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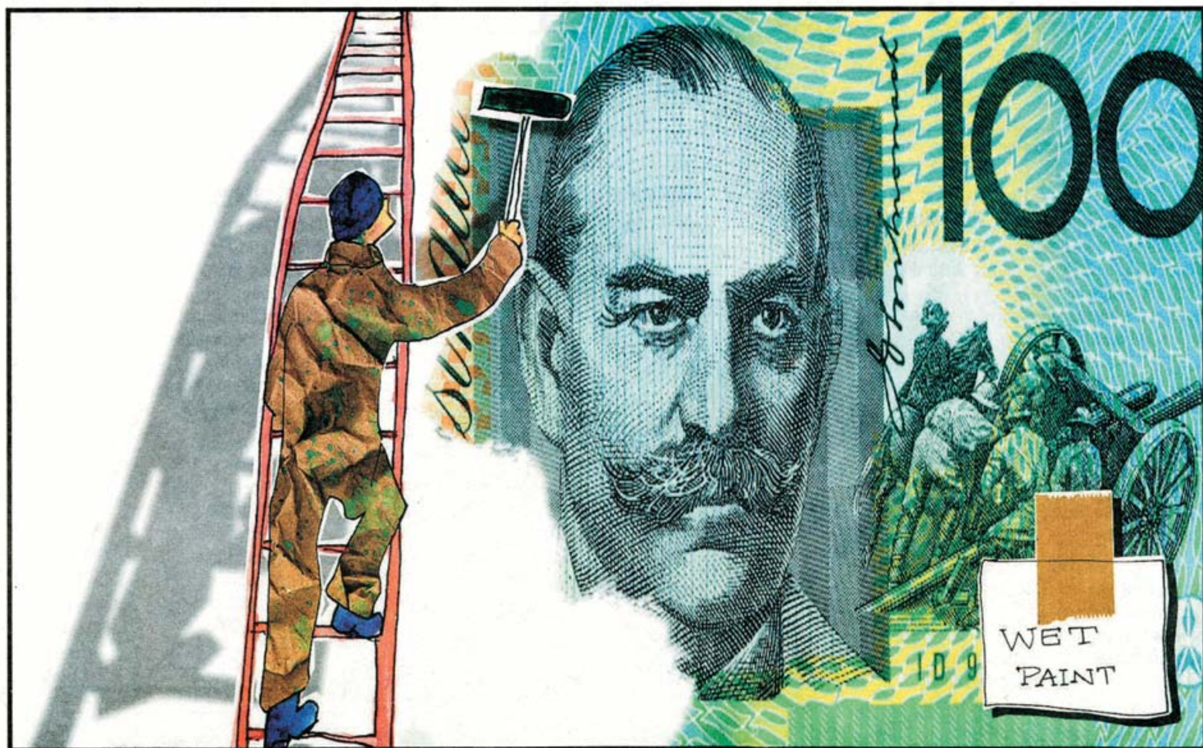

Photo-illustration: MICHELE MOSSOP

Acid test for DIY investors

Market mayhem and regulatory rigour – it's time for DIY funds to nail down their game plans, writes **John Wasiliev**.

Australia's 390,000 do-it-yourself super funds and their estimated 750,000 members face as challenging an economic and regulatory environment as they are likely ever to have encountered.

This particularly applies to those troubled by the major decline in the value of direct shares or managed funds from the peak of the bull stockmarket late last year.

In bull markets, investors tend to take the greatest interest in their personal finances, so any pain is most keenly felt in the immediate aftermath of a boom period.

Those most surprised by the reversal in the sharemarket, which has reversed two years of gains, will be DIY investors who committed heavily to share-related investments without a proper appreciation of the volatility that shares can exhibit.

It's these investors who will be most likely to question the investment strategies they devised as either individuals or under the guidance of financial advisers.

The same applies to those who have committed themselves to DIY super without fully appreciating what is involved.

One group that won't like what is happening are relative newcomers to DIY super, who were attracted by the Howard government's so-called better super reforms.

These reforms, which came into effect in July last year, included the rule that allowed people to contribute $1 million to super before the introduction of contribution limits and tax-free super benefits for the over 60s.

From the time the government foreshadowed these reforms in May 2006, there was a surge in the number of DIY funds established.

More than 87,000, or about 22 per cent of all DIY funds, were set up after the reforms were announced, possibly half of those because of the government's planned changes. Even with the present market challenges, the rate of DIY fund establishment is about 4000 a month.

Brisbane-based Pro-Super's Brad Hoffman says one change introduced as part of the reforms requires trustees of new funds to sign a document saying they understand the responsibilities they are taking on.

This requirement is likely to have applied to about a third of funds set up since the super reforms were announced.

"This is an important change designed to focus people's minds on what they are taking on when they set up a DIY fund," Hoffman says. While basically the same responsibility is assumed when DIY fund trustees sign the trust deed that sets up their fund, the previous government obviously did not think this was sufficiently understood, Hoffman says.

Understanding responsibility is the important message promoted by prudent advisers and regulators, says Self-Managed Super Fund Professional Association (SPAA) chief executive Andrea Slattery, a former financial planner.

It is expected to be the main theme of a government review into superannuation that is now under way.

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Checklist

Key rules governing self-managed super funds

Purpose of fund

- The fund must be managed and maintained by the trustees in accordance with the sole purpose test. For example, the sole purpose of the fund is to provide retirement benefits for members

Trust deed

- Must include a statement that the fund has appointed a corporate trustee or that the sole or primary purpose of the fund is to provide old-age pensions
- It must also set out who the trustees are, how they are appointed, how they can be removed and their powers

Tax file number

- The fund must have its own tax file number

Australian business number

- The fund must have its own Australian business number

Separate bank account

- A separate bank account must be opened so that money belonging to the fund can be kept separate from accounts of the members, the trustees and related employers (employer-sponsors)

Investment strategy

- The fund must have a medium to long term investment strategy that considers a wide range of investment possibilities such as cash, low risk investments, growth investments and combinations of investment types
- Contravention of the requirement to have an acceptable investment strategy can result in the trustees being fined or sued for loss or damages. The fund can lose its compliance status and, as a result, its concessional rate of tax

Investing

- The assets of the fund are kept separate at all times from those of the members, trustees and related employers
- Each member must have a separate account in the fund
- The fund's accounting and banking records must be kept entirely separate from those of members/trustees/employers
- All transactions by the fund must be conducted on a strict commercial basis
- The fund must be able to demonstrate that market value has been paid and received on all transactions

Keeping the records

- The trustees must keep accounting records that comply with accounting guidelines for true and accurate accounts and provide an accurate record of the true financial position of the fund
- Accounting records must be kept for five years
- Other records must be kept for 10 years, including minutes of all meetings, records of changes of trustees, records of changes of directors (if corporate trustees) and a paper copy of any returns lodged electronically with the ATO

SOURCE: TAX OFFICE

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The review will also examine what level of knowledge a competent trustee should acquire.

It is possible that the government is worried that there are large numbers of DIY funds with trustees who are not be as educated as they should be.

Slattery is confident the majority of funds are run by educated trustees who are coping well with what is taking place in the financial markets.

Many have experience of past market reversals and have diversified portfolios with assets other than shares.

DIY funds have traditionally held high levels of cash in their portfolios.

But she acknowledges that people are getting some practical lessons in how investing works.

This applies not only to DIY fund investors but to other personal investors.

The lessons include being aware that during bull markets it is much harder to sort the good from the bad when it comes to making investments and judging investment advice.

"It is during bear markets that you see how easy it is to be an investor during bull markets," says Slattery.

It is also when the true character and skill of those who run businesses and provide financial services is revealed, be it investment management or investment advice.

One of the major worries for investors during the recent turmoil has been reluctance by many companies, including banks, to be honest about the state of their financial affairs.

A bear market is also when investors find themselves having to admit that perhaps they were not as diligent about their investment assessment process.

When times become tough, those who claim to be financial experts must be honest about what they are doing.

They must also be able to justify their fees.

It is also the time when investors will take the greatest interest in assessing whether they are getting value for the fees they are paying.

Alan Dixon, of Canberra-based Dixon Superannuation and Advisory Services, says that when financial markets are delivering 15 per cent plus returns, many people don't notice if their investment expenses are anywhere between 1 per cent to 3 per cent a year of their total assets.

"But when you are in an environment where your average investment return is a loss of between 4 to 8 per cent, that makes a big difference," he says.

Though investors are often encouraged to look at longer-term returns when investment markets are experiencing short-term volatility, Dixon says this makes high expenses look even worse.

If an adviser is quoting an expected long-term return of between 10 per cent and 12 per cent for a diversified portfolio with a reasonable proportion of growth investments, being charged 2 per cent to 3 per cent in expenses could represent more than 20 per cent of this. Dixon reckons DIY investors should not be paying fees of more than 1 per cent of fund assets every year.

He says that a market reversal should encourage people to check they haven't committed themselves to a fee structure in which they are giving away too much of their investment returns to their advisers and service providers.

Against this tough economic and financial markets backdrop is the prospect of a stricter regulatory regime for DIY funds, as both fund auditors and the Australian Taxation Office lift their game, especially against trustees who may not be as diligent as they should be.

"This year will certainly see an increased level of compliance-checking activity by the Tax Office," says Sharyn Long of Sharyn Long Chartered Accountants.

"My understanding is that they now have a process where they will look to review most of the contravention reports lodged by fund auditors," she says.

There will certainly be more investigation and follow-up of fund problems identified by auditors in reports to the ATO.

Though not suggesting that every contravention will be investigated, Long says that when trustees do something wrong, there will be a much greater chance of contact with the tax authorities in their role as DIY super regulator.

Slattery says an important regulatory development this year that trustees must note is that the Tax Office has had the power since June to impose penalties and even disqualify DIY super fund trustees, auditors and actuaries who do the wrong thing.

According to DIY super administrator SuperGuardian's Ed Bernard, trustees must be aware of increased emphasis the Tax Office is placing on monitoring superannuation.

This was recently highlighted by tax commissioner Michael D'Ascenzo when he announced that the Tax Office would boost its monitoring of superannuation in 2008-09.

During 2007-08, the regulator conducted more than 9400 audits and reviews of DIY super funds.

What the Tax Office will focus on this year is ensuring contributions and withdrawals comply with the rules. Illegal access schemes are a particular target.

Regulatory matters that will attract attention will be loans to members and relatives, fund assets that members use, borrowing by funds and ensuring that all allowable transactions between funds and members happen under a proper commercial arrangement.

TRICKS FOR PROPERTY PLAYERS TO EASE THE STING

Many do-it-yourself super funds that invest in property are missing out on valuable opportunities to claim a major tax concession that should dramatically reduce a super fund's tax liability when the property is part of super that is paid out due to a member's death.

The concession is called anti-detriment deductions. Melbourne superannuation lawyer Bryce Figot, of DBA Butler, describes the concession as one of the most powerful but also one of the most poorly understood super strategies available.

The problem with assets such as property inherited by, say, adult children on the death of a member, is that there could be a significant capital gains tax bill for the fund to pay, Figot says.

This liability could, however, be reduced or even eliminated if the trustees have done some anti-detriment planning in advance.

Anti-detriment deductions were introduced in 1988, when tax-deductible super contributions first became liable for a 15 per cent income tax paid by the super fund.

What the deductions seek to ensure is that children – including adult children – and spouses of deceased super-fund members don't suffer any detriment as a result of contributions tax.

To illustrate the entitlement, Figot gives the example of a member who makes a $100,000 concessional contribution to a new super fund.

The fund pays $15,000 tax on the contribution, leaving $85,000.

If the member then dies, there would be only $85,000 left in his account to pay to his spouse or children.

Figot says tax law states that if the benefit paid to a spouse or children is $85,000 plus the tax detriment amount ($15,000), the super fund will get a deduction of $100,000.

This is calculated by dividing the tax detriment amount by 15 per cent, creating the $100,000 deduction that is available to the fund.

But making use of this deduction needs to be carefully planned and requires specialist advice, he says.

There are three common methods to calculate the detriment amount, Mr Figot says.

The first involves auditing the fund's records and calculating the actual amount of tax paid.

He advises that if a fund can legally use this method it should do so.

Two other methods involve the use of formulas from the legislature and the Australian Taxation Office.

The problem with the formula methods is that they are structured so that if the member has implemented a withdrawal and re-contribution strategy to maximise the tax-free component of their super, the tax detriment amount calculated could end up being quite small.

The resulting anti-detriment deduction would thus also end up being very small.

This has led to the misconception that super-fund members face a trade-off between maximising the tax-free component or using an anti-detriment deduction strategy. But this is true only when the fund has used formula methods for calculating the detriment deduction entitlements.

Figot says that if a fund can use the actual tax paid method, it could implement a recontribution strategy and still get the full detriment entitlement.

"They can have their cake and eat it too."

But trustees still have to plan how they will use the deduction, which needs to be paid out to members before it can be claimed from the Tax Office.

One way is to establish a reserve account in the fund, a pool of money that is not allocated to any specific member.

Reserves are quite common in large super funds, Figot says, but they are rarely used in DIY super funds, although they can be if the fund implements a reserving strategy. Any specialist super legal firm should be able to provide guidance on establish a reserving strategy, he says.

Among other strategies for funds that do not have reserves is using any life insurance entitlements as part of the strategy, so long as the fund's governing rules allow this.

Another feature of the anti-detriment strategy is that the fund can end up not only wiping out the tax in the fund upon death, but it can generate carry-forward losses that can be used to reduce future tax bills if the fund has other members.

John Wasiliev