WEALTH BITES

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Understanding self-managed superannuation

Self-managed funds - or DIY funds as they are often termed- are privately managed superannuation funds that have six or fewer members. In most cases, these members are close family relatives, but they could also be business partners or close friends. Employees can only join the fund if they are also a relative.
If you are planning to open a self-managed superannuation fund (SMSF) you should think carefully about who else you ask to be a member and seek advice about the possible implications.

What is a self-managed superannuation fund?

As already mentioned, an SMSF can have six or fewer members. The fund will be regulated by the Australian Taxation Office (ATO). All members must be trustees of the fund or directors if the fund has a corporate trustee. The trustee is the person (or group of people) who takes responsibility for ensuring the fund is managed correctly. If you are planning to be the only member of the fund, you either need to have a corporate trustee (and can be the sole director or ask someone else to be an additional director), or you need to ask someone else to be a trustee with you. Trustees cannot be paid for any services provided as trustees.

It's about control

With your own SMSF - you're in control. In contrast to your typical public offer fund or employer-sponsored fund, you are the 'captain of the ship', steering your own SMSF towards retirement and beyond. As trustee, you are in charge of the day-to-day running of the fund, including management of investments and administrative and compliance obligations. This means you also take on all the legal responsibilities. It is important that you have the time and ability to take on these responsibilities. You can employ advisers to help with the work, but the trustees are still ultimately responsible for all actions and decisions.

What are the advantages?

The benefits of running your own SMSF may include:

Control and flexibility

As a trustee, you choose what assets the fund invests in. This may give you a broader range of options and can include direct shares and property, overseas assets and alternative assets such as artwork or antiques. Importantly, however, all investments need to be made in accordance with the fund's investment strategy (see below) and superannuation laws. You don't need to exit or rollover out of an SMSF just because you have retired. These funds can continue into retirement by starting an account-based pension with your savings once you meet a condition of release. An SMSF can also provide the flexibility that is often lacking in larger funds. For example, the flexibility to tailor investment strategies or to implement estate planning strategies that can help to transfer wealth to the next generation.

Management of tax

As you build up superannuation savings, tax is applied to some contributions, and fund earnings in accumulation are taxed at the maximum rate of 15%. Choosing share investments that pay franked dividends may reduce the effective tax rate as franking credits can be used to offset tax payable on other income. You may also be able to wait to sell assets with accumulated capital gains until after you start a pension so that no tax is payable on these realised gains. Your financial planner or accountant can explain to you in more detail how tax can be effectively managed in an SMSF.

Cost savings

Cost savings may or may not be a key driver of your decision to start an SMSF, but it is possible to achieve cost savings compared to public offer superannuation funds. The extent of cost savings depends on the type of investments, how you operate the fund and the amount of savings held in the fund. The fixed costs of SMSFs may make it uneconomical to run the fund at a low balance (see below).

What about the disadvantages?

While SMSFs might offer significant advantages, the onerous duties that must be performed as trustees may be a disincentive. The tax penalties can be very high if you get it wrong. As trustee of the fund, you are ultimately responsible for ensuring the fund is properly invested and administered in accordance with the relevant superannuation law. It is well worth highlighting that a breach of superannuation law can result in harsh penalty tax, which could see you losing almost half of your savings in tax. You could also incur fines and jail sentences for severe breaches. While the role of trustee may sound both demanding and time-consuming, the truth is that it need not be, as long as you follow the rules and seek professional advice before carrying out any actions you are not sure about. Professional SMSF administration companies exist to take care of the day-to-day administration and compliance requirements of the fund. This leaves you free to focus on the fund's investments and strategy in conjunction with your financial planner. You also need to be aware that SMSF trustees/members must resolve their own complaints and do not have access to the Australian Financial Complaints Authority (AFCA). Costly legal assistance may be required to resolve disputes between trustees and members. Furthermore, SMSFs are not eligible for statutory Government compensation if they suffer a loss due to fraud or theft.

Investment rules - what can you invest in?

Superannuation law does not prescribe the type of assets a superannuation fund can and can't invest in. Rather, it sets an investment framework that trustees must adhere to for how to purchase and use investments. In the first instance, superannuation law requires the trustee of the fund to put together a written investment strategy. All investments in the fund must be made and maintained in accordance with this strategy. The investment strategy must take into consideration the risk and return of holding assets, diversification, liquidity and the ability of the fund to meet liabilities. It must also cover the insurance needs of members. It is important that investments are made on an arm's length basis and are made for the 'sole purpose' of providing members with retirement or death benefits. This is probably the most important point for trustees of SMSFs to keep in mind.

There are several specific investment restrictions that include:

- Assets can’t be acquired from a member or 'related party' unless they are listed shares, units in a widely held trust or business real property at market value;
- All transactions need to be conducted on an arm's length commercial basis;
- A superannuation fund cannot borrow to invest unless it meets the limited borrowing recourse arrangement (LRBA) rules;
- A superannuation fund may not provide financial assistance to members.
- The investment rules are complex in some areas, and professional advice is recommended to ensure you do not make mistakes.

Costs of running an SMSF

In practice, the costs involved in running an SMSF can vary greatly between funds depending on various factors, including:

- the level of advice required,
- the cost of services that are outsourced,
- how quickly the fund will increase in value,
- the frequency of investment activities, and
- how much of the administration and investment activities are performed by the trustees.

There are some costs associated with SMSFs that can't be avoided (e.g. legal costs for establishing the trust deed, and the annual SMSF levy). Other costs are optional. The costs of the fund will generally change throughout its lifecycle, and cost-effectiveness will usually improve as the fund assets increase. The starting fund balance (whether high or low), whilst important, is only one factor to consider when deciding whether an SMSF is appropriate. Other important factors include:

- how much administration and management for the fund you are willing to take on,
- the level and timing of future contributions to the fund,
- whether you have a demonstrated ability to save,
- your cash flow position,

- your previous investment experience and interest in managing your own affairs,
- your financial goals and needs (including insurance needs),
- your investment preferences and goals,
- whether you have the potential to understand the responsibility of running an SMSF, and
- the suitability of your current super arrangements.

Who are self managed superannuation funds appropriate for?

SMSFs may be appropriate if you wish to take greater control of your retirement savings and have the willingness to take on the role of trustee. Not everyone is eligible to be a trustee, so you need to check the rules.

If you can accept the role of trustee, the operation of an SMSF may provide investment flexibility, tax benefits and cost savings that simply are not possible elsewhere in the superannuation environment.

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