

The Auditor-General
Audit Report No.52 2006–07
Performance Audit

The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds

Australian Taxation Office

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of Australia 2007

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Canberra ACT
28 June 2007

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Australian Taxation Office in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds*.

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian McPhee', is positioned above the printed name.

Ian McPhee
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

For further information contact:
The Publications Manager
Australian National Audit Office
GPO Box 707
Canberra ACT 2601

Telephone: (02) 6203 7505
Fax: (02) 6203 7519
Email: webmaster@anao.gov.au

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Audit Team

Jonathan Hansen
Elisa Serje
Lesa Craswell
David Crossley

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Abbreviations

ABN	Australian Business Number
ABR	Australian Business Register
ACR	Auditor Contravention Report
<i>ANTS</i>	<i>A New Tax System</i>
APRA	Australian Prudential Regulatory Authority
ASIC	Australian Securities and Investment Commission
EM	Explanatory Memorandum
ISC	Insurance and Superannuation Commission
IT	Information Technology
MOU	Memorandum of Understanding
RoCS	Register of Complying Superannuation Funds
SCF	Strategic Costing Framework
SFI Project	Superannuation Fund Integrity Project
<i>SISA</i>	<i>Superannuation Industry (Supervision) Act 1993</i>
SIS Regulations	Superannuation Industry (Supervision) Regulations 1994
SMSFs	Self managed superannuation funds
Tax Office	Australian Taxation Office
TFN	Tax File Number
The Treasury	The Department of the Treasury

Summary and Recommendations

Summary

Introduction

1. Superannuation is a long-term vehicle for building retirement savings, and is a key element of the Government's policies to address the financial independence of Australia's ageing population.
2. Superannuation is the largest financial asset of Australian households.¹ The level of superannuation savings has grown by 76 per cent over the last 5 years to \$913.9 billion as at 30 June 2006.² This significant increase in savings has been underpinned by concessional tax treatment, including a tax rate of 15 per cent on the income of complying superannuation funds.³
3. For taxation purposes, superannuation funds are defined in the *Superannuation Industry (Supervision) Act 1993 (SISA)* to include schemes which are for the payment of superannuation benefits upon retirement or death.
4. Superannuation funds are broadly categorised into those:
 - (a) regulated by the Australian Prudential Regulation Authority (APRA):
 - retail or public offer funds: offering products to the public generally;
 - corporate or employer-sponsored funds: for the benefit of employees of the sponsoring entity;
 - industry funds: for employees under a common industrial award or working in the industry;
 - public sector funds: for the benefit of government employees; and
 - small APRA funds: funds with fewer than five members which are regulated by APRA.

¹ The average balance of superannuation funds was \$63 000 per household across all households in 2003–04. Nearly 75 per cent of households have some superannuation assets. See Australian Bureau of Statistics, April 2006, *Household Wealth And Wealth Distribution, Australia*, 2003–04, p. 3.

² Australian Prudential Regulation Authority, *Statistics – Quarterly Superannuation Performance*, June 2006, p. 5.

³ A complying superannuation fund is defined under section 42 of the *Superannuation Industry (Supervision) Act 1993*. Complying superannuation funds are taxed under the *Income Tax Assessment Act 1936* Part IX.

(b) regulated by the Australian Taxation Office (Tax Office):

- self managed superannuation funds (SMSFs).

5. As at 30 June 2006, the Tax Office was responsible for the supervision of some 320 000 SMSFs (approximately 98 per cent of all complying superannuation funds)⁴, comprising 616 000 members⁵ (approximately 2 per cent of all superannuation member accounts⁶). Approximately one quarter (or \$209.9 billion)⁷ of all superannuation savings was invested through SMSFs. In addition, an estimated \$3.95 billion in tax concessions were made available to SMSFs in the 2005–06 financial year.⁸

6. SMSFs, or do-it-yourself funds, by statutory definition are superannuation funds:

- with **fewer than five members** (all of whom are trustees⁹);
- where **no trustee of the fund receives remuneration** from the fund or any persons for duties or services performed by the trustee in relation to the fund; and
- where **no member is an employee of another member** (unless that member is a relative).

Objective and scope

7. This is the first of two audit reports concerning the Tax Office's administration of SMSFs pursuant to the provisions of the *Superannuation Industry (Supervision) Act 1993*.

8. This audit report examines the efficiency and effectiveness of the Tax Office's approach to regulating and registering self managed superannuation funds. Specifically the ANAO examined the:

- environment in which SMSFs operate, including the Tax Office's regulatory roles and responsibilities;
- Tax Office's governance of its SMSF regulatory role; and

⁴ Australian Prudential Regulation Authority, op. cit. p. 7

⁵ Commissioner of Taxation, *Annual Report 2005–06*, p. 180

⁶ As at 30 June 2006 there were some 28.9 million superannuation member accounts in Australia.

⁷ Australian Prudential Regulation Authority, loc. cit. p. 7. This figure is discussed further in Chapter 3.

⁸ Tax Office data from its Revenue Analysis Branch.

⁹ Unless, for example, the member is subject to a legal disability (subsection 17A(3) of the *S/SA*).

- systems, processes and controls the Tax Office uses to register SMSFs, and enforce the lodgement of fund income tax and regulatory returns.

9. The second audit report, scheduled for tabling in the first quarter of 2007–08, will examine the efficiency and effectiveness of the Tax Office’s approach to managing self managed superannuation fund compliance risks. Specifically the ANAO will examine the processes the Tax Office uses to:

- identify the risks relevant to SMSFs not complying with their obligations under the *SISA*, including members accessing their superannuation early;
- mitigate SMSF compliance risks; and
- wind-up funds.

Overall conclusion

10. The decision to transfer the regulation of SMSFs from APRA presented the Tax Office with a number of challenges. In 1999–2000 the Tax Office inherited responsibility for an unfamiliar regulatory role covering a sector of the superannuation industry that was at the time suspected of having high levels of non-compliance. The SMSF sector consisted of approximately 187 000 funds, which were growing at a rate of 470 funds each week, but which had not received close supervision by their previous regulators.

11. In addition, the Tax Office was given the responsibility for administering SMSFs when it was implementing *A New Tax System*, and was asked to absorb a large proportion of the costs applicable to regulating SMSFs.

12. Overall, the ANAO concluded the Tax Office’s initial approach to regulating and registering SMSFs could have been more efficient and effective. In particular, the Tax Office could have taken steps to clarify its role and responsibilities earlier, managed its funding, costs and revenue (levy) collections more effectively, and, improved the collection and assessment of registration data, and fund income tax and regulatory return data, prior to issuing SMSFs with complying fund status. In this context, it is important that members and potential members understand the limited extent of the Tax Office’s prudential supervision of SMSFs.

13. The ANAO recognises that, since 2003–04, the Tax Office has initiated significant steps to resolve deficiencies with the administrative and costing systems that support its regulation and registration of SMSFs. The Tax Office intends to make further changes to its SMSF management practices in

implementing the *Simplification Superannuation* reforms. Further, the Tax Office is in the process of developing a new publication which will assist to clarify its role and responsibilities for the public.

14. The introduction of the *Simplification Superannuation* reforms may further increase the attractiveness of SMSFs as a retirement savings vehicle, resulting in a continuing need for the Tax Office to focus its attention on SMSF intelligence gathering and data deficiencies if it is to effectively carry out its responsibilities under the *SISA*.

Key findings

Background and context (Chapter 1)

15. There are two principal legislative instruments that define the obligations of superannuation fund trustees. These are the: *SISA* and Superannuation Industry (Supervision) Regulations 1994 (SIS Regulations).¹⁰

16. Three Australian Government agencies are responsible for administering the *SISA* and the SIS Regulations: the APRA, the Australian Securities and Investment Commission (ASIC) and the Tax Office. To provide assurance the superannuation industry is properly regulated it is important that there is effective coordination between the three regulators.

17. The role of the Tax Office in regulating SMSFs is determined by both general requirements applicable to all superannuation funds and specific SMSF requirements as set out in the *SISA* and the SIS Regulations.¹¹

Growth in self managed superannuation funds.

18. Since 1999–2000, the number and value of SMSFs has increased considerably. From 2000–01 to 2005–06, the number of SMSFs increased by some 109 000 (a 52 per cent increase). Over the same period, the value of SMSF assets was estimated to have increased by approximately \$132 billion (a 169 per cent increase).

¹⁰ SMSFs must also comply with general trust law, as well as legislation such as State and Territory Trustee Acts, the *Corporations Act 2001*, the Income Tax Assessment Acts, the Surcharge Acts, the Superannuation Guarantee Acts and the *Family Law Act 1975*.

¹¹ Section 6 of the *SISA* specifies which provisions of the *SISA* are relevant to each regulator. There are a number of provisions of the *SISA* that are common to some or all of the regulators.

Recent developments in the administration of self managed superannuation funds

19. The Government has recently initiated significant changes that will assist the Tax Office to administer SMSFs and to simplify applicable administrative functions for SMSF trustees. On 15 March 2007, the *Tax Laws Amendment (Simplified Superannuation) Act* and related legislation received Royal Assent. Changes introduced by the amending legislation include:

- streamlined reporting requirements;
- the introduction of a trustee declaration form to ensure that new trustees, or directors of corporate trustees, understand their duties as trustee of a SMSF;
- new administrative penalties for late returns and false statements; and
- increases in the superannuation supervisory levy from \$45 to \$150 to recover the Tax Office's regulatory costs.

20. These changes will generally apply from 1 July 2007. The Tax Office advised that some of the recommendations in this report will be satisfied by changes it is proposing to make as part of implementation of the *Simplification Superannuation* legislation.

The Tax Office's self managed superannuation fund role and responsibilities (Chapter 2)

21. To provide the Parliament and the public with assurance the Tax Office is fulfilling its role as the SMSF regulator, it is important the role of the Tax Office is defined clearly and conveyed publicly, and that the Tax Office reports the actions it undertakes to discharge its role.

22. When the Tax Office was given responsibility for regulating SMSFs in 1999–2000, the Government specified that the Tax Office was to ensure that SMSFs complied with the non-prudential requirements of the superannuation law. Following changes made to the *SISA* in 2004, the Tax Office sought legal advice to clarify whether its regulatory role encompassed any prudential supervisory responsibilities. This advice indicated that the *SISA* does not make it clear whether or not the Commissioner of Taxation has a prudential supervisory function. The Tax Office was advised that legislative amendment to the *SISA* and or SIS Regulations would assist in clarifying the Government's policy intent regarding the Tax Office's interpretation of its prudential supervisory responsibilities.

23. Subsequently, the Tax Office approached the Treasury in 2004–05 and in 2005–06 to clarify whether it had a prudential role under the *SISA*. Following consultation with the Treasury, the Tax Office determined that although there are a number of provisions of the *SISA* that have a ‘prudential flavour’, its role does not extend to reviewing or commenting on specific investment strategies prepared by SMSF trustees, or whether SMSFs are financially sound.

24. The Tax Office’s position and hence operating approach to investment strategies, is influenced by the large number of funds it regulates and as such differs to APRA’s approach. APRA considers it has a responsibility for ensuring trustees’ have properly formulated their investment strategies as set out in trustee documentation and that this can be demonstrated through practical implementation. Where an investment strategy or the investments appear to be significantly inappropriate, APRA advised it would work with trustees to ensure an appropriate strategy was formulated, and, where required, would consider legislative options under the *SISA* to ensure the situation was remedied, including disqualification of the trustees.

25. The Tax Office’s approach is, however, consistent with past Tax Office practice and the Government’s original policy intent. This intent specified that whilst SMSFs are a key vehicle in the accumulation of retirement savings, they do not require onerous prudential supervision as members should be able to protect their own interests.

26. The process the Tax Office undertook to clarify its role and responsibilities was useful in providing additional clarity regarding its regulation of SMSFs. Notwithstanding this, in order to provide legislative clarity of the Tax Office’s role and thus support the current interpretation of its prudential supervisory responsibilities, the ANAO considers the Tax Office should consult with the Treasury in due course to assess the benefits of further refining the *SISA*.

27. As noted, this sector of the superannuation industry accounts for approximately one quarter of all superannuation savings. Notwithstanding the potential impact of *Simplification Superannuation* amendments, it is important that members and potential members of SMSFs understand the limited extent of the Tax Office’s prudential supervision of these funds.

28. The Tax Office advised that it is in the process of developing a new publication which will assist to clarify its role and responsibilities for the public. The ANAO considers that over time the Tax Office should also enhance

its wide range of existing SMSF documentation to be consistent with the new publication.

29. The coordination between the Tax Office and the Treasury regarding the timely identification and resolution of issues relating to the interpretation and application of legislative requirements is an important element of the effective regulation of SMSFs by the Australian Government. Examples such as the extent of the Tax Office's prudential responsibilities and the treatment of instalment warrant products as legitimate SMSF investments have been identified by the Tax Office as requiring clarification by the Government.¹²

30. The ANAO acknowledges the steps taken by the Tax Office, as part of its review of SMSFs in late 2005, to resolve such issues. However, the ANAO considers, especially in regard to the treatment of instalment warrants, the Tax Office could have established its position on this issue sooner, which may have led to a more timely resolution, and minimised the potential for public uncertainty.

31. As the Tax Office's SMSF intelligence capability develops, it should have a continuing focus on risks posed by emerging investment products, especially those targeted at SMSFs. Clearly defined processes and procedures should be in place to enable the Tax Office to identify and advise the Treasury, and the Government generally on a timely basis, of key risks to the effective operation of relevant superannuation legislation. Where required, the Tax Office should develop and promulgate relevant educational material relating to products utilised by SMSFs.

Other aspects of the Tax Office governance of the self managed superannuation fund regulatory function (Chapter 3)

32. An important aspect of managing the effective allocation of the Tax Office's finite SMSF regulatory resources is to identify which administrative functions are required and, given all SMSFs pay a supervisory levy which is intended to recover the Tax Office's costs, to cost these functions appropriately. The Tax Office did not have adequate systems in place between 1999–2000 and 2002–03 to record budgets or actual expenditure for SMSF regulation. It has significantly changed the methodology it uses to determine its expenditure and develop its budgets from 2003–04 to 2005–06.

¹² An instalment warrant is a derivative based product where investors are able to purchase assets in two payments: one payment upfront, generally representing 50 percent of the purchase price and one payment during the end of a defined period which includes interest and fee costs.

33. A key aspect of funding the regulation of the superannuation industry is that the costs of regulation should be borne by those who benefit from it.¹³ In the case of SMSFs, the costs should be borne by the funds' trustees. Through the *Superannuation (Self Managed Superannuation Fund) Supervisory Levy Imposition Act 1991*, a \$45 levy (per fund per annum) was introduced, to cover the Tax Office's regulatory costs.

34. However, since the levy was introduced in 1999–2000, there are a number of indicators that the levy has not been operating on a cost recovery basis. Specifically, the expenditure on SMSF regulatory activities has never been commensurate with levy revenue; the levy is not tied to the Tax Office's funding base; the Tax Office has not complied with reporting requirements set out in the *Australian Government Cost Recovery Guidelines* for cost recovered revenues; the absence of an effective cost allocation system has inhibited the Tax Office's capacity to accurately determine its regulatory costs; and, the levy rate (\$45) has not been adjusted despite changes in the cost of regulation.

35. On 5 September 2006, the Government announced the levy rate will be increased to \$150 per fund per annum to cover the increased costs of SMSF regulation. The explanatory memorandum to the *Simplification Superannuation* legislation confirms the revised levy is to recover costs. The ANAO considers that, for the Tax Office to fulfil its obligations, it should undertake steps to; determine if the levy will operate on a partial or full cost recovery basis and develop arrangements with the Treasury to regularly review the levy rate; develop and implement procedures to collect un-remitted levy payments from SMSF trustees; and report publicly on the cost of SMSF regulation and the revenue collected through the levy.

36. The ANAO examined the Tax Office's interaction with other superannuation regulators. On the whole, the Tax Office's relationship with the other regulators appears to be working well. The ANAO noted the Memorandum of Understanding between the Tax Office and APRA had lapsed in 2003 and was only updated in May 2007.

37. Since the introduction of SMSFs, the Tax Office has worked to foster a constructive relationship with the superannuation industry and other

¹³ For discussion about the funding of regulatory services see S.Wallis, March 1997, *Financial System Inquiry Final Report*, p.532.

stakeholders. Based on the interviews with SMSF stakeholders¹⁴, the ANAO considers that, overall, the Tax Office's relationship with these stakeholders is sound.

38. Important elements of robust governance are effective corporate and business planning, risk management and reporting processes which provide assurance that all corporate objectives and planning documentation are aligned and mutually supportive.

39. The Tax Office's business planning, risk management and reporting processes generally are sound. However, the ANAO considers that the Tax Office needs to improve the quality of the SMSF data collected from its systems to ensure business decision making processes are robust. The Tax Office advised it is in the process of improving the quality of the data, and the intelligence it derives from that data.

40. There are large numbers of SMSF trustees that do not lodge their fund income tax and regulatory returns on time, or at all.¹⁵ For this reason, the Tax Office derives an estimate of SMSF assets using return forms that have been lodged. The ANAO considers the reliability of the Tax Office methodology for estimating SMSF assets could be improved by incorporating 'inactive funds' information currently recorded on other Tax Office systems and by comparing original estimates with actual lodgement data when this becomes available.

41. The Tax Office advised it is introducing a lodgement program in 2007-08 which aims to improve the lodgement time of fund income tax and regulatory returns from 70 to 94 per cent within 6 months of the due date. If effective, this initiative should also improve the quality of SMSF statistical information released publicly.

Registering self managed superannuation funds and issuing notices of compliance (Chapter 4)

42. For a fund to be a complying fund the *SISA* states that two distinct events must occur. First, a fund must elect to be a *regulated fund*¹⁶ within

¹⁴ The ANAO spoke to the following organisations during the audit: Institute of Chartered Accountants Australia (ICAA), CPA Australia Ltd; National Tax and Accountants' Association Ltd. (NTAA); Association of Superannuation Funds of Australia Ltd. (ASFA); Investment and Financial Services Association (IFSA); Australian Association of Independent Retirees (AIR); Self Managed Super Fund Professionals Association (SPAA).

¹⁵ In the 2004–05 year, approximately 30 per cent of SMSFs did not lodge their income tax and regulatory return on time. Approximately eight per cent of SMSFs have never lodged a return.

¹⁶ Paragraph 42(1AA) of the *SISA*.

60 days after establishment through lodgement of an approved registration form with the Tax Office. Second, the Tax Office must issue a *notice of compliance*¹⁷, to notify fund trustees their fund is a *complying superannuation fund*.¹⁸ Without these two events occurring, a fund is not entitled to tax concessions¹⁹ and any superannuation contributions made to the fund by an employer may be subject to additional charges.

43. The ANAO's analysis of SMSF data indicates that a small but consistent proportion of SMSFs registered by the Tax Office do not appear to have met some basic *SISA* requirements such as the number of members allowed in a SMSF, that there are assets (of at least \$1) set aside for the benefit of members and that the SMSF reasonably complies with the *SISA* requirement to lodge a registration form within 60 days of establishment.

44. Since January 2004, the Tax Office has been analysing information contained on superannuation fund registration forms to determine whether new funds comply with their registration requirements. At the time of the audit, the Tax Office compiled and analysed this information on an industry-wide level, but did not use it to assess whether individual funds are complying with the *SISA* requirements in making a decision on whether to 'register' the fund.

45. The current Tax Office approach to issuing notices of compliance, coupled with indicative high-levels of non-compliance by SMSF trustees, does not provide adequate assurance that SMSFs are fully complying with the *SISA* requirements when issued with notices of compliance by the Tax Office.

46. The ANAO recognises the Tax Office must use a risk-based approach to identify potentially non-complying funds, as it is not efficient or effective to examine all new fund returns to determine whether they should receive notices of compliance. However, to enhance its SMSF compliance assessment process, the Tax Office could better utilise intelligence obtained at the point of registration to assess individual SMSF compliance with their *SISA* responsibilities prior to issuing the notice of compliance up to 18 months after initial registration.

47. Similarly, under the *SISA* it is illegal for a disqualified person to knowingly act as a trustee of a SMSF (or any other fund). To date, the Tax

¹⁷ Sections 40 and 41 of the *SISA*.

¹⁸ This occurs after the registered SMSF has lodged its first fund income tax and regulatory return.

¹⁹ Tax concessions are received under subsection 26(1) of the *Income Tax Rates Act 1986*.

Office, ASIC and APRA do not have a central register of all disqualified persons. Such a register would, ideally, complement recent changes to the SMSF registration form and minimise the likelihood that disqualified persons can act as SMSF trustees.

48. The Register of Complying Superannuation Funds (RoCS) is a publicly available list of complying funds. RoCS is an important control mechanism to provide increased levels of assurance that transfers of superannuation assets and contributions are only made to complying superannuation funds.

49. The Tax Office advised, during the audit, that it had commenced work to implement a number of changes to improve the operation of RoCS including: allowing the public real-time access to RoCS information; increasing the amount of information contained on RoCS including the type of fund registered and whether funds have received a notice of compliance; and improving the RoCS search engine capability.

Recommendations

50. The ANAO made six recommendations aimed at improving the Tax Office's approach to regulating and registering SMSFs. The Tax Office agreed to all of the six recommendations made.

Summary of Tax Office's response

51. The Tax Office welcomes this review and considers the report is supportive of the Tax Office's overall direction in enhancing its administration of SMSFs.

52. It is pleased that the ANAO report concluded that the Tax Office has initiated significant improvements to the administrative and costing systems that support its regulation and registration of SMSFs; as well as noting the further changes to SMSF management practices in implementing the simpler super reforms.

53. The Tax Office agrees with the six recommendations contained in the report. It is already making progress to address some of the recommendations but notes that some will take time to complete given the need to implement and bed down the simpler super measure and the redevelopment of the Tax Office's business system.

54. The Tax Office's full response is at Appendix 1.

Recommendations

Recommendation No.1

Para 2.67

To provide assurance that risks to the operation of self managed superannuation fund (SMSF) policy and legislation are identified in a timely way, the ANAO recommends that the Tax Office:

- monitors information and intelligence collected in relation to investment products targeted at SMSFs; and
- clearly defines the review processes and procedures which will ensure it is able to establish its position on a timely basis, and if necessary, to advise the Department of the Treasury of risks to the effective operation of relevant superannuation legislation.

ATO response: Agreed

Recommendation No.2

Para 3.26

To improve its accountability for the regulatory services it provides to self managed superannuation funds (SMSFs), and to comply with the Australian Government's Cost Recovery Guidelines, the ANAO recommends that the Tax Office:

- in consultation with the Department of the Treasury, clarify the extent to which the Superannuation (Self Managed Superannuation Fund) Supervisory Levy recovers the costs of regulating SMSFs;
- periodically reviews the levy rate to accurately reflect Tax Office regulatory costs covered by the levy in accordance with the Australian Government Cost Recovery Guidelines;
- examines the costs and benefits of developing information systems which distinguish levy revenue from other tax revenue;
- develops and implements procedures to identify and collect levy payments that are not remitted; and
- publicly report on the amount of annual levy revenue collected and the Tax Office's cost of administering SMSFs, in accordance with the disclosure requirements under the Government's Cost Recovery Policy.

ATO response: Agreed

**Recommendation
No.3**

Para 3.54

To improve the quality of Tax Office planning, risk management and reporting relating to self managed superannuation funds (SMSFs), the ANAO recommends the Tax Office improves the underlying data by:

- reviewing SMSF data to determine its accuracy and completeness; and
- examining the costs and benefits of developing systems, processes and controls to detect and rectify anomalous data at the time it is entered into Tax Office systems.

ATO response: Agreed

**Recommendation
No.4**

Para 3.62

To provide more accurate self managed superannuation funds (SMSFs) asset information to Government and the public, the ANAO recommends that the Tax Office:

- incorporate information on 'inactive' SMSFs in its SMSF asset estimation model;
- re- evaluate the number of active SMSFs after the 2007–08 Lodgement Program; and
- regularly reconcile SMSF asset estimates with actual lodgement data to improve the accuracy of its estimating methodology.

ATO response: Agreed

**Recommendation
No.5**

Para 4.40

To provide increased assurance that the Tax Office identifies SMSFs that do not comply with their *Superannuation Industry (Supervision) Act 1993* requirements, and prevents those funds from receiving complying status, the ANAO recommends that the Tax Office:

- utilises the intelligence obtained from the SMSF registration process to more accurately assess SMSF compliance prior to issuing notices of compliance; and
- develop and implement a risk-based methodology to assess SMSF compliance with their obligations prior to issuing notices of compliance.

ATO response: Agreed

**Recommendation
No.6**

Para 4.51

The ANAO recommends that the Tax Office consult with the Australian Prudential Regulation Authority, and the Australian Security and Investments Commission to assess the benefits in developing a central register of persons who have been disqualified to act as superannuation fund trustees.

ATO response: Agreed

Audit Findings and Conclusions

1. Introduction

This Chapter provides the background to the audit, presents contextual information relevant to the Tax Office's administration of self managed superannuation funds, and outlines the audit's objective and methodology.

Background

Superannuation

1.1 Superannuation is a long-term vehicle for building retirement savings, and is a key element of the Government's policies to address the financial independence of Australia's ageing population. The objective of Australia's superannuation system is:

...to assist and encourage people to achieve a higher standard of living in their retirement than would be possible from the age pension alone, to ensure Australians have security and dignity in their retirement.²⁰

1.2 Superannuation is the largest financial asset of Australian households.²¹ The level of superannuation savings has grown by 76 per cent over the last 5 years to \$913.9 billion as at 30 June 2006.²² This significant increase in savings has been underpinned by concessional tax treatment, including a tax rate of 15 per cent on the income of complying superannuation funds.²³ The projected tax concessions applicable to superannuation were \$15.9 billion in 2005–06, representing the Australian Government's largest reported single tax expenditure in that year.²⁴

1.3 For taxation purposes, superannuation funds are defined in the *Superannuation Industry (Supervision) Act 1993 (SISA)* to include schemes which are for the payment of superannuation benefits upon retirement or death.

1.4 Superannuation funds are broadly categorised into those:

²⁰ Explanatory Memorandum to the Tax Laws Amendment (Simplified Superannuation) Bill 2006, p.186.

²¹ The average balance of superannuation funds was \$63 000 per household across all households in 2003–04. Nearly 75 per cent of households have some superannuation assets. See Australian Bureau of Statistics, April 2006, *Household Wealth And Wealth Distribution, Australia, 2003–04*, p. 3.

²² Australian Prudential Regulation Authority, *Statistics – Quarterly Superannuation Performance*, June 2006, p. 5.

²³ A complying superannuation fund is defined under section 42 of the *Superannuation Industry (Supervision) Act 1993*. Complying superannuation funds are taxed under the *Income Tax Assessment Act 1936* Part IX.

²⁴ Department of the Treasury, 2005, *Tax Expenditures Statement 2005*, p. 8.

- (a) regulated by the Australian Prudential Regulation Authority (APRA):
- retail or public offer funds: offering products to the public generally;
 - corporate or employer-sponsored funds: for the benefit of employees of the sponsoring entity;
 - industry funds: for employees under a common industrial award or working in the industry;
 - public sector funds: for the benefit of government employees; and
 - small APRA funds: funds with fewer than five members which are regulated by APRA.
- (b) regulated by the Tax Office:
- self managed superannuation funds (SMSFs).

SMSFs

1.5 The regulation of SMSFs is a large and complex area of superannuation administration. As at 30 June 2006, the Tax Office was responsible for the supervision of some 320 000 SMSFs (98 per cent of all complying superannuation funds), comprising 616 000 members²⁵ (approximately 2 per cent of all superannuation member accounts²⁶). Approximately one quarter (or \$209.9 billion) of all superannuation savings was invested through SMSFs. In addition, an estimated \$3.95 billion in tax concessions were made available to SMSFs in the 2005–06 financial year.

1.6 Further information on the changes in the number and values of SMSFs is shown in Figure 1.2.

1.7 To establish a SMSF, fund trustees must comply with a wide range of provisions specified in superannuation legislation.²⁷ In simple terms SMSFs, or do-it-yourself funds, are generally superannuation funds:

- with **fewer than five members** (all of whom are trustees²⁸);

²⁵ Commissioner of Taxation, *Annual Report 2005–06*, p. 180.

²⁶ As at 30 June 2006 there were some 28.9 million superannuation member accounts in Australia.

²⁷ A more detailed description of the relevant provisions of the superannuation legislation is provided at Appendix 1.

²⁸ Unless, for example, the member is subject to a legal disability (subsection 17A(3) of the *S/SA*).

- where **no trustee of the fund receives remuneration** from the fund or any persons for duties or services performed by the trustee in relation to the fund; and
- where **no member is an employee of another member** (unless that member is a relative).

1.8 Although there is a large body of legislation that is relevant to SMSFs, there are two principal legislative instruments that define the obligations of SMSF trustees, and the regulatory role of the Tax Office. These are:

- the *SISA*; and
- Superannuation Industry (Supervision) Regulations 1994 (SIS Regulations).

1.9 Aspects of the Tax Office's regulatory responsibilities as defined by this legislation are discussed in Chapter 2.

1.10 SMSFs must also comply with general trust law, as well as legislation such as State and Territory Trustee Acts, the *Corporations Act 2001*, the Income Tax Assessment Acts, the Surcharge Acts, the Superannuation Guarantee Acts and the *Family Law Act 1975*. Although the ANAO was cognizant of SMSF responsibilities under these Acts, they were not examined in detail as part of this audit.

The SMSF regulatory framework

1.11 SMSFs were introduced on 8 October 1999²⁹, following a Government inquiry into the Australian financial services industry (the *Wallis Inquiry*). Although elements of the *Wallis Inquiry's* findings were not accepted in full by Government, the inquiry's findings provide useful insight into the current superannuation regulatory framework, and the role and function of the Tax Office within that framework.³⁰

²⁹ Australian Government, *Budget Paper No.2 1998–1999*, at 1–107: Attachment D. The budget measure was implemented pursuant to the *Superannuation Amendment Act (No.3) 1999*, Attachment E.

³⁰ A summary of the *Wallis Inquiry's* findings is included in Appendix 2.

1.12 A key outcome of the *Wallis Inquiry* was that a new category of small funds, SMSFs, be established and their regulation be transferred from APRA to the Tax Office.³¹ The inquiry provided a number of reasons why the Tax Office was the most appropriate agency to manage SMSFs. These were that it:

- already had responsibility for ensuring taxation rules were met;
- had the resources and powers appropriate for this kind of regulation; and
- would have a less onerous regulatory role than other comparable regulators (for example APRA), as it should not have a 'prudential' regulatory role.³²

1.13 The Tax Office's responsibility for SMSFs was part of broader and more significant regulatory change for the superannuation industry. Specifically, the Government established a tripartite framework to regulate distinct aspects of the superannuation industry, comprising APRA, the Australian Securities and Investment Commission (ASIC) and the Tax Office. This framework is shown in Figure 1.1.

³¹ The recommendations of the *Wallis Inquiry* were used as a basis for drafting the *Superannuation Legislation Amendment Act (No.3) 1999*. This Act introduced SMSFs and specified the Tax Office as regulator.

³² S. Wallis, March 1997, *Financial System Inquiry Final Report*, pp. 333–334.

Figure 1.1**Tripartite superannuation regulatory framework**

Source: ANAO representation of regulators' roles and responsibilities.

1.14 An important factor to provide assurance the superannuation industry (including SMSFs) is regulated well is the effective coordination between the three regulators. Effective coordination between the regulators is important, as:

- the three regulators are responsible for administering the same legislation (the *SISA* and *SIS* Regulations). It is therefore important the regulators work closely to ensure that this legislation is interpreted and applied consistently (where applicable³³); and

³³ Section 6 of the *SISA* specifies which provisions of the *SISA* are relevant to each regulator. There are a number of provisions of the *SISA* that are common to some or all of the regulators.

- superannuation legislation is regularly reviewed and amended and often impacts on the attractiveness of certain superannuation fund arrangements. Examples of this include the introduction of Superannuation Choice; APRA licensing regime and more recently the *Simplification Superannuation* laws.

1.15 The ANAO conducted interviews with APRA and ASIC as part of the audit to examine the collaborative arrangements between these agencies and the Tax Office. These arrangements are discussed in Chapter 3.

Context

The implications of using a SMSF as a retirement savings vehicle

1.16 There are a number of reasons why it is attractive for prospective fund members to use SMSFs over other categories of superannuation investment as a retirement savings vehicle. These include:

- *Members are largely able to control their fund's investments.* Members can potentially achieve higher returns on their fund assets than professional fund managers. SMSFs also allow members to have greater control over estate planning as they are more easily able to influence the content of a fund's trust deed;
- *Fund fees.* There is a perception that SMSFs do not generally attract the fees charged by professionally managed superannuation funds. Some members perceive that they are able to minimise the costs associated with managing a SMSF. That said, there can be significant fees incurred by SMSFs as discussed in paragraph 1.17; and
- *Exemptions to invest in certain types of assets unavailable to other funds.*³⁴ For example, business real property and leases between the fund and a related party (involving business real property). There are also other exemptions for SMSFs to invest in companies and unit trusts that meet specific conditions prescribed by the SIS Regulations.

1.17 However, there are also a number of factors that fund members should consider carefully before they select a SMSF as their retirement savings vehicle. These include:

³⁴ The ANAO notes that these exemptions also apply to APRA regulated funds with less than five members.

- *Trustee investment experience.* Trustees of a SMSF generally require time and experience to make sound investment decisions to minimise the risk of poor returns;
- *SMSF members do not have access to the Superannuation Complaints Tribunal (SCT).* The SCT is an independent tribunal set up to provide a conciliatory forum for members of other superannuation funds;
- *SMSF members are not eligible for compensation for losses arising from fraudulent conduct or theft (as specified under Part 23 of the SISA);*
- *Significant penalties may apply if a fund is found to be non-complying.* If the Tax Office finds that a SMSF has not been complying with its obligations under the SISA, the Commissioner of Taxation has the discretion to tax at 45 per cent, the fund's total assets and any income in the year the fund is found to be non-complying;³⁵
- *Members/trustees may be jointly liable for actions of other members/trustees; and*
- *SMSFs are generally only cost effective for fund members with sufficient resources invested in the fund.*³⁶ To be an effective retirement savings vehicle, a SMSF should have sufficient resources to save for retirement. This includes having enough resources to cover the administrative costs of the fund, and minimise the risk of poor returns through the effective diversification of fund assets. Tax Office data indicates the annual cost of running a SMSF can range between \$1 500 and \$12 000.

1.18 The Tax Office, other regulators, and key superannuation stakeholders³⁷ have provided education information to fund members on the advantages and disadvantages of using SMSFs as a retirement savings vehicle.

Current SMSF environment

1.19 To obtain an understanding of the current SMSF environment, the ANAO assessed the data relating to SMSFs contained on Tax Office systems. Although some of the data quality was poor, overall the data was reliable

³⁵ Section 288A *Income Tax Assessment Act 1936*.

³⁶ The amount of fund assets required for a fund to be viable is discussed further in Chapter 2.

³⁷ These industry stakeholders are discussed in paragraph 1.33.

enough to undertake trend analysis. Figure 1.2 highlights some of the challenges faced by the Tax Office regarding its administration of SMSFs.³⁸

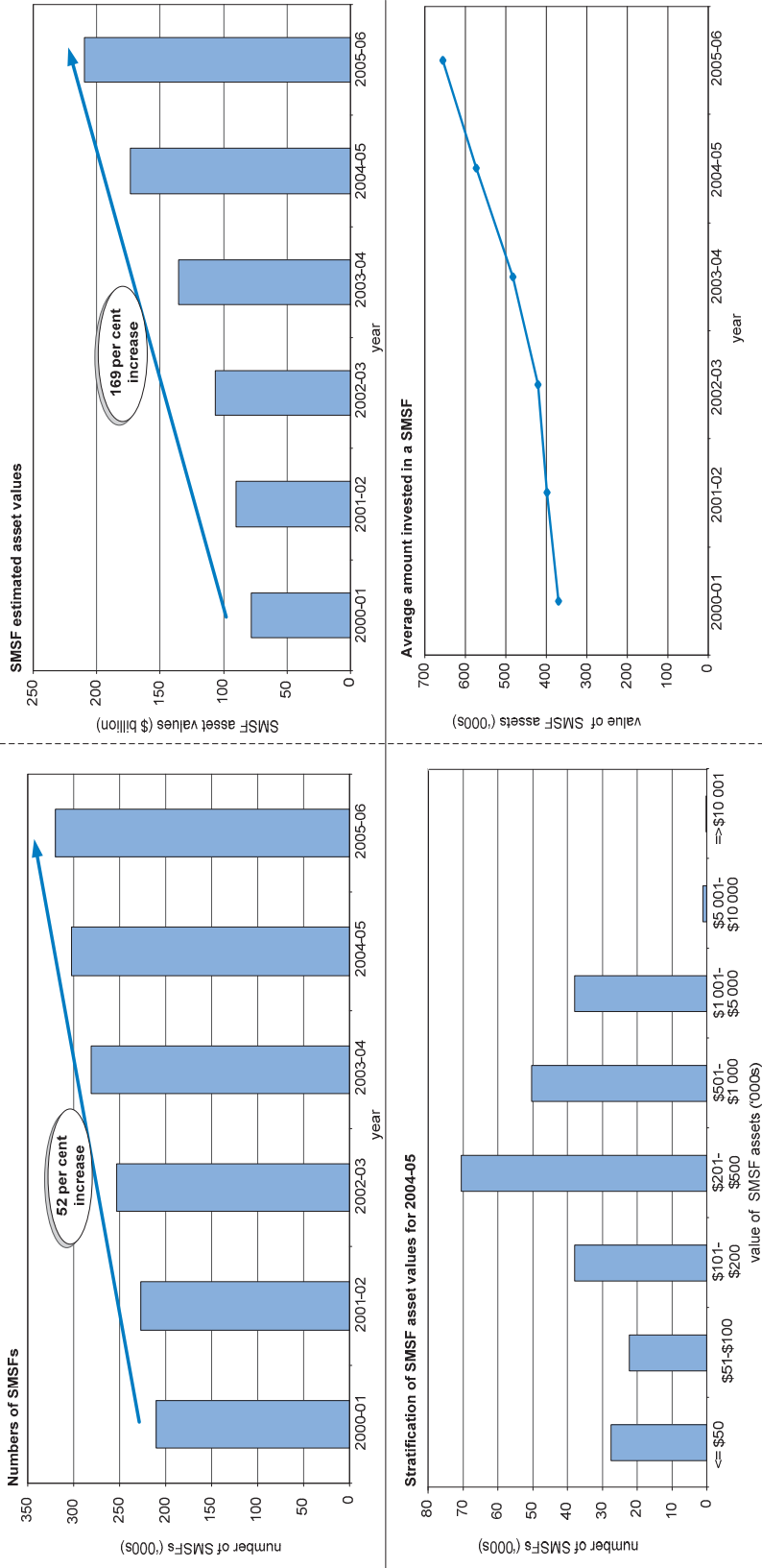
1.20 As shown in Figure 1.2, there are a number of interesting trends in relation to SMSF numbers and the amount invested in SMSFs. In particular:

- the number of SMSFs increased by some 109 000 between 2000–01 and 2005–06 (a 52 per cent increase);
- the total amount invested in SMSF assets increased by 169 per cent between 2000–01 and 2005–06 (or \$132 billion);
- there are approximately 87 500 SMSFs (or 35 per cent of all lodging SMSFs) that have less than \$200 000 of fund assets. ASIC consider that, as a guide, the minimum investment for a SMSF to be cost effective is \$200 000; and
- the average amount invested has increased by 77 per cent (from \$370 000 to \$656 000).

³⁸ The ANAO examined Tax Office data as at 16 August 2006. The amounts included in Figure 1.2 will not reconcile with information included in external publications such as APRA statistics, which derive SMSF asset balances using an estimation methodology. This methodology is examined further from paragraph 3.56.

Figure 1.2

Self managed superannuation fund industry overview



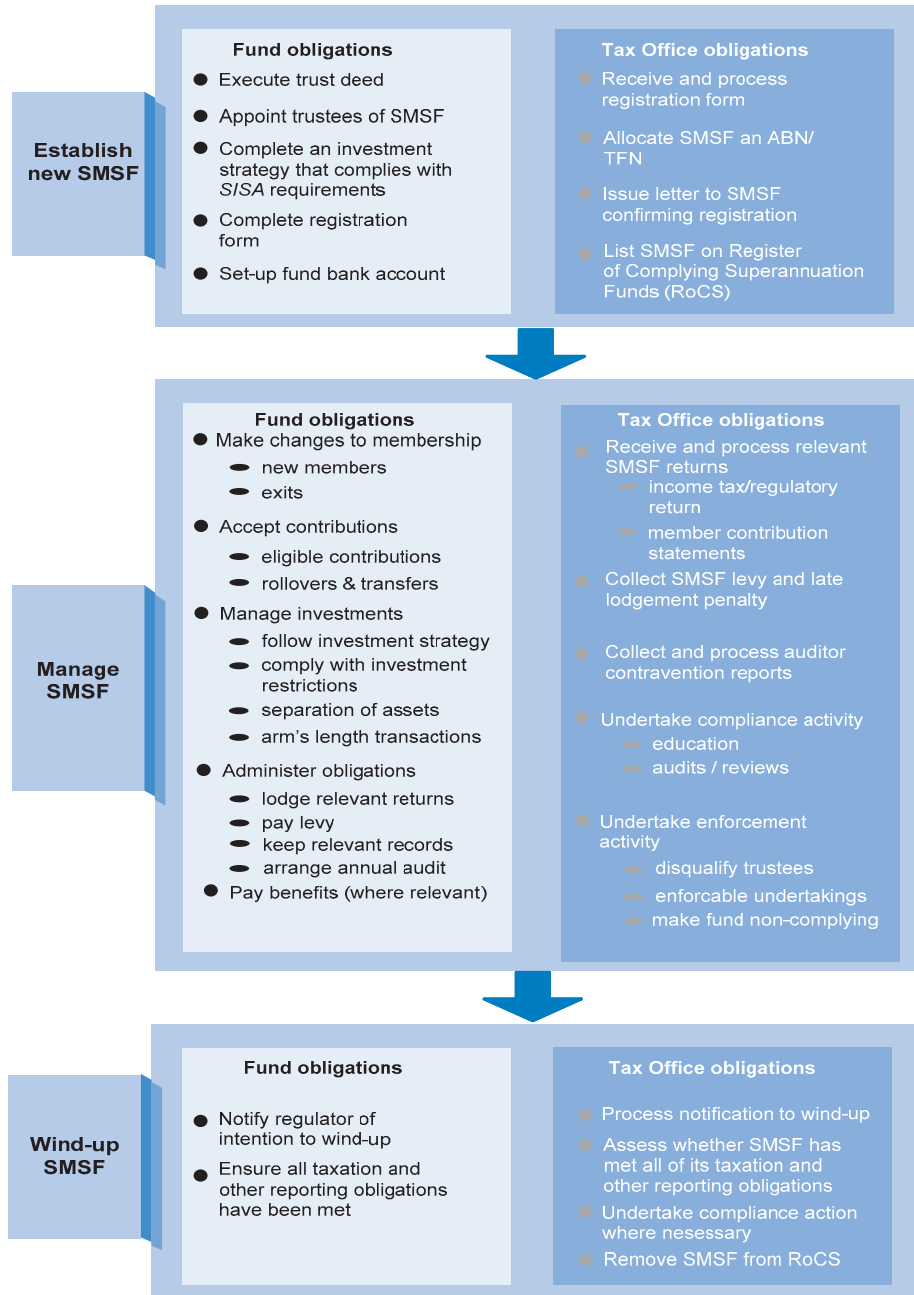
Source: ANAO analysis of Tax Office information.

The current administration of SMSFs

1.21 To provide a level of assurance that SMSFs comply with the *SISA* and SIS Regulations, both the Tax Office and SMSF trustees must complete a range of administrative activities and functions. A broad overview of these activities and functions is shown in Figure 1.3.

Figure 1.3

Tax Office and fund trustees obligations for SMSFs



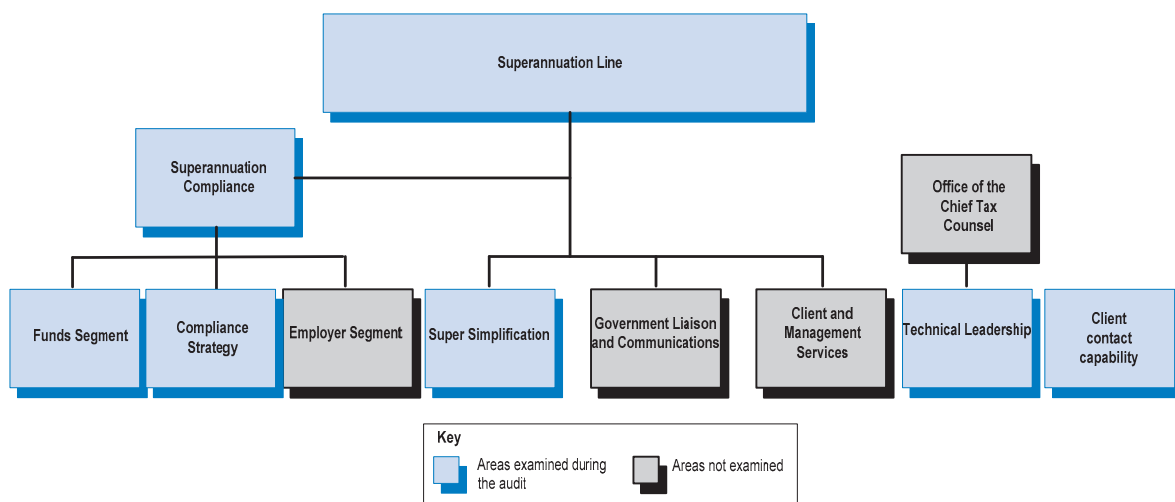
Source: ANAO representation of Tax Office information.

1.22 As discussed in paragraph 1.12, the Tax Office leveraged off its existing resources to fulfil its role as the regulator of SMSFs. Whilst there are a

number of areas within the Tax Office that contribute to the administration of SMSFs, the Tax Office's Superannuation Line is the main area responsible for administering SMSFs. The Superannuation Line has a wide range of superannuation administrative functions, from the Superannuation Guarantee through to managing the introduction of the Government's Simplified Superannuation policy. Figure 1.4 is an abridged Superannuation Line structure showing the areas examined during the audit.

Figure 1.4

Abridged Superannuation Line structure



Source: ANAO interpretation of Tax Office information

1.23 The management of SMSFs is spread across a number of areas within the Superannuation Line, which employed approximately 959 staff in 2005–06. Some 292 Full Time Equivalent (FTE) staff worked in areas relevant to SMSFs in 2005–06.

1.24 Other Tax Office Business Lines are also responsible for activities linked to SMSF administration. For example, the Tax Office's Operations Line is responsible for the processing of fund income tax and regulatory returns. To coordinate the various areas of the Tax Office responsible for aspects of superannuation administration, the Superannuation Line established a Superannuation Product Committee to oversee the management of all superannuation products (including SMSFs). Membership comprises all Tax Office Business Lines that deal with superannuation issues.

1.25 While the ANAO briefly examined the functions undertaken by other Lines in the Tax Office, the audit focused predominantly on areas within the Superannuation Line as shown in Figure 1.4.

Recent developments in the administration of SMSFs

1.26 As part of a series of ongoing reforms to simplify and streamline the Superannuation system, the Government has recently initiated significant changes that will assist the Tax Office to administer SMSFs and to simplify applicable administrative functions for SMSF trustees. On the 15 March 2007, the *Tax Laws Amendment (Simplified Superannuation) Act 2007* and related legislation received Royal Assent. Changes introduced by the amending legislation include:

- streamlined reporting requirements;
- the introduction of a trustee declaration form to ensure that new trustees, or directors of corporate trustees, understand their duties as trustee of a SMSF;
- new administrative penalties for late returns and false statements; and
- increases in the superannuation supervisory levy from \$45 to \$150 to recover the Tax Office's regulatory costs.

1.27 These changes will generally apply from 1 July 2007. The Tax Office advised that some of the recommendations in this Report will be satisfied by changes it is proposing to make as part of implementation of the *Simplification Superannuation* legislation.

Audit objective and methodology

Audit objective

1.28 This is the first of two audit reports concerning the Tax Office's administration of SMSFs pursuant to the provisions of the *Superannuation Industry (Supervision) Act 1993*.

1.29 This audit report examines the efficiency and effectiveness of the Tax Office's approach to regulating and registering SMSFs. Specifically the ANAO examined the:

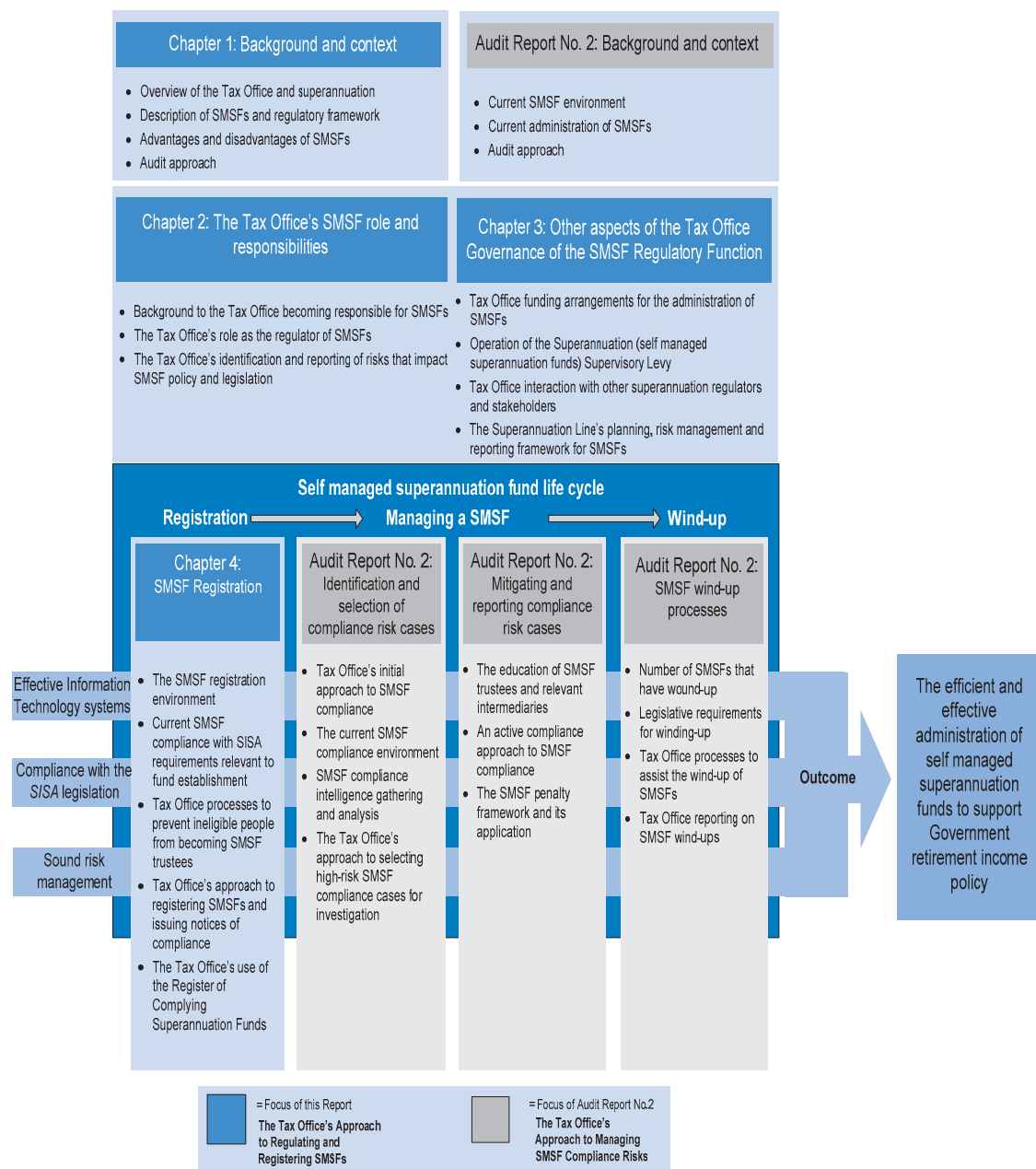
- environment in which SMSFs operate, including the Tax Office's regulatory roles and responsibilities;

- Tax Office's governance of its SMSF regulatory role; and
- systems, processes and controls the Tax Office uses to register SMSFs, and enforce the lodgement of fund income tax and regulatory returns.

1.30 The second audit report, scheduled for tabling in the first quarter of 2007–08, will examine the efficiency and effectiveness of the Tax Office's approach to managing SMSF compliance risks. Specifically, the ANAO will examine the process the Tax Office uses to:

- identify the risks relevant to SMSFs not complying with their obligations under the *SISA*, including members accessing their superannuation early;
- mitigate SMSF compliance risks; and
- wind-up funds.

1.31 Figure 1.5 shows the structure of the audit, including the areas covered in each report.

Figure 1.5**Structure of the audit and areas covered in each report**Source: ANAO³⁹³⁹ The Report No.2 structure is indicative and dependant on the finalisation of the audit.

Audit methodology

1.32 The majority of the audit fieldwork for this audit was conducted from June 2006 to September 2006. In addition to the review of relevant superannuation documentation, the ANAO undertook qualitative and quantitative analysis of the data contained on a range of Tax Office superannuation systems that are used to administer SMSFs. Interviews with key Tax Office staff from the Superannuation and Operations Lines were also conducted.

1.33 Interviews were held with stakeholders from the superannuation industry⁴⁰, representatives from the accounting professional bodies⁴¹, and relevant Australian Government organisations⁴² on aspects of the Tax Office's administration of SMSFs. Stakeholder views are discussed in Chapter 3.

1.34 We also undertook a review of the processes and controls applicable to the management of SMSFs. This involved a review of relevant systems documentation, change control and systems testing procedures.

1.35 The audit was conducted in accordance with auditing standards at a cost to the ANAO of approximately \$346 000.

Other relevant ANAO reports

1.36 This audit is the third in a series of audit reports into the Tax Office's administration of relevant aspects of the Australian superannuation system. The other audits are:

- Audit Report No.17, 2005–06, *Administration of the Superannuation Lost Members Register*; and
- Audit Report No.39, 2004–05, *The Australian Taxation Office's Administration of the Superannuation Contributions Surcharge*.

1.37 The ANAO has also examined APRA's regulation of superannuation funds as part of Audit Report No.6, 2003–04, *APRA's Prudential Supervision of Superannuation Entities*.

⁴⁰ National Tax and Accountants' Association Ltd. (NTAA); Association of Superannuation Funds of Australia Ltd. (ASFA); Investment and Financial Services Association (IFSA); Australian Association of Independent Retirees (AIR); Self Managed Super Fund Professionals Association (SPAA).

⁴¹ Institute of Chartered Accountants Australia (ICAA) and CPA Australia Ltd.

⁴² APRA, ASIC and the Treasury.

Acknowledgements

1.38 The ANAO recognises and appreciates the contribution of Tax Office staff, superannuation industry representatives, accounting professional organisations, and the Australian Government organisations, who assisted in the conduct of this audit.

2. Tax Office Self Managed Superannuation Fund Role and Responsibilities

This Chapter and Chapter 3 examine aspects of the Tax Office's SMSF governance framework. In this Chapter the ANAO focuses on the Tax Office's role and responsibilities under the Superannuation Industry (Supervision) Act 1993. The ANAO also examines whether the Tax Office identifies and reports on key policy and legislative risks applicable to the effective regulation of SMSFs.

Introduction

2.1 The administration of SMSFs presents a significant challenge for the Tax Office. In addition to the Tax Office taking over the regulation of SMSFs in 1999 (which was a new, unfamiliar, role for the Tax Office at that time), it also became responsible for regulating large and growing numbers of SMSFs, which are governed by complex superannuation legislation which can be subject to differing interpretation.⁴³

2.2 Within this challenging environment, the Tax Office has continually sought additional resources to assist with its administration of SMSFs.⁴⁴ It is also reliant on the cooperation of other regulators (APRA and ASIC) and key industry stakeholders. It is therefore important the Tax Office has an effective governance framework to provide assurance that its finite resources are utilised efficiently, decisions made by the Tax Office's senior management are well informed, and it coordinates effectively with other superannuation regulators and industry stakeholders.

Governance framework

2.3 Effective public sector governance comprises a number of generally accepted principles which include: accountability, transparency, integrity, stewardship, efficiency, and leadership.⁴⁵ Effective governance also takes account of achieving results while remaining cognizant of risk. This makes risk

⁴³ See paragraphs 2.11 to 2.22 regarding the Tax Office's responsibilities for areas relating to prudential regulation.

⁴⁴ See paragraphs 3.5 to 3.8 regarding the Tax Office's financial management framework for SMSFs.

⁴⁵ ANAO Better Practice Guide, *Public Sector Governance and the Individual Office – Guidance*.

management a key component of sound public sector governance and practice.⁴⁶

2.4 This Chapter and Chapter 3 take into consideration these principles. This Chapter focuses specifically on the following areas of the Tax Office's administration:

- challenges faced by the Tax Office when it was given responsibility for SMSFs;
- the Tax Office's roles and responsibilities under the *SISA* as the regulator of SMSFs; and
- the Tax Office's identification and reporting of risks that impact SMSF policy and legislation.

Challenges faced by the Tax Office when it was given responsibility for SMSFs

2.5 Listed below are some of the difficulties the Tax Office inherited when it became responsible for SMSFs.⁴⁷ In summary, the Tax Office:

- assumed a new and unfamiliar regulatory role. The Tax Office considered that its SMSF regulatory role was markedly different to other areas of its tax administration, and the other superannuation responsibilities it had at that time;
- became responsible for a sector of the superannuation industry that was at the time suspected of high levels of non-compliance with their obligations under the *SISA*⁴⁸;
- was to regulate superannuation funds that had not received close supervision by their previous regulators (the Insurance and Superannuation Commission (ISC) and APRA); and
- was to oversee a sector of the superannuation industry that numbered approximately 187 000 funds in 1998–99 and was growing at around

⁴⁶ Discussion about the application of these principles to the Tax Office's Superannuation Line are discussed in Audit Report No.39, 2004–05, *The Australian Taxation Office's Administration of the Superannuation Contributions Surcharge*.

⁴⁷ Appendix 3 provides an overview of the events that led to the transfer of 187 000 fund records from APRA to the Tax Office.

⁴⁸ In 1997, the Insurance and Superannuation Commission (ISC) undertook a survey of 1 000 excluded funds to determine their compliance with the *SISA*. This survey found compliance issues with approximately 20 per cent of those funds surveyed (see Appendix 3).

470 funds each week. At the time, this was the fastest growing sector of the superannuation industry with an annual asset growth rate of approximately 23 per cent.

2.6 There were a number of other factors which impacted on and challenged the Tax Office's ability to administer superannuation in 1999–2000. These are discussed in detail in Audit Report No.39, 2004–05, *The Australian Taxation Office's Administration of the Superannuation Contributions Surcharge* (the Surcharge report), and include funding for:

- *administration of superannuation.* Between 1990–91 and 1996–97, the Tax Office was made responsible for a number of superannuation functions.⁴⁹ The Tax Office was asked to internally absorb a large proportion of the costs associated with managing these functions; and
- *implementation of A New Tax System (ANTS).* In 1999 and 2000, Tax Office resources were focused primarily on managing the introduction of ANTS. The Tax Office advised that during the introduction of tax reform, it did not focus on rigorous compliance action (for example comprehensive tax audits) for tax practitioners. Rather, its compliance activity focussed largely on education. The Tax Office extended this compliance approach to its regulation of SMSFs.

2.7 Despite the factors noted above, the Tax Office's established procedures and processes to manage the timely transfer of small funds from APRA and liaised with industry through the Self Managed Funds Industry Liaison Group. The Tax Office effectively managed this transition to SMSF regulator, under difficult circumstances, and in a timely way.

The Tax Office's role and responsibilities under the SISA as the regulator of SMSFs

2.8 The role of the Tax Office has its basis in the SISA and the SIS Regulations. It is important the role of the Tax Office is defined clearly and conveyed publicly to provide the Parliament and the public with assurance that the Tax Office is successfully fulfilling its role as the SMSF regulator. It is also important the Tax Office reports the actions it has undertaken to discharge its role.

⁴⁹ These were the Superannuation Guarantee, Superannuation Holding Accounts Reserve, Reasonable Benefits Limits, and the Lost Members Register.

2.9 The *SISA* and the SIS Regulations are complex, with a number of *SISA* provisions and SIS Regulations common to either two or all of the superannuation fund regulators. For this reason it is important all three superannuation fund regulators understand each others role, and where there are *SISA* provisions or SIS Regulations common to more than one regulator, these provisions and regulations are interpreted and applied consistently to all superannuation fund vehicles.

2.10 If the Tax Office's role in relation to SMSFs is clearly defined it will assist the Tax Office to fulfil and report on its obligations as a regulator of the *SISA*, and clarify its accountabilities for its administration of SMSFs by the Parliament and the public. A clearly defined Tax Office role under *SISA* will also assist SMSF trustees and other relevant stakeholders to understand their obligations, and whether they are likely to demonstrate compliance with the *SISA*.

What does the Tax Office's regulatory role encompass?

2.11 During the *Wallis Inquiry*⁵⁰ there was debate over the type of regulatory role the Tax Office should have if it was to regulate small funds. In particular there was discussion over whether the Tax Office should have a 'prudential regulatory role'. When the Tax Office was given responsibility for the regulation of SMSFs in 1999–2000, the Government accepted in principle the recommendations of the *Wallis Inquiry*.⁵¹ The final report advised the Tax Office was not intended to have a prudential regulatory role. Specifically, the inquiry stated:

...as self managed funds, they should not be subject to prudential regulation. To apply prudential regulation in such circumstances is impracticable. Moreover, it should be made clear that such schemes are conducted entirely at the risk of the beneficiaries – in relation to financial safety, there should be no regulatory assurance attaching to such schemes.⁵²

2.12 The Government's policy regarding the Tax Office's regulatory responsibilities was clarified with the introduction of the Superannuation Legislation Amendment Bill (No.3) 1999. In his second reading speech for this Bill, the then Minister for Financial Services and Regulation stated that:

⁵⁰ See Appendix 3 for a brief overview of the Wallis Inquiry and its findings.

⁵¹ Senator the Hon. Rod Kemp, 15 April 2007, *The Launch of the Australian Taxpayer's Association Manual entitled 'Do it Yourself Superannuation'*, Windsor Hotel Melbourne.

⁵² S.Wallis, March 1997, *Financial System Inquiry Final Report*, p. 334.

The ATO will have responsibility for ensuring that self managed superannuation funds comply with the non-prudential requirements of the superannuation law and APRA will continue its more extensive role as the prudential regulator of all other funds.⁵³

2.13 However, the explanatory memorandum to that Amendment Bill, rather than confirming the Tax Office does not have any prudential responsibility within its regulatory role, specified that:

As members of self managed superannuation funds will be able to protect their own interests these funds will be subject to a **less onerous prudential regime** under the SIS Act [emphasis added].

2.14 The clarity around the Tax Office's role was complicated further by the introduction of the *Superannuation Safety Amendment Act 2004*⁵⁴, following which the Tax Office sought legal advice on its roles and responsibilities, and also wrote to the Treasury to clarify its role.

2.15 This advice stated that it was unlikely the Commissioner of Taxation could be held liable for losses incurred by fund members as a result of SMSFs being in an unsatisfactory financial position. However, it also stated the *SISA* does not make clear that, as a matter of Australian Government policy, the Commissioner of Taxation does not have a prudential supervision function. It suggested that the Australian Government may, therefore, wish to review the terms of the *SISA* and seek appropriate amendments to make clear that the Commissioner has a regulatory rather than prudential function.

2.16 As part of a review of its compliance capability in June 2005, the Tax Office took this advice into consideration. This internal review found that:

The scope of the Tax Office's role in regulating SMSFs was not well understood (especially in regard to the potential [prudential] role of the Tax Office).

2.17 The Tax Office sought to mitigate this risk by sending a minute to the Treasury to clarify its responsibilities. The Tax Office also recommended to the Treasury that the law (*SISA*) would need to be clarified at an appropriate time. The Treasury responded in September 2005 and stated that:

⁵³ Australia, House of Representatives 2000–01, *Superannuation Legislation Amendment Bill (No.3) 1999 House of Representatives Second Reading Speech by the Hon. Joe Hockey, Minister for Financial Services and Regulation*, 31 March 1999, p. 4040.

⁵⁴ The Tax Office sought legal clarification on the changes made by *Superannuation Safety Amendment Act 2004* to the *SISA*. In particular the changes made to section 130 of the *SISA*, prompted the Tax Office to examine its prudential responsibilities. This specific issue is discussed further in paragraphs 2.23 to 2.43.

The Commissioner [of Taxation] is responsible for ensuring that SMSFs comply with all the provisions applying to SMSFs under the SIS Act and associated regulations, as referred to in section 6 [of the *SISA*]. The Tax Office is responsible for ensuring compliance with these provisions even though some provisions could be considered to have a prudential element, for example, provisions restricting disqualified persons from being trustees.⁵⁵

2.18 The Tax Office undertook a review in November 2005 of its administration of SMSFs (the 2005 SMSF review), and identified several areas that required either improvement or clarification. One of the areas identified by the Tax Office as requiring further clarification was its prudential responsibilities.

2.19 The Tax Office identified a potential gap between its intended role (as defined in the *Wallis Inquiry*) and the *SISA*.

Prudential supervision in respect of SMSF investments would require the Commissioner [of Taxation] to monitor whether appropriate risk management processes are in place and are reviewed regularly by trustees. It would also be necessary to determine whether particular investments constitute a high level of risk to the fund.

...These prudential responses would require significant changes to our regulatory approach and require further resources as well as additional skilling for existing Tax Office staff.⁵⁶

2.20 Further to these comments, the Tax Office noted that if it has such prudential responsibilities, it would not have the same legislative protection as APRA has under its *Australian Prudential Regulation Authority Act 1998*. That is, APRA is protected from liability in respect of anything done, or omitted to be done, in the exercise of powers, functions or duties under a law of the Commonwealth.

2.21 In its 2005 SMSF review, the Tax Office also notes that the *SISA* provides the Tax Office, in its regulatory role, with the same prudential powers as APRA. The Tax Office concluded that:

Without clarification of the intended extent of the Commissioner's prudential responsibilities, we will continue to operate without the full confidence that our approaches are consistent with the Government's expectations.

⁵⁵ Letter from The Treasury, 14 September 2005, *Regulation of Self Managed Superannuation Funds*, to the Tax Office.

⁵⁶ Tax Office, November 2005, *Self Managed Superannuation Funds – Review of Self Managed Superannuation Funds*, p. 23.

The SIS Act provides the Tax Office with the same powers as APRA, however if the Commissioner is to perform a regulatory role which accords with the expectations of the Wallis report, this would need to be reflected in the relevant legislative provisions.⁵⁷

2.22 The ANAO notes that legislative changes to clarify the intended extent of the Commissioner's prudential responsibilities have not been scheduled as part of *Simplification Superannuation* changes. However the Tax Office has sought to clarify its prudential roles and responsibilities since its 2005 SMSF review (and during this audit).

The Tax Office's interpretation of its role and the extent of its prudential responsibilities

2.23 Although the view of the *Wallis Inquiry* was that the Tax Office should not have a prudential role regarding the regulation of SMSFs, the Tax Office has acknowledged that it is responsible for certain provisions under the *SISA* that have a 'prudential flavour'. These include:

- the disqualification of trustees from SMSFs where they are not 'fit and proper persons';
- accepting undertakings from trustees regarding the rectification of *SISA* contraventions;
- freezing fund assets to minimise the risk of the loss of fund member's retirement assets; and
- enforcing the restrictions on in-house assets (see paragraph 5 of Appendix 2).

2.24 The Tax Office considers, however, that its prudential role does not extend to determining whether the investment strategy and specific investment decisions made by SMSF trustees are in accordance with the *SISA*, nor does it see its role as extending to an oversight of the financial position of SMSFs. Since 2004 the Tax Office has sought to obtain assurance from the Treasury that certain provisions of the *SISA* are consistent with this understanding of its prudential supervisory responsibilities. In particular whether the Tax Office had a:

- responsibility to examine if SMSFs have an investment strategy in place and the potential risks associated with those **investment strategies**; and

⁵⁷ Tax Office, November 2005, *Self Managed Superannuation Funds – Review of Self Managed Superannuation Funds*, p. 24.

- broad prudential role to review whether SMSFs are in a financially satisfactory position. The fund's auditor has an obligation to advise the Tax Office if a fund is not in a financially satisfactory position via the lodgement of an **Auditor Contravention Report (ACR)**.

SMSF investment strategies

2.25 Investment strategies are a requirement for all superannuation funds (see paragraph 6 of Appendix 2) and are represented in the SIS Regulations as operating standards (SIS Regulation 4.09). These operating standards state that trustees must formulate and give effect to an investment strategy, and that this strategy must have regard to the whole of the circumstances of the fund including the:

- risk involved with investing in particular assets;
- diversification of the fund's investments;
- liquidity of the fund's investments; and
- ability of the fund to discharge current and future liabilities.⁵⁸

2.26 A contravention of an operating standard is an offence that is punishable by a fine upon conviction as set out in *SISA* Part 3.

2.27 Following passage of the *Superannuation Safety Amendment Act 2004*, the Tax Office re-examined its responsibilities, and identified that it may have a prudential role in examining one of the key elements of SIS Regulation 4.09. In particular, whether SMSFs have paid adequate regard to the risk involved in investing in particular assets.

2.28 The Tax Office sought clarification from the Treasury on this matter in 2005. The Tax Office advised the Treasury that if it did have a prudential role to assess whether particular investments constituted high levels of risk to SMSFs, it would represent a significant change to the Tax Office's regulatory approach at that time, and would require additional resources to manage this regulatory function.

2.29 During the course of the audit (February 2007), and following consultation with the Treasury, the Tax Office advised the ANAO that:

The Tax Office's view of the application of regulation 4.09 is that it requires trustees to formulate and implement an investment strategy that has regard to

⁵⁸ SIS Regulation 4.09.

a number of factors, including risk, exposure, diversification and liquidity. The regulation does not require the investment of the fund to be diversified, or to be liquid, or to be free from risk. It simply requires that the trustee has regard to these issues in formulating an investment strategy.

In practice, the Tax Office would see the failure to formulate and/or implement an investment strategy as a breach of this operating standard. The action we might take in the face of such a contravention would depend on the overall circumstances of the fund.

If an investment strategy was formulated, but there was evidence that the trustee had not had regard to the relevant considerations set out in regulation 4.09 the Tax Office would not view that as a contravention of the regulation. However we may informally suggest that the trustee review this for their own benefit.

2.30 The ANAO notes the Tax Office's interpretation is influenced by the large number of funds it regulates and hence differs to APRA's view of its responsibilities defined within the same legislation. APRA expects consideration of risk, exposure, diversification and liquidity to be set out in trustee documentation and demonstrated through the documentation and practical implementation of the investment strategy. Where an investment strategy or investments appear significantly inappropriate having regard to the circumstances of a fund, APRA advised it would work with trustees to ensure an appropriate strategy was formulated without loss to the members.

2.31 APRA also advised that where it considered the trustees could not be relied on to remedy the situation, it would consider legislative options under the *SISA* including disqualification of the trustees.

2.32 The Tax Office's interpretation is, however, consistent with past Tax Office compliance approaches which are based on the initial policy intent of the Government following the *Wallis* inquiry. In applying this interpretation the Tax Office does not take a proactive approach in seeking resolution of apparently inappropriate investment strategies having regard to the circumstances of the fund. An example of how the Tax Office has applied this approach is shown in the Case Study below.

Case Study

Background

In early 2006 the Tax Office commenced an audit into whether SMSF X's trustees illegally loaned money to a member of the fund (a contravention of section 65 of *SISA*). The audit also examined potential contraventions of the *SISA* relating to:

- lending money to a member of the fund without a written loan agreement and without charging interest on the loan (section 109 of the *SISA*); and
- the sole purpose test by providing unsecured loans to a member of the fund without a written loan agreement and with no requirement to pay interest on the outstanding amounts (section 62 of the *SISA*).

Facts

SMSF X's asset balance at its highest level in 2002–03 was \$7 350.

\$6 500 was loaned to a member of SMSF X over a two year period.

\$3 050 was invested in 'investment advice' relating to a well known investment publication over a two year period.

Result

Consistent with its past and present interpretation of its role under Regulation 4.09, the Tax Office did not comment, or take any action on, whether SMSF X's trustees had regard to risk, diversification, liquidity, and liabilities when formulating the fund X's investment strategy.

After the Tax Office's investigation, the SMSF member receiving the loan repaid the loan with interest to SMSF X. Although there were several breaches of the *SISA*, the Tax Office did not seek to achieve a remedial solution having regard to the circumstances of the fund.

The ANAO notes that, ASIC considers, generally, for a fund to be cost-effective, a minimum of \$200 000 of fund assets is required (see Chapter 1).⁵⁹ The highest asset balance at any time for SMSF X totalled \$7 350. Also, the Tax Office noted that the average running cost of a compliant SMSF was from around \$1 500 to \$12 000 per annum.

If the funds circumstances remained constant it would be difficult for SMSF X to achieve a sufficient level of diversification amongst its asset/s to minimise risk to the fund.

The only regulatory penalty available to the Tax Office in this case was to revoke the complying status of SMSF X under subsection 40(1) of the *SISA*. The Tax Office exercised its discretion under subsection 42A(5) of the *SISA* to allow the fund to maintain its complying status, as the Tax Office considered that this penalty was too harsh.

Source: Tax Office case files

2.33 The ANAO considers that actions undertaken by the Tax Office to clarify its responsibilities with the Treasury (and the Government) regarding the examination and assessment of SMSF investment strategies were useful. As noted in paragraph 2.15, legislative amendment to the *SISA* and or SIS Regulations would further assist the clarification of the Government's policy intent regarding the Tax Office's interpretation of SIS Regulation 4.09. The

⁵⁹ In 2005–06 approximately 35 per cent of the total current number of SMSFs (or approximately 87 500 funds) had asset balances below \$200 000.

ANAO considers the coordination between the Tax Office and the Treasury regarding the timely identification and resolution of difficult policy matters (such as SIS Regulation 4.09) is an important element of the effective regulation of SMSFs by the Australian Government.⁶⁰

2.34 In addition to improving Tax Officers' understanding of their roles and responsibilities, the clarification of SIS Regulation 4.09 should also improve the public's understanding of their responsibilities under the *SISA*, and the Tax Office's expectations as regulator. The ANAO considers the Tax Office should, as a matter of good public sector management, communicate clearly its interpretation of its roles under SIS Regulation 4.09 to the public, and the compliance actions it will apply when dealing with SMSFs.

2.35 The Tax Office advised that it intends to issue a publication to consolidate and clarify its roles and responsibilities to the public. The ANAO considers that this publication could be used to state its position regarding SIS Regulation 4.09.

Auditor contravention reports (ACRs)

2.36 Each year, all superannuation funds (including SMSFs) must undergo a financial and compliance audit by an approved auditor.⁶¹ These audits are an essential aspect of the overall approach to providing assurance that trustees of the funds are complying with their *SISA* obligations.

2.37 Where an approved auditor discovers that SMSF trustees have breached their obligations under the *SISA*⁶², the auditor must advise the Tax Office of the breach using an Auditor Contravention Report (ACR). Importantly paragraph 130(1)(a) of the *SISA* (which was introduced as part of the *Superannuation and Safety Amendment Act 2004*) prescribes that an approved auditor must advise the Tax Office in writing when the approved auditor:

...forms the opinion that the financial position of the entity may be, or may be about to become, unsatisfactory.

⁶⁰ The coordination between the Tax Office and the Treasury regarding the timely identification of legislative or policy issues regarding SMSFs is discussed from paragraph 2.49.

⁶¹ An approved auditor may be: (a) the Auditor-General of the Australian Government, a state or territory or (b) a registered auditor under the Corporations Law or be associated in a specified manner with a professional accounting organisation (as prescribed in Sch 1AAA) (section 131 of the *SISA*, or SIS Regulation 1.04).

⁶² Under paragraph 129(3)(b) of the *SISA*, an auditor is required to provide a written report to the Tax Office where the auditor considers that it may affect the interest of the members or beneficiaries of the SMSF.

2.38 Following the introduction of the *Superannuation and Safety Amendment Act 2004*, the Tax Office sought legal advice regarding whether it had a broader, prudential role in ensuring that SMSFs are in a financially satisfactory position. This advice indicated that the terms of the *SISA* suggest, on their face, that the Commissioner does have a broader role in ensuring that SMSFs are in a financially satisfactory position. This advice noted, however, that a court would be unlikely to find the Commissioner either has a statutory duty, or a common law duty of care, to exercise his powers under *SISA* and/or the *SIS Regulations* to prevent a member of a SMSF suffering financial loss by ensuring that the SMSF is in a financially satisfactory position.

2.39 Following discussions with the Treasury, the Tax Office clarified its position in February 2007. The Tax Office considers the *SISA* does not provide the Commissioner with powers to undertake any action in respect of the unsatisfactory financial position of a SMSF, unless this indicated that a contravention of a provision of the *SISA* had occurred, or was an indication that the trustee was not fit and proper. This may be the case in some circumstances.

2.40 The Tax Office's view is that while it is not obliged to take action directly in respect of these notifications, they form part of the overall picture in respect of a SMSF that can be incorporated into its compliance risk identification and profiling tools.

2.41 Similar to its approach to resolving interpretive issues with investment strategies, the Tax Office sought to clarify its responsibilities regarding the examination of ACRs with the Treasury, and also sought legal advice. While the Tax Office's interpretation of its prudential supervisory responsibilities acknowledges some provisions of the *SISA* have a 'prudential flavour' (paragraph 2.23), it does not extend to reviewing or commenting on the investment strategy and specific investment decisions made by SMSF trustees, or whether SMSFs are financially sound.

2.42 These 'exclusions' are consistent with past Tax Office practice and the Government's original policy intent, which specified that SMSFs do not require onerous prudential supervision as members should be able to protect their own interests. Notwithstanding, to support the Tax Office's current interpretation of its prudential supervisory responsibilities, and to provide legislative clarity on the Tax Office's role, the ANAO considers the Tax Office should consult with the Treasury in due course to assess the benefits of further refining the *SISA*.

2.43 It is important that members and potential members of SMSFs understand the limited extent of the Tax Office's prudential supervision of these funds. The ANAO also considers that to provide additional certainty to SMSF trustees, their intermediaries, and to other SMSF industry stakeholders, the Tax Office should clearly articulate its prudential supervisory responsibilities under the *SISA*.

The Tax Office's communication of its role and responsibilities

2.44 The ANAO considers that clarifying and communicating the Tax Office's roles and responsibilities publicly will assist SMSF trustees and relevant stakeholders to comply with their obligations under the *SISA*.

2.45 The Tax Office has advised the ANAO that it considers it has clearly communicated to the public its role and responsibilities under the *SISA* via marketing and education products and industry speeches. The Tax Office advised further that endorsement of the Tax Office's understanding of its roles and responsibilities, in the regulatory context of ensuring compliance with *SISA* provisions, has been sought from the Treasury with a view to consolidating key messages on this issue in a publication to be released in 2007.

2.46 The Tax Office has provided the ANAO with a statement of its roles and responsibilities which notes that:

...the Commissioner [of Taxation] ensures that SMSFs comply with the *SISA* and regulations. In practice, this means the Commissioner ensures SMSFs comply with the legislation in their establishment and operation by undertaking activities including:

- ensuring SMSFs' primary purpose is to generate a retirement benefit for its members (that is, no remuneration for trustees or illegal early access to benefits);
- checking that SMSFs are managed in line with the rules and regulations in the relevant legislation;
- ensuring that SMSF trustees have prepared and implemented an investment strategy; and
- reviewing the work of approved auditors to ensure that audits are carried out with the appropriate integrity; and any contraventions are reported to the Tax Office.

2.47 Although this role statement provides a broad outline of the Tax Office's role and responsibilities, it could be refined further to incorporate an

explanation of the Tax Office's regulatory responsibilities under SIS Regulation 4.09 and *SISA* section 130.

2.48 The publication the Tax Office intends to release (paragraph 2.35) should provide further clarification on its role and the extent of its prudential supervisory responsibilities. The ANAO considers that over time the Tax Office should also enhance its wide range of existing SMSF documentation to be consistent with the new publication.

The Tax Office's identification and reporting of risks that impact SMSF policy and legislation

2.49 The Tax Office has demonstrated that where there has been uncertainty about its role and responsibilities under *SISA*, it has sought to clarify these issues with Government through the Treasury. The timely identification and reporting of these risks to the Government, so action can be taken if necessary, is an important aspect of the effective regulation of SMSFs, particularly as the SMSF market is quite large and is evolving rapidly (see Chapter 1).

2.50 The ANAO acknowledges the work undertaken as part of the 2005 SMSF review (paragraph 2.18) and notes this review consolidates a number of important issues that the Tax Office needed to identify for Government consideration regarding the SMSF regulatory framework. It was also an important element to initiate proposed changes to SMSF administration as part of the *Simplification Superannuation* law reforms.

2.51 However, the ANAO considers that there have been aspects of the Tax Office's approach to identifying and reporting key SMSF risks to Government in a timely manner that could have been better managed. An example is the identification of key policy and legislative risks applicable to SMSFs investing in instalment warrant products, as explained below.

Instalment warrants

2.52 Instalment warrants are a derivative based investment product developed in the 1990s following the success of instalment receipt products used in the sale of the Australian Government Bank and Telstra. In simple terms, with an instalment warrant, investors are able to purchase assets (such as shares) in two payments – one upfront (representing say 50 per cent of the purchase price) and one either during or at the end of a defined period (including interest and fee costs applicable to the unpaid portion).

2.53 The principal benefits of SMSFs investing in instalment warrants are that the full benefits of the assets (shares) such as ordinary dividends are available upon payment of the first instalment, and interest/fee costs attached to the instalment warrant are tax deductible. Importantly, dividends paid on instalment warrant assets during the defined period are often applied towards payment of the final instalment amount (loan), meaning that there may be no significant cash-flow implications after the first instalment is paid. Thus, an investor is able to effectively finance the purchase of a certain amount of shares by depositing only a portion of the final cost and at the same time avoiding the need to borrow the shortfall. This is an attractive strategy for superannuation funds which are generally precluded from borrowing funds.

2.54 In recent times, there has been a significant growth in both the number of instalment warrants in the market place and amounts invested. In the 2005 calendar year there were approximately 2 500 warrant products listed on the Australian Stock Exchange with the turnover in these warrants valued at \$6.5 billion, up from \$3.7 billion in 2004 (a 76 per cent increase in one year).

2.55 Recent media articles and promotional material indicates the continued growth in SMSFs over the past three years has made SMSFs an attractive market for instalment warrant issuers. The Tax Office advised that although it does not have empirical data on the number of funds that have invested in instalment warrants, anecdotal evidence received from major instalment warrant issuers indicates that SMSF investment in instalment warrants comprise a large portion of the total investment in these products.

Are instalment warrants a legal investment for SMSFs?

2.56 As discussed in Appendix 2, there are a number of obligations that a SMSF must meet if it is to be considered a complying superannuation fund. One of these obligations is that a complying superannuation fund cannot borrow except in limited circumstances.⁶³ This rule is designed to reduce the risk to retirement income from funds gearing their investments. The consequences of not complying with this requirement are serious, and could result in civil and/or criminal legal action.⁶⁴

2.57 Given the requirement that a SMSF may not borrow, a key consideration for the Tax Office was whether the outstanding balance following the initial deposit amount in respect of instalment warrants

⁶³ S/SA subsections 67(1) and (2).

⁶⁴ S/SA subsection 67(7).

constituted a 'borrowing', which would mean that they are therefore not a valid investment prescribed by the *SISA*.

2.58 Government agencies including APRA and the Tax Office as well as other parties such as the Australian Stock Exchange and warrant issuers did not challenge the general public perception that instalment warrants were a valid investment for SMSFs following their increased popularity in the 1990s. However, in 2002, APRA and the Tax Office became concerned that instalment warrants may not be legal superannuation fund investments, and they issued a joint press release stating that:

use of a fund's existing equity holdings to purchase instalment warrants, may breach section 67 of the Superannuation Industry Supervision (SIS) Act.⁶⁵

2.59 Despite raising this concern, the Tax Office did not undertake further examination to determine whether the instalment warrant products issued at the time were legal SMSF investments, nor did it try to establish the extent of SMSF investments in the product.

2.60 In early 2004 a taxpayer requested a product ruling relating to a product similar to an instalment warrant⁶⁶, to determine whether it was a legal SMSF investment. This matter was referred to the Tax Office's Senior Tax Counsel in 2004. The Senior Tax Counsel's advice stated that SMSF investment in the relevant product was a breach of the *SISA*.

2.61 In April 2004, the Tax Office advised the Minister for Revenue and Assistant Treasurer of the superannuation regulators' past position on instalment warrants, the advice provided by the Tax Office's Senior Tax Counsel, and the perceived high growth rate in the number of SMSFs investing in instalment warrants reflected in the large amounts of capital invested in these products.

The consequences of the Tax Office delaying the clarification of its position regarding instalment warrants

2.62 Notwithstanding that the Tax Office expressed reservations about the legitimacy of instalment warrants as investments for SMSFs in 2002, the delay in establishing its position on the instalment warrant issue resulted in the Government effectively facing limited choices to resolve the matter, being to:

⁶⁵ Australian Prudential Regulation Authority, Tax Office, 2002, Joint Media Release: *Super Regulators urge caution on instalment warrants*, 16 December 2002.

⁶⁶ The product ruling requested related to a 'property warrant'. This warrant was to be marketed to SMSFs as a legal investment.

- retain the existing provisions of the *SISA*, which may have led to:
 - Tax Office enforcement action and the imposition of severe civil and criminal penalties being applied to large numbers of SMSFs who had invested in instalment warrants; or
 - the Commissioner applying his discretion under section 42A(5) of the *SISA* to prevent the imposition of penalties on a large number of SMSFs.
- amend the *SISA*, either prospectively or retrospectively, to specifically allow SMSFs to invest in instalment warrants notwithstanding the inability under *SISA* of SMSFs to otherwise borrow funds.

2.63 The Australian Government's position on this matter was clarified in November 2006, when the Minister for Revenue and the Assistant Treasurer stated that:

While the Regulators have concluded that investment in instalment warrants by superannuation funds is not in keeping with the SIS Act, the practice is long standing and widespread and superannuation fund investment comprises a significant proportion of the instalment warrant market. The Government will legislate to allow longstanding practice to continue, following consultation with industry regarding the precise scope of amendments to the SIS Act.⁶⁷

2.64 On 22 May 2007, the Government indicated that it intends to legislate to allow superannuation funds to invest in instalment warrants of a limited recourse nature over any asset a fund would be permitted to invest in directly.⁶⁸ The ANAO notes that until the new legislation is passed by Parliament, some uncertainty may have been created for the stakeholders with an interest in instalment warrants, including:

- instalment warrant issuers⁶⁹;
- the Australian Stock Exchange;
- SMSFs that have investments in instalment warrants;
- SMSFs that have investments in derivations to the instalment warrant product but who may have not sought an Tax Office product ruling;

⁶⁷ The Hon Peter Dutton Minister for Revenue and the Assistant Treasurer, Press Release No.078, *Investment in Instalment Warrants by Superannuation Funds*, 3 November 2006.

⁶⁸ The Hon Peter Dutton Minister for Revenue and the Assistant Treasurer, Press Release No.066, *Investment in Instalment Warrants by Superannuation Funds*, 22 May 2007.

⁶⁹ Instalment warrant issuers include the Macquarie Bank, ABN AMRO, Westpac, and UBS AG.

- those planning to invest in instalment warrants or derivations thereof;
- other instalment warrant investors who use the secondary market; and
- superannuation industry advisors, financial planners and commentators.

2.65 The discussion on SMSF investment in instalment warrants products illustrates the importance of the Tax Office having defined processes and procedures to allow it to identify potential policy or legislative (*SISA*) issues early for resolution, and if necessary communicate those issues to the Treasury and the Government.

2.66 During the audit, the Tax Office advised that it had begun reorganising its approach to collecting and analysing information to obtain more accurate and timely SMSF intelligence. This information will assist in the identification of key policy and legislative risks that will be communicated if necessary to the Treasury and the Government as they arise. The Tax Office's SMSF intelligence capability should have a continuing focus on risks posed by emerging investment products, especially those targeted at SMSFs.

Recommendation No.1

2.67 To provide assurance that risks to the operation of self managed superannuation fund (SMSF) policy and legislation are identified in a timely way, the ANAO recommends that the Tax Office:

- monitors information and intelligence collected in relation to investment products targeted at SMSFs; and
- clearly defines the review processes and procedures which will ensure it is able to establish its position on a timely basis, and if necessary, to advise the Department of the Treasury of risks to the effective operation of relevant superannuation legislation.

Tax Office response

2.68 Agreed

The Tax Office has always undertaken an active role in identifying risks that affect SMSF policy and legislation and has always progressed areas of concern to Treasury and co-regulators.

Further it has, and continues to, actively involve and engage both internal and external stakeholders so as to identify possible risks, find solutions and, where appropriate, advise the community. For example, through the Tax Office

Superannuation Consultative Committee, the Tax Office engages in continuous consultation and collaboration to seek views, advise on the implementation of government policy on superannuation, and to resolve issues by working together.

Given the importance the Tax Office places on this issue it has undertaken a program of continuous improvement and, most recently, it restructured its intelligence capability so as to identify risks in a more timely and accurate manner.

Once an issue has been identified, the Tax Office has a structured process in place that ensures the issue is escalated to Treasury and the co-regulators, as appropriate. For example, in 2005 the Tax Office undertook a review of all aspects of SMSFs, including the outcome of a number of benchmarking projects and areas of concern. This document was later used by Treasury in its formulation of SMSF policy that was used in the simpler super measure.

The Tax Office also has formal systems in place so that the community can be advised in a timely manner, for example by the release of fact sheets, ATO interpretive decisions (ATOIDs) and rulings. Examples of where the Tax Office is improving assurances that can be given to the community include the proposed release in July 2007 of Tax Office rulings on interpreting the SISA.

3. Other Aspects of the Tax Office Governance of the Self Managed Superannuation Fund Regulatory Function

This Chapter continues examination of the Tax Office's governance arrangements relevant to its SMSF regulatory responsibilities. In particular, it considers the Tax Office's: financial management of its SMSF regulatory function; interaction with other superannuation regulators and stakeholders; and the Tax Office's planning, risk management and reporting framework.

Introduction

3.1 As discussed in Chapter 2, the Tax Office has regulated SMSFs in a difficult environment. A fast growing SMSF population and complex legislation places significant pressure on the Tax Office to manage SMSFs effectively within its operational resource constraints.

3.2 In this environment, it is important the Tax Office has a robust governance framework in place to manage its finite resources effectively, manage its relationships with other relevant superannuation stakeholders well, and to identify and mitigate risks to good management. The ANAO examined the following aspects of the Tax Office's governance framework:

- Tax Office's funding arrangements for the administration of SMSFs;
- Tax Office interaction with other superannuation regulators and stakeholders; and
- The Superannuation Line's planning, risk management and reporting framework for SMSFs.

Tax Office funding arrangements for the administration of SMSFs

3.3 Administering large and growing numbers of SMSFs efficiently requires the Tax Office to effectively allocate its resources. An important aspect of managing the effective allocation of Tax Office's finite SMSF regulatory resources is to identify what administrative functions are required to regulate SMSFs and to cost these functions appropriately.

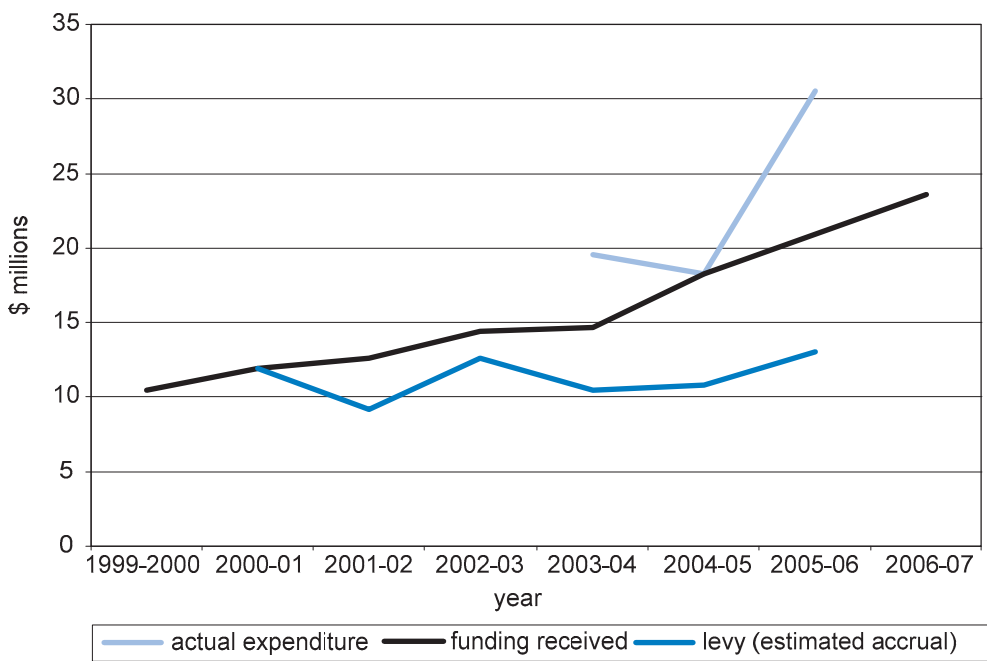
3.4 In accordance with reporting requirements it is also important the cost of administering SMSFs is reported in a timely and accurate way as all SMSFs pay a supervisory levy (the SMSF levy) which is intended to recover the costs of the Tax Office providing its regulatory services. The ANAO examined the Tax Office’s SMSF financial management framework and operation of the SMSF levy.

SMSF financial management framework

3.5 Figure 3.1 provides an overview of Tax Office funding, expenditure and SMSF levy collections since 1999–2000.⁷⁰

Figure 3.1

Tax Office SMSF funding, expenditure and SMSF levy collections from 1999–2000 to 2006–07



Source: ANAO analysis of Tax Office information.

3.6 Based on the information contained in Figure 3.1 the following points provide a broad overview of the Tax Office’s SMSF financial management framework:

⁷⁰ An overview of the Tax Office’s funding, expenditure and SMSF levy collections can also be found in Appendix 4.

- *The Tax Office did not have adequate systems in place to record budgets or actual expenditure for SMSF regulation between 1999–2000 and 2002–03*⁷¹;
- *The Tax Office has significantly changed the methodology it uses to determine its expenditure from 2003–04 to 2005–06.* For example, the large increase in SMSF regulation expenditure between 2004–05 and 2005–06 is attributed to a change in the methodology the Tax Office uses to determine its expenditure, not an actual increase in expenditure;
- *Tax Office funding has increased consistently between 2003–04 and 2006–07.* The funding increase represents a \$18.7 million (or a 30 per cent) increase over this time period;
- *Estimated SMSF levy collections*⁷² *have not increased in line with additional Government funding for SMSF regulation.* For example, in 2005–06, the Tax Office received funding for SMSFs of \$20.9 million compared to the amount of revenue it estimated it collected through the SMSF levy of \$13 million; and
- *Estimated levy collections have not matched Tax Office expenditure on SMSFs.* For example, in 2005–06 the Tax Office spent approximately \$30.5 million in regulating SMSFs. This compares to the \$13 million it estimated it collected through the levy.

3.7 The ANAO found that the Tax Office’s capacity to adequately determine its SMSF funding requirements was also diminished between 1999–2000 and 2002–03 (the period that it did not record budgets or track actual expenditure for SMSFs’ regulation).

The Tax Office’s current financial management framework for SMSF regulation

3.8 From 2003–04 the Tax Office undertook steps to improve its financial management framework for SMSF regulation. This included the introduction of systems to cost SMSF regulatory activities and track expenditure, which were enhanced with the introduction of a Strategic Costing Framework (SCF) to cost all superannuation products for the 2005–06 financial year. The SCF is overseen by the Tax Office’s central Finance area, and considers SMSF regulation expenditure across the whole of the Tax Office, applying a consistent methodology to allocate direct and indirect costs. The SCF should

⁷¹ As Figure 3.1 shows, the Tax Office was not able to provide actual expenditure figures (light blue line) between 1999–2000 and 2002–03.

⁷² The Tax Office is not able to provide actual levy collection figures. This issue is discussed in paragraphs 3.9 to 3.25.

improve the Tax Office's ability to determine the resources it uses to fulfil its role as SMSF regulator.

Operation of the Superannuation SMSF Supervisory Levy

3.9 The *Wallis Inquiry* considered how the regulatory costs applicable to SMSFs were to be funded. Its final report states that, as a general principle, the costs of financial regulation should be borne by those who benefit from it, through the imposition of a levy set at a rate that is proportionate to the resources expended on the relevant regulatory services.⁷³ Applying this principle to SMSFs, the costs should be borne by the funds' trustees at a rate that reflects the Tax Office's cost of providing regulatory services.

3.10 In 1998 industry raised concerns with Government that the levy imposed on small funds was being used to subsidise regulatory activities on larger funds. To address these concerns, the Government decided to significantly reduce the levy on the majority of these funds from \$200 to \$45 when responsibility for excluded funds was transferred to the Tax Office. The reduction in the levy was achieved legislatively through the *Superannuation (Self Managed Superannuation Fund) Supervisory Levy Imposition Act 1991*.

3.11 The explanatory memorandum to the *Simplification Superannuation* legislation, released publicly in December 2006, re-affirms the 'cost-recovery' view put forward in *Wallis* by stating that:

cost recovery of general regulatory oversight continues to be appropriate for the entire superannuation industry.⁷⁴

Has the SMSF levy been used to recover Tax Office costs relating to the provision of SMSF regulatory services?

3.12 Although the expectation was that SMSF regulatory services would be undertaken on a cost recovery basis, factors that indicate the levy may not have been accurately linked to recovering the Tax Office's costs for regulating SMSFs include:

- *Tax Office expenditure on SMSF regulatory activities has never been commensurate with the revenue collected from the levy.*⁷⁵ This is shown in Figure 3.1. Incidentally, in 1999–2000 the Tax Office received funding

⁷³ S. Wallis, March 1997, *Financial System Inquiry Final Report*, p. 532.

⁷⁴ Explanatory memorandum to the Tax Laws Amendment (Simplified Superannuation) Bill 2006, paragraph 8.187.

⁷⁵ The accuracy of the levy revenue collections is discussed further in paragraph 3.17.

based on costs of \$56.55 per fund per annum. This is \$11.55 more than the levy rate;

- *the levy is not tied directly to the Tax Office's funding base.* Currently all levy revenue collections go into the Government's consolidated revenue account and are not linked to the Tax Office's departmental appropriation;
- *Tax Office has not complied with reporting requirements for cost recovered revenues.* The Government's Cost Recovery Policy was introduced in 2002 and is detailed in Finance Circular No.09/2005 and the associated Australian Government Cost Recovery Guidelines for Regulatory Agencies.⁷⁶ It specifies that all cost recovered revenues be separately identified and published in a note to agencies' financial statements.⁷⁷ The Tax Office has not done this⁷⁸;
- *Tax Office did not have a cost allocation system in place between 1999–2000 and 2002–03 for SMSF regulation and it has significantly changed its SMSF cost allocation system from 2003–04 to 2005–06.*⁷⁹ This has precluded it from being able to calculate an appropriate levy amount; and
- *Tax Office costs of administering SMSFs are not regularly reviewed to determine whether the levy rate is correct or needs to be adjusted.* Unlike APRA, which in conjunction with the Treasury undertakes periodic reviews of the amount of its supervisory levy⁸⁰, the Tax Office does not review whether its levy collections cover its costs.

Clarification of the SMSF Levy

3.13 Based on the information contained in Figure 3.1 it is apparent that the cost of providing regulatory services for SMSFs is not currently, nor has it historically been, commensurate with the apparent revenue collected from the levy. In this context, the Australian Bureau of Statistics provided the following

⁷⁶ For further information refer to <http://www.finance.gov.au/finframework/fc_2005_09.html>.

⁷⁷ This includes Annual Reports and Portfolio Budget Statements prepared by the agency.

⁷⁸ The ANAO also notes that the Tax Office has not been included as part of the revised review schedule for cost recovery arrangements listed on the Finance website for Finance Circular No.09/2005.

⁷⁹ Refer to paragraph 3.6.

⁸⁰ The last review of APRA's levy occurred as part of *Report of the Review of Financial Sector Levies* - Treasury and Australian Prudential Regulation Authority - October 2003.

advice on what is classified as cost recovered revenue (or fee for service⁸¹), and what is classified as a tax:

If the payment is commensurate with the cost of the service provided, then it is considered a fee for service [or cost recovery]. If it is clearly out of all proportion to the cost of providing the service, then the fee is classified as a tax.⁸²

3.14 Accordingly, in view of the intent of the *Wallis Inquiry*, and the recent changes introduced by the *Simplification Superannuation* legislation, closer monitoring of the extent of cost recovery by the levy would be appropriate.

Disclosing levy revenue collections

3.15 As discussed in paragraph 3.10, a factor leading to the review of the levy rate in 1998 was industry concern over small fund levies being used to subsidise regulatory activity for larger funds during the time when all funds were regulated by APRA. Based on the information contained in Figure 3.1, it is evident that the Tax Office did not track its expenditure on SMSF regulatory activities between 1999–2000 and 2002–03. The Tax Office cannot, therefore, provide assurance that for these years, its expenditure was equal to or greater than the levy revenue it collected.

3.16 The ANAO considers that if levy collections were to be reported separately and publicly, it would improve the Tax Office's accountability regarding the delivery of SMSF regulatory services. A number of issues that make it difficult for the Tax Office to report levy collections accurately are discussed below.

Difficulties in collecting and reporting on levy revenue

3.17 The Tax Office advised that the levy revenue figures shown in Figure 3.1 are most likely incorrect. The main reason for this is that although the Tax Office requires SMSF trustees to remit the levy separately from other income tax payments, many funds remit the levy and their income tax liabilities as a single payment. This makes separating levy payments from other income tax

⁸¹ For the purpose of this audit, fee for service is synonymous with cost recovered revenues. This issue is discussed in Auditor-General Audit Report No.7, 2006–2007, *Visa Management: Working Holiday Makers*, p. 101.

⁸² Letter from Australian Bureau of Statistics to Australian National Audit Office, *re: Performance Audit – Visa Management: Working Holiday Matters*, 31 August 2006.

liability payments difficult.⁸³ This problem is compounded if levy payments for multiple years are submitted in one payment.

3.18 Consequently, the Tax Office is not able to provide accurate data on levy revenue collections, and is only able to provide estimates. Importantly, the Tax Office is not able to readily determine the value of levy payments that have not been remitted, and which SMSFs have not remitted these payments.

3.19 Based on the number of fund income tax and regulatory returns that have not been lodged, the ANAO estimates that since 2000–01 approximately 200 000 levy payments have not been remitted to the Tax Office. This is equivalent to \$8.5 million in levy revenues that have not been collected. This is a conservative estimate, as it does not take into account the number of SMSFs that lodge their fund income tax and regulatory return but do not remit their levy payment.

Tax Office levy revenue collection practices

3.20 Since the introduction of SMSFs, the Tax Office has not sought to recover levy payments that have not been made by SMSF trustees. The Tax Office advised that this was due to the value of the levy (\$45) being less than the cost of undertaking the activity to recover unpaid levy amounts. Although this approach may be inequitable to those SMSF trustees that do remit their levy payments, the Tax Office's approach is understandable given the large number of SMSFs that would need to be pursued and the cost associated with recovering outstanding levy payments.

Changes to the levy

3.21 The Treasurer announced on the 5 September 2006 the levy will be increased as from 1 July 2007 to better reflect the cost of undertaking regulatory activities. Specifically, the Treasurer announced that:

...the regulation of self managed superannuation funds (SMSFs) will be improved by increasing funding to the Tax Office for compliance activities, streamlining reporting requirements and other measures. The supervisory levy will be increased to \$150 which will place SMSFs on a similar cost recovery basis as other superannuation funds.⁸⁴

⁸³ The ANAO notes that changes to the SMSF annual return to be implemented as part of *Simplified Superannuation* mean that in the future all levy payments will be included as part of overall income tax payments.

⁸⁴ The Hon Peter Costello Treasurer, *Press Release no.093, Simplified Superannuation—Final Decisions*, 5 September 2006.

3.22 The reasons for increasing the levy value to better reflect cost recovery principles (paragraph 3.11) were clarified further in the explanatory memorandum to the *Simplification Superannuation* legislation. This states that:

The current supervisory levy imposed on self managed superannuation funds is \$45 per annum. This amount has not been changed since 1999 and no longer covers the cost of the ATO's regulation of self managed superannuation funds nor the expected costs of future regulation. The shortfall between the amount levied and the ATO's regulatory costs has, to date, been subsidised from general tax revenue.⁸⁵

3.23 The introduction of the *Simplification Superannuation* legislation confirms the revised levy is intended to recover costs. The explanatory memorandum for this legislation includes a Cost Recovery Impact Statement relating to the decision to raise the levy to \$150. The Treasury advised in February 2007 that the future collection of the levy by the Tax Office will comply with the cost recovery guidelines.

3.24 The Tax Office advised in April 2007, that the revised levy may not be sufficient to fully recover the cost of SMSF regulation (i.e. partial cost recovery will continue). This means that any shortfall will continue to be subsidised from general tax revenue. The ANAO considers the Tax Office should clarify the extent to which the levy will recover the cost of its SMSF regulatory services and amend current practice to comply with the Australian Government's Cost Recovery Guidelines.

3.25 The ANAO also considers that with the significant increase in the levy rate the Tax Office should: examine ways to separate levy remittances from other income tax remittances; and develop and implement procedures to collect levy payments from funds that do not remit the levy.

⁸⁵ Explanatory memorandum to the Tax Laws Amendment (Simplified Superannuation) Bill 2006, paragraph 8.192.

Recommendation No.2

3.26 To improve its accountability for the regulatory services it provides to self managed superannuation funds (SMSFs), and to comply with the Australian Government's Cost Recovery Guidelines, the ANAO recommends that the Tax Office:

- in consultation with the Department of the Treasury, clarify the extent to which the Superannuation (Self Managed Superannuation Fund) Supervisory Levy recovers the costs of regulating SMSFs;
- periodically reviews the levy rate to accurately reflect Tax Office regulatory costs covered by the levy in accordance with the Australian Government Cost Recovery Guidelines;
- examines the costs and benefits of developing information systems which distinguish levy revenue from other tax revenue;
- develops and implements procedures to identify and collect levy payments that are not remitted; and
- publicly report on the amount of annual levy revenue collected and the Tax Office's cost of administering SMSFs, in accordance with the disclosure requirements under the Government's Cost Recovery Policy.

Tax Office response

3.27 Agree

The Tax Office agrees to consult with Treasury to clarify the extent to which the supervisory levy recovers the costs of regulating SMSFs.

The Tax Office will also work with Treasury to implement review processes so that the levy continues to provide appropriate cost recovery of the Tax Office's functions in accordance with Australian Government Cost Recovery Guidelines.

The Tax Office already has systems in place that distinguish SMSF levy revenue from other tax revenue. This occurs via the Generic Accounting System (GAS) which will operate until 2008. Work is continuing on the development of the new system, Integrated Core Processing, which will replace GAS, so that the levy revenue continues to be distinguished from other tax revenue.

Various options are being considered about the collection of the existing unpaid levy. Moving forward, the levy will form part of the income tax

assessment and will be subject to the usual collection processes including that of recovering outstanding debts.

Levy revenue and the Tax Office's cost of administering SMSFs will be reported in the Tax Office's annual report, in accordance with the Australian Government Cost Recovery Guidelines and financial reporting requirements.

Tax Office interaction with other superannuation regulators and stakeholders

3.28 As part of its revised approach to regulation in 1999–2000, the Government established a tripartite approach to the regulation of the *SISA*, consisting of APRA, ASIC and the Tax Office.⁸⁶ It was anticipated that this approach would assist the three regulators to maintain close contact with one another, and ensure they had a common interpretation of the relevant provisions of the *SISA*. Each regulator must also have processes to track people that the other regulators have disqualified and to ensure that these people do not operate superannuation funds.

3.29 Given the finite resources the Tax Office has to regulate SMSFs, it is imperative that it has effective processes in place to liaise with superannuation and SMSF industry groups. The work undertaken by industry groups is also an essential component of the Tax Office's overall compliance approach, as these groups are responsible for educating SMSF trustees and tax agents, and for overseeing the performance and behaviour of approved auditors.

SMSF related committees and forums

3.30 Since becoming responsible for SMSFs, the Tax Office has established a sound network of committees and forums to discuss issues affecting industry and the other regulators. These committees and forums include:

- Superannuation Consultative Committee;
- Superannuation Technical Sub Committee of the National Tax Liaison Group;
- Superannuation Funds Working Group;
- Software Developers Consultative Group; and
- Quarterly regulators meeting between APRA, ASIC, the Tax Office and the Treasury.

⁸⁶ Refer to Figure 1.1.

3.31 The other superannuation regulators and stakeholders interviewed during the audit consider that these committees and forums are an effective way to communicate their views and concerns to the Tax Office.⁸⁷

Relationship with other superannuation regulators

3.32 The Tax Office and the other superannuation regulators have actively sought to establish and maintain a coordinated approach to regulating superannuation funds. This is evidenced by the following initiatives:

- *secondment of staff between ASIC and the Tax Office.* This has resulted in the mutual transfer of SMSF regulatory knowledge and practice between the two agencies. There is also evidence that it has improved the day-to-day communication between the two agencies and joint operations;
- *joint compliance operations resulting in enforcement action on those fund trustees that do not comply with their SISA obligations;*
- *joint media releases with the other regulators.* The Tax Office and the other superannuation regulators work jointly to produce press releases to address community concerns about the interpretation of the SISA⁸⁸; and
- *joint development of educational material.* The Tax Office provides the other superannuation regulators with the opportunity to comment on the educational material it produces before it is released publicly.

3.33 On the whole, the relationship between the superannuation regulators appears to be working well. However, some stakeholders interviewed during the audit did comment that there had been instances where APRA and the Tax Office had inconsistent interpretations of the SISA.⁸⁹

3.34 The ANAO also notes that ASIC and the Tax Office have an up to date and comprehensive Memorandum of Understanding (MOU). However, the MOU between APRA and the Tax Office was only recently updated.

3.35 The previous MOU between APRA and the Tax Office was developed before the introduction of SMSFs. The MOU is intended to set out a framework for co-operation between APRA and the Tax Office and to facilitate

⁸⁷ The individuals interviewed as part of this audit are listed in Chapter 1.

⁸⁸ Issues that have been addressed through joint media releases include early access to superannuation benefits.

⁸⁹ An example given was the interpretation of paragraph 52(2)(f) of the SISA.

co-ordination between the agencies in relation to superannuation matters generally.

3.36 A Tax Office internal audit report completed in 2003 recommended that the MOU between the Tax Office and APRA be amended and updated to reflect the changing circumstances between the two regulators. In late February 2007, the Tax Office advised that it had progressed discussions with APRA and it was in the final stages of completing an MOU. An updated version of the Tax Office's MOU with APRA was completed in May 2007.

Relationship with industry

3.37 Since the introduction of SMSFs, the Tax Office has worked hard at fostering a constructive relationship with the superannuation industry and other stakeholders. Based on the interviews with SMSF stakeholders (see Chapter 1), the ANAO considers that, on the whole, the Tax Office's relationship with these stakeholders is sound. Superannuation stakeholders identified the following positive aspects of the Tax Office's approach when interacting with the superannuation industry:

- *a willingness of the Tax Office to tailor its approach to SMSF regulation and distinguish this from taxation administration;*
- *SMSF related publications and educational material are of a high quality.* Superannuation stakeholders considered that educational material originally released in 2003 by the Tax Office addressed educational needs of SMSF trustees at the time; and
- *senior Tax Officers are available to present and provide technical advice to stakeholders.* A number of superannuation and accounting professional associations have utilised Tax Office staff for SMSF conferences and seminars. This has resulted in increased industry awareness of the Tax Office's role as SMSF regulator and its expectation of compliance levels by SMSF trustees.

3.38 A number of issues were also identified by SMSF stakeholders, which they considered if addressed by the Tax Office, could improve both the Tax Office's relationship with industry and overall SMSF compliance levels. Stakeholders commented on the need for:

- *improved SMSF statistical information.* Stakeholders indicated that additional statistical information on SMSFs would be useful. On 20 December 2006 the Tax Office commenced the publication of a quarterly *Self managed*

superannuation fund statistical report. This report provides for the first time, general information on the number of SMSFs being established, and being wound-up;

- *the development of a publicly available Approved Auditor Register.* A number of stakeholders indicated that the quality of work undertaken by some approved auditors needs improvement. These stakeholders advised that the construction of a publicly available Approved Auditor Register would allow the professional associations to keep track of fund auditors and more effectively target their education and advisory material;
- *improvements to the Register of Complying Superannuation Funds (RoCS).* Superannuation stakeholders indicated they would like changes to RoCS, including improvements to the quality and timeliness of the information on the register. This issue is discussed in greater detail in Chapter 4; and
- *information on outcomes of the Tax Office's compliance activity.* To assist approved auditors, some stakeholders indicated they would like access to the outcomes of the Tax Office's SMSF audits and reviews. This includes the Tax Office providing case studies of common compliance issues that arise in audits, including penalties imposed on the trustees.

The Superannuation Line's planning, risk management and reporting framework for SMSFs

3.39 Important elements of robust governance are effective corporate and business planning, risk management and reporting processes, which provide assurance that all corporate objectives and planning documentation are aligned and mutually supportive. Ideally, planning, risk management and reporting documentation should cascade from an agency's intended purpose (as expressed in its outputs and outcomes) through to specific team plans and reports. This reduces the possibility for confusion, particularly over objectives and performance targets, and whether these objectives and targets have been met.

The ANAO's overall assessment of the Tax Office's planning, risk management and reporting framework for SMSFs

3.40 In Chapter 2 of the Surcharge report, the ANAO established a framework for examining SMSF related planning, risk assessment and reporting processes. Although the Surcharge report focused on the surcharge specifically, the majority of the recommendations relating to governance were

applicable to the Superannuation Line as a whole (including SMSF administration). The ANAO assessed the Tax Office's progress against these recommendations as part of this audit.

3.41 Overall, our review indicates that the Tax Office has put in place measures to strengthen planning, risk management and reporting and to support the effective administration of SMSFs. In 2006–07 the Tax Office had a:

- co-ordinated approach to SMSF planning at the Superannuation Line and corporate levels. The quality of individual team plans across the Superannuation Line was mixed. However, there was a consistent approach to planning and setting performance objectives across a number of SMSF compliance teams⁹⁰;
- well structured approach to identifying, assessing and rating the Superannuation Line's risks. This process was underpinned by a comprehensive risk register, which is used to document and rate all risks applicable to the Superannuation Line; and
- consistent and comprehensive regime to report against performance objectives and risks at the Tax Office's corporate level.

3.42 Although the Superannuation Line has significantly improved its overall practices in the areas discussed above, the ANAO notes that SMSF IT systems, and the quality of the data contained on those systems, have the potential to undermine planning, risk assessment and reporting processes. That is, if SMSF IT systems collect poor quality data and this data is not rectified then information upon which planning, risk assessment and reporting documentation is constructed may be flawed. This may, in turn, lead to poor decision making by the users of that documentation.

The quality of SMSF data

3.43 As part of its comprehensive risk assessment approach, the Tax Office determined that data quality is a high risk to revenue and the Tax Office's reputation.⁹¹ Specifically, the Tax Office notes the data quality of fund information is questionable due to historical and current uses of different SMSF related systems. This has led to incorrect, inconsistent information or an

⁹⁰ The ANAO notes however that other than the compliance teams, the team plans for other areas examined during the audit varied widely in content and quality (see Figure 1.4).

⁹¹ The Tax Office has identified SMSF data quality as a separate risk in its superannuation risk register. The Tax Office has rated SMSF data quality as a 'high risk'.

absence of information being held and relied upon for all facets of decision making and compliance work. Examples of poor quality data remaining on Tax Office systems include the accuracy of the number of SMSFs regulated by the Tax Office and SMSF asset values.

The number of SMSFs regulated by the Tax Office

3.44 The number of SMSFs regulated by the Tax Office is determined by adding new SMSF registrations to the existing SMSF population and subtracting those SMSFs that advise the Tax Office they have been wound-up.⁹² As part of its risk processes, the Tax Office has determined that a number of funds have wound-up, but have not advised the Tax Office and been removed from Tax Office systems. Having wound-up funds on Tax Office systems adversely affects the Tax Office's understanding of the number of funds it is regulating.

3.45 To assess how many funds have potentially been wound-up but have not advised the Tax Office, the ANAO analysed Tax Office data on the number of SMSFs that have elected to be regulated by the Tax Office, but have never lodged a regulatory return, or an income tax return.

3.46 As at August 2006, 24 366 SMSFs have never lodged a regulatory or income tax return. This indicates that potentially a large number of funds have been wound-up and have not reported this situation to the Tax Office. Alternatively it could indicate that a significant number of funds are not complying with their *SISA* obligations to lodge an annual income tax and regulatory return.

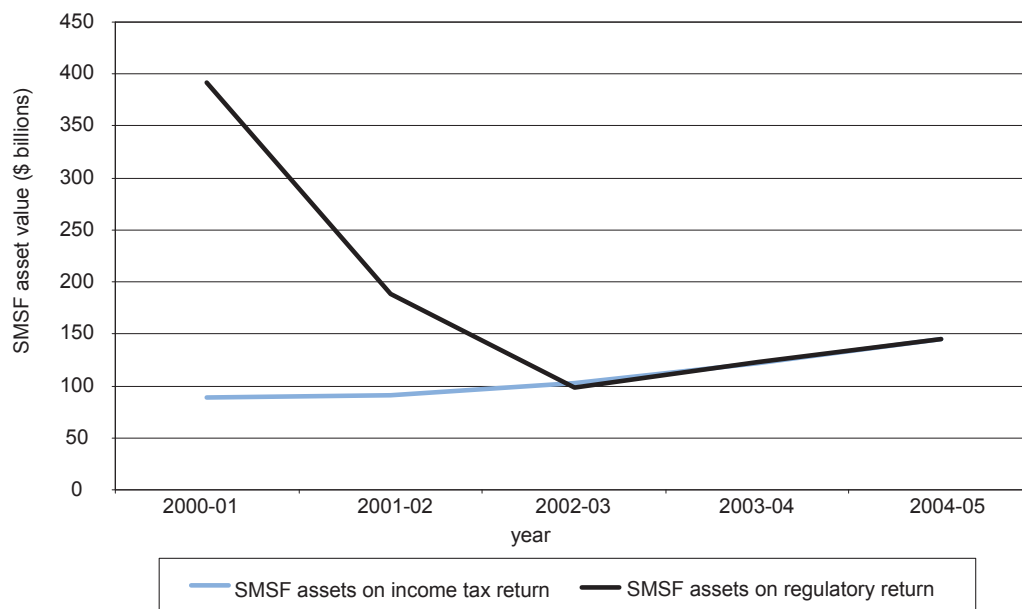
SMSF asset values

3.47 The Tax Office obtains SMSF asset values through the lodgement of fund income tax and regulatory returns. The ANAO analysed the asset values being reported on the fund income tax and regulatory return as shown in Figure 3.2.

⁹² The Tax Office noted that the number of SMSF entities is subject to historical revisions. This is due to late SMSF notices of establishment and late notice of wind-ups.

Figure 3.2

Value of SMSF assets by return type



Source: APRA statistical data and ANAO analysis of Tax Office system data.

3.48 Figure 3.2 shows that there were significant discrepancies between the asset figures reported on income tax returns and regulatory returns between 2000–01 and 2002–03. For example, in 2000–01 SMSF trustees reported assets of \$392 billion in their regulatory returns and \$88 billion in their income tax returns (345 per cent difference).

3.49 Since that time the Tax Office has undertaken measures to ensure that there is no variance between income tax and regulatory return asset data. The Tax Office advised that SMSF system edit checks were introduced on 1 July 2005, to provide assurance that the values being reported on the income tax component of returns matched the value reported on the regulatory return component.

3.50 Although the number of instances of incorrect asset data has reduced in recent times, ANAO analysis revealed a number of instances where incorrect asset data has remained on Tax Office systems. For example, Tax Office SMSF systems examined in August 2006, showed one SMSF as having \$17.4 billion worth of assets reported in 2001–02. This amount was also identified by the Tax Office as being incorrect, although, it has remained on Tax Office systems.

3.51 The ANAO's analysis is consistent with a review of SMSF data undertaken by the Tax Office in 2005. This review analysed the data of funds with the top 50 highest asset values recorded on SMSF systems. It found that 18 of these funds (or 36 per cent) had incorrect asset amounts recorded against Tax Office accounts.⁹³ It found these errors were likely due to either Tax Office keying errors or SMSF trustees incorrectly recording information on their returns.

3.52 The ANAO's and the Tax Office's analysis indicates that the quality of SMSF data contained on Tax Office systems is not high. Although short-term work around solutions can be established to minimise the potential for discrepant data, longer-term automated solutions need to be considered to rectify data quality problems.

3.53 A more comprehensive solution could involve matching return data with other Tax Office systems to assess the risk of the data contained on these forms being incorrect at the time of lodgement.

Recommendation No.3

3.54 To improve the quality of Tax Office planning, risk management and reporting relating to self managed superannuation funds (SMSFs), the ANAO recommends the Tax Office improves the underlying data by:

- reviewing SMSF data to determine its accuracy and completeness; and
- examining the costs and benefits of developing systems, processes and controls to detect and rectify anomalous data at the time it is entered into Tax Office systems.

Tax Office response

3.55 Agree

Ongoing processes are in place to improve SMSF data collection and data holdings. With streamlining of SMSF reporting under simplification, in conjunction with in-built edit checks and extensive changes to Tax Office systems, the risk to data quality will be reduced.

Further, the introduction of the combined income tax and regulatory returns with the member contribution statement will reduce errors as:

⁹³ The review found that the combined assets recorded on the top 50 SMSF income tax returns totalled \$1.89 billion, whereas the amounts recorded on their regulatory returns totalled \$29 million (or a \$1.86 billion difference).

trustees will only be asked for the information once;
there will be cross utilisation of labels and data; and
it will be harmonised with the revised ACR.

The Tax Office continues to explore the costs and benefits within a risk assessment framework for developing systems and processes to improve the accuracy of data provided.

SMSF asset values reported publicly

3.56 SMSF asset values reported publicly by APRA and the Tax Office are used by the superannuation industry and the Parliament to gauge the overall level of retirement saving invested in SMSFs. Although all SMSF trustees must provide SMSF asset values on their income tax and regulatory returns, the combined asset values reflected in these returns is not used by the Tax Office (nor is it reflected in APRA statistics) to represent the total value of SMSF assets. This is because large numbers of SMSF trustees do not lodge their fund income tax and regulatory returns on time, or do not lodge at all. For the 2004-05 year, approximately 30 per cent of SMSF trustees did not lodge on time. There are approximately eight per cent of SMSFs that have never lodged a regulatory return.⁹⁴ For this reason the Tax Office derives an estimate of SMSF asset values.

How the estimate for SMSF assets is derived

3.57 Every three months, the Tax Office undertakes a series of calculations based on regulatory return data to derive a SMSF asset balance that is reported in quarterly APRA statistics. Adjustments to estimates are made in each quarter in an effort to reduce the impact of the non-lodgement of regulatory returns by active SMSFs, and to reflect average investment returns, average asset allocation, earnings and transfers. The estimates produced by the model are heavily reliant on the number of SMSFs assumed to be 'active'.

Evaluating the Tax Office's model

3.58 To test whether the Tax Office's asset methodology is robust, the accuracy of the estimates it produces should be evaluated against data from income tax and regulatory returns when it subsequently becomes available on lodgement. The Tax Office advised that on a quarterly basis estimates are reconciled and revised retrospectively when outstanding fund income tax and regulatory returns are lodged. After applying this reconciliation process, the

⁹⁴ The Tax Office used the 2004-05 lodgement year to describe lodgement rates in its submissions to the Treasury regarding the Government's plan to streamline and simplify superannuation.

Tax Office considers that the results of the model are reliable enough to produce an appropriate point in time estimate.

3.59 The ANAO evaluated the Tax Office's SMSF asset estimation model and reconciliation process by reconciling actual SMSF asset values reported on regulatory returns to original estimates produced by the model. The ANAO found that between 2002–03 and 2004–05:

- *There are significant variations in the results obtained from the ANAO's reconciliation process to those derived from the Tax Office's.* The Tax Office's reconciliation process resulted in a difference between estimated SMSF asset values and actual SMSF asset values of -1.16 and +1.69 per cent. In contrast, the ANAO found that the Tax Office model overestimated SMSF asset values, in some instances by 14 per cent of actual return information;
- *The Tax Office's SMSF model does not adjust its SMSF asset estimates for inactive funds.* The model includes the number of SMSFs as determined by adding new SMSF registrations to the existing SMSF population and subtracting those SMSFs that have formally advised the Tax Office they have been wound-up. There is no adjustment made, however, for 'inactive' SMSFs that have ceased to operate as a fund (and have been recorded on Tax Office systems as having 'no further return required') but have not formally notified the Tax Office that they have been wound-up; and
- *The Tax Office uses revised estimates rather than the original estimates of SMSF assets provided to APRA in its reconciliation process.* Currently, the Tax Office uses revised estimates, which takes into consideration subsequent lodgement information from when the estimates were first calculated. By not using the original estimates produced by the Tax Office's model, the Tax Office is not accurately measuring the accuracy of its model's projections. The ANAO considers that the Tax Office should be reconciling actual reported information to the original estimates produced by the model to enable it to more accurately evaluate its model.

3.60 These factors limit the reliability of estimates produced by the SMSF asset methodology and model. The ANAO considers that the reliability of the estimates produced by the SMSF asset estimation model could be improved by incorporating information on 'inactive' funds currently recorded on Tax Office systems and employing original estimates in the reconciliation process rather than revised estimates.

3.61 The Tax Office advised that it is introducing a SMSF Lodgement Program in 2007–08 which aims to raise the on time lodgement of SMSF fund income tax and regulatory returns from 70 to 94 per cent within 6 months of the due date by the end of 2009–10. The ANAO expects that the reliability of the model's estimates should improve following the completion of the Lodgement Program.

Recommendation No.4

3.62 To provide more accurate self managed superannuation fund (SMSF) asset information to Government and the public, the ANAO recommends that the Tax Office:

- incorporate information on 'inactive' SMSFs in its SMSF asset estimation model;
- re- evaluate the number of active SMSFs after the Lodgement Program ; and
- regularly reconcile SMSF asset estimates with actual lodgement data to improve the accuracy of its estimating methodology.

Tax Office response

3.63 Agree

The Tax Office agrees with this recommendation as it is continually aiming to improve the methodology for estimating assets holding of SMSFs. The statistical model was developed to provide an estimate of SMSF assets at a particular point in time; figures are not available until a fund lodges an annual return. The current model has been endorsed by both the Tax Office and APRA. The Tax Office will undertake analysis of the impact of discrepancies from funds described by the ANAO as 'inactive' and the cost effectiveness of incorporating changes into the model.

Further, as the existing model is updated on a quarterly basis the Tax Office agrees a more robust lodgement program from 2007–08 will assist in evaluation of numbers of funds in existence at a particular point in time.

The Tax Office currently updates estimated total assets on a quarterly basis with actual return data for SMSFs using the most up-to-date lodgment information. The Tax Office will ensure a reconciliation process occurs on an annual basis.

4. Registering Self Managed Superannuation Funds and Issuing Notices of Compliance

This Chapter examines the Tax Office's approach to registering SMSFs through to issuing notices of compliance. It considers the extent to which the Tax Office's approach provides assurance that SMSFs meet their legislative obligations when they are first established.

Introduction

4.1 A well functioning process for registering SMSFs and issuing notices of compliance is an essential component of an effective SMSF regulatory framework. Without an effective process the Tax Office is not able to provide assurance that: ineligible funds (or other ineligible arrangements) are excluded from becoming 'complying' SMSFs; and ineligible (or disqualified) people are prevented from becoming SMSF trustees.

4.2 An effective process for registering SMSFs and issuing notices of compliance also has the potential to positively affect other areas of the Tax Office's administration of SMSFs. In particular, the pressure placed on the Tax Office's scarce compliance resources is reduced, as ineligible funds are prevented from becoming complying SMSFs. This has the twofold benefit of allowing the Tax Office to more effectively target its compliance resources on those funds that require the most supervision, and to minimise costs by not expending compliance resources on funds that do not present a serious compliance risk or are not SMSFs to begin with.⁹⁵

4.3 The ANAO reviewed whether the Tax Office's current process for registering SMSFs and issuing notices of compliance provides a high level of assurance that all funds meet *SISA* requirements. To do this, the ANAO examined the:

- SMSF registration environment;
- current SMSF compliance with *SISA* requirements relevant to fund establishment;

⁹⁵ Situations can arise where the Tax Office may register a fund as a SMSF, but the fund does not meet the *SISA* requirements to be classified as a SMSF. For example, having five or more members in the fund.

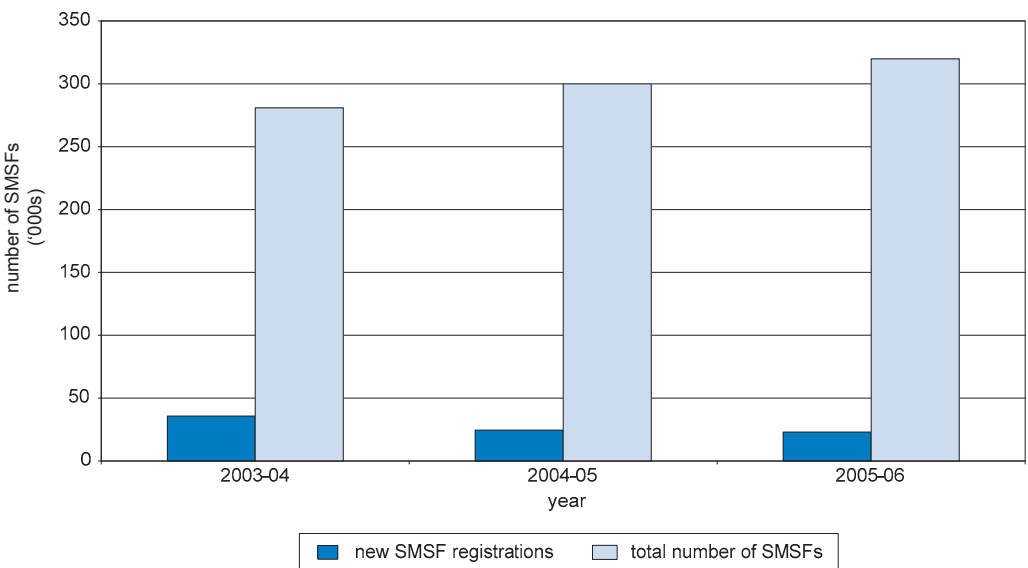
- Tax Office’s approach to registering SMSFs and issuing notices of compliance;
- Tax Office’s processes to prevent ineligible people from becoming SMSF trustees; and
- use and operation of the RoCS.

The SMSF registration environment

4.4 There has been, and continues to be, significant growth in the number of SMSFs. The number of new funds registered, has been significantly higher than the number of funds that notify the Tax Office they are winding-up each year. The number of registrations is shown in Figure 4.1.

Figure 4.1

The number of registrations and total number of SMSFs from 2003–04 to 2005–06



Source: ANAO analysis of ARPA and Tax Office data

4.5 Although there have been large increases in the total number of SMSFs since 2003–04, the number of new SMSFs registering annually is now decreasing. For example, in 2003–04 the average number of SMSFs registering each month was approximately 3 000. In 2005–06 the average number of SMSFs registering was approximately 1 900 each month (or a 35 per cent decrease in the number of new registrations). This trend has gone against

original expectations when Superannuation Choice legislation was introduced in July 2005.⁹⁶

4.6 The ANAO notes, however, that monthly registrations increased to 3 000 in May 2006. The Tax Office expects that the introduction of the *Simplification Superannuation* laws will result in an increase in the number of SMSFs being registered annually.⁹⁷

Current SMSF compliance with *SISA* requirements relevant to fund establishment

4.7 All funds electing to become *regulated funds* must meet a range of legislative requirements specified in the *SISA* and SIS Regulations. These requirements are described broadly in Appendix 2 of this report. If unregistered funds do not meet these requirements they are not entitled to the tax concessions and other advantages applicable to SMSFs.

4.8 To assess the number of funds being registered that may not be complying with *SISA* requirements or meet the definition of a SMSF, the ANAO analysed Tax Office data relating to three basic *SISA* requirements, being the:

- number of members in each SMSF;
- number of SMSFs with zero asset balances; and
- number of SMSFs not lodging a registration form within 60 days of establishing the fund.

4.9 It should be noted that the results of this analysis are not definitive, as SMSFs can legally alter their membership and investment strategies once they are registered. However, when assessed in combination, they may be indicative of SMSFs' non-compliance with *SISA* requirements at the time they were registered. The ANAO notes that the Tax Office has not undertaken analysis to determine whether issues of non-compliance discussed below were apparent at the time of registration.

⁹⁶ See Appendix 3 of this report.

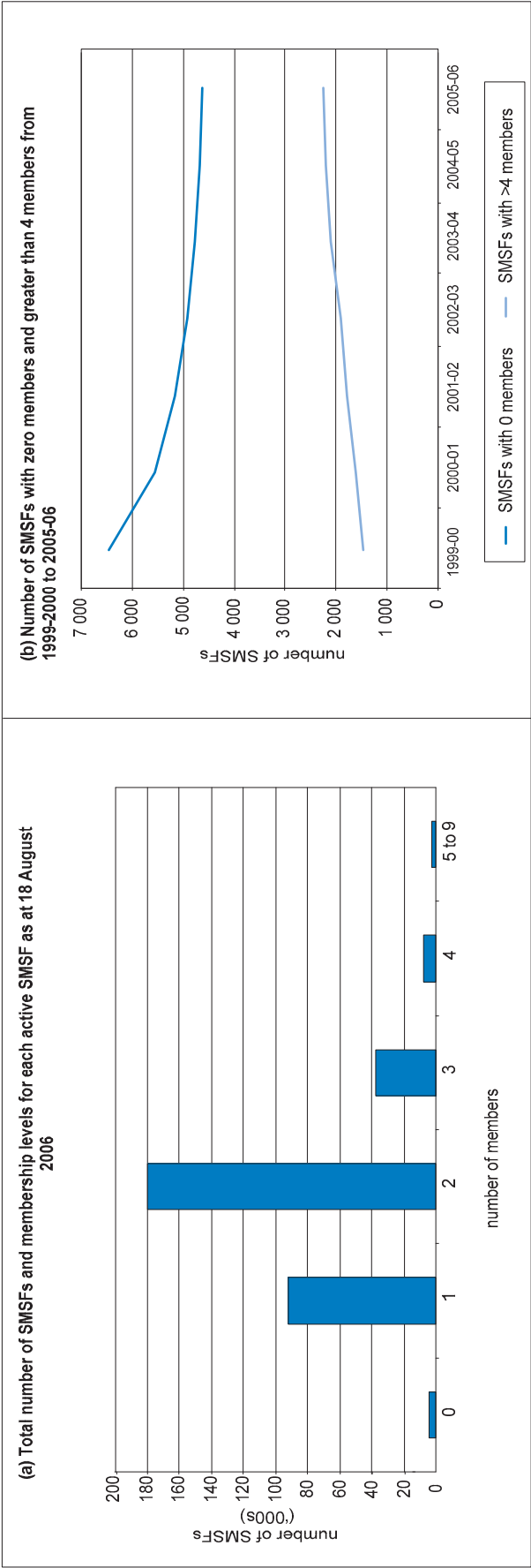
⁹⁷ As at May 2007, the Tax Office advised the average number of monthly SMSF registrations was around 2 900.

The number of members in each SMSF

4.10 A basic and fundamental requirement for a fund to meet the definition of a SMSF is that each fund has at least one member, and no more than four members⁹⁸. The ANAO examined Tax Office data to determine whether the Tax Office only registers funds that meet these parameters. Our analysis is contained in Figure 4.2.

⁹⁸ S/SA subsection 17A(1).

Figure 4.2
Number of members in SMSFs



Source: ANAO analysis of Tax Office data.

4.11 Figure 4.2 (a) shows that approximately 6 900 funds have either zero members or greater than four members. This may indicate that: the Tax Office has registered funds that are not SMSFs; or that funds have changed their membership after registration, and now do not meet the definition of a SMSF.

4.12 The Tax Office advised that, without closer examination, it is unable to determine which of the 6 900 funds were originally registered in error, in contrast to those funds that fail to meet the definition of a SMSF due to increases or decreases in the number of fund members after registration.

4.13 Figure 4.2(b) shows that when funds were transferred from APRA in 1999–2000, 4 per cent (or approximately 8 000) funds did not have the correct number of members to be a SMSF. Since then, the Tax Office has reduced the number of funds with zero members by about 2 000 funds, however, the number of funds with more than four members has increased by approximately 800 funds.⁹⁹

Tax Office measures to reduce the number of SMSFs that currently do not meet the definition of a SMSF

4.14 In 2004 the Tax Office commenced a data cleansing project with APRA on approximately 3 000 registered SMSFs identified as potentially not meeting the definition of a SMSF. The Tax Office advised that ongoing work under this project has reduced that 3 000 to less than 150. This type of work will continue the reduction of the number of SMSFs that may not meet the definition, including those that potentially have an incorrect number of members.

Administrative difficulties in ensuring that SMSFs have the correct number of trustees

4.15 For the Tax Office to effectively monitor the number of trustees in a SMSF, it must know when there have been changes in trustees. In the past there has been no legislative requirement for SMSF trustees to advise the Tax Office where there has been a change in trustees. The Tax Office had processes

⁹⁹ The ANAO notes that, if the information contained on the Tax Office's registration form is completed correctly, it is not possible to register a fund with more than four members, or zero members as a SMSF. However, it is possible for funds to operate a SMSF with the incorrect number of members if the SMSF trustees do not complete the registration form correctly, or if they change the membership structure after registration.

available for SMSFs to notify a change in trustees; however, trustees were not compelled to use these processes.¹⁰⁰

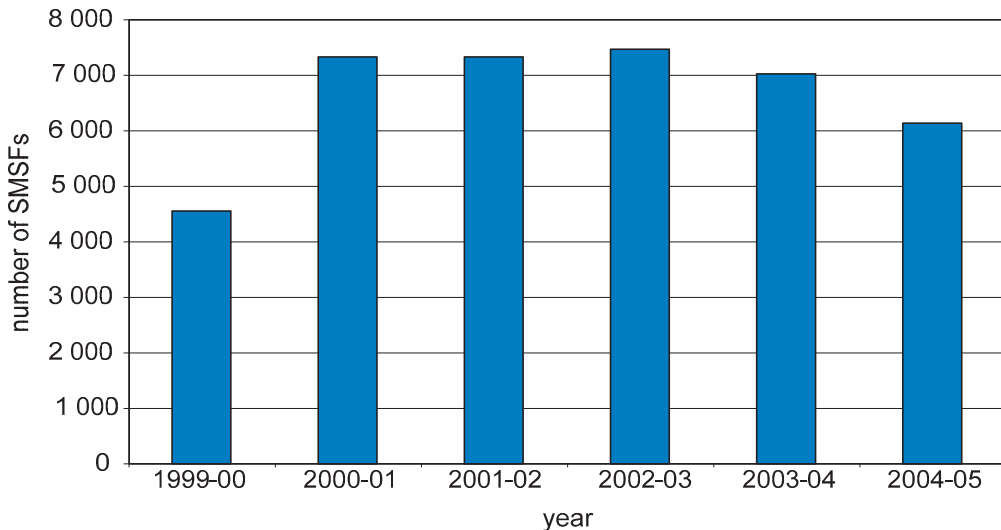
4.16 The Tax Office advised that changes to the SIS Regulations flowing from the *Simplification Superannuation* reforms will require SMSF trustees to notify the Tax Office of any fund membership changes from 1 July 2007.

SMSFs with zero asset balances

4.17 General trust law requires that for a SMSF to be established, assets must be set aside for the benefit of members. A nominal amount such as \$1 is sufficient to set up a trust. The ANAO analysed Tax Office data to identify the number of funds that have may have reported zero asset balances, and therefore should not be considered a SMSF. This analysis is shown in Figure 4.3.

Figure 4.3

Number of SMSFs lodging income tax and regulatory returns with zero asset balances



Source: ANAO analysis of Tax Office information.

4.18 Figure 4.3 shows that between 1999–00 to 2004–05 there have been approximately 40 000 instances where SMSFs have reported they had zero

¹⁰⁰ A fund can update its details via the Australian Business Register website and/or by lodging a superannuation entities change of details form with the Tax Office. The types of details that can be updated include: entity type; structure; residency status; entity name; address and financial account details. A fund may also use this form to elect to be regulated under the SISA; become a SMSF or become an APRA regulated superannuation fund.

asset balances. Of these instances, there have been approximately 11 000 occasions where particular SMSFs have reported zero asset balances for more than one year running.

4.19 This may indicate that a SMSF has simply been ‘wound-up’ and trustees have not communicated this to the Tax Office, or, it may indicate that arrangements that are not SMSFs have been registered by the Tax Office.

4.20 In any event, it is incumbent on the Tax Office to better understand the reasons behind the number of SMSFs that are reporting zero asset balances. Importantly, the Tax Office should not be issuing a notice of compliance to funds that do not have assets set aside for the benefit of member and therefore do not meet the definition of a SMSF.

Funds electing to be regulated within 60 days of being established

4.21 If a fund chooses to be regulated by the Tax Office as a SMSF¹⁰¹, and therefore be eligible for tax concessions, the fund must elect to be regulated by the Tax Office within 60 days of being established.¹⁰² Compliance by unregistered funds with this obligation is important, as the Tax Office is unaware of the existence of a fund until the fund lodges a registration form.

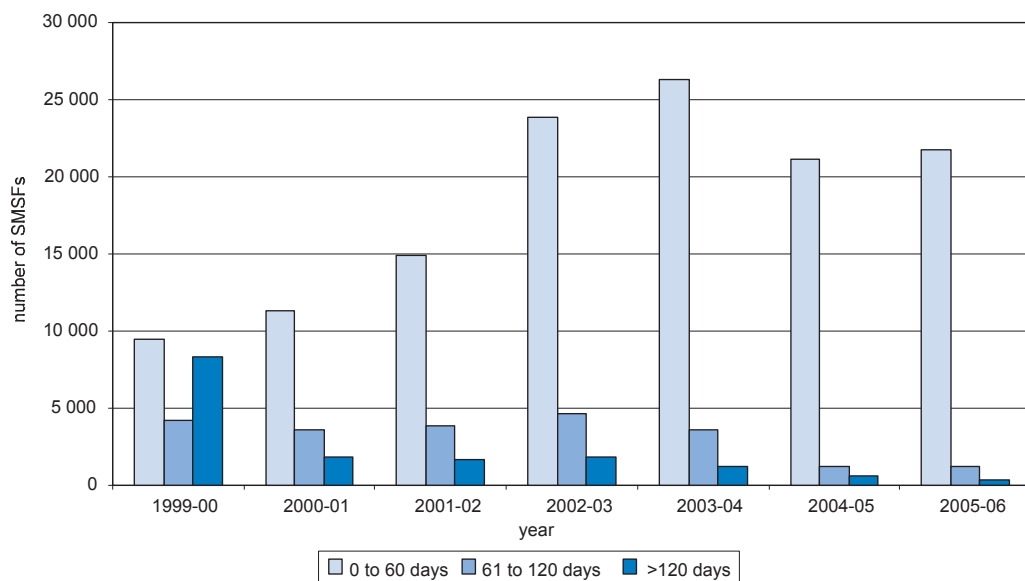
4.22 The ANAO identified the potential for funds which do not meet this 60 day requirement to remain outside the regulatory system which increases the likelihood of trustees failing to understand their obligations under *SISA* and further impacts on Tax Office data holdings. To assess fund compliance with the 60 day rule, the ANAO analysed Tax Office data as shown in Figure 4.4.

¹⁰¹ Funds elect to be regulated as a SMSF by lodging a registration form with the Tax Office.

¹⁰² *SISA* paragraph 42(1AA)(b)

Figure 4.4

The time taken by SMSF trustees to lodge their registration form following the establishment of SMSFs



Source: ANAO analysis of Tax Office data.

4.23 As Figure 4.4 shows, there is an increase in the proportion of new funds registering within the 60 day timeframe. However, since 1999–2000, 23 per cent (or approximately 38 000 funds) did not lodge their registration forms within 60 days of establishing the fund. The Tax Office advised that since it was made responsible for SMSFs it has only sought to penalise funds that did not lodge their registration forms within 365 days of being established. The Tax Office provided the following reasons for not strictly applying the 60 day rule:

- *the penalty applied to funds that do not comply with the 60 day rule is too severe.* The Tax Office advised that under the *SISA*, the only penalty available to the Tax Office regarding the 60 day rule is to make the fund a non-complying fund; and
- *the large number of funds not meeting the 60 day rule.* As shown in Figure 4.4, a large number of funds did not meet the 60 day rule. The Tax Office determined that its compliance resources were better utilised on other compliance activities.

4.24 The Tax Office advised that it did not consider the 60 day requirement was a high risk to retirement incomes as funds that failed to register for a TFN/ABN were not in a position to operate as a regulated fund.

4.25 While recognising the Tax Office has some discretion under the *SISA* about when to apply or not apply the 60 day rule, the ANAO considers it should introduce practices consistent with the rule in the interests of efficient and equitable administration. At the time of the audit, the Tax Office did not monitor the 60 day rule, and did not systematically undertake action against those funds that do not meet their *SISA* requirements in this regard.

Tax Office's approach to registering SMSFs and issuing notices of compliance

4.26 For a fund to be a complying fund the *SISA* states that two distinct events must occur. These are the:

- fund must elect to be a *regulated fund*¹⁰³ within 60 days after the establishment of that fund. This is accomplished by the fund lodging an approved registration form with the Tax Office; and
- Tax Office must issue a *notice of compliance*¹⁰⁴, to notify fund trustees that their fund is a *complying superannuation fund*. This occurs after the registered SMSF has successfully lodged its first fund income tax and regulatory return (which can be up to one year after registration).

4.27 Without these two events occurring, a fund is not entitled to tax concessions¹⁰⁵ and any Superannuation Guarantee contributions made to the fund by an employer may be subject to additional charges. To manage the two above mentioned events, the Tax Office has established a framework of IT and manual systems to register SMSFs and issue notices of compliance. This process is shown in more detail in Figure 4.5.

¹⁰³ Paragraph 42(1AA) of the *SISA*.

¹⁰⁴ Sections 40 and 41 of the *SISA*.

¹⁰⁵ Tax concessions are received under subsection 26(1) of the *Income Tax Rates Act 1986*.

4.28 The Tax Office advised that the Australian Business Register (ABR), ATO Integrated System (AIS) and SMSF system do not have checks in place to identify SMSF non-compliance with *SISA* requirements. The ANAO did not examine the systems and processes applicable to the allocation of Australian Business Numbers (ABNs) and Tax File Numbers (TFNs) to new funds. This was examined as part of Audit Report No.59, 2002–03, *Administration of Australian Business Number Registrations*. All other systems, processes and controls applicable to Figure 4.5 were examined.

The Tax Office's assessment of funds electing to be SMSFs

4.29 The ANAO examined whether the Tax Office has the processes and controls in place to provide an adequate level of assurance that funds that do not meet the *SISA* requirements are prevented from either being registered, or being issued with a notice of compliance. Specifically, the ANAO examined:

- the Tax Office's current approach to identifying funds that do not comply with *SISA* requirements at the point of registration; and
- the Tax Office's approach to issuing notices of compliance.

The Tax Office's current approach to identifying funds that do not comply with SISA requirements at the point of registration

4.30 The Tax Office currently has two sources of information it can use to identify where an unregistered fund may not meet *SISA* requirements at the point of registration. These are as follows:

- *the information contained on superannuation entity registration forms.* Although the information contained on registration forms allows the Tax Office to make a basic assessment of the unregistered fund, it does not allow the Tax Office to assess independently whether the fund meets all *SISA* requirements.¹⁰⁶ Also, the Tax Office does not examine and analyse all the information contained on the registration form at the time it is lodged.
- *third parties alerting the Tax Office to unregistered funds that do not fulfil SISA requirements.* This includes the other regulators, tax agents, and other superannuation funds.

¹⁰⁶ Originally the SMSF registration form did not request information from trustees that allowed the Tax Office to obtain any assurance that the unregistered fund met the *SISA* obligations. In June 2005, the Tax Office introduced fund trustee disclosure questions which provide a basic level of assurance that the unregistered fund complies with *SISA* obligations.

4.31 Since January 2004 the Tax Office has been collecting, analysing, and reporting on information obtained from registration forms. This analysis provides the Tax Office with an important source of intelligence, which may be used to identify funds being established for illegitimate purposes (for example accessing superannuation assets early). This intelligence collected includes:

- the numbers of trustees with multiple SMSFs;
- analysis of the taxable income of SMSFs;
- age of trustees establishing new SMSFs;
- number of new funds established and wound-up within 12 months; and
- new SMSFs that are linked to high-risk tax agents.¹⁰⁷

4.32 This intelligence is compiled and analysed at an industry-wide level, and is not used to assess the individual suitability of unregistered funds at the point of registration. The Tax Office advised that registration intelligence is incorporated in its risk assessment tools including the selection of SMSFs for compliance (audit) activity. However the earliest compliance activity can commence on a fund would be about 18 months from when the fund registered.

4.33 The ANAO considers the Tax Office does not fully utilise intelligence collected at the point of registration to assess the risk of individual funds not complying with their *SISA* requirements. The situations outlined in paragraph 4.10 to 4.25 highlight a number of instances where entities have registered SMSFs that may not have met *SISA* requirements.¹⁰⁸

Process to issue notices of compliance

4.34 As explained in paragraph 4.26, for a SMSF to be a complying fund under the *SISA*, the Tax Office must issue that SMSF with a notice of compliance. Once a SMSF has received its notice of compliance, the Tax Office is not required to issue that SMSF with additional notices of compliance for subsequent years of income.¹⁰⁹ If a SMSF is subsequently found not to be complying with their *SISA* requirements, the Tax Office can revoke that SMSF's complying status. The fund may then be treated as a non-complying

¹⁰⁷ The ANAO has compiled and summarised some of this intelligence in Appendix 7.

¹⁰⁸ The need to better use intelligence collected at the point of registration is also highlighted in Appendix 5.

¹⁰⁹ *SISA* section 41.

fund for each of the years of income covered by the original notice of compliance, or in respect of a particular year of income.¹¹⁰

4.35 As shown in Figure 4.5, notices of compliance are automatically generated by the Tax Office SMSF systems once fund income tax and regulatory returns are received from a newly registered SMSF. The Tax Office will only issue a notice of compliance if all information requested on the fund income tax and regulatory return is provided, and if the information provided on the return does not appear to be anomalous or irregular.

4.36 The Tax Office is heavily reliant on SMSF trustees providing well considered and accurate information in their income tax and regulatory returns, as Tax Office staff and systems do not check SMSF compliance with the *SISA* at this stage of the process. Once a notice of compliance has been issued, the information contained on a SMSF's income tax and regulatory return is evaluated by the Tax Office's income tax compliance systems and risk assessment tools. However, the Tax Office advised that once issued with a notice of compliance few SMSFs are reviewed to determine actual or continuing compliance with the *SISA*.

4.37 Based on our assessment of the controls over the Tax Office's processes to issuing notices of compliance, the ANAO considers that the Tax Office's approach does not provide a high-level of assurance at the time of registration that funds are complying with their *SISA* requirements. In particular, there is scope to make better use of intelligence obtained at the point of registration before issuing SMSFs with a notice of compliance.

4.38 The ANAO's view of the SMSF registration process is supported by the Tax Office's Superannuation Fund Integrity (SFI) Project. This project commenced in June 2004 to assess and improve the controls for the registration and change of details processes. Following a comprehensive analysis of the Tax Office's SMSF registration controls, the SFI project concluded that Tax Office systems did not have sufficient registration checks in place and that overall the SMSF registration process was inadequate. The SFI project made a number of recommendations aimed at improving the registration process.¹¹¹

4.39 The ANAO recognises the Tax Office uses a risk-based approach to identify potentially non-complying funds as a matter of practicality, as it is not efficient or effective to examine all new fund returns to determine whether

¹¹⁰ *SISA* subsection 42A.

¹¹¹ See Appendix 6 for additional information relating to the SFI project.

they should receive complying status. However, the introduction of a more robust process to issue notices of compliance should be considered within the context of improvements to the Tax Office's overall approach to identify high-risk funds. The ANAO considers that there could be more use of the intelligence collected at the point of registration.

Recommendation No.5

4.40 To provide increased assurance that the Tax Office identifies SMSFs that do not comply with their *Superannuation Industry (Supervision) Act 1993* requirements, and prevents those funds from receiving complying status, the ANAO recommends that the Tax Office:

- utilises the intelligence obtained from the SMSF registration process to more accurately assess SMSF compliance prior to issuing notices of compliance; and
- develop and implement a risk-based methodology to assess SMSF compliance with their obligations prior to issuing notices of compliance.

Tax Office response

4.41 Agree

The Tax Office current systems only enable minimal checks prior to issuing notices of compliance – with further checks undertaken at a later time. However under the third release of the redevelopment of the Tax Office's business system (R3), the Tax Office will be able to assess, more accurately, SMSF compliance prior to the issuing of notices of compliance. R3 will recognise, to a much greater degree, at risk trustees due to improved cross matching of data held on record. Further, the Tax Office is investigating the feasibility of including on the combined income tax and regulatory return and the member contribution statement identifiers, which will highlight issues prior to the notices of compliance being issued.

The Tax Office is in the process of markedly improving its assessment of funds that do not comply. Considerable steps have been taken to strengthen the registration process with edit checks in place to identify potential non-compliance in conjunction with improved registration and change of detail forms. The Tax Office's ability to identify non-compliance after the issue of a notice of compliance will be enhanced by the following measures:

- improving new trustees awareness and understanding of their eligibility to be a trustee of an SMSF, as well as their ongoing obligations. (The new trustee declaration form will assist with this.);
- improving compliance with the superannuation and income tax laws by increasing coverage to 2.9 per cent of funds;
- mandating that trustees notify the Commissioner of Taxation of any changes of trustees of their SMSF;
- requiring auditors to lodge an auditor contravention report for any reportable breach of *Superannuation Industry (Supervision) Act 1993* (regardless of dollar value) during the first year of operation an SMSF and following up 100 per cent of these; and
- improving the lodgment compliance program, with a goal of achieving, by the 2009–10 year, 94 per cent lodgment compliance within six months of the due date.

Tax Office processes to prevent ineligible people from acting as SMSF trustees

4.42 A key aspect of an effective registration system is that ineligible (or disqualified) persons are prevented from acting as SMSF trustees. Without established processes in place to identify and prevent disqualified persons from acting as trustees of SMSFs, the Tax Office has a diminished capacity to adequately regulate SMSFs. Specifically, it increases the risk that retirement savings may be eroded where they are placed in the hands of those that are unfit to run SMSFs.

4.43 Disqualified persons include:

- individuals who have been convicted of offences involving dishonest conduct;
- insolvents; and
- companies that are under administration or equivalent.

4.44 Under the *SISA* it is illegal for a disqualified person to knowingly act as a trustee of a SMSF or any other fund. The Tax Office advised that by registering a SMSF, as trustee of that fund, a disqualified person is automatically committing an offence. However, under the *SISA*, the Tax Office cannot refuse to register the SMSF and must take action to remove the disqualified person at the earliest possible time following registration.

Monitoring disqualified trustees

4.45 In January 2004, the Tax Office recognised that it could not accurately identify whether disqualified superannuation fund trustees were registering new SMSFs. As a result, the Tax Office's registration form was first changed in June 2005 as part of the SFI project (see Appendix 6) to include disclosure questions which require disqualified persons to identify themselves when registering SMSFs. The Tax Office also advised that in June 2006 additional changes were made to registration and change of details forms for superannuation entities to include a further nine trustee disclosure questions. Disqualified persons identified at the point of registration may be removed or suspended by the Tax Office following registration.

4.46 The Tax Office currently does not match all trustees identified on registration forms to a list (or register) of persons who have been disqualified by the Tax Office or other *SISA* regulators. This means there is a high probability that a disqualified person could act as a SMSF trustee without being detected if they did not identify themselves as being disqualified in their registration form.

Improving the Tax Office's process for detecting and tracking disqualified persons

4.47 To provide a level of assurance that the persons it disqualifies are not permitted to be trustees of complying SMSFs the Tax Office has developed a proposal to introduce a 'disqualified trustee indicator' for its SMSF system (see Figure 4.5). The Tax Office advised that a further development of this proposal will be the introduction of a Disqualified Trustee Register, similar to those currently used by ASIC and APRA.

4.48 It is important that the Tax Office has access to information of persons disqualified by the other *SISA* regulators, as these people are also ineligible to act as SMSF trustees. Since September 2004, the Tax Office entered into an arrangement to exchange lists of disqualified trustees with APRA.¹¹² However, the Tax Office does not currently have a reciprocal arrangement with ASIC.¹¹³

¹¹² This arrangement was discontinued in December 2004, when APRA made available its disqualification register on its website.

¹¹³ ASIC maintains lists of banned company directors. Although these directors are not automatically disqualified from being SMSF trustees, their current status may raise the compliance risk of SMSFs they are associated with.

4.49 The ANAO considers that, ideally, there should be a central register of persons disqualified from being trustees of *any* fund. This would allow all SISA regulators to access 'real time' information about disqualified trustees and increase the likelihood that those persons seeking to misuse the superannuation system are prevented from doing so.

4.50 The Tax Office advised key issues impacting the ability to establish a central register that require consideration include the lack of a unique identifier (e.g. Tax File Number) for individuals shared by relevant agencies, privacy issues and secrecy provisions of each agency, particularly regarding TFN information.

Recommendation No.6

4.51 The ANAO recommends that the Tax Office consult with the Australian Prudential Regulation Authority, and the Australian Security and Investments Commission to assess the benefits in developing a central register of persons who have been disqualified to act as superannuation fund trustees.

Tax Office response

4.52 Agree

The Tax Office agrees to consult with the Australian Prudential Regulatory Authority, Australian Security and Investments Commission and Treasury to assess the benefits of developing a central register of persons who have been disqualified to act as superannuation fund trustees.

The Tax Office's use of the Register of Complying Superannuation Funds

4.53 The Register of Complying Superannuation Funds (RoCS) is the Tax Office's fifth most accessed website, and has averaged approximately 100 000 hits per month since it was introduced in 1999–2000. On its website the Tax Office states that:

The Register of Complying Super Funds (RoCS) is a publicly available list of complying funds that are regulated by APRA and the Tax Office...the purpose of this list is to:

- provide fund contact details; and
- facilitate the transfer of superannuation monies between funds.

Why RoCS is necessary

4.54 Although there is no legal requirement for the Tax Office to administer RoCS¹¹⁴, it is an important part of the Australian superannuation framework. Importantly it allows entities/persons to validate that the fund:

- to which they want to make personal contributions is a complying superannuation fund (a legal requirement);
- to which they want to roll-over superannuation assets from other funds is a complying superannuation fund;
- they are nominating to receive co-contributions is a complying superannuation fund (as stipulated on the Tax Office co-contributions forms); and
- to which their Superannuation Guarantee contributions go to is a complying superannuation fund.

Key issues with the operation of RoCS

4.55 The Tax Office's website notes that RoCS is a listing of complying superannuation funds. The ANAO considers that this statement is not strictly correct. As discussed in paragraph 4.26 for a fund to be a complying SMSF it must:

- elect to be a regulated fund (as part of the Tax Office's registration process); and
- receive a notice of compliance from the Tax Office (following the receipt of the funds first income tax and regulatory return).

4.56 At the time of audit fieldwork, all funds that register with the Tax Office were placed immediately onto RoCS without being issued with a notice of compliance. This could mean that users of RoCS may roll superannuation assets into, or make contribution into, a fund that he/she believes to be a complying fund. As a consequence, it may be that this fund has not yet been assessed as a complying fund under the *SISA*, as it has only been registered and has not received its notice of compliance.

¹¹⁴ The ANAO notes that the transfer of RoCS from APRA to the Tax Office in 2000, was not considered as part of the Tax Office's overall administration of SMSFs. As a result, the Tax Office has absorbed the costs of running the RoCS.

Other RoCS issues

4.57 Users rely on RoCS being accurate and up to date. However, since its inception in 2000, there have been numerous problems with RoCS data. These problems have required multiple data 'clean-ups' that have led to the removal of over 30 000 funds from RoCS since September 2004. A further 29 000 funds were reviewed as part of the SFI project. This review is continuing.

4.58 A key concern about the accuracy of RoCS data relates to the time it takes to refresh or update the data. That is, it can take Tax Office systems up to 14 days to refresh RoCS data. This could mean that non-complying funds remain on RoCS for up to 14 days after they have been made non-complying.

4.59 The impact of a less than adequate RoCS system is illustrated in the Case Study in Appendix 5. A key issue in the Case Study was that the information contained on RoCS did not allow larger funds to identify that they were rolling multiple members superannuation assets into an ineligible financial arrangement purporting to be a SMSF. If the larger funds had known this was not a complying superannuation fund, it is possible that they would have alerted the Tax Office, and the fraud may have been prevented.

The Tax Office's redevelopment of RoCS

4.60 The Tax Office recognised the importance of improving RoCS in April 2004, when it was identified as a potential area for improvement as part of the SFI project. The Tax Office subsequently commenced the redevelopment of RoCS in late 2005. The changes made included cross matching RoCS data with the Australian Business Register (ABR) to identify and remove discrepant data.

4.61 Further changes to RoCS were discussed by Tax Office management in January 2007 and advised publicly in April 2007. These include:

- accessing the register via the look-up tables on the ABR website;
- only displaying funds with an Australian Business Number;
- changing the name of the register to Superannuation LookUp; and

- being able to search for additional fund information including 'real time' data on the complying status of the fund, whether the fund has been wound up, the funds' contact details and which agency the fund is regulated by.

4.62 These changes will be implemented in July 2007. From December 2007, superannuation entities will also be able to download the register to help work out eligible rollovers.



Ian McPhee
Auditor-General

Canberra ACT
28 June 2007

Appendices

Appendix 1: Agency Response



Australian Government
Australian Taxation Office



Mr David Crossley
Executive Director
Australian National Audit Office
19 National Circuit
Barton ACT 2600

Dear Mr Crossley

Thank you for your letter of 14 May 2007 in which you provided, for comment, a proposed audit report on the Australian Taxation Office's administration of self managed superannuation funds (SMSFs) pursuant to section 19 of the *Auditor-General Act 1997*. The Commissioner has asked me to respond on his behalf.

We are pleased that the ANAO report concluded that the Tax Office has initiated significant improvements to the administrative and costing systems that support its regulation and registration of SMSFs; as well as noting the further changes to SMSF management practices in implementing the simpler super reforms.

We agree with the six recommendations contained in the report. We have commenced progressing some of the recommendations but note that some will take time to complete given the need to implement and bed down the simpler super measure and the redevelopment of the Tax Office's business system.

Enclosed are our responses to the six recommendations, as well as our summary response.

Should you wish to discuss this matter further please contact me on (02) 6216 1840.

Thank you for the constructive and co-operative approach to this review. I would like to commend to you the work of Jonathon Hansen, Ben Sladic, Elisa Serje and Lesa Craswell, who were committed, professional and thorough in their dealing with the Tax Office representatives throughout the course of this audit.

Yours sincerely

Raelene Vivian
Deputy Commissioner, Superannuation
12 June 2007

<p>Recommendation</p> <p>No. 1</p>	<p>To provide assurance that risks to the operation of self managed superannuation fund (SMSF) policy and legislation are identified in a timely way, the ANAO recommends that the Tax Office:</p> <ul style="list-style-type: none"> • monitors information and intelligence collected in relation to investment products targeted at SMSFs; and • clearly defines the review processes and procedures which will ensure it is able to establish its position on a timely basis, and if necessary, to advise Treasury of risks to the effective operation of relevant superannuation legislation. 	<p><i>Tax Office Response: Agree</i></p> <p>The Tax Office has always undertaken an active role in identifying risks that affect SMSF policy and legislation and has always progressed areas of concern to Treasury and co-regulators.</p> <p>Further it has, and continues to, actively involve and engage both internal and external stakeholders so as to identify possible risks, find solutions and, where appropriate, advise the community. For example, through the Tax Office Superannuation Consultative Committee, the Tax Office engages in continuous consultation and collaboration to seek views, advise on the implementation of government policy on superannuation, and to resolve issues by working together.</p> <p>Given the importance the Tax Office places on this issue it has undertaken a program of continuous improvement and, most recently, it restructured its intelligence capability so as to identify risks in a more timely and accurate manner.</p> <p>Once an issue has been identified, the Tax Office has a structured process in place that ensures the issue is escalated to Treasury and the co-regulators, as appropriate. For example, in 2005 the Tax Office undertook a review of all aspects of SMSFs, including the outcome of a number of benchmarking projects and areas of concern. This document was later used by Treasury in its formulation of SMSF policy that was used in the simpler super measure.</p> <p>The Tax Office also has formal systems in place so that the community can be advised in a timely manner, for example by the release of fact sheets, ATO interpretive decisions (ATOIDs) and rulings. Examples of where the Tax Office is improving assurances that can be given to the community include the proposed release in July 2007 of Tax Office rulings on interpreting the SISA.</p>
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<p>Recommendation</p> <p>No. 2</p>	<p>To improve its accountability for the regulatory services it provides to self managed superannuation funds (SMSFs), and to comply with the Australian Government's Cost Recovery Guidelines, the ANAO recommends that the Tax Office:</p> <ul style="list-style-type: none"> • in consultation with the Treasury, clarify the extent to which the Superannuation (Self Managed Superannuation Fund) Supervisory Levy recovers the costs of regulating SMSFs; • periodically reviews the levy rate to accurately reflect Tax Office regulatory costs covered by the levy in accordance with the Australian Government Cost Recovery Guidelines; • examines the costs and benefits of developing information systems which distinguish levy revenue from other tax revenue; • develops and implements procedures to identify and collect levy payments that are not remitted; and • publicly report on the amount of annual levy revenue collected and the Tax Office's cost of administering SMSFs, in accordance with the disclosure requirements under the Government's cost recovery policy. 	<p>Tax Office Response: Agree</p> <p>The Tax Office agrees to consult with Treasury to clarify the extent to which the supervisory levy recovers the costs of regulating SMSFs.</p> <p>The Tax Office will also work with Treasury to implement review processes so that the levy continues to provide appropriate cost recovery of the Tax Office's functions in accordance with Australian Government Cost Recovery Guidelines.</p> <p>The Tax Office already has systems in place that distinguish SMSF levy revenue from other tax revenue. This occurs via the Generic Accounting System (GAS) which will operate until 2008. Work is continuing on the development of the new system, Integrated Core Processing, which will replace GAS, so that the levy revenue continues to be distinguished from other tax revenue.</p> <p>Various options are being considered about the collection of the existing unpaid levy. Moving forward, the levy will form part of the income tax assessment and will be subject to the usual collection processes including that of recovering outstanding debts.</p> <p>Levy revenue and the Tax Office's cost of administering SMSFs will be reported in the Tax Office's annual report, in accordance with the Australian Government Cost Recovery Guidelines and financial reporting requirements.</p>
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<p>Recommendation</p> <p>No. 3</p>	<p>To improve the quality of Tax Office planning, risk management and reporting relating to SMSFs, the ANAO recommends the Tax Office improves the underlying data by:</p> <ul style="list-style-type: none"> • reviewing SMSF data to determine its accuracy and completeness; and • examining the costs and benefits of developing systems, processes and controls to detect and rectify anomalous data at the time it is entered into Tax Office systems. 	<p><i>Tax Office Response: Agree</i></p> <p>Ongoing processes are in place to improve SMSF data collection and data holdings. With streamlining of SMSF reporting under simplification, in conjunction with in-built edit checks and extensive changes to Tax Office systems, the risk to data quality will be reduced.</p> <p>Further, the introduction of the combined income tax and regulatory returns with the member contribution statement will reduce errors as:</p> <ul style="list-style-type: none"> • trustees will only be asked for the information once; • there will be cross utilisation of labels and data; and • it will be harmonised with the revised Auditor Contravention Report. <p>The Tax Office continues to explore the costs and benefits within a risk assessment framework for developing systems and processes to improve the accuracy of data provided.</p>
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<p>Recommendation No. 4</p>	<p>To provide more accurate self managed superannuation funds asset information to Government and the public, the ANAO recommends that the Tax Office:</p> <ul style="list-style-type: none"> • incorporate information on 'inactive' SMSFs in its SMSF asset estimation model; • re- evaluate the number of active SMSFs after the Lodgement Program ; and • regularly reconcile SMSF asset estimates with actual lodgement data to improve the accuracy of its estimating methodology. 	<p><i>Tax Office Response: Agree</i></p> <p>The Tax Office agrees with this recommendation as it is continually aiming to improve the methodology for estimating assets holding of SMSFs. The statistical model was developed to provide an estimate of SMSF assets at a particular point in time; figures are not available until a fund lodges an annual return. The current model has been endorsed by both the Tax Office and APRA. The Tax Office will undertake analysis of the impact of discrepancies from funds described by the ANAO as 'inactive' and the cost effectiveness of incorporating changes into the model.</p> <p>Further, as the existing model is updated on a quarterly basis the Tax Office agrees a more robust lodgement program from 2007-08 will assist in evaluation of numbers of funds in existence at a particular point in time.</p> <p>The Tax Office currently updates estimated total assets on a quarterly basis with actual return data for SMSFs using the most up-to-date lodgment information. The Tax Office will ensure a reconciliation process occurs on an annual basis.</p>
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<p>Recommendation</p> <p>No. 5</p>	<p>To provide increased assurance that the Tax Office identifies SMSFs that do not comply with their <i>Superannuation Industry (Supervision) Act 1993</i> requirements, and prevents those funds from receiving complying status, the ANAO recommends that the Tax Office:</p> <ul style="list-style-type: none"> • utilises the intelligence obtained from the SMSF registration process to more accurately assess SMSF compliance prior to issuing notices of compliance; and • develop and implement a risk-based methodology to assess SMSF compliance with their obligations prior to issuing notices of compliance 	<p>Tax Office Response: Agree</p> <p>The Tax Office current systems only enable minimal checks prior to issuing notices of compliance – with further checks undertaken at a later time. However under the third release of the redevelopment of the Tax Office’s business system (R3), the Tax Office will be able to assess, more accurately, SMSF compliance prior to the issuing of notices of compliance. R3 will recognise, to a much greater degree, at risk trustees due to improved cross matching of data held on record. Further, the Tax Office is investigating the feasibility of including on the combined income tax and regulatory return and the member contribution statement identifiers, which will highlight issues prior to the notices of compliance being issued.</p> <p>The Tax Office is in the process of markedly improving its assessment of funds that do not comply. Considerable steps have been taken to strengthen the registration process with edit checks in place to identify potential non-compliance in conjunction with improved registration and change of detail forms. The Tax Office’s ability to identify non-compliance after the issue of a notice of compliance will be enhanced by the following measures:</p> <ul style="list-style-type: none"> • improving new trustees awareness and understanding of their eligibility to be a trustee of an SMSF, as well as their ongoing obligations. (The new trustee declaration form will assist with this.); • improving compliance with the superannuation and income tax laws by increasing coverage to 2.9 per cent of funds; • mandating that trustees notify the Commissioner of Taxation of any changes of trustees of their SMSF; • requiring auditors to lodge an auditor contravention report for any reportable breach of <i>Superannuation Industry (Supervision) Act 1993</i> (regardless of dollar value) during the first year of operation an SMSF and following up 100 per cent of these; <p>improving the lodgment compliance program, with a goal of achieving, by the 2009–10 year, 94 per cent lodgment compliance within six months of the due date;</p>
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Recommendation No. 6	<p>The ANAO recommends that the Tax Office consult with the Australian Prudential Regulation Authority, and the Australian Security and Investments Commission to assess the benefits of developing a central register of persons who have been disqualified to act as trustees.</p>	<p><i>Tax Office Response: Agree</i></p> <p>The Tax Office agrees to consult with the Australian Prudential Regulatory Authority, Australian Security and Investments Commission and Treasury to assess the benefits of developing a central register of persons who have been disqualified to act as superannuation fund trustees.</p>
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Appendix 2: SMSF Legislative Requirements

1. To become a SMSF, the fund must elect to be a regulated superannuation fund and comply with the rules of the *SISA* and associated SIS Regulations. A complying superannuation fund's taxable income is taxed at a rate of 15 per cent. A non-complying fund's income is taxed at 45 per cent.
2. The *SISA* establishes a number of conditions that must be met for the fund to meet the definition of a self managed superannuation fund. First a fund must be a superannuation fund under the purposes of the *SISA*. A fund must also meet the following conditions:
 - the fund must have fewer than five members;
 - each trustee must be a member of the fund;
 - no member of the fund can be an employee of another member unless they are related;
 - each member of the SMSF must be a trustee; and
 - no trustee of the fund can receive any remuneration for their services as a trustee.¹¹⁵
3. It is also possible to have a SMSF with only one member. A single member fund may have a corporate trustee, but the member must:
 - be the sole director of the trustee or company; or
 - be related to the other director of the trustee company and there are only two directors of that company; or
 - not be an employee of the other director of the company of the trustee company and there are only two directors of that company¹¹⁶.
4. A single member fund may alternatively have two individuals as trustees. The member must be one trustee and the other trustee must be:
 - a person who is related to the member; or

¹¹⁵ *SISA* subsection 17A(2).

¹¹⁶ *SISA* paragraph 17A(2)(a).

- any other person, provided the member is not an employee of that person¹¹⁷.
5. To be a complying SMSF, no trustee of the fund is to contravene a regulatory provision in the *SISA* and SIS Regulations. This includes the following provisions:
- *Arm's-length transactions*. Any business transaction between a SMSF and its members must be conducted as if it were a commercially based transaction¹¹⁸;
 - *Acquisition of assets from a related party*. Assets cannot be acquired from related parties of a fund, although there are some limited exceptions, for example business real property and listed securities¹¹⁹;
 - *In-house assets*. Trustees are restricted from making investments in, providing loans to, or leasing assets to, a related party of the fund where the value exceeds 5 per cent of the fund's total assets (or results in the total value of the fund's in-house assets exceeding 5 per cent of the fund's total assets)¹²⁰; and
 - *Borrowings*. A superannuation fund cannot borrow except for some limited exceptions for limited periods, for example, to pay member benefits.¹²¹
6. In addition to the *SISA* and related regulatory legislation, the governing rules or trust deed of a SMSF govern the operation of the fund. The trust deed or governing rules of a SMSF are any rules contained in the trust instrument, other document or legislation, or a combination of them; or any unwritten rules, governing the establishment or operation of the fund.¹²² Section 52 of the *SISA* requires the trustees of a SMSF to put into effect the following:
- to act honestly in all matters affecting the entity;

¹¹⁷ *SISA* paragraph 17A(2)(b).

¹¹⁸ *SISA* subsection 109.

¹¹⁹ *SISA* section 66.

¹²⁰ *SISA* sections 69 to 85.

¹²¹ *SISA* subsection 67.

¹²² *SISA* subsection 10(1).

- to exercise the degree of care, skill and diligence of an ordinary prudent person;
 - to act in the best interests of the beneficiaries;
 - to keep fund assets separate;
 - to properly perform and exercise powers and functions;
 - to formulate and give effect to an investment strategy;
 - to prudently manage reserves for the fund, to discharge liabilities; and
 - allow a beneficiary to have access to information.¹²³
7. Following from the *Superannuation Simplification* changes, trustees of a SMSF must also sign a trustee declaration form within 21 days of establishing a fund. The trustee declaration form ensures that trustees understand their roles and responsibilities.¹²⁴
8. To provide adequate assurance that it is complying with the *SISA*, a SMSF must be audited each year by an approved auditor who, since July 2004 must advise the Tax Office via an ACR of any material breaches identified during the course of an audit.¹²⁵
9. A SMSF can lose the 15 per cent concessional tax treatment on taxable income if the Commissioner, pursuant to subsection 42A(5) of the *SISA*, makes the fund non-complying by applying the 'compliance test.' The compliance test considers whether a SMSF trustee has contravened regulatory provisions in the *SISA* and the SIS Regulations. If a contravention or contraventions have occurred, the compliance test requires consideration of the following:
- the taxation consequences of making a fund non-complying;
 - the seriousness of the contravention or contraventions; and
 - all other relevant circumstances.

¹²³ *SISA* sub section 52(2).

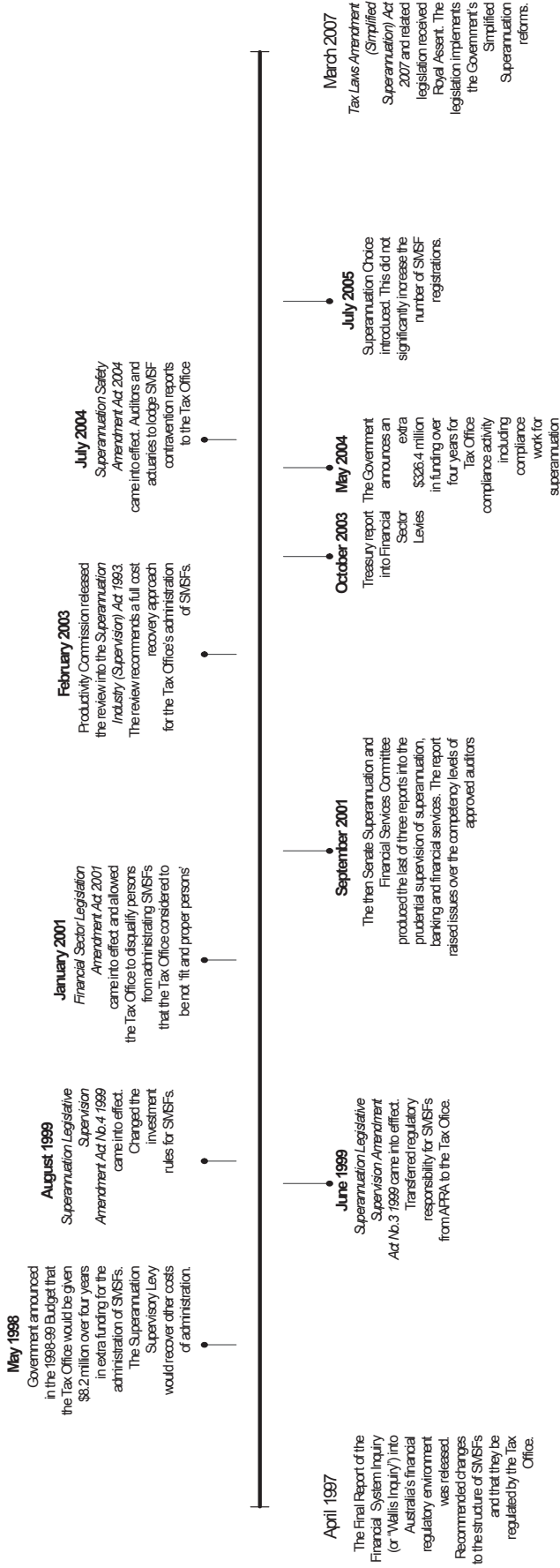
¹²⁴ *Superannuation Legislation Amendment (Simplification) Act 2007* paragraph 54(2)(b).

¹²⁵ *SISA* section 113.

Appendix 3: History of SMSFs

To understand the current SMSF regulatory framework, it is useful to examine the key events that led to the formation of SMSFs, and the Tax Office's current regulatory role. The following timeline provides an overview of the key events that have impacted on the Tax Office's current SMSF administrative responsibilities.

Timeline of key SMSF events



Source: ANAO analysis of Tax Office information

1. Up to **30 June 1999**, APRA and its predecessor, the Insurance and Superannuation Commission (ISC) had responsibility for regulating all small superannuation funds. Until this time, all small funds were known as Excluded Funds.¹²⁶
2. In **April 1997** Financial Systems Inquiry¹²⁷ (the Wallis Inquiry) recommended, amongst other things, to change significantly Australia's superannuation regulatory framework. In particular it recommended:
 - *the establishment of a new agency known as the Australian Prudential Regulation Commission.* This agency was to be responsible for the regulation of all deposit taking institutions as well as for life companies, friendly societies, general insurers and superannuation funds; and
 - *new responsibilities for excluded funds.* The inquiry recommended that the Tax Office be made responsible for regulating excluded funds, and that all members of these funds be trustees.
3. Importantly the *Wallis Inquiry* report recommended that:

...such schemes [excluded funds] are conducted entirely at the risk of the beneficiaries – in relation to financial safety, there should be no regulatory assurance attaching to such schemes.¹²⁸
4. In **June 1999** the *Superannuation Supervisory Amendment Act (No.3)* (the *Amendment Act*) came into effect. This Act re-categorised excluded funds into two new categories of small funds: SMSFs and small APRA Funds (SAFs).
5. SAFs are similar to SMSFs in most respects, except for the following:
 - SAFs are regulated by APRA;
 - SAFs have a trustee that holds an extended public offer licence;
 - SAFs are subject to the Registrable Superannuation Entity (RSE) licensing regime;

¹²⁶ Excluded funds were superannuation funds with fewer than five beneficiaries. They were established to allow the self-employed and small business to maintain their own cost-effective superannuation vehicles.

¹²⁷ S.Wallis, March 1997, *Financial System Inquiry Final Report*

¹²⁸ S.Wallis, *ibid.*, p. 334.

- members have access to the Superannuation Complaints Tribunal;
 - members have the protection of the culpability test which is designed to protect arm's-length members who are not involved in trustee decision making¹²⁹; and
 - the regulatory levy for SAFs (\$500 minimum) is higher than the current levy for SMSFs (\$45 flat fee).¹³⁰
6. The explanatory memorandum to the *Amendment Act* clarified the Tax Office's regulatory role, where it was stated that:
- As members of self managed superannuation funds will be able to protect their own interests, these funds will be subject to a less onerous prudential regime under the *SIS Act*.¹³¹
7. Another key change instituted by the *Amendment Act* was the reduction of the SMSF superannuation supervisory levy from \$200 to \$45. This levy was reduced to better reflect expected Tax Office regulatory costs, and to recognise the past cross-subsidisation of larger fund regulatory costs by small funds.
8. Since 8 October 1999, SMSFs have been regulated by the Tax Office, and at that date they accounted for approximately:
- 98 per cent of the total number of excluded funds (small funds); and
 - 90 per cent of the total value of excluded fund (small fund) assets.
9. In **September 2000**, approximately 187 000 SMSF records were transferred across from APRA to the Tax Office. The Tax Office considers that some of these records were of poor quality and required rectification. The Tax Office also suspects that prior to the *Superannuation Supervisory Amendment Act (No.3)* coming into effect,

¹²⁹ *SISA* section 42.

¹³⁰ As noted in Chapter 1, the SMSF levy will increase to \$150 from 1 July 2007.

¹³¹ The Parliament of the Australian Government of Australia, House of Representatives 1998–99, *Superannuation Legislation Amendment Bill (No.3)* 1999, p. 1

compliance by a large proportion of these funds had been poor¹³² and that ISC and APRA had undertaken a limited amount of compliance work on these funds in comparison to larger funds.

10. Significant changes were made to the Tax Office's role as regulator when the Financial Sector Legislation Amendment Act was passed in **January 2001**, allowing the Tax Office to disqualify persons that they considered not to be 'fit and proper' to manage a fund. Previously only APRA had been able to disqualify individuals from being a trustee or investment manager of any superannuation entity.
11. In **September 2001**, the then Senate Superannuation and Financial Services Committee produced the last of three reports into the prudential supervision of superannuation, banking and financial services. The report recommended that changes be made to section 16 of the *SISA*. This recommendation related to approved fund auditors being required to inform relevant regulators of funds breaching their obligations under the *SISA*.
12. In **April 2003** the Productivity Commission released a report into the *SISA*. The report recommended that the costs of administering SMSFs should be fully cost recovered. This is consistent with the Government's cost recovery policy as well as funding arrangements for APRA and ASIC regrading the regulation of superannuation funds.
13. In **October 2003**, the Department of the Treasury released a report into financial sector levies relevant to APRA, ASIC and the Tax Office. The superannuation supervisory levy relating to SMSFs was not examined as part of this report, indicating that the levy does not operate on a cost recovery basis.
14. In **July 2004**, the *Superannuation Safety Amendment Act 2004* came into effect. This Act required fund auditors (including approved auditors) and actuaries to lodge auditor contravention reports with fund regulators. Specifically, it requires approved auditors to notify the Tax Office of any major breaches of the *SISA* by SMSFs, regardless of whether SMSFs take action to resolve the breaches.

¹³² In 1997, the ISC undertook a survey of the compliance practices of 1 000 funds. Approximately 20 per cent were investing in unit trusts controlled by the members or the employer sponsor, and about half of these unit trusts were involved with geared investments (see the Explanatory Memorandum to Superannuation Legislation Amendment Bill (No.4) 1999: Attachment F). The ANAO notes that there were industry criticisms of the ISC's approach and the conclusions of the survey.

15. In **July 2005**, the Superannuation Choice legislation came into force. This gave many employees the right to choose the superannuation fund to receive their superannuation contributions. The Tax Office prepared for the possibility of significant increases in the number of SMSFs due to the Superannuation Choice legislation. However, significant increases in SMSF numbers did not occur.¹³³
16. In **March 2007**, the *Tax Laws Amendment (Simplified Superannuation) Act 2007* and related legislation received Royal Assent. This legislation implements the Government's *Simplification Superannuation* reforms. This includes changes to the reporting arrangements for SMSFs; clarification of SMSF trustee and approved auditor requirements and the application of administrative penalties to SMSFs.

¹³³ Figure 1.2 shows that numbers of SMSFs have been increasing at a relatively consistent rate since 1999–2000, and that no significant increases in SMSF numbers occurred after the introduction of Superannuation Choice legislation.

Appendix 4: Tax Office SMSF Regulation Funding, Expenditures and SMSF Levy Revenues Information from 1999–2000 to 2006–07

	1999–2000 (\$millions)	2000–01 (\$millions)	2001–02 (\$millions)	2002–03 (\$millions)	2003–04 (\$millions)	2004–05 (\$millions)	2005–06 (\$millions)	2006–07 (\$millions)
Output Pricing Agreement 1 (1999–2000)	10.50	11.9	12.6					
Output Pricing Agreement 2 (2002–03)				14.4	14.7	15.0	15.3	15.6
2004–05 Budget measure (compliance challenges)						3.3	4.5	4.5
2005–06 Superannuation Choice funding							1.1	1.5
2006–07 Budget measure (<i>Simplification Superannuation</i>)								2.0
Total Funding per annum	10.50	11.90	12.60	14.40	14.70	18.30	20.90	23.60

	1999–2000 (\$millions)	2000–01 (\$millions)	2001–02 (\$millions)	2002–03 (\$millions)	2003–04 (\$millions)	2004–05 (\$millions)	2005–06 (\$millions)	2006–07 (\$millions)
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Revenue collected through SMSF Levy

	1999–2000 (\$millions)	2000–01 (\$millions)	2001–02 (\$millions)	2002–03 (\$millions)	2003–04 (\$millions)	2004–05 (\$millions)	2005–06 (\$millions)	2006–07 (\$millions)
Levy (estimated accrual)		11.90	9.20	12.60	10.50	10.80	13.00	

Tax Office expenditure on SMSF regulation

	1999–2000 (\$millions)	2000–01 (\$millions)	2001–02 (\$millions)	2002–03 (\$millions)	2003–04 (\$millions)	2004–05 (\$millions)	2005–06 (\$millions)	2006–07 (\$millions)
Actual expenditure					19.60	18.30	30.50	

Source: ANAO Analysis of Tax Office budget, costing and expenditures information.

Appendix 5: Illegal SMSF Scheme Case Study

Issue

Inadequate controls led to the establishment of a simple SMSF scheme that allowed members to illegally access their funds early, in part as a result of the scheme promoter's use of RoCS.

Facts

In 2003 a scheme promoter established a financial arrangement aimed at NSW State Railway employees. This simple scheme involved the promoter purporting to have established a SMSF, then advising scheme participants to roll-over their superannuation assets from their existing superannuation funds.

The promoter attracted 700 participants into the scheme. The promoter took 20 per cent of the members' superannuation assets and claimed it was the amount of tax to be remitted to the Tax Office. He kept this 'tax' for himself which was estimated at \$2 million. The promoter then advised the members' to access their superannuation assets early. This illegitimate financial arrangement allowed the members to access approximately \$10 million of superannuation assets early.

The Tax Office commenced action against the promoter in 2005 after a NSW financial adviser informed the Tax Office of the scheme in 2003. The Tax Office's registration and compliance systems were not capable of detecting this scheme during its operation.

Result

While action was being undertaken against the promoter (who subsequently changed his name), the promoter registered a similar financial arrangement in 2005 with a view to committing a similar fraud. The Tax Office is currently pursuing this case.

Issue 1: A financial arrangement affecting approximately 700 participants was attempted to be registered as a SMSF and not detected by the Tax Office

Tax Office registration and compliance processes could not detect attempts to register a SMSF (which is supposed to have between 1 to 4 members) that was used for a scheme involving 700 participants.

Issue 2: The Register of Complying Superannuation Funds (RoCS) did not specify the type of superannuation fund recorded

RoCS did not specify the type of superannuation fund recorded, so it was not possible for larger funds to know that they were rolling over superannuation amounts for members into a purported SMSF. The scheme promoter also gave the SMSF scheme a name that was similar to another large fund.

After the SMSF scheme was found to be an illegitimate financial arrangement and removed from RoCS in 2004, the scheme promoter's new SMSF scheme was placed on RoCS in 2005 and \$429 550 was accessed by the promoter. This money was also accessed early by members that had transferred their superannuation benefits into the scheme.

Issue 3: The illegal SMSF scheme continued to receive contributions from members 11 months after the scheme was discovered

Despite the Tax Office being aware of the original SMSF scheme in March 2003, members of the illegal SMSF were allowed to roll over and access their superannuation benefits until February 2004.

Issue 4: The promoter was not disqualified until three years after the Tax Office identified the scheme

The Tax Office took almost three years to make a decision to disqualify the scheme promoter as trustee. This occurred in May 2006. The Tax Office noted that this was due in part to: the Tax Office not having adequate procedures in place to disqualify trustees; and the Tax Office seeking legal clarification on how (and whether it was able) to disqualify trustees.

Issue 5: The promoter set up a new SMSF scheme while under investigation by the Tax Office

Disqualification did not prevent the promoter from establishing another SMSF scheme for the intended purpose of early access in the same month they were disqualified. The Tax Office advised that it was not able to prevent the scheme promoter from attempting to register a new fund even though being disqualified.

Issue 6: The Tax Office did not immediately schedule an audit of the schemes, even though it had detected potential non-compliance with the SISA

There was also a significant period between identifying potential non-compliance of the purported SMSF and undertaking compliance activity. In the case of the first SMSF scheme, the Tax Office was first notified of potential non-compliance in March 2003 and audit activity officially commenced in December 2005. Similarly, the Tax Office took 18 months from identifying the second illegal SMSF scheme to conducting an audit on the arrangement.

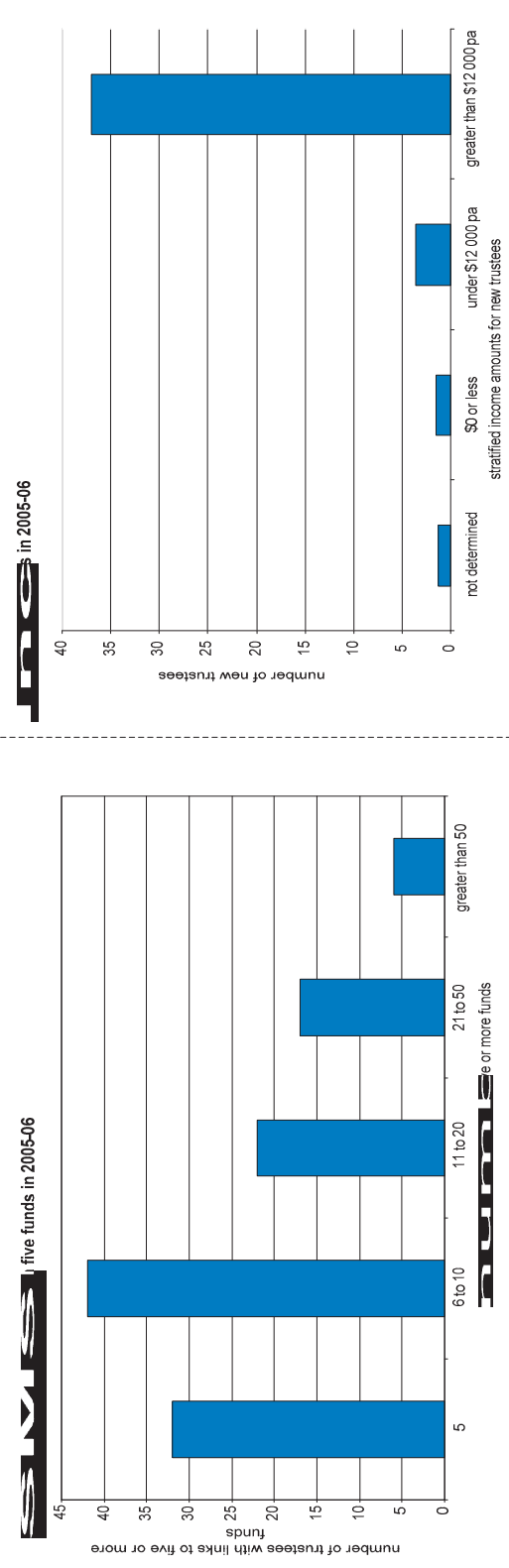
Appendix 6: Registration of SMSFs and the Superannuation Integrity Project

1. In June 2004 the Tax Office recognised that, among other issues, its registration process was inadequate to provide assurance that illegitimate funds were not being registered. To resolve the identified weaknesses in the Tax Office's registration for SMSFs (including data integrity issues), the Tax Office commenced the Superannuation Fund Integrity (SFI) Project. A number of recommendations emerged from the Project to improve the Tax Office's SMSF registration process. These included:
 - developing a mechanism to receive and store data from the other regulators to enhance the accuracy of registration checks;
 - establishing controls to detect and prevent early access schemes at the point of registration;
 - implementing new registration checks to detect those SMSFs that may become non-compliant post registration;
 - addressing funds that are not registered within the same financial year as establishment and are taxed concessional; and
 - collecting information on registration to determine whether applicants are eligible to be SMSF trustees.
2. The Tax Office reviewed the status of the changes proposed above in April 2005 and determined that it was not feasible to proceed with the proposed changes in their entirety. Specifically, it has not proceeded with initiatives to implement controls at the point of registration to detect and prevent high risk schemes from registering as SMSFs. It has implemented several changes that have improved the registration process, including:
 - changes to the registration form involving new disclosure requirements¹³⁴ to determine whether the trustees of a fund are ineligible persons;

¹³⁴ These changes included whether the trustee has been convicted of an offence; subject to the civil penalty under the SISA; discharged or bankrupt or had been disqualified by the regulator.

- the introduction of a 'Change in details' form, allowing SMSFs to notify the Tax Office of changes made to the fund including: entity type; structure; residency status and entity name details. These forms are reviewed by a team in the operations area; and
 - incorporating registration checks in the Tax Office's post registration risk identification tools.
3. The ANAO acknowledges these initiatives and considers there is scope to revisit some of the recommendations of the SFI Project once the Tax Office has received additional funding in 2007–08 (see Chapter 1).

Appendix 7: Registration Intelligence Overview



Source: ANAO analysis of Tax Office data.

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