You know an SMSF has passed its use by date when …

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Overview

Much attention is given to the technical and legal issues relating to the establishment and maintenance of self managed superannuation funds ("SMSFs") but how much is given to the ongoing needs of the participants in these SMSFs?

How much attention do we as practitioners and advisers give to whether the SMSF has "passed its use by date" and a more appropriate structure might be considered?

This has become more topical over recent years given:

- the deliberations, findings and recommendations of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry ("Royal Commission"),
- ongoing commentary from the regulators (ASIC in particular) on the need to ensure the ongoing appropriateness of SMSFs for their members, and
- the release and implementation of the Code of Ethics by the Financial Adviser Standards and Ethics Authority ("FASEA").

This paper will consider the changing environment and its effect on licenced advisers in particular, although the issues are appropriate for all practitioners involved in the provision of the ongoing support and advice to SMSFs and their participants.

Specific events or circumstances will be considered to illustrate the additional care and attention that needs to be given to ensure that an SMSF remains "fit for purpose" for its participants.

Emotional rather than technical

The issues being addressed in this paper are likely to be more aligned to issues of emotional intelligence, especially those that relate to effective communication and understanding and empathy with others.

Some of the suggestions might challenge the reader to consider whether they agree with the thoughts being raised, but that is the nature of the current day financial advice environment.

As practitioners we can provide numerous technical reasons for the establishment and maintenance of a SMSF, but we also have an obligation to the SMSF participants to ensure that the SMSF is only retained while it serves a purpose and there is no alterative arrangement that will provide a "better" outcome for them.

This will require a discussion about what we mean by "better", and this might not be simply a taxation or financial deliberation. It could be a personal deliberation as to whether the SMSF structure remains appropriate given the personal mind set or abilities of the individual participants.

Legislative and regulatory issues – the source

Over recent years there have been a number of reports, guides, standards, codes and communications which are worthy of noting (this is not an exhaustive list):

- ASIC Information Sheet INFO 205 "Advice on self-managed superannuation funds: Disclosure of risks", released by ASIC in July 2015, which provided ASIC's view on what information should be provided in advice for the establishment of SMSFs to ensure full disclosure of responsibilities, risks and alternatives;
- ASIC Information Sheet INFO 206 "Advice on self-managed superannuation funds: Disclosure of costs", re-released by ASIC in October 2019, which provided ASIC's view on what information should be provided in advice for the establishment of SMSFs in relation to the costs and ongoing appropriateness of the SMSF arrangement;
- ASIC Report 575, "SMSFs: Improving the quality of advice and member experiences", released by ASIC in June 2018, which provided information about a survey conducted of recently established SMSFs and comments made about the appropriateness of SMSF structures and advice in these cases;
- The infamous ATO letter sent to trustees in September 2019 expressing concerns about the lack of diversification in the investments of SMSFs which appeared to have more than 90% of their assets in a single investment class (i.e. property);
- Financial Planner and Advisers Code of Ethics 2019, and Explanatory Statement, both released by FASEA in February 2019, setting out the 5 values and 12 standards under the new Code of Ethics, to take effect from 1 January 2020; and
- FG002 Financial Planners and Advisers Code of Ethics 2019 Guidance, released by FASEA in October 2019, followed by FG002 Financial Planners and Advisers Code of Ethics 2019 Guidance, Preliminary Response to Submissions, released by FASEA in December 2019. While there may be a lack of clarity in some of the responses to submissions made, the "new world" will prove challenging for advice providers to ensure that they comply with the spirit of the announcements and not just the "black letter" law that has previously been relied upon.

There is sufficient breadth and depth of content in these publications to provide licenced advisers with fair notice that increased attention is being granted to the consumer and the expectation that advice needs to be fit for purpose and advisers are required to act in the client's best interests at all times.

Legislative and regulatory issues – the detail

ASIC Information Sheet INFO 205 includes the comments:

> *"There may be other options available for clients who may not be prepared to take on the responsibilities and obligations of an SMSF trustee. These options may still provide some of the benefits of an SMSF, such as a 'member direct investment facility' within an APRA-regulated fund."*

Reframing these comments for the advice provided to an ongoing SMSF client, it is reasonable to suggest that ASIC would expect an ongoing and regular assessment to be made as to whether other options would be likely to better meet the needs of the incumbent SMSF participants.

ASIC Information Sheet INFO 206 includes the comments:

> *"An important consideration is whether the likely balance of the SMSF makes it cost-effective for the client. If it is not cost-effective, it is very unlikely to be in the client's best interests."*

and

> *"**Advice on the continued suitability of an SMSF for the client***
>
> *Later advice should include an assessment of whether the client's relevant circumstances are significantly different from when the initial advice to set up an SMSF was given. This includes considering the ongoing appropriateness of the SMSF……*
>
> *….*
>
> *Further advice should also assess whether an SMSF that drops below $500,000 (e.g. while the SMSF is in pension phase) continues to be appropriate for the client.*
>
> *The continued capacity, capability and time commitments of the client should also be considered."*

While the comments about the specific economically critical balance of $500,000 are not helpful, there will clearly be thresholds at which the ongoing viability of the SMSF are questionable for an adviser and their clients.

Paragraph 278 of ASIC Report 575 states:

> *"Before setting up an SMSF, advice providers should discuss the following in detail with their clients:*
>
> *(a) the client's reasons for setting up an SMSF;*
>
> *(b) whether the client's superannuation balance is enough to justify setting up an SMSF;*
>
> *(c) the costs of setting up and running an SMSF;*
>
> *(d) the time and commitment associated with running an SMSF, and whether the client possesses any special characteristics that may make an SMSF structure inappropriate; and [sic]*
>
> *(e) the financial literacy skills required to run an SMSF. [sic]*
>
> *(f) succession planning."*

If we consider these issues from a converse perspective, we can determine ASIC's likely expectation of the ongoing advice that needs to be provided for SMSF participants as to the ongoing appropriateness of the SMSF structure, namely:

(i) are the reasons for which the SMSF was established still applicable and valid (para a);

(ii) are the economics of the SMSF still viable relative to alternatives (paras b and c);

(iii) is the trustee of the SMSF still capable of understanding it and maintaining it effectively (paras d and e); and

(iv) is there still a valid succession plan for the SMSF or has that been removed (para f).

Paragraph 297 of ASIC Report 575 states:

> *"For older clients, it will often be appropriate for the advice provider to revisit the issue of fund balance size. SMSFs will generally have a reduced balance size as clients progress through retirement. This is because, as clients age, they are required to make minimum pension drawdowns. It may be beneficial for these clients to move out of the SMSF sector."*

This is a clear reference to the expectation that an ageing SMSF (such as one where there is not a younger generation to supplement the fund balance with contributions) will be expected to decline in value over time.

The ATO "diversification" letters sent to trustees in September 2019 caused potentially more concern in the wrong areas rather than what the ATO was trying to address. In particular, the letter included the following comments:

> *"Our records indicate that your self-managed super fund (SMSF) investment strategy may hold 90% or more of its funds in one asset, or a single asset class.*
>
> *This means that your fund may be at risk of not meeting the diversification requirement as outlined in the operating standard of the Superannuation Industry (Supervision) Regulations 1994.*
>
> *As a trustee you are ultimately responsible for ensuring your investment strategy meets the requirements under the law. You could also be liable for an administrative penalty of $4,200 if your investment strategy fails to meet these requirements."*

Unfortunately, the relatively blunt message was lost amid the resulting hue and cry among practitioners that a non-diversified or concentrated asset exposure was potentially fully compliant in the right context.

The ATO message was apparently intended to reflect their concern that a concentrated asset exposure involving highly illiquid assets (such as property) posed the risk that the SMSF might not be able to meet its minimum pension obligations in the short to medium term future and as a result the trustee had not given proper regard to the appropriateness of the fund's investment arrangements.

This talks to the need for the adviser to ensure that the SMSF remains an appropriate arrangement for their clients, including the way that it is invested for the short and longer terms.

The FASEA Code of Ethics contains some significant new requirements that place the onus on advisers to continue to review their actions against an "independent person" type of benchmark. In particular (emphasis added where relevant):

> *Standard 2*
>
> *"You must act with integrity and <u>in the best interests of each of your clients</u>."*
>
> *Standard 5*
>
> *"All advice and financial product recommendations that you give to a client must be in the best interests of the client <u>and appropriate to the client's individual circumstances</u>."*
>
> *Standard 6*
>
> *"You must take into account the broad effects arising from the client acting on your advice and actively <u>consider the client's broader, long-term interests and likely circumstances</u>."*

While the Code and these standards are relatively new and yet to be rigorously or even lightly tested, there are issues which are being raised which resonate with the need to ensure that the SMSF structure remains appropriate for our clients.

When is a SMSF no longer appropriate ?

This paper will examine a number of circumstances where the facts suggest that there is a need to review the ongoing need or appropriateness of an SMSF structure, and the need to either provide advice for the cessation of the SMSF or ensure that the specific circumstances of the client / participants clearly warrant the retention of the arrangements.

Cases which will be considered include:

- low and reducing overall fund balances,
- reduced member involvement in conduct of the fund,
- concern about loss of or lack of capacity to manage the fund,
- specific reasons for the SMSF being established no longer applying, and
- review of reasons for having a SMSF versus alternatives.

Low and reducing overall fund balance

This is specifically called out in ASIC Report 575 paragraph 297 and is particularly relevant for a person or a couple who have pension arrangements that are grandfathered, having commenced prior to 1 January 2015.

The income assessed for these pensions will be related to the portion of the pension payments which exceed the annual deductible amount. With appropriate use of lump sum payments (partial commutations) the pensions might produce nil assessable income for Centrelink purposes.

However, as the balance of the pension accounts gets smaller, the impact of assessed income under the alternative deeming approach might be minimal or nil on any age pension entitlement.

Without examination of alternatives, the unadvised or less firmly advised trustees and members might prefer to retain their existing arrangements, without undertaking any form of cost v benefit analysis for retaining the SMSF and pension arrangements against the alternatives. The costs of maintaining an SMSF are likely to become more fixed with relatively small balances, while the alternative of a retail pension arrangement or even a simple joint personal investment portfolio are likely to involve proportionate costs at a lower level.

As pension balances get smaller, the effect of one off lump sum drawings, such as for a car or home maintenance, can dramatically reduce the fund's balance.

Members can be so wedded to the efficiency of SMSF that they are reluctant to receive a conversation about alternative arrangements. That is where a persistent advice provider needs to put the numbers in front of the trustees and members.

Case study

Into the future the 'On Just Terms SMSF' has Das (aged 82) and Sal (aged 75) as members and the total of their pension balances is $200,000, with the fund invested in cash and listed shares only. They are drawing annual payments of $15,000 per annum (to supplement the age pension) and the annual fixed costs of the fund are $2,800 including the ATO levy.

They have less than $500,000 in the bank and are still living in their own home. After their roof develops holes they need to draw $20,000 to repair it, leaving $180,000 in the fund.

Let's consider the alternatives for them. If they keep the SMSF, their investment income is tax free and they will continue to incur annual costs of $2,800 in addition to any cost of buying and selling shares.

If they draw the balance from the SMSF and jointly invest they have no fixed costs and it is most unlikely that they will generate sufficient income (including realised capital gains) to incur any tax.

Are they just keeping the SMSF because it has the right "vibe" for them? It's time for a strong conversation.

Reduced member involvement

When we talk about reduced member involvement, this is not related to an involuntary action (discussed later) but a conscious or sub-conscious decision by the trustees to do as little as possible with the fund. This involves not only an outsourcing of the technical functions of administration, for example, but placing the investments in a fully managed platform or outsourced arrangement.

In these circumstances, what role are the trustees performing and is the SMSF a de facto form of retail or public offer superannuation for them?

If a trustee fully outsources the activities of the fund, they have effectively handed over control of the fund to third parties, but retain the risk of being a trustee under the auspices of the auditor and ATO as regulator.

If the SMSF provides a more cost effective solution for the trustees and members relative to the alternatives, it is essential that the adviser has this conversation with the trustees and members and clearly documents this on their files. In the absence of that documented note, the conversation either did not happen or might as well not have happened if any future action or questions are raised.

This reduction in involvement is likely to have arisen over time as the SMSF should ideally have been commenced if the initial trustees were actively involved with all or some aspects of the fund at that time.

This "lack of interest" can occur on the death of the principal participant in the SMSF, that original person having a strong interest in the investment process in particular. The spouse will often defer to the fund's service providers without necessarily having an understanding of what the SMSF was or is currently about. It is not unusual for the service provider to then suggest that a second family member become a trustee or trustee director to continue the fund's existence.

As indicated at the inception of the paper, that is the time for a more emotional personal consideration to be raised as to whether the SMSF remains an appropriate superannuation vehicle for the less engaged surviving spouse.

It's time for a balanced discussion to be had with the surviving spouse and possibly supporting family members in these circumstances. In this context "balanced" requires a genuine review of the alterative arrangements and their relative merits and demerits.

Concern about loss of or lack of capacity to manage the SMSF

There is an expanding conversation in Australia around ageing, increased life expectancies and quality of life. Inevitably those conversations include stories about people losing capacity to make daily decisions on a consistent and reasonable basis.

This is a very human and personal experience. The partner or other family members who are seeing their life partner or family member decline in capacity can be very protective towards their loved one. This protection can even extend to not wanting to acknowledge to the person that their cognitive abilities are becoming compromised and they need greater help. That protection, however, can come at significant personal, emotional and even financial cost.

This has similarities with the previous issue of reduced member involvement, but in this case it is involuntary on the part of the affected person but absolutely conscious on the part of the other parties.

With SMSFs that are closely advised, it is to be hoped that a robust conversation could be had early on in the cognitive decline process while the issue and its potential effect on the good conduct and financial "health" of the SMSF are yet to develop too far. The conversation could involve issues such as:

> *"If you were not able to make the same decisions about investing that you could make today, what would you expect to happen with the SMSF at that time ?"*
>
> *"What would you want your partner to do to ensure that the good things you have achieved with the SMSF are not lost and you can continue to support yourselves?"*

If these conversations (a bit like an informal "pre-nuptial" agreement for loss of capacity) are not had in advance, it is a lot harder to make the better decision when they need to be addressed.

This situation is at its worst when the investment of the SMSF is managed almost exclusively by the primary participant, who then loses capacity, and the partner or family is reluctant to intercede on the control of the investment process even though they acknowledge that poor decisions or non-decisions will occur.

Powers of attorney might be available to be used but not invoked until very late in the process, out of respect by the partner or family for the person whose abilities have declined.

Advice providers need to ensure that they have appropriate conversations with their clients on these "loss of capacity" circumstances ahead of time.

Reasons for having SMSF no longer apply

Among the reasons adviser have for arranging an SMSF for their clients is the ability to undertake superannuation investments such as commercial property or other unique investments that are not available in retail superannuation arrangements.

Having established an SMSF to enable that investment to be undertaken, it is therefore appropriate that a similar assessment of suitability for purpose be undertaken if that investment has been sold or transferred out of the fund.

Case study

Das and Sal established the 'On Just Terms SMSF' to enable the purchase of a commercial property to be leased to a family related business, as part of their overall life investing process.

Some 10 years later, Das and Sal are no longer running the business and have arranged for the property to be sold to the SMSF of the new proprietors.

At the time the SMSF was commenced, Das and Sal transferred their entire superannuation balances from their industry super funds to support the purchase of the property with limited recourse borrowing. At the time Das and Sal said that they had limited investment experience.

Potentially, at the time of advising on the new SMSF structure their adviser would have discussed what would happen if they no longer had the property in the SMSF.

Again, it's time to have a new conversation with Das and Sal about why they have the SMSF and what they would like to do in the future to meet their ongoing needs and goals.

A new advice relationship will frequently flush out this issue when the advice provider asks "*why do you have an SMSF?*". It's interesting to consider the types of responses that are forthcoming which indicate that the SMSF may have limited ongoing utility:

- "*My adviser/accountant told me I should have one.*"
- "*I'm not sure why.*"
- "*It was to allow us to invest in the property.*"

Experience suggests that a good way to approach this conversation is to ask the trustees if they have a special need for a SMSF structure into the future and to have the same foundation conversation that would be had for a brand new SMSF client or prospect.

Review of reasons for SMSF versus alternatives

As well as establishing an SMSF to allow for unique or direct investment arrangements, clients will have other reasons such as control of investments and the ability to arrange direct share portfolios in superannuation.

At the time of establishment of the SMSF, these requirements might have only been able to be met from an SMSF structure. However, the retail and industry superannuation segments have evolved significantly over the last 5 or 10 years.

In this case, it is not that the reason for having the SMSF has ceased to be relevant but that the comparative alternatives have changed and the relative advantage of SMFS in those circumstances has declined or possibly even disappeared.

Issues such as fees and costs and the ability to have an active share portfolio are cases in point where these issues made an SMSF almost essential 15 years ago for members who wanted to invest and trade in shares directly. A large number of platform, retail and industry superannuation funds arrangements can now accommodate cost effective direct share investment.

This means that the issue of "investment control" needs to be politely revisited if it has come up in previous conversations.

These conversations can be difficult as there may be some inertia or resistance from the trustees and members to the assertion that their current comfortable SMSF arrangements need to be challenged and reviewed to ensure they remain "fit for purpose".

Barriers to change

As well as these emotional (e.g. pride, ego) and personal barriers to considering changing from the SMSF arrangements which were implemented some time ago, there are physical barriers which need to be acknowledged.

Just as there are costs that need to be considered when setting up an SMSF, so to do we need to address the costs involved on its completion or wind up. These are not intended to be the fixed costs which will inevitably be incurred at some time in future as the fund will inevitably cease at some time but for the costs or taxes as a result of the "life stage" of the members of the fund.

These "ahead of time" costs more relate to issues such as tax, which is relevant for a fund which has a significant accumulation component in the fund. A wind up of the fund with a large accumulation component could result in significant capital gains tax being incurred on asset sales prior to wind up. These taxes might not otherwise be incurred if the fund was retained, and the investments also, until the members commenced retirement income streams on meeting a condition of release.

The incidence of these potential taxes needs to be considered when comparing the retention of the SMSF against the alterative of winding up the SMSF and changing structures.

Fund where the whole or the majority of the balance is in pension phase are likely to cause fewer issues here.

Concluding comments

These are intended as an illustration of the package of issues that need to be considered when assessing whether the SMSF structure is likely to be in the best interests of the members in the short and longer term.

The plethora of regulator and advice conduct guidance, codes, reports and recommendations make it very clear that as advisers we need to ensure that their SMSF structure remains appropriate for them or advise on alternatives. We are on notice.

This makes the advice relationship much more dynamic than it might have been in the past, and it will now be one where the clients should end up being more appreciative of the relationship as the adviser is clearly placing them at the top of the value pyramid.