superannuation market.

In terms of industry advocacy roles, I have been at times on the tax committees of the Business Council of Australia, of the Financial Services Council, of ASFA and of the Property Council of Australia, in addition to having been chair of Taxpayer's Australia. I have appeared, on behalf of the financial service industry, at four Senate committee hearings.

## **Comments**

## **1. Material structural differences of SMSF: Limits on application of metrics to SMSF**

While I understand that it is intended to subject the SMSF sector to the complete set of analytics that are under discussion, I note from the observations in Appendix G that the competition and efficiency criteria to be included in the assessment of SMSFs is limited, when compared with that for the non-SMSF sector of the superannuation system.

Specifically, according to Appendix G, these will be limited to maximising net returns as a measure of efficiency, including accounting for the way that tax of the fund affects that, and, with respect to the preferences and needs of members, the learning from behavioural finance to 'lean against' biases. In addition, how well the system provides for the payment of benefits in retirement will be considered. Finally, consideration of the affect of the ability of SMSF to leverage, as in Limited Recourse Borrowing Arrangement, will also be considered in the context of system stability.

In that case then, I would support that approach, primarily because of the material differences between the two sectors, SMSFs and non-SMSFs type superannuation funds, discussed below, notwithstanding that nominally they have the same purpose.

Observations are made in the Draft Report about significant structural differences between SMSFs and other types of superannuation funds in the superannuation system.

Perhaps the most significant being that SMSF are not intermediated by third parties who are independent of members. Or, to put that another way, because of the commonality between members and fund administrators in SMSFs (trustees or directors of trustee companies) there are no agency issues, as can be the case for non-SMSF superannuation funds.

That raises some significant issues in that one of the controls on agency problems arising in the non-SMSF sector is through APRA's and, indeed ASIC's, licencing systems, which contain quality controls on the capacity and capabilities of managers of non-SMSF superannuation funds, as well as positive obligations about acting for members- see Part 2A Superannuation Industry (Supervision) Act 1993 ("SIS Act").

Indeed, the differences between the two sectors are considered to be deeper than just licensing. Specifically, and some comments are made in the Draft Report on this aspect, members of SMSFs are necessarily engaged per force of the transactions that they need to complete in order to set up and maintain their SMSF.

For example, the legal formalities involved in obtaining and executing a trust deed, but even more importantly the obligation on trustees and directors of the

trustee company to sign a declaration that they understand their duties as trustees of an SMSF-Section 104A SIS Act.

Also important in this regard, is the positive obligation on SMSF trustees to have an investment strategy, which requires that they consider investment of the funds against the four basic principles of investing: diversification, liquidity, risk/return and liability ( Section 52B(2)(f) SIS Act as a covenant and as an operating standard at reg. 4.09(2) SIS Reg.)

Examples of regulation forcing engagement, perhaps?

## **2. Integration of SMSF and member assets**

The design of the system for SMSFs, specifically in terms of the regulations, incentivises members to use their fund for business purposes. That is, the rules permit a member to sell or otherwise transfer certain types of their business assets (“Business Real Property”) to their SMSF and, also, to lease it back.<sup>1</sup>

This is another significant difference between this sector and other types of superannuation funds, which, necessarily, impinges on engagement by the members with their funds. How more engaged could a member be than operating their business from premises that they lease from their SMSF?

Indeed, it is arguably overly beneficial for SMSF members who can, in effect, use their retirement assets for their business purposes, resulting in very favourable tax outcomes as well.

Compare this with non-SMSF members who have virtually no ability to access their superannuation fund for anything other than retirement purposes (see section 62 SIS Act, the “sole purpose” test)

## **3. Licensees obligated to assist with service provider selection**

Another difference, which, interestingly, emanates from the financial services licensing system but in this case the licensing of certain of the service providers to SMSFs and not trustees themselves, is around Statements of Advice and the “best interest duty” (Section 712A Corporations Act).

Specifically, from work that we have been doing with the Alumni of the SMSF Specialisation program mentioned above, we see that one of the obligations of licensees advising on SMSFs is with respect to selecting and managing other professional service providers who may be needed for the SMSF to properly function.

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<sup>1</sup> See exception to prohibition on trustees intentionally acquiring assets from members and related parties (section 65 SIS Act), as well as the exception to in – house asset rules in respect of Business Real property (Part 8 SIS Act).

In Appendix A I include the questions in the assessment of SMSF Specialisation Alumni who are seeking RG 146 certification for limited licensing purposes. That is, those who want to be licensed under the Corporations Act to provide limited advice on SMSFs.

The skills that are being assessed here are dictated pursuant to Appendix B RG 146.

You will see that that one of the demonstrated Skills required as part of obtaining RG 146 compliance is the ability to identify service providers, and to help appoint, judge suitability and monitor those service providers to a SMSF.

In other words, licensees are obligated to assist with service providers to SMSFs.

It seems to me that these regulatory aspects of selecting and using service providers should be included in the considerations of efficiency of the superannuation system with respect to SMSFs.

#### **4. Tax and superannuation**

As mentioned above, I was involved recently in research that was conducted into how, if at all, Chief Investment Officers of some of the largest public offer superannuation funds accounted for tax when making investment decisions.

A copy of the research is appended but what was observed is that of the 19 or so tax strategies that could be applied to funds management in a superannuation fund, the Chief Investment Officer focussed on only two. First, in managing CGT payable by the fund, as in holding assets for at least 12 months to gain the benefit of the 1/3<sup>rd</sup> discount on assessable gains, and, secondly, with respect to the tax rules for imputation credits. Specifically, ensuring that the 45-day rule (Section 177EA Income Tax Assessment Act 1997) was not breached, thereby protecting the funds' entitlement to claim the imputation credits.

This limited application or use of the tax rules is notwithstanding an obligation on trustees of non-SMSFs superannuation funds to have regard to tax when making investment decisions.<sup>2</sup>

One aspect of taxation of superannuation, which also came out of the research, that I would draw to your attention, that may already be under consideration, is the tax effect when a member moves from accumulation mode to pension mode in some large public offer superannuation funds.

Surprisingly, as that event is not a taxable event, members can be, in effect, charged tax at that point.

Specifically, we were told when doing our research that because some of these funds hold member's accumulation assets and pension assets in separate pools,

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<sup>2</sup> See Section 52 (6)(vi) SIS Act.

when the trustee moves the funds supporting the accumulation account from that pool of assets to a pool of assets supporting the member's pension account, the value of their interest in the accumulation pool that is transferred is net of any accrued deferred tax liability. In other words, the member is, in effect, paying tax at that point.

We understood the reason for that is that the trustee will have a liability for tax, accounted for as the deferred tax liability, on unrealised gains on assets in the accumulation pool. Had the trustee disposed of those assets while the member was still in the accumulation pool, then the member would have incurred that tax liability in that the trustee would debit their account for that tax payable.

Nevertheless, that transition is not a taxable event and, absent holding accumulation and pension assets in separate pools, would not result in tax being payable by the member.

Another aspect of taxation which should be considered is the design of the tax system which principally affects members who use a SNSF and that is the ability to contribute "catch-up" contributions.

While there is a limit on the amount of contributions that individuals can make to a superannuation fund owners of business assets are able to contribute up to \$1.395M from the proceeds of the sale of their business assets in addition. Now the rules are far more nuanced than explained here, the point of these rules is that they implicitly acknowledge that business owners, who are the most likely user of SMSF, will fund their retirement from the sale of their business assets, rather than progressively over their working life.

The point here is that this design aspect of the tax of superannuation is an important consideration in the efficiency of the system particularly with respect to SMSF members.

Finally in this regard, just two other comments about the taxation of superannuation, and SMSFs in particular.

First, the taxation rules that apply to a SMSF in calculating fund income tax are the same as those they apply to any other type of superannuation fund, excluding certain Government funds, which are not taxpaying. That is there is not a distinct code for the taxation of SMSF, as opposed to the taxation of any other type of superannuation fund that pays tax. All types of funds calculate their tax using the same rules.

In that case, as the same tax rules apply to all types of non-government superannuation funds, any difference in the effective tax rate between a SMSF and non-SMSF, and consequently affecting the member's rate of return, is a function of how the tax liability calculation is managed.

Secondly, in that regard, from having engaged with 600+ tax advisers to SMSFs, from the SMSF Specialisation Program mentioned above, anecdotally (and I do

appreciate that you have requested evidence based comments) it seems to me that, in the main, and there are always outliers, the tax advisers to SMSFs are very conservative in the way that they manage the tax of SMSFs.

However, that is not to say that they do not do it efficiently.

## **5. Role of the ATO and auditors in SMSF regulation**

For the sake of completeness it is worthwhile making a few observations about the regulation of SMSFs by the ATO and SMSF auditors.

The starting point is that, while the ATO is the tax collector, it has, under section 6 (1) SIS Act, general administration of the regulation of SMSFs. That is the ATO is regulator of the conduct of SMSF trustees.

This should be contrasted with the observation at page 282 of the Draft Report that “Therefore, the ATO focuses on regulating SMSFs by ensuring members comply with tax law” and, then again at page 283, that “As the regulator of SMSFs, the ATO has a strong focus on **compliance with tax law.**”

Indeed, the role of the ATO in regulating SMSF is much wider than just ensuring compliance with the tax law as, pursuant to Section 6 (1) SIS Act, it regulates compliance by SMSF with the SIS Act and Regulations.

With respect to SMSF auditors, the Draft Report at page 252 notes that “Auditors are required to report any contravention of superannuation or taxation rules to the ATO and play a key role in managing legal compliance.’

In fact the auditors role is limited to legal compliance, as in compliance with the relevant sections of the SIS Act and its Regulations. SMSF auditors are not obligated to report income tax related issues, but are restricted to regulatory issues.<sup>3</sup>

## **Conclusion**

So, overall, these comments are intended to highlight:

- 1 That the regulation of SMSF recognises structural differences between SMSF and other types of superannuation funds, which may impact on what analytics are appropriate for measuring efficiency of SMSFs,
2. The design of the SMSF system actively incentivises SMSF members to integrate business assets with their SMSF,

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<sup>3</sup> What’s ahead for SMSFs? Keynote address by James O’Halloran, Deputy Commissioner Superannuation ATO, CPA SMSF Conference 12 August 2016 Melbourne at page 12

3. Licensing conditions seem to impact on selection and management of service providers to SMSFs,

4. Taxation consideration such as:

- i. limited use of tax planning in non-SMSFs,
- ii. inappropriate tax in non-SMSFs when moving from accumulation to pension mode,
- iii. an assumption that business owners, who are more often SMSF members in the taxation of superannuation, will fund their retirement from disposal of their business assets, and
- iv. that if there are significant difference in the way that tax is managed in SMSFs, compared with other types of funds, then more likely than not, given that both types of funds use the same rules, that is a result of efficiency.

5. Finally, some comments about the role of the ATO in regulating SMSFs.

In conclusion, it seems to me that the differences of SMSFs, when compared with other types of superannuation funds, suggest that a head-to-head application of the analytics under discussion may be contraindicated.

I trust that these observations are of value.

Yours sincerely,

A square box containing a handwritten signature in black ink. The signature is stylized and appears to be 'Gordon D Mackenzie'.

Gordon D Mackenzie



## APPENDIX A

**These questions are part of the assessment of SMSF Specialisation Alumni seeking accreditation in terms of RG 146 for limited licensing purposes.**

The Jemma and Jason mentioned in the question are the subjects of the Case Study at the basis of the assessment.

## UNSW SMSF Specialisation Workshop

### Skills Module

### Section 2 Part B

**(There are 4 parts to this section. Type your answers into the boxes provided.)**

- (a) (i) Describe four (4) key obligations that would be imposed on Jason and Jemma in running an SMSF. Ensure your response includes legal issues, investment considerations and specific fund documentation.
- (ii) Explain which service providers they must use and what role these providers play in relation to SMSFs.
- (iii) Advise what other service providers Jason and Jemma could use — if they wanted to — and the services they provide.

(250 words)

Type your answer here:

***Assessor feedback:***

- (b) (i) Explain how Jason and Jemma can identify potential service providers.
- (ii) What process should they use to determine whether to appoint a particular service professional?
- (iii) Describe five (5) criteria you would use to judge the suitability of an administrator to provide accounting, tax, annual return and compliance services.

(150 words)

Type your answer here:

*Assessor feedback:*

- (c) Jason and Jemma are keen for your help with monitoring appointed service providers. Explain the role you could play in reviewing reports from an investment adviser to assist in establishing an investment strategy, arranging investments and reporting outcomes.

(100 words)

Type your answer here:

*Assessor feedback:*

- (d) (i) Discuss the risks to Jason and Jemma of an underperforming service provider.  
(ii) Explain what problems they might experience when changing service providers.  
(iii) How could they avoid these issues?

(200 words)

Type your answer here:

***Assessor feedback:***