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Audit Report No.13 2007–08
Performance Audit

The Australian Taxation Office's Approach to Managing Self Managed Superannuation Fund Compliance Risks

Australian Taxation Office

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Canberra ACT
1 November 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 Managing Self Managed Superannuation Fund Compliance Risks.*

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

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.

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Abbreviations

ACR	Auditor contravention report
ANTS	*A New Tax System*
APRA	Australian Prudential Regulatory Authority
ASIC	Australian Securities and Investment Commission
GST	Goods and Services Tax
FTE	Full time equivalent
HOTSA	Health of the System Assessment
MCS	Member Contribution Statement
NTEC	New Trustee Education Campaign
RAP tool	Risk assessment profiling tool
RoCS	Register of Complying Superannuation Funds
SISA	*Superannuation Industry (Supervision) Act 1993*
SIS Regulation	Superannuation Industry (Supervision) Regulations
SMSF	Self managed superannuation fund
TAA	*Taxation Administration Act 1953*
Tax Office	Australian Taxation Office
Treasury	Department of the Treasury

Summary and Recommendations

Summary

Introduction

1. This is the second of two audit reports concerning the Australian Taxation Office's (Tax Office's) administration of self managed superannuation funds (SMSFs) pursuant to the provisions of the *Superannuation Industry (Supervision) Act 1993*. The first audit report, tabled in June 2007[1], examined the efficiency and effectiveness of the Tax Office's approach to regulating and registering self managed superannuation funds.

2. 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.

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 can be broadly categorised under *SISA* into those regulated by the Australian Prudential Regulation Authority (APRA) and SMSFs, which are regulated by the Tax Office. As discussed in the first audit report[2] the *SISA* legislation is complex with a number of *SISA* provisions and SIS regulations common to APRA and the Tax Office in their regulation of these two very different superannuation market segments.

5. The Government has recently initiated significant changes that will assist the Tax Office to regulate SMSFs and to simplify applicable administrative functions for SMSF trustees. On 15 March 2007, the *Tax Laws Amendment (Simplified Superannuation) Act 2007* and related legislation received Royal Assent. These changes generally applied from 1 July 2007.

6. As at 30 June 2006, the Tax Office was responsible for the regulation of some 320 000 SMSFs (approximately 98 per cent of all complying superannuation funds)[3], comprising 616 000 members[4] (approximately

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[1] See ANAO Report No.52 2006–07 *The Australian Tax Office's Approach to Regulating and Registering Self Managed Superannuation Funds*.

[2] ibid, paragraph 2.9

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

2 per cent of all superannuation member accounts[5]). 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.[6]

7. SMSFs, by statutory definition, are superannuation funds:

- with fewer than five members (all of whom are trustees[7]);
- 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).

Audit scope and objective

8. This second audit report relating to SMSFs examines the effectiveness of the Tax Office's approach to managing SMSF compliance risks. Specifically the ANAO examined 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
- administer fund wind-ups.

Conclusion

9. In 1999–2000 the Tax Office assumed regulatory responsibility for SMSFs, a sector of the superannuation industry that had received minimal 'compliance checking' from previous regulators. At this time, the Tax Office was aware of significant non-compliance in a range of areas, however prior to 2003–04 the Tax Office's approach to managing SMSF compliance risks was largely educational. This was in part due to organisational constraints

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

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

6 Tax Office data from its Revenue Analysis Branch.

7 Unless, for example, the member is subject to a legal disability (subsection 17A(3) of the *SISA*).

associated with the introduction of *A New Tax System* and was also consistent with the Tax Office Compliance Model.

10. The Tax Office's management of compliance risks has been influenced by its initial approach to regulating and registering SMSFs. As noted in the previous SMSF audit report the Tax Office could have taken steps to improve the collection and assessment of registration data, and fund income tax and regulatory return data, prior to issuing SMSFs with complying fund status. This filtering of new SMSFs would have assisted the Tax Office to limit the extent of non-compliance given that the number of SMSFs registered in the period 2000–01 to 2003–04 increased from 210 600 to 281 100.

11. Specific analysis undertaken by the Tax Office in 2002–03 and 2003–04 revealed high levels of non-compliance across the SMSF population and became the catalyst for significant changes to the Tax Office's SMSF compliance approach.

12. Since 2003–04 the Tax Office has sought to resolve SMSF non-compliance through a combination of educational strategies and increased active compliance activity. However, low Tax Office compliance audit coverage and the Tax Office's discretionary use of the SMSF penalty regime has resulted in few funds in breach of the *SISA* being subjected to remedial measures.

13. The ANAO considers the implementation of *Simplified Superannuation* reforms and the additional resources provided to the Tax Office will impact on the Tax Office's management of SMSF compliance risks in the future. In particular, tripling of the SMSF active compliance workforce, the associated increase in audit coverage of SMSFs and the requirement for an annual audit by an approved auditor can be expected to improve SMSF compliance with their *SISA* and income tax obligations. However, given the continuing significant growth in the number of new SMSFs, the Tax Office will need to monitor the effectiveness of its compliance approach in light of these latest reforms and its ongoing assessment of SMSF compliance.

14. Notwithstanding the increase in compliance activity, the ANAO considers that the Tax Office has significant potential to establish more effective processes for identifying and mitigating SMSF compliance risks. Until it does so, it will not be in a position to provide adequate assurance that its compliance approach is effective and that SMSFs are complying with their obligations.

Key findings by chapter

Background and context (Chapter 1)

15. When the Tax Office assumed responsibility for SMSF regulation it had been noted in the *Wallis Inquiry*[8] that as the members of SMSFs are also trustees of the fund, they were expected to be able to protect their own financial interests. This is in part supported by a number of requirements within the *SISA*, most notably the requirement for SMSFs to undergo an independent audit examination by an approved auditor.[9] The annual audit comprises a financial audit of a fund's accounts and a compliance audit against the *SISA* requirements.

16. The annual audit process undertaken by an approved auditor is regarded as a key leverage point in achieving greater compliance by superannuation funds. In September 2001, the Senate Select Committee on Superannuation and Financial Services reviewed the competency requirements of approved auditors.[10] In particular, the Committee reviewed the adequacy of auditing and accounting standards; the reporting requirements under the *SISA*; the quality of audit reports; and the role of professional bodies in improving compliance.

17. In 2004 the Government passed the *Superannuation Safety Amendment Act 2004 (Superannuation Safety Act)* to strengthen the prudential regulation of superannuation funds. Measures introduced by the *Superannuation Safety Act*, such as the introduction of Auditor Contravention Reports (ACRs), had a notable impact on the operations of SMSFs and the regulatory approach of the Tax Office.

Simplified Superannuation

18. As part of a series of ongoing reforms to simplify and streamline the superannuation system, the Government has recently initiated significant changes to assist the Tax Office to regulate the SMSF regime and to simplify applicable administrative functions for SMSF trustees. The changes delivered by this legislation generally applied from 1 July 2007 and include:

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8 S. Wallis, March 1997, Financial System Inquiry Final Report.

9 Regulation 1.04 of the SIS Regulations states that an approved auditor may be: (a) the Auditor-General of the Commonwealth, a state or territory or (b) a registered auditor under the Corporations Law or (c) be associated in a specified manner with a professional organisation (as prescribed in Sch 1AAA).

10 Senate Select Committee on Superannuation and Financial Services- *Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services- Third report- Auditing of Superannuation Funds,* September 2001.

- streamlining fund reporting requirements;
- introducing a trustee declaration form to ensure new trustees, or directors of corporate trustees, understand their duties as trustee of a SMSF;
- requiring approved auditors to lodge a report in the first year of a fund's operation where there has been any contravention of the *SISA*;
- new administrative penalties for late returns and false statements; and
- increasing the superannuation supervisory levy from $45 to $150 to recover the Tax Office's regulatory costs.

19. The Tax Office also plans to improve SMSF compliance with income tax and superannuation laws by almost tripling its current case work levels over the next two years. This will involve:

- increasing Tax Office audit coverage of SMSFs by 2.9 per cent of funds (equating to 6500 additional compliance reviews and audits for 2007-08); and
- between 2007–08 and 2009–10, annually undertaking reviews of the returns submitted by 7 per cent of approved SMSF auditors.

Identification and selection of compliance risk cases (Chapter 2)

20. With over 360 000 SMSFs now currently operating in this market segment, it is to be expected that there will be some level of non-compliance with *SISA* and income tax obligations. Education of trustees undertaken by the Tax Office during the lifecycle of SMSFs is a broad based activity to address non-compliance across the whole market segment. However, it is essential the Tax Office also has a systematic risk-based methodology for identifying and resolving specific non-compliant SMSF behaviour.

21. In identifying significant non-compliance in a range of areas when first given responsibility for the regulation of SMSFs, the Tax Office adopted and promoted an educational approach to support SMSF trustees to comply with their obligations between 1999–2000 and 2002–03. Although constrained by resources, the ANAO considers the Tax Office could have done more at the time to better understand SMSF compliance risks originally identified in its 1999–2000 risk assessment.

22. To assess the extent of SMSF non–compliance, the Tax Office completed two Benchmarking Projects in 2002–03 and 2003–04. The Benchmarking

Projects were used to determine an overall measure of compliance for the broader SMSF population.[11] Based on the results of the 2003–04 Benchmarking Project, an estimated 9.2 per cent of SMSFs have low levels of compliance with their *SISA* obligations.

23. The Benchmarking Projects became the catalyst for significant change to the Tax Office's SMSF compliance approach in 2004–05. Since the Tax Office has not undertaken further Benchmarking analysis, the results of the 2003–04 Project continue to be heavily relied on by the Tax Office when assessing levels of SMSF non-compliance. While it is in the process of developing a comprehensive approach to SMSF compliance, capable of producing better compliance intelligence, the ANAO considers that the Tax Office should continue to undertake Benchmarking Projects on a periodic basis.

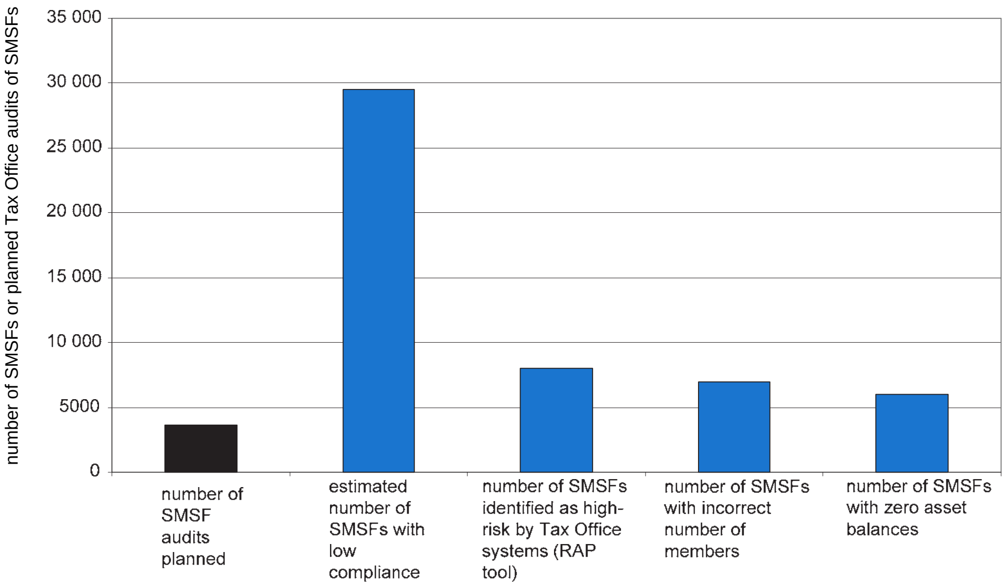
24. Since 2004–05 SMSFs have been rated by the Tax Office Executive as a 'severe' compliance risk. This coincided with the Tax Office being funded in 2004–05 to undertake 3600 compliance audits.

25. Table 1 below compares the estimated number of SMSFs likely to not be complying with the *SISA* based on 2001–02 data highlighted in the 2003–04 Benchmarking result, and other high risk indicators derived from Tax Office data, with the number of compliance audits funded for 2004–05.

[11] The Tax Office engaged the Australian Bureau of Statistics to design the selection methodology. The sample of funds selected by the Tax Office is statistically valid, with a target standard error of 0.02 per cent.

Table 1

Number of planned Tax Office audits of SMSFs compared to the number of SMSFs likely to not be complying with their *SISA* obligations in 2004-05



Source: ANAO analysis of Tax Office information.

26. Based on the results of the 2003–04 Benchmarking Study an estimated 28 000 (or 9.2 per cent of the total) funds as at June 2005 potentially had low levels of compliance with their *SISA* obligations.[12] Other indicators of funds likely to not be complying with the *SISA* included 8000 funds specifically identified by Tax Office systems; 7000 funds with either zero or greater than four members; and 6000 funds with zero asset balances.

27. The Tax Office advised that the number of SMSFs with low compliance calculated using the 2003–04 Benchmarking Study will have been influenced by various activities, including the following, which may have decreased this number:

- measures introduced by the *Superannuation Safety Act* from 1 July 2004, such as the ACR which made it mandatory for the notification of breaches to the Tax Office in certain circumstances;

[12] This was determined by extrapolating the results of the 2001–02 data in the 2003–04 Benchmarking Project to 2004–05 actual data.

- the release of education products including *DIY Super It's your money…but not yet!* and the Tax Office presenting over 100 seminars per year to the SMSF community; and
- the influence of the New Trustee Education Campaign on trustees' behaviour in following years.

28. Notwithstanding the identification of large numbers of funds receiving SMSF tax concessions, but which were at a high risk of *SISA* non-compliance, the Tax Office audit coverage to address this significant risk profile was very low. Similarly, the Tax Office approach to audit case selection at that time was based on a variety of other indicators that extended beyond those risk indicators highlighted in Table 1. As a result the low level of audit coverage did not focus on the areas of highest risk.

29. Consequently, the Tax Office did not have an adequate SMSF compliance strategy for the 2004–05 year to respond adequately to the risk profile presented by either its Benchmarking studies or the other key risk indicators available.

30. The ANAO notes the Tax Office proposal to triple its SMSF casework from 2007–08 should enhance its ability to encourage greater SMSF compliance going forward.

31. The concessional taxation treatment of superannuation is the largest reported single tax expenditure by the Government. There are a large number of SMSFs that have potentially committed multiple serious breaches of the *SISA* and a significant number are at risk of being penalized, or being deemed as 'non-complying.' If a fund is deemed as non-complying it loses its tax concessional status. The ANAO notes however, that to date, the Tax Office has encouraged funds to rectify breaches where they are found, rather than make funds non-complying. Only when a fund refuses to rectify a serious breach of the *SISA* or has recurrent breaches would the Tax Office make a fund non-complying.

32. The limited Tax Office compliance audit coverage means that funds in breach of the *SISA* are unlikely to be subjected to remedial measures and therefore are in a position to receive concessional taxation treatment for their superannuation funds. The ANAO sought to estimate the potential revenue implications in respect of those SMSFs which continue to receive tax concessions but which were most at risk of non-compliance.

33. Using the compliance levels established by the Benchmarking Projects the ANAO analysed the tax concessions claimed by SMSFs from 1999-2000 to 2005–06. The estimated annual average value of income tax concessions claimed by SMSFs during this period was some $2.3 billion per annum. During the same period the minimum estimated annual average value of income tax concessions claimed by SMSFs with potentially multiple serious breaches of the *SISA* was some $230 million per annum.

34. Using lodgement information as at March 2007, the Tax Office estimated the amount of income tax not reported by active SMSFs for the period 1999–00 to 2004–05, was approximately $500 million.

35. In influencing SMSF compliance and thereby minimising the risk to Australian Government revenue, it is important for the Tax Office to generate reliable intelligence about SMSF compliance behaviour. The two main sources of intelligence used by the Tax Office to identify high-risk SMSF compliance cases are the income tax and regulatory returns lodged by funds and information received from approved auditors.

36. Prior to October 2004 there was no lodgement assessment process to encourage timely, complete and accurate reporting by SMSFs. This included the Tax Office not applying penalties for the late lodgement of regulatory returns, although under the *SISA* an individual is guilty of an offence if they fail to do so. The ANAO estimates by not applying the regulatory return penalty, the Tax Office has foregone some $29 million in penalty payments.

37. The Tax Office introduced some interim measures to achieve lodgement compliance in 2005–06. Project work undertaken in late 2006 identified a number of SMSF lodgement compliance issues and the Tax Office has now taken steps to develop a suitable superannuation lodgement enforcement program. The inconsistent approach taken in the past by the Tax Office in applying penalties to SMSFs that have not met their lodgement obligations may have also influenced current SMSF lodgement compliance practices.

38. The *Simplified Superannuation* reforms will now only require trustees of SMSFs to lodge a single annual return. New administrative penalties will also apply to SMSFs for failing to lodge documents on time or making false or misleading statements in their returns. The Tax Office considers these changes should improve the accuracy of information reported by SMSFs in the future

and help to rectify current inconsistencies in the imposition of lodgement penalties.

39. The Tax Office is commencing a lodgement enforcement program in 2007–08 directed towards increasing the number of SMSFs that lodge their returns within six months of the due date from the current levels of 70 per cent to 94 per cent by the end of 2009–10.

40. As noted previously, the Tax Office relies heavily on the work undertaken by approved auditors to report SMSF non-compliance with the *SISA*. However, the Tax Office did not take any action until 2003–04 to assess whether approved auditors were adequately meeting their obligations. Tax Office reviews indicated a significant proportion of approved auditors did not conduct high quality SMSF audits. The Tax Office is updating its approach and procedures for taking action against approved auditors that do not adequately meet their obligations.

41. The ANAO examined the extent of approved auditor information collected by the Tax Office from fund returns and found it was generally not adequate to accurately identify the approved auditor shown on the return. The Tax Office advised that changes to the annual return form implemented as part of the *Simplified Superannuation* reforms, should improve the quality of approved auditor information collected for the 2007–08 financial year onwards.

42. The implementation of these changes is unlikely to improve the Tax Office's approved auditor data holdings until late 2008 at the earliest. In preparation for this, the ANAO considers there would be benefit from the Tax Office cleansing its existing approved auditor data of erroneous, duplicated and/or incomplete records where possible.

43. Similarly the ANAO notes that the proposed changes, of themselves, will not allow the Tax Office to validate the bona fides of the fund auditors in terms of their membership of an approved professional organisation through matching its data with the professional bodies' records. The ANAO considers that to improve the verification of approved auditor information, the Tax Office should seek to expand existing working relationships with professional organisations.

44. The ANAO notes that *Simplified Superannuation* reforms will mandate the lodgement of an 'approved form' to replace the auditor contravention reports (ACRs). Previously the ACRs were lodged with the Tax Office after being prepared by approved auditors when they considered *SISA* breaches

were serious and may affect the financial interests of the fund's members. The Tax Office advised that since the introduction of ACRs in 2004, breaches reported by approved auditors have not always aligned with the Tax Office's view of a serious breach. The new legislation will now prescribe those matters to be reported by approved auditors on the approved form.

45. The Tax Office's approach to selecting high-risk SMSFs for compliance assessment has continued to develop since 2004. The Tax Office is introducing an Operational Analytics (OA) capability to improve its case selection approach for high-risk SMSFs. In addition to improving the focus and basis of its case selection approach, the Tax Office intends that the OA capability will reduce the level of manual review and the potential for inconsistent case selection decision processes relative to the risks identified.

Mitigating and reporting compliance risk cases (Chapter 3)

46. The Tax Office has adopted a variety of compliance approaches and products to address the various types and severity, of non-compliant behaviour. These approaches and products have ranged from SMSF trustee support and assistance (such as education products and rulings) to Tax Office audits and reviews.

47. When the Tax Office assumed responsibility for SMSFs in late 1999, it identified[13] a knowledge deficiency among trustees of small funds in relation to their obligations. The Tax Office conducted a number of educational initiatives to address this knowledge gap, including a campaign contacting new trustees of SMSFs, issuing a number of publications and providing telephony services to SMSF trustees.

48. The Tax Office could also develop more educative compliance products based on known high-risk areas and target SMSF trustees at all stages of the fund lifecycle rather than only new trustees. The ANAO considers there is scope for the Tax Office to consider the costs and benefits of re-introducing an educative compliance approach similar to the now defunct New Trustee Education Campaign to supplement its evolving Compliance Program.

49. As part of its education process, the Tax Office will begin to issue *SISA* interpretative decisions for SMSFs as from September 2007. To avoid public uncertainty about the role and function of the new *SISA* based superannuation

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13 The Tax Office used information from a variety of sources to assess SMSF trustee knowledge. These information sources include the APRA, workshops conducted with superannuation fund professionals and Tax Office research.

rulings regime these non-binding rulings should be clearly differentiated from the existing regime of taxation rulings which are legally binding on the Tax Office. Appropriate processes to support the construction of the new *SISA* superannuation rulings regime will also be needed.

50. Following the results of its Benchmarking Projects, the Tax Office adjusted its compliance strategy to focus more on an 'active compliance' approach from 2003–04. A wide variety of activities is deemed to constitute 'active compliance' for example, letters, telephone calls and desk and field audits.

51. The application of penalties for non-compliant SMSF trustee behaviour is an essential component of a well functioning compliance framework. As a consequence of not having a robust active compliance program in place until 2003–04 and the inflexibility of the *SISA* penalty regime, before 2006, the Tax Office imposed few penalties on SMSF trustees.

52. In November 2006, to clarify its policy on administering the penalties, the Tax Office issued new practice statements for use by its active compliance staff. As of 1 July 2007 a new penalty regime for SMSFs was introduced under *Simplified Superannuation* reforms. The effectiveness of the new regime may benefit from an evaluation after an appropriate period to assess the flexibility the Tax Office has in administering the *SISA* and in applying appropriate penalties to SMSF trustees or their intermediaries.

Self managed superannuation fund wind-ups (Chapter 4)

53. The wind-up of a SMSF occurs when trustees decide to terminate the fund, usually resulting in SMSF monies being rolled into another superannuation fund. An effective process for winding-up a SMSF is fundamental to the protection of retirement savings and in assisting Tax Office systems to accurately record the number of active SMSFs.

54. The ANAO found the educational material on wind-ups is inadequate having regard to the importance of this activity. The Tax Office has identified through a review that the adequacy of educational material and the lack of well defined administration processes has created uncertainty for some SMSF trustees involved in winding-up of funds. This has created additional workload for the Tax Office in confirming the status of SMSFs that have been wound-up, and has impacted on SMSF reporting.

55. The ANAO considers the Tax Office should review its educational material provided to SMSF trustees to assist with wind-ups to ensure the

content is both appropriate and consistent with the legislative requirements imposed on SMSFs. The ANAO also considers the introduction of a single form to replace the nine currently available methods for trustees to wind-up SMSFs would simplify SMSFs' reporting obligations and reduce current administrative costs.

Recommendations

56. The ANAO made six recommendations aimed at improving the Tax Office's approach to managing self managed superannuation fund compliance risks. The Tax Office agreed to all six recommendations made.

Summary of Agency's response

57. The Tax Office welcomes this review and considers the report is supportive of our overall compliance direction in administering self managed superannuation funds (SMSFs).

58. In keeping with the objective of Australia's superannuation system - to assist and encourage people to achieve a higher standard of living in retirement than would be possible from the age pension alone – the Tax Office does not automatically make a fund non-complying if there is a breach of the superannuation laws. Its role is focussed on retirement income, not revenue protection. It works with trustees to help them meet their superannuation law obligations and preserve their retirement income. In doing so, the Tax Office's aim is to be as least intrusive as possible to the majority of individuals and businesses who want to meet their superannuation law obligations, while at the same time being highly visible to those who are reluctant to comply.

59. The Tax Office agrees that the implementation of Simplified Superannuation reforms and the additional resources provided to it will impact on the management of SMSF compliance risks in the future. The tripling of SMSF active compliance work, the associated increase in audit coverage of SMSFs and the requirement for an annual audit by an approved auditor are expected to improve SMSF compliance with the superannuation and income tax law obligations.

60. The Tax Office agrees with the six recommendations contained in the report. Some of the recommendations found in this report were already being implemented prior to the audit, or alternatively are now being implemented. And, as with all activities that are undertaken, the Tax Office continually assess

their effectiveness so as to ensure that actual outcomes are aligned with desired outcomes.

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

Recommendations

Recommendation No.1

Para 2.17

To assist in determining its SMSF compliance programme, the ANAO recommends the Tax Office:

- assess the costs and benefits of undertaking periodic benchmarking exercises that indicate overall SMSF compliance levels; and
- develop performance indicators for each benchmarking exercise that enable measurement of the success of compliance approaches over time.

Tax Office response: Agreed

Recommendation No.2

Para 2.76

To improve the quality of approved auditor information held by the Tax Office, and to increase assurance that all SMSFs are audited only by approved auditors, the ANAO recommends the Tax Office:

- undertake processes to cleanse its approved auditor data of erroneous, duplicated and/or incomplete records; and
- seek to expand existing working arrangements with the professional organisations including to examine ways to confirm all approved auditors listed on Tax Office systems are valid members of their organisation.

Tax Office response: Agreed

Recommendation No.3

Para 2.102

To continue to improve the selection of high-risk SMSFs for Tax Office compliance action (including Tax Office audits) and to better utilise its compliance resources, the ANAO recommends the Tax Office:

- continue to refine and fully implement its Operational Analytics capability to enable a systematic and consistent risk-based approach to identifying SMSFs that do not comply with their *Superannuation Industry (Supervision) Act 1993* obligations;
- as part of the development of Operational Analytics, utilise the information contained in other relevant Tax Office systems to obtain a 'whole of client' compliance assessment for all SMSFs, including an analysis of SMSFs' compliance histories; and
- develop procedures to assess the performance of Operational Analytics to identify high risk cases and report on the results of this performance assessment to identify potential improvements to the case selection approach.

Tax Office response: Agreed

Recommendation No.4

Para 3.26

To further refine existing Tax Office SMSF education products and approaches, the ANAO recommends the Tax Office examine the costs and benefits of:

- developing and implementing approaches to deliver educative compliance products to trustees that are targeted to address identified compliance risks;
- developing educative products targeted towards the obligations of SMSF trustees during the various stages of the fund lifecycle; and
- periodically assessing the effectiveness of these targeted SMSF educational products using client surveys or other evaluative methods.

Tax Office response: Agreed

Recommendation No.5

Para 4.19

The ANAO recommends the Tax Office update the wind-up information available on its website, and from seminars and publications to reflect the requirements imposed on SMSFs by the *Superannuation Industry (Supervision) Act 1993* and Superannuation Industry (Supervision) Regulations 1994.

Tax Office response: Agreed

Recommendation No.6

Para 4.31

To assist SMSF trustees meet their fund wind-up obligations, and to improve the effectiveness of the wind-up process, the ANAO recommends the Tax Office:

- assess the costs and benefits of current notification options; and
- consider the introduction of a single wind-up form for SMSF trustees.

Tax Office response: Agreed

Audit Findings and Conclusions

1. Introduction

This Chapter provides the background to the audit and outlines the audit approach. This report is the second of two audit reports examining the Tax Office's administration of self managed superannuation funds.

Background

Superannuation

1.1 This is the second of two audit reports concerning the Tax Office's administration of self managed superannuation funds (SMSFs) pursuant to the provisions of the *Superannuation Industry (Supervision) Act 1993 (SISA)*. The first audit report, tabled in late June 2007, examined the efficiency and effectiveness of the Tax Office's approach to regulating and registering SMSFs.[14]

1.2 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.[15]

1.3 For taxation purposes, superannuation funds are defined in the *SISA* to include schemes which are for the payment of superannuation benefits upon retirement or death. Superannuation funds are broadly categorised into those regulated by the Australian Prudential Regulation Authority (APRA) and SMSFs, which are regulated by the Tax Office.

SMSFs

1.4 The regulation of SMSFs is a large and complex area of superannuation administration. As at 30 June 2006, the Tax Office's was responsible for the regulation of some 320 000 SMSFs (approximately 98 per cent of all complying superannuation funds), comprising 616 000 members[16] (2 per cent of all

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[14] ANAO Report No.52 2006–07 *The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds.*

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

[16] Commissioner of Taxation, *Annual Report 2005–06*, p. 180

superannuation member accounts[17]). 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.

1.5 To establish a SMSF, fund trustees must comply with a wide range of provisions specified in superannuation legislation. SMSFs, by statutory definition, are superannuation funds:

- with fewer than five members (all of whom are trustees[18]);
- 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).

1.6 Although there is a large body of legislation relevant to SMSFs, there are two principal legislative instruments defining 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*)*.

1.7 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.

SMSF compliance

1.8 SMSFs were introduced on 8 October 1999[19], following a Government inquiry into the Australian financial services industry (the *Wallis Inquiry*). A key outcome of the *Wallis Inquiry* was the transfer of the regulation of SMSFs

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

[18] Unless, for example, the member is subject to a legal disability (subsection 17A(3) of the *SISA*).

[19] 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.

from APRA to the Tax Office.[20] In September 2000, approximately 187 000 SMSFs were transferred from APRA to the Tax Office.

1.9 Prior to the transfer taking place, it was suspected compliance by a large proportion of these funds had been poor.[21] Previous regulators had undertaken limited compliance work on small funds compared to larger funds under their regulation.

1.10 When the Tax Office assumed responsibility for SMSF regulation, it had been noted by the *Wallis Inquiry* that as the members of SMSFs are also trustees of the fund, they would protect their own financial interests. This is in part supported by a number of requirements within the *SISA*, most notably the requirement for SMSFs to undergo an independent audit examination by an approved auditor. This annual audit comprises a financial audit of a fund's accounts and a compliance audit against the *SISA* requirements.[22]

1.11 The Tax Office requires a SMSF's annual audit is completed before the lodgement of a fund's income tax and regulatory return. A broad overview of the administrative activities and functions separating responsibilities between the Tax Office and SMSF trustees in regulating funds, is shown in Figure 1.1.

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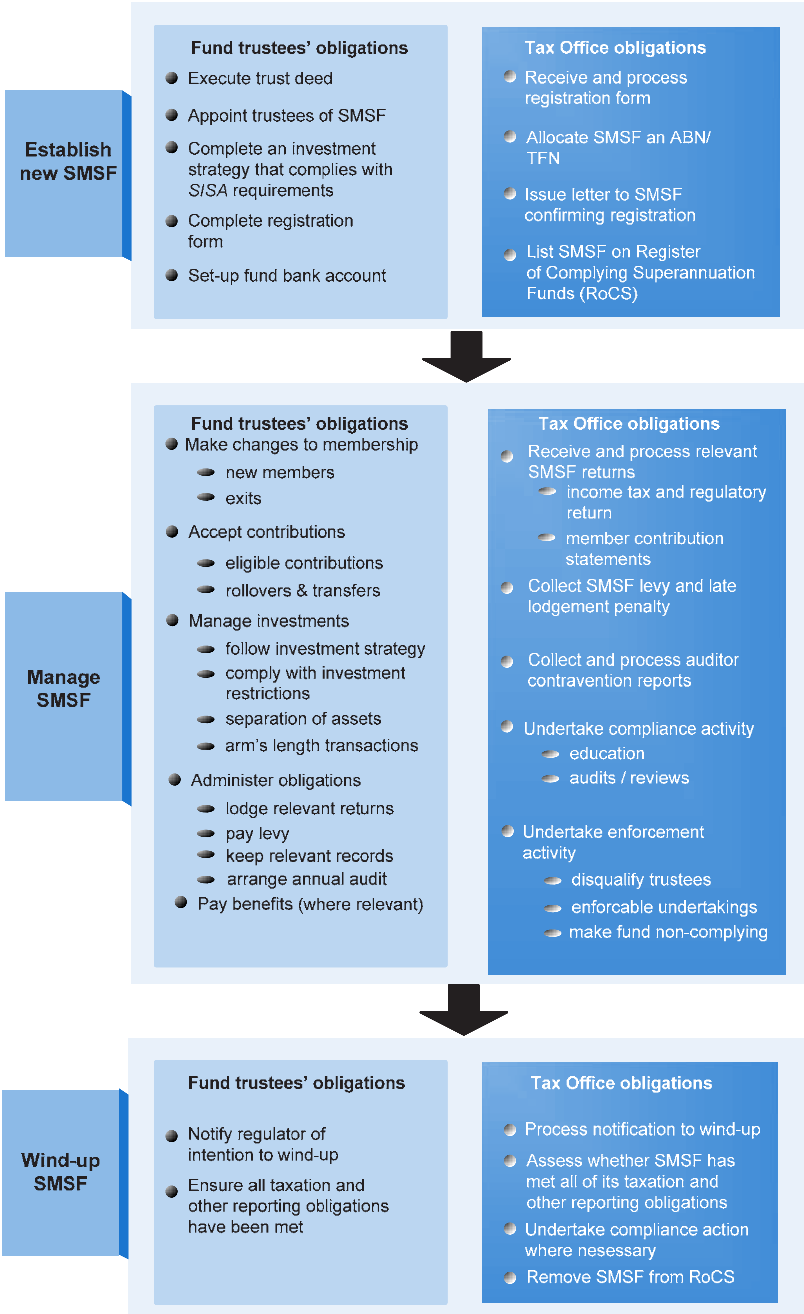
20 The recommendations of the *Wallis Inquiry* were used as a basis for drafting the *Superannuation Legislation Amendment Act (No. 3) 1999*. This Act introduced SMSFs and specified the Tax Office as regulator.

21 In 1997, the Insurance and Superannuation Commission (ISC) undertook a survey of the compliance practices of 1000 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.

22 Part 13 of the *SISA.*

Figure 1.1

Fund trustees' and Tax Office obligations for SMSFs



Source: ANAO representation of Tax Office information.

Role of approved auditors in the regulation of SMSFs

1.12 The annual audit process undertaken by an approved auditor is regarded as a key leverage point in achieving greater compliance by superannuation funds. In September 2001, the Senate Select Committee on Superannuation and Financial Services reviewed the competency requirements of superannuation fund auditors.[23] In particular, the Committee reviewed the adequacy of auditing and accounting standards; the reporting requirements under the *SISA*; the quality of audit reports; and the role of professional bodies in improving compliance.

1.13 Following the Senate Committee's review and in conjunction with a report released by the Productivity Commission on the *SISA* and other superannuation legislation,[24] the Government established a Superannuation Working Group to consult with the superannuation industry on ways to improve the safety of superannuation.

1.14 In 2004, the Government passed the *Superannuation Safety Amendment Act 2004 (Superannuation Safety Act)* to strengthen the prudential regulation of superannuation funds. A number of the safety measures introduced by the *Superannuation Safety Act*, such as the introduction of Auditor Contravention Reports (ACRs), had a notable impact on the operations of SMSFs and the regulatory approach of the Tax Office.

Simplified Superannuation

1.15 As part of a series of ongoing reforms to simplify and streamline the superannuation system, the Government has recently initiated significant changes to assist the Tax Office to regulate the SMSF regime and to simplify applicable administrative functions for SMSF trustees.

1.16 When being consulted on the reforms, the Tax Office considered there was a need to address a number of SMSF risks, especially given proposed changes to member contribution limits and the sustained increase in the number of SMSFs. These risks included:

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[23] Senate Select Committee on *Superannuation and Financial Services-Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services-Third report-Auditing of Superannuation Funds,* September 2001.

[24] Productivity Commission–*Review of the Superannuation Industry (Supervision) Act 1993 and Certain Other Superannuation Legislation,* December 2001.

- in the absence of an adequate compliance program involving the gathering, monitoring and verifying member information, the temptation to exceed the contributions limit would be great;
- without timely and accurate member information, non-lodging SMSFs may gain tax concessions benefiting their members to the disadvantage of complying funds; and
- timely and accurate reporting is required to minimise the risk of funds gaining access to tax concessions without appropriately providing for their members' retirement.

1.17 On the 15 March 2007, the *Tax Laws Amendment (Simplified Superannuation) Act 2007* and related legislation received Royal Assent. The changes delivered by the amending legislation generally applied from 1 July 2007 and include:

- streamlining fund SMSF reporting requirements;
- introducing a trustee declaration form to ensure new trustees, or directors of corporate trustees understand their duties as trustee of a SMSF;
- requiring approved auditors to lodge a report in the first year of a fund's operation where there has been any contravention of the *SISA*;
- new administrative penalties for late returns and false statements made by SMSF trustees; and
- increasing the superannuation supervisory levy from $45 to $150 to recover the Tax Office's regulatory costs.

1.18 The Tax Office also plans to improve SMSF compliance with income tax and superannuation laws by almost tripling its current case work levels over the next two years. This will involve:

- increasing Tax Office coverage of SMSFs by 2.9 per cent of funds (equating to 6500 additional compliance reviews and audits for 2007-08); and
- between 2007–08 and 2009–10, annually undertaking reviews of the returns submitted by 7 per cent of the approved SMSF auditors.

1.19 Further background information including: the SMSF regulatory framework; relevant legislation; the implications of using a SMSF as a retirement savings vehicle; the current SMSF environment and Tax Office administrative arrangements can be found in Chapter 1 of the first audit report, ANAO Report No.52 2006–07 *The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds.*

Audit objective and methodology

Audit objective

1.20 This is the second of two audit reports concerning the Tax Office's administration of SMSFs pursuant to the provisions of the *Superannuation Industry (Supervision) Act 1993.* The first audit report, tabled in June 2007, examined 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
- systems, processes and controls the Tax Office uses to register SMSFs and enforce the lodgement of fund income tax and regulatory returns.

1.21 The ANAO's overall conclusion in the first audit report was that 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.

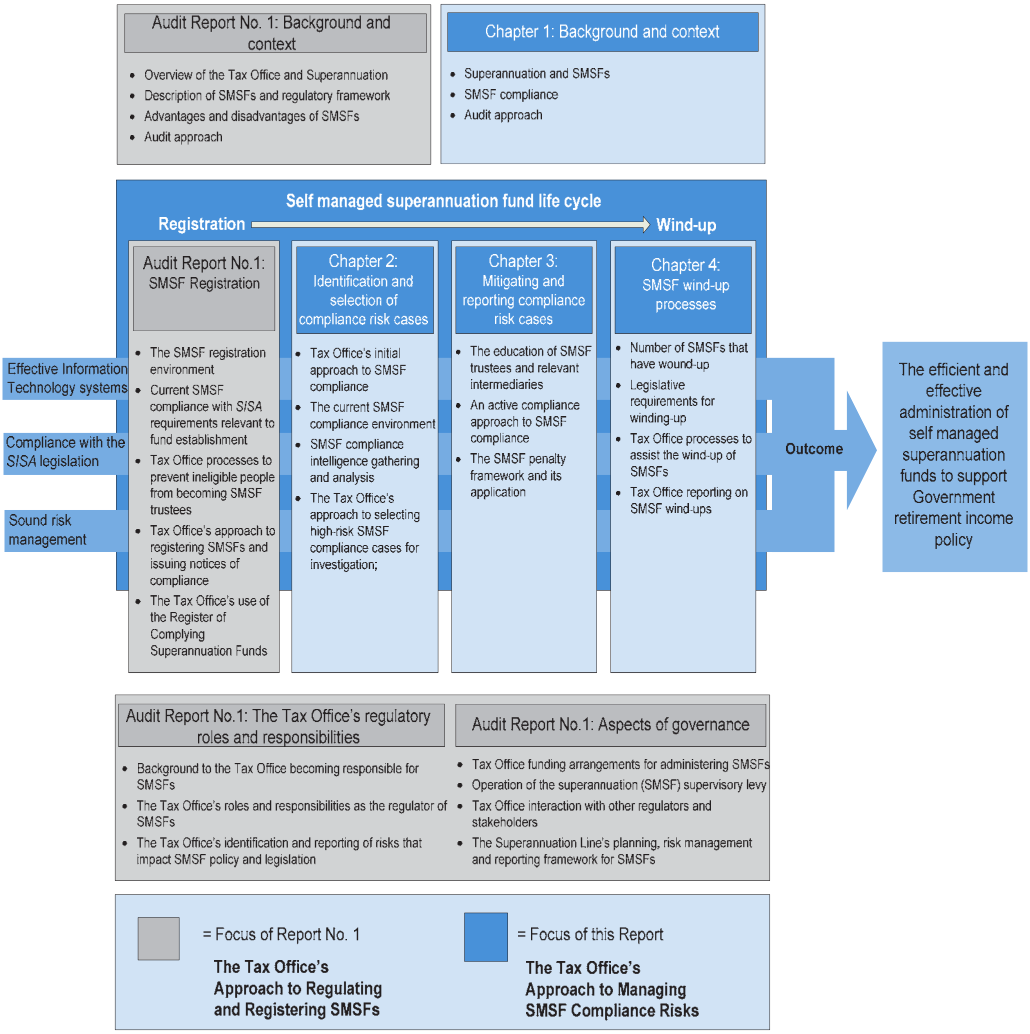
1.22 This second audit report examines the effectiveness of the Tax Office's approach to managing self managed superannuation fund compliance risks. Specifically the ANAO examined the processes the Tax Office uses to:

- 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
- administer fund wind-ups.

1.23 Figure 1.2 shows the structure of the audit, including the areas covered in each report.

Figure 1.2

Structure of the audit and areas covered in each report



Source: ANAO

Audit methodology

1.24 The majority of the audit fieldwork was conducted from June 2006 to September 2006. Additional information relevant to this report was also provided in March and April 2007. In addition to the review of relevant superannuation documentation, the ANAO undertook qualitative and quantitative analysis of the data stored on a range of Tax Office superannuation systems used to regulate SMSFs. Interviews with key

Tax Office staff from the Superannuation and Operations Lines were also conducted.

1.25 Interviews were held with stakeholders from the superannuation industry[25], representatives from the professional accounting organisations[26], and relevant Australian Government organisations[27] on aspects of the Tax Office's administration of SMSFs.

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

1.27 The audit was conducted in accordance with auditing standards at a cost to the ANAO of approximately $325 000.

Acknowledgements

1.28 The ANAO recognises and appreciates the contribution of Tax Office officers, superannuation industry representatives, professional accounting organisations, and the relevant Commonwealth organisations, who assisted in the conduct of this audit.

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25 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) and Self Managed Super Fund Professionals' Association of Australia (SPAA).

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

27 Australian Prudential Regulation Authority; the Australian Securities and Investment Commission; and the Treasury.

2. Identification and Selection of Compliance Risk Cases

This Chapter considers the Tax Office's initial approach to SMSF compliance and the SMSF compliance environment. It focuses on the intelligence gathering techniques used by the Tax Office to identify SMSFs not complying with their SISA and income tax obligations and examines SMSF case selection practices.

Introduction

2.1 With over 360 000 SMSFs[28] now currently operating in this market segment, it is to be expected that there will be some level of non-compliance with *SISA* and income tax obligations. Education of trustees undertaken by the Tax Office during the lifecycle of SMSFs is a broad based activity to address non-compliance across the whole market segment. However, it is essential the Tax Office also has a systematic risk-based methodology for identifying and resolving specific non-compliant SMSF behaviour. The absence of an effective methodology to identify and redress non-compliant fund behaviour reduces the ability of the Tax Office to detect SMSF trustees either deliberately or unintentionally:

- accessing their retirement savings illegally before retirement (early access);
- obtaining SMSF tax concessions to which their superannuation fund is not entitled; and
- not declaring all taxable income derived from SMSF assets.

2.2 To be effective, a risk-based approach to identifying non-compliant SMSFs must be based on sound intelligence derived from accurate, comprehensive and up-to-date data. It should also be systematic, following established processes and procedures to allow all SMSFs to be assessed equitably. This allows the Tax Office to obtain a measure of the overall effectiveness of its SMSF compliance program and whether its regulatory performance is improving over time. To assess the Tax Office's approach to identifying high-risk compliance cases the ANAO examined:

- the Tax Office's initial approach to SMSF compliance;
- the SMSF compliance environment;

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28 Australian Prudential Regulation Authority, *Statistics- Quarterly Superannuation Performance* June 2007, p. 7.

- SMSF compliance intelligence gathering and analysis; and
- the Tax Office's approach to selecting high-risk SMSF compliance cases for investigation.

The Tax Office's initial approach to SMSF compliance

2.3 As noted in Chapter 1, the Tax Office assumed responsibility for the regulation of a sector of the superannuation industry that at the time was suspected of high levels of non-compliance with their obligations under the *SISA*.

2.4 In 1999–2000 the Tax Office completed a study of the potential risks applicable to SMSFs not complying with their *SISA* and income tax obligations. This study identified significant non-compliance in a range of areas requiring immediate attention. These areas included poor: fund investment practices; fund income reporting practices; lodgement of fund income tax and regulatory returns; and fund auditor compliance with their obligations. The Tax Office considers all of these areas remain high-risks to good SMSF compliance practices.

2.5 In response to demonstrated non-compliance in this sector, between 1999–2000 and 2002–03 the Tax Office adopted and promoted an educational approach to support SMSF trustees to comply with their *SISA* obligations.[29] While it undertook ad-hoc audits of SMSFs as part of Tax Office projects, or following the receipt of information from third parties (for example approved auditors), the Tax Office was not able to produce specific statistical information on the number and type of SMSFs audited during this period.

2.6 A number of factors led the Tax Office to focus predominantly on education as its principle compliance approach at this time. These included:

- *the introduction of A New Tax System (ANTS) in 2000–01.* The Tax Office gave an undertaking to tax practitioners in 2000–01 not to use audits as the principal mechanism to enforce compliance with *ANTS* legislation (in the short-term). Instead, it chose to develop comprehensive education campaigns. The Tax Office extended this approach to its regulation of SMSFs; and
- *SMSF resources.* The Tax Office had limited resources to undertake activity aimed at ensuring SMSF trustees complied with their

[29] The Tax Office's use of educational activities to promote SMSF compliance is examined further at paragraph 3.4.

obligations. SMSF education processes provided the Tax Office with a level of assurance that SMSF trustees were aware of their obligations, and therefore would be more likely to comply with them.

2.7 Although these factors affected the Tax Office's initial SMSF compliance approach, the ANAO considers the Tax Office could have done more at the time to better understand the nature of SMSF compliance risks originally identified in its 1999–2000 risk assessment.

The Tax Office's Compliance Benchmarking Projects

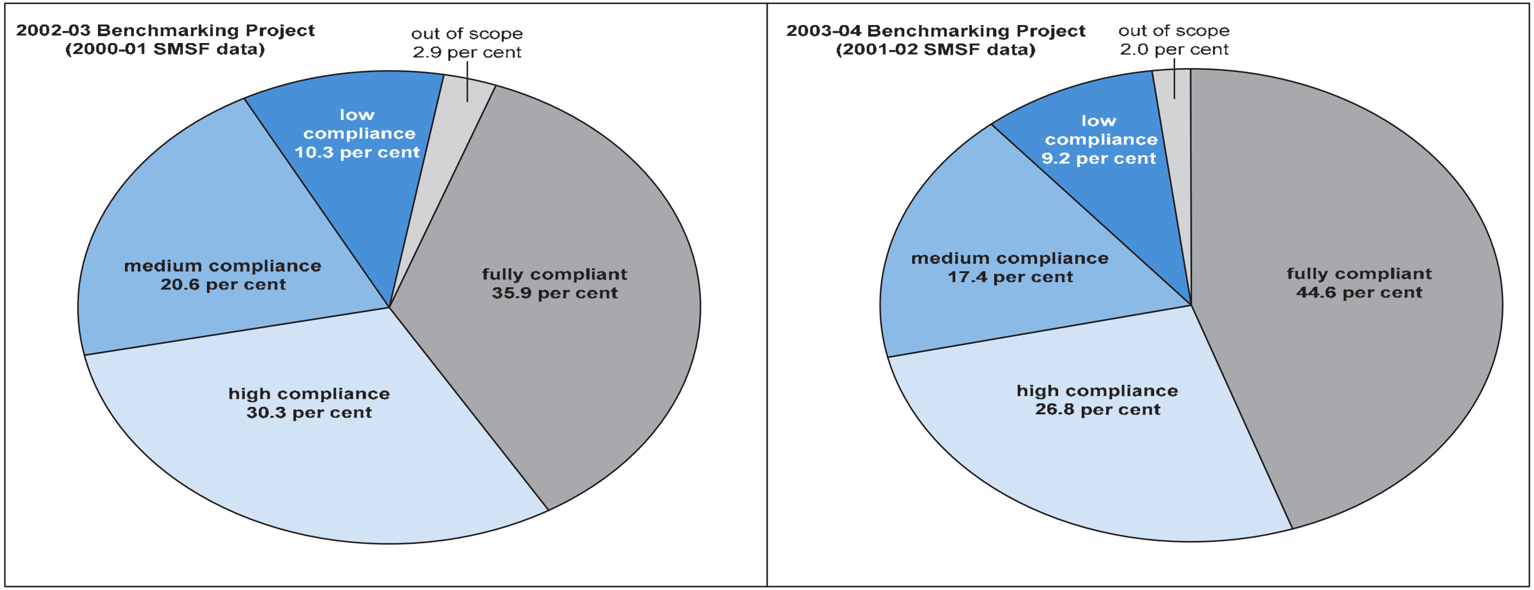
2.8 In 2002–03 and 2003–04 the Tax Office completed two Benchmarking Projects to assess the extent of SMSF non-compliance. The Projects (the Benchmarking Projects) examined samples of SMSF data from 2000–01 and 2001–02 respectively, and the outcomes were used to determine an overall measure of compliance for the broader SMSF population.

2.9 The Tax Office engaged the Australian Bureau of Statistics (ABS) to design the selection methodology. Funds selected were reviewed by either field or desk audits, involving a physical examination of the financial and source documents of each SMSF. The sample of funds selected by the Tax Office was statistically valid, with a target standard error of 0.02 per cent.

2.10 The summary results of the Benchmarking Projects are represented in Figure 2.1.

Figure 2.1

Levels of compliance by SMSFs with their *SISA* obligations in the Benchmarking Projects



Source: Tax Office Compliance (Benchmarking) Projects.[30]

30 Funds selected for the Benchmarking Projects that had either wound-up, or were found not to be SMSF were considered out of scope for the projects.

2.11 Figure 2.1 shows overall SMSF compliance levels improved between 2000–01 and 2001–02, as indicated by the decline in the number of SMSFs identified with low compliance levels. While this may indicate the Tax Office's educational approach had a positive effect on the overall compliance of SMSFs, the 2001–02 data indicates 55.6 per cent of all SMSFs sampled had either serious or minor breaches of their obligations under the *SISA*. Of these, an estimated:

- *9.2 per cent of SMSFs had multiple serious SISA compliance problems (low compliance)*. These included: funds failing to meet the definition of a SMSF (without advising the regulator); funds not dealing at arm's-length from their members; members borrowing from the fund; having 'in-house assets' of greater than 5 per cent; and loans or financial assistance to members by the fund;
- *17.4 per cent of SMSFs had one serious SISA compliance problem, or numerous minor compliance problems (medium compliance)*; and
- *26.8 per cent had one or two minor breaches of the SISA (high compliance)*.[31]

Impact of the Compliance Benchmarking Projects

2.12 The Benchmarking Projects became the catalyst for a significant change to the Tax Office's SMSF compliance approach in 2004–05. In 2003–04, the Tax Office began implementing a SMSF audit capability to identify and take action against SMSFs not complying with their *SISA* and income tax obligations.

2.13 The Benchmarking Projects also identified several areas of SMSF non-compliance requiring specific Tax Office attention. This resulted in several specific projects to identify non-compliant SMSFs and to obtain a SMSF market-wide view of perceived SMSF non-compliance. Since 2003–04, the Tax Office has undertaken special projects in three major areas of SMSF compliance (discussed further in paragraph 2.92 to 2.95).

The Tax Office's ongoing reliance on Benchmarking Projects

2.14 The Tax Office continues to rely heavily on the results of its previous Benchmarking Projects to support its current assessment of SMSF non-compliance. A contributing factor to this is intelligence produced

[31] A more detailed overview of the specific compliance issues identified in the Compliance Benchmarking Projects is found in Appendix 2 of this report.

from its current compliance activities does not provide an accurate and holistic assessment of SMSFs' compliance risks and issues.[32]

2.15 There have been significant changes to superannuation legislation and the Tax Office's approach to SMSF compliance since 2001–02. Given the reliance that has, and continues to be, placed on the results of these original Benchmarking Projects, the ANAO recommends that the Tax Office should consider undertaking benchmarking activities on a periodic basis while it is in the process of developing a comprehensive approach to SMSF compliance capable of producing high quality compliance intelligence. This will enable the Tax Office to assess SMSF compliance more adequately. It will also allow the Tax Office to examine the effectiveness of its SMSF compliance approach, including whether its performance in this area is improving.

2.16 The ANAO notes undertaking additional benchmarking activities will also assist the Tax Office to measure the success of the relevant aspects of the Government's *Simplified Superannuation* reforms.

Recommendation No.1

2.17 To assist in determining its SMSF compliance programme, the ANAO recommends the Tax Office:

- assess the costs and benefits of undertaking periodic benchmarking exercises that indicate overall SMSF compliance levels; and
- develop performance indicators for each benchmarking exercise that enable measurement of the success of compliance approaches over time.

Tax Office response

2.18 Agreed

2.19 The Tax Office continually reviews the level of taxpayer compliance and the effectiveness of its compliance approaches. For example, and as recognised in this report, to date two benchmarking exercises have been undertaken to measure SMSF compliance levels. Consequently the Tax Office agrees to assess the costs and benefits of undertaking periodic benchmarking exercises that indicate overall SMSF compliance levels.

[32] The ANAO considers that the small number and type of SMSF related audits and other reviews undertaken by the Tax Office does not provide it with enough information to assess overall SMSF compliance levels. This is discussed in paragraphs 2.22 to 2.26, and in Chapter 3.

2.20 However, in undertaking these exercises, the Tax Office will not conduct random audits. It will continue to develop performance indicators that measure the success of SMSF compliance in accordance with the Compliance Model by minimising intrusion on the majority of individuals and businesses who want to meet their superannuation law obligations, while at the same time being highly visible to those who are reluctant to comply.

2.21 The Tax Office is also revising the Auditor Contravention Report to collect improved compliance information from approved auditors from July 2008, and developing an electronic tool that will assist auditors to identify the contraventions to be reported. The improved compliance information collected will enhance risk analysis and case selection activities and will provide the basis for a greater understanding of compliance levels.

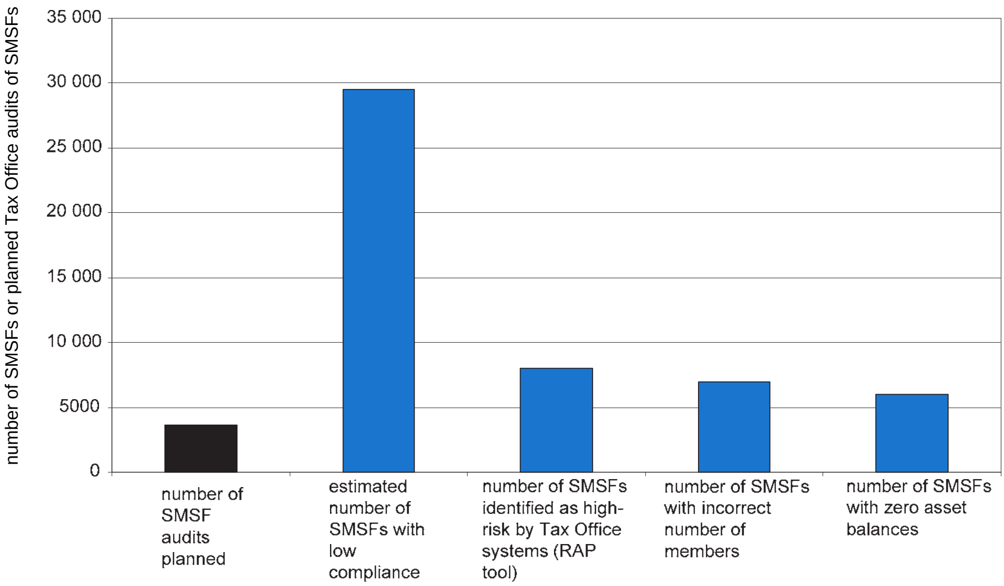
The SMSF compliance environment

2.22 Following the findings of the 2003–04 Benchmarking Project in 2004– 05 the Tax Office Executive, as part of its corporate compliance risk assessment process, rated SMSFs as a 'severe' compliance risk.[33] This coincided with the Tax Office being funded in 2004–05 to undertake 3600 audits. Figure 2.2 compares the estimated number of SMSFs likely to not be complying, based on 2001–02 data highlighted in the 2003–04 Benchmarking result, and other high risk indicators derived from Tax Office data, with the number of audits funded.

[33] A 'severe' risk-rating denotes the highest level of risk applied by the Tax Office to its compliance activities. The Tax Office has also rated the SMSF residual risk as severe. A residual risk rating refers to the assessment of risk, once Tax Office mitigation strategies have been put in place. Only two Tax Office corporate compliance functions have been assigned this level of risk.

Figure 2.2

Number of planned Tax Office audits of SMSFs compared to the number of SMSFs likely to not be complying with their *SISA* obligations in 2004–05



Source: ANAO analysis of Tax Office information.[34]

2.23 Based on the results of the 2003–04 Benchmarking Study an estimated 28 000 (or 9.2 per cent of the total) funds as at 30 June 2005 potentially had low levels of compliance with their *SISA* obligations.[35]

2.24 The Tax Office advised that the number of SMSFs with low compliance calculated using the 2003–04 Benchmarking Study will have been influenced by various activities, including the following, which may have decreased this number:

- measures introduced by the *Superannuation Safety Act* from 1 July 2004, such as the ACR which made it mandatory for the notification of breaches to the Tax Office in certain circumstances;
- the release of education products including *DIY Super It's your money…but not yet!* and the Tax Office presenting over 100 seminars per year to the SMSF community; and

[34] SMSFs represented in each of the blue bars in Figure 2.2 may belong to more than one category. For example, a SMSF may have an incorrect number of members as well as a zero asset balance.

[35] This was determined by extrapolating the results of the 2003–04 Benchmarking Project to 2004–05 data.

- the influence of the New Trustee Education Campaign on trustees' behaviour in following years.

2.25 Notwithstanding the identification of large number of funds receiving SMSF tax concessions but which were at a high risk of *SISA* non-compliance; the Tax Office audit coverage to address this significant risk profile was very low. Similarly, the Tax Office approach to audit case selection at that time was based on a variety of other indicators that extended beyond those risk indicators highlighted in Figure 2.2. As a result the low level of audit coverage did not even focus on the areas of highest risk. Consequently, the Tax Office did not have a comprehensive approach to respond adequately to the risk profile presented by either its Benchmarking studies or the other key risk indicators available. The ANAO therefore considers that the Tax Office did not have an adequate SMSF compliance strategy for the 2004–05 year.

2.26 The ANAO notes the Tax Office proposal to triple its SMSF casework from 2007–08 should enhance its ability to encourage greater SMSF compliance in the future.

The impact of SMSFs not complying with their regulatory obligations

2.27 The concessional taxation treatment of superannuation is the largest reported single tax expenditure by the Government. Tax concessions are provided to superannuation funds based on their ongoing compliance with obligations imposed on them by the *SISA*, which aims to support the Government's objective of greater retirement savings.

2.28 Where a SMSF has one or multiple serious breaches of the *SISA* they may be penalised or their ongoing entitlement to tax concessions could be threatened if the Tax Office were to deem them as non-complying.

2.29 As noted in Chapter 3 of the Report the options available to the Tax Office in penalising non-compliant SMSFs are limited, and are likely to have a major impact on those funds. The *SISA* does not provide for a graduated scale of penalties which could be applied by the Tax Office to match the severity of the contravention in each case.

2.30 Consequently the Tax Office advised that, when a fund breaches a provision of the *SISA*, it encourages the fund to rectify the breach rather than deem the fund to be non-complying. Only when a fund refuses to rectify a serious breach of the *SISA* or has recurrent breaches would the Tax Office make a fund non-complying.

2.31 If the Commissioner, pursuant to subsection 42A(5) of the *SISA*, makes a fund non-complying by applying the 'compliance test', the SMSF can lose the 15 per cent concessional tax treatment on taxable income 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.

2.32 The Tax Office's current position in resolving the status of non-complying funds is consistent with *SISA* provisions and the Government's retirement income policy. However the significance of certain risks accompanying this approach would heighten, if the relative levels of potential non-compliance were to remain and the SMSF market segment continues to expand. The risks of a significant proportion of non-compliant SMSFs include diminishing the public confidence in the effective regulation of this sector and the risk that funds by not complying with the *SISA* regulations may compromise the underlying value and financial viability of the fund.

2.33 As shown in Figure 2.2, audit resourcing arrangements for 2004–05 indicate the Tax Office would examine less than 13 per cent of SMSF funds estimated to have low compliance. However, as noted above, the case selection process will have reviewed funds which may not be those with the highest risk profiles.

2.34 However, regardless of the outcome of Tax Office active compliance activities on SMSFs, there are a significant number of funds (some 87 per cent in 2004–05) that were unlikely to be subject to review by the Tax Office and therefore continue to receive tax concessions despite potentially having one or multiple serious breaches of the *SISA.*

2.35 As noted in paragraph 2.30, the Tax Office's approach is to work with non-compliant SMSFs to rectify breaches rather than deem funds as non-compliant and penalise them accordingly. Notwithstanding this, the ANAO sought to estimate the potential revenue implications in respect of those SMSFs at most risk of non-compliance, given the large estimated number of SMSFs that have potentially committed major breaches of the *SISA*. Two areas were examined. The first focused on the estimated amount of tax concessions claimed by funds, using compliance levels established by the

2001–02 data used in the Benchmarking Projects. The second focused on the estimated taxation not remitted by active SMSFs using lodgement information as at March 2007.[36]

2.36 The estimated average value of income tax concessions claimed by SMSFs during the period 1999–2000 to 2005–06 was some $2.3 billion per annum. During the same period the minimum estimated value of income tax concessions claimed by SMSFs with potentially multiple serious breaches of the *SISA* was some $230 million per annum. The concessions claimed were significantly greater if funds with just one potential serious breach were also included.

2.37 The Tax Office has also estimated that the income tax not reported by active SMSFs that have not yet lodged for 1999–2000 to 2004–05, was about $500 million.[37]

2.38 These figures indicate the significant financial concessions claimed by SMSFs which are likely not to be complying with the *SISA*. As a consequence of the relatively low audit coverage, a significant number of funds are likely to be receiving concessional tax treatment, despite breaching the *SISA* regulations. To have an effect on SMSF compliance it is important for the Tax Office to generate reliable intelligence about SMSF compliance behaviour.

SMSF compliance intelligence gathering and analysis

2.39 To gather intelligence on SMSFs the Tax Office has traditionally relied on the information contained in registration forms and fund income tax and regulatory returns lodged by funds. Recently, the Tax Office has moved towards using a more sophisticated methodology for gathering intelligence, including electronically matching SMSF data with other tax systems, as well as gathering and analysing SMSF information from external sources such as tax agents and approved auditors.

2.40 The ANAO examined the Tax Office's use of the two major sources of intelligence used to identify high-risk SMSF compliance cases:

- fund income tax and regulatory returns and member contribution statements (MCSs); and

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36 See Appendix 3 for the assumptions used to derive these values.

37 The Tax Office advises that this value was obtained by multiplying the average tax payable of lodging SMSFs to the estimate of the number of yet to lodge SMSFs.

- approved auditors.

Fund income tax and regulatory returns and MCSs

2.41 To meet their taxation and regulatory obligations, all SMSFs must lodge a fund income tax and regulatory return, and a MCS. Without the lodgement of these returns the Tax Office's ability to assess the risk of SMSF non-compliance is significantly diminished. These forms provide the Tax Office with important information about a SMSF including it's: asset values; income; income tax deductions; and member contributions. SMSF returns also provide the Tax Office with valuable information on the tax agents, accountants and approved auditors used by a SMSF.

2.42 Under the Tax Office's approach to selecting SMSFs for review, funds meeting their lodgement obligations and lodging their returns on time are more likely to be selected than funds lodging their returns late or not lodging at all. Therefore, for the Tax Office's case selection process to be equitable to SMSF trustees, and to have a sound basis, the majority of funds must meet their lodgement obligations in a timely manner.

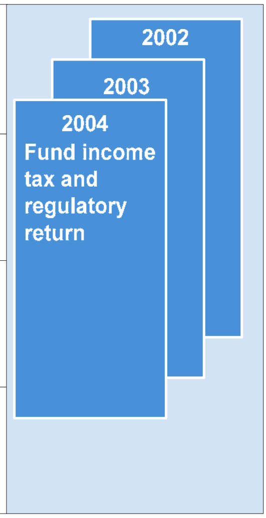
2.43 Prior to October 2004 there was no lodgement assessment process to encourage timely, complete and accurate reporting by SMSFs. However, some interim measures were introduced in 2005–06, when the Tax Office took initial steps to develop a suitable superannuation lodgement enforcement program. This included the introduction of teams following-up on SMSFs not lodging their returns. The program resulted in the lodgement of approximately 9800 outstanding fund income tax and regulatory returns and 8200 outstanding MCSs.

2.44 The Tax Office also completed a specific project in late 2006 to analyse SMSF lodgements. The project focused on the lodgement of fund income tax and regulatory returns. The results of the project are detailed in Table 2.1.

Table 2.1

SMSF Lodgement Project Findings

At least 35 700 funds have not remitted at least one income tax return.
Some 53 per cent of these funds (approximately 19 000 funds) had more than one income tax return outstanding.
The Tax Office is unable to contact approximately 10 per cent of these funds.
Approximately 53 per cent of these funds were established prior to the 1999-2000 year.



Source: Tax Office

2.45 Although the project was successful in obtaining a snapshot of SMSF lodgement compliance issues, the Tax Office acknowledged further work was needed to understand the diversity of cases, including data cleansing activities to improve the quality of lodgement data on Tax Office systems. The ANAO considers the inconsistent approach taken in the past by the Tax Office in applying penalties to SMSFs that did not meet their lodgement obligations, may have also influenced current SMSF lodgement compliance practices.

Penalties for the late lodgement of fund income tax and regulatory returns

2.46 Despite fund income tax and regulatory returns being lodged with the Tax Office on the same form, SMSF trustees have been liable to pay separate penalties under the *Taxation Administration Act 1953* and the *SISA*, for the late lodgement of these returns.[38]

2.47 Since 2000–01 the Tax Office has applied a 'failure to lodge' penalty to 14 200 SMSFs not lodging income tax returns. The total value of penalties applied is approximately $5.9 million.[39] The number of penalties applied, is significantly lower than the number of SMSFs not lodging their income tax

[38] The penalties for the late lodgement of SMSF income tax returns are applied under the *Taxation Administration Act 1953 section 286–75*. Penalties for the late lodgement of regulatory returns are applied under *SISA* subsection 36(A).

[39] The Tax Office also waived some 1200 penalties at a cost of approximately $450 000.

returns since 2000–01. This may be indicative of the Tax Office not using a consistent approach to apply ‘failure to lodge’ income tax penalties to recalcitrant SMSFs.

2.48 The Tax Office has not applied penalties for the late lodgement of regulatory returns since it was made responsible for regulating SMSFs. This is in spite of the Tax Office advising on its website that SMSFs not lodging regulatory returns (post 1999) will be liable for a penalty of:

> $10 per month or part thereof beginning on the day after the day on which the regulatory return should have been lodged and will continue to accrue until the return is lodged.[40]

2.49 According to Tax Office information technology systems documentation examined during the audit, Tax Office systems automatically record a late lodgement penalty for regulatory returns. However, the Tax Office advised the application of the penalty is a manual process. As such, no debt has been raised.

2.50 The ANAO estimates by not applying the regulatory return penalty the Tax Office has foregone some $29 million in penalty payments.[41] The ANAO considers a consistent approach to applying penalties would improve SMSF lodgement compliance.

Simplified Superannuation

2.51 The *Simplified Superannuation* reforms will now only require trustees of SMSFs to lodge a single annual return.[42] New administrative penalties also apply to SMSFs for failing to lodge documents on time or making false or misleading statements in their returns.

2.52 In March 2007 the Tax Office also advised it intends to implement a lodgement enforcement program directed towards improving the timeliness of SMSF lodgements. The Tax Office plans to increase the number of SMSFs lodging their returns within six months of the due date from the approximate current levels of 70 per cent to around 94 per cent by the end of 2009–10.

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[40] *Self managed superannuation funds–late lodgement amount* <http://www.ato.gov.au/print.asp?doc=/content/35749.htm> [accessed 13 November 2006].

[41] This is a conservative estimate, as ANAO calculations only included those funds that lodged their regulatory returns late. It does not include the funds that have not lodged at all.

[42] The single annual return consists of the fund’s income tax and regulatory return and a member contribution statement in respect of each member.

2.53 The Tax Office considers the changes to be introduced as part of *Simplified Superannuation* reforms should improve the accuracy of information reported to the Tax Office in the future and help to rectify current inconsistencies relating to the imposition of lodgement penalties.

2.54 While the Tax Office has started taking compliance action against funds not lodging their returns, the penalties relating to the large backlog of un-remitted returns may be difficult to collect. In addition, changing the compliance behaviour of recalcitrant SMSFs may be difficult, as many funds (approximately 25 000)[43] have never lodged a regulatory return. The ANAO considers as the Tax Office's lodgement compliance strategy evolves, it should undertake further research to understand the reasons for large numbers of SMSFs not meeting their lodgement obligations.

Approved auditors

2.55 The *SISA* requires all SMSFs to undergo an annual audit by an approved auditor.[44] To perform their role effectively, approved auditors[45] are required to have a high level of accounting and auditing knowledge, which is overseen by the professional organisations which are prescribed in the SIS Regulations.[46]

2.56 From the introduction of SMSFs in 1999, the Tax Office recognised, given its limited resources and the large and increasing numbers of SMSFs, it would need to place a heavy reliance on approved auditors identifying SMSF non-compliance with the *SISA*. The Tax Office considered if the work undertaken by approved auditors was of a high quality, it could obtain vital, market sector-wide intelligence that could be used to accurately assess SMSF non-compliance.

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43 This figure was derived from the ANAO's analysis of Tax Office data. It was not obtained from the lodgement analysis project. Although the results of the ANAO analysis and the lodgement analysis project differ, both indicate that significant numbers of SMSF trustees do not meet their lodgement obligations.

44 *SISA* subsection 113(3)(b) specifies that all SMSFs must be subjected to a mandatory annual compliance audit by an approved auditor.

45 Regulation 1.04 of the SIS Regulations states that an approved auditor may be: (a) the Auditor-General of the Commonwealth, a state or territory or (b) a registered auditor under the Corporations Law or be associated in a specified manner with a professional organisation (as prescribed in Sch 1AAA).

46 The professional organisations prescribed in the *SISA* include the CPA Australia Ltd; the Institute of Chartered Accountants in Australia; National Institute of Accountants, Association of Taxation and Management Accountants; and the National Tax and Accountants Association Ltd.

2.57 Since July 2004, approved auditors have been required to report serious contraventions of the *SISA* to the Tax Office using an Auditor Contravention Report (ACR). They must also report instances where a fund's financial position may be, or may be about to become, unsatisfactory.

Approved auditor compliance with their audit responsibilities

2.58 The Tax Office did not take any action to assess whether approved auditors were fulfilling their obligations and reporting breaches of the *SISA* to the Tax Office until 2003–04. In that year, it commenced and completed an Approved Auditor Review Project.

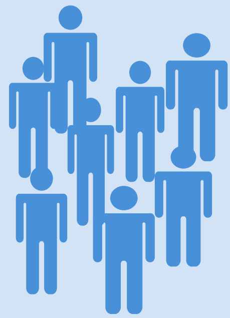
2.59 The aim of the project was to identify the compliance risks and areas of significant concern relating to the role of the approved auditor. The Tax Office engaged the ABS to select a statistically valid random sample. This allowed it to extrapolate the project results to the whole approved auditor industry.

2.60 This sample totalled 250 approved auditors. The Tax Office reviewed one SMSF audited by each auditor to determine whether the audits they were undertaking were of an acceptable quality. The audits reviewed related to the 2001–02 financial year.

2.61 The results of the project indicated a significant proportion of approved auditors did not conduct high quality SMSF audits, and did not adequately fulfil their obligations as an approved auditor under the Australian Auditing Standards. The results of the project are detailed in Table 2.2.

Table 2.2

Approved Auditor Project Findings

Forty two per cent of approved auditors did not maintain sufficient working papers to support their findings and opinions.	
For 26 per cent of the SMSFs reviewed as part of the project, the Tax Office was unable to identify evidence to support that an audit had actually been undertaken.	
Forty seven per cent had an apparent conflict of interest, where of this percentage, 27 per cent of approved auditors were also the accountant or tax agent for the SMSF.	
Where it could be established that an audit had been undertaken, up to 64 per cent of the total number of *SISA* contraventions identified by the Tax Office were not identified by approved auditors.	

Source: Tax Office.

2.62 Following the results of the Approved Auditor Review Project the Tax Office concluded it could not place significant reliance on work undertaken by approved auditors to provide a high level of assurance that SMSFs were complying with their obligations under the *SISA*.

Tax Office initiatives to improve approved auditor compliance

2.63 Since completing its Approved Auditor Review Project, the Tax Office has worked with the superannuation industry and professional organisations to assist with the development of approved auditor training material and to identify areas of approved auditor non-compliance.

2.64 The Tax Office is able to make a written order disqualifying a person from being an approved auditor under subsection 131(1) of the *SISA*. Although the Tax Office has identified approved auditors that have not adequately fulfilled their obligations, it has not sought to disqualify them. The Tax Office advised, based on APRA's experience, the disqualification of approved auditors can be a complex and time consuming process. In the first instance, the Tax Office's preference is to refer 'at-risk' approved auditors to their professional organisation for remedial training or disciplinary action.

2.65 As at March 2007, the Tax Office was updating its approach and procedures to taking action against approved auditors not adequately meeting their obligations. This includes referring approved auditors to their professional organisation and where appropriate disqualifying them. The Tax Office advised that to date one auditor had been referred to their professional organisation and a further six were in the process of being referred.

Approved auditor information

2.66 To improve approved auditor compliance it is essential the Tax Office and the professional organisations are aware of, and are able to contact, approved auditors. Accounting professional organisations interviewed during the audit advised they do not collect information on which of their members audit SMSFs. In contrast, the Tax Office collects approved auditor information provided by SMSF trustees on their fund income tax and regulatory returns. Based on this information, as at November 2005, the Tax Office estimated there were 12 600 approved auditors.

2.67 The ANAO examined the quality of the data collected by the Tax Office from fund returns and found on the whole, it was not adequate to accurately identify the approved auditor shown on the return. Specifically:

- *there were large numbers of duplicate records for approved auditors on Tax Office systems*[47]; and
- *information was inaccurate or incomplete for large numbers of approved auditors.* For example, the contact details for a large number of approved auditors were incomplete or did not make sense.

2.68 The ANAO considers a principal reason for poor quality data is that few automated or manual controls exist to ensure only high quality approved auditor information is accepted by the Tax Office. The Tax Office advised in June 2007 that changes to the annual return form implemented as part of the *Simplified Superannuation* reforms should improve the quality of approved auditor information collected in the future. From the 2007–08 financial year, the annual return will mandate the provision of previously optional information concerning an approved auditor's name, professional organisations and membership number.

2.69 The ANAO notes the changes implemented as part of *Simplified Superannuation* are unlikely to affect the Tax Office's approved auditor data holdings until late 2008 at the earliest. In preparation for this, the ANAO considers there would be benefits from the Tax Office cleansing its

[47] For example in one instance there were 40 individual records for the same approved auditor.

approved auditor data of erroneous, duplicated and/or incomplete records where possible.

2.70 Similarly the ANAO notes that even when implemented, the proposed changes, of themselves will not allow the Tax Office to validate the bona fides of fund auditors in terms of their membership of an approved professional organisation.

2.71 The Tax Office agreed its capacity to verify approved auditor details, and to link approved auditors to SMSFs, is impacted by the absence of a unique identifier (i.e. Tax File Number) for approved auditors. This reduces the effectiveness of any cross matching undertaken against other Tax Office data sources.

2.72 The Tax Office is also unable at present to confirm the accuracy of approved auditor details submitted in annual returns or ACRs through matching its approved auditor information to the member information retained by professional organisations. By not being able to confirm the persons listed on its approved auditors list are members of a *SISA* prescribed professional organisation, the Tax Office cannot provide assurance all SMSFs submitting a fund income tax and regulatory return have been audited by an appropriate person.

2.73 The Tax Office considers that the provision of member information by the professional organisations for matching purposes is not only the most efficient approach to resolving this issue but is potentially beneficial for both the Tax Office and the professional organisations.

2.74 The Tax Office would be able to verify that the approved auditors' information contained on its systems is accurate, and it would be able to identify SMSFs that do not have approved auditors. Similarly, allowing the Tax Office to match member data (provided by the professional organisations) to its approved auditor list would allow the professional organisations to work with the Tax Office to target their SMSF information and educational products only to those members who require it.

2.75 The ANAO notes however, that for effective cross-matching of approved auditor information to occur, both the Tax Office and the professional organisations must cooperate, while remaining cognizant of relevant privacy laws.

Recommendation No.2

2.76 To improve the quality of approved auditor information held by the Tax Office, and to increase assurance that all SMSFs are audited only by approved auditors, the ANAO recommends the Tax Office:

- undertake processes to cleanse its approved auditor data of erroneous, duplicated and/or incomplete records; and
- seek to expand existing working arrangements with the professional organisations including to examine ways to confirm all approved auditors listed on Tax Office systems are valid members of their organisation.

Tax Office response

2.77 Agreed

2.78 Work has already commenced on improving the quality of approved auditor data holdings and includes the following:

- the cleansing of approved auditor data;
- meetings with the professional organisations on approved auditor issues, including ways to confirm all approved auditors listed on Tax Office systems are valid members of their relevant professional organisations; and
- cross matching of approved auditor data against SMSF regulatory returns. This involves reviewing approved auditor details as listed on the regulatory return and confirming, where possible, the identification of a single approved auditor who may have been recorded under different name derivatives.

2.79 As part of Simpler Super, a new initiative has been commenced with the introduction of the new combined income tax, regulatory return and member contribution statement form, which will be used by trustees of SMSFs from 1 July 2008. This form will improve compliance levels, as well as enabling easier identification of approved auditors. This is because it contains more information about auditors, including:

- family and first name;
- professional body and membership number;
- address; and

- date audit completed and whether it was qualified.

2.80 The Tax Office is working with the professional organisations on improving auditor competencies and integrity. There is little evidence that audits are being conducted by unqualified persons. The issue is considered to be low risk and the Tax Office considers the question is one of quality of the information being provided by approved auditors rather than one of fraud.

The use of Auditor Contravention Reports

2.81 ACRs prepared by approved auditors are a key leverage point for the Tax Office to identify SMSFs not complying with their obligations under the *SISA*. These reports are provided to the Tax Office by approved auditors when they believe a *SISA* contravention is of such a nature it may affect the financial interests of the SMSF's members.[48]

2.82 In March 2005 the Tax Office advised approved auditors they could use their professional judgement when determining whether a contravention would affect the financial interests of members. As approved auditors may consider the commercial impact of remitting an ACR to the Tax Office, specifically the risk of potentially losing a client by identifying and reporting compliance breaches to the Tax Office, these reports would generally not contain minor breaches that are easily rectified by SMSF trustees.[49]

2.83 As the *SISA* breaches reported in ACRs are likely to be serious breaches, it is logical the Tax Office should have an interest in investigating all ACRs it receives. The Tax Office advised that in practice, however, breaches reported on ACRs do not always align with the Tax Office's view of a serious breach.

2.84 The ANAO notes that the *Simplified Superannuation* legislation replaces the ACR with an 'approved form'. Approved auditors will now be required to lodge an approved form for any contravention of the *SISA* made by a SMSF in the first year of its operations. The new legislation also prescribes those matters to be reported by approved auditors on the approved form.

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[48] *SISA* subsection 129(3).

[49] The ANAO notes that the commercial considerations regarding the loss of clients following the lodgement of an ACR is only one factor that may bear on whether an approved auditor lodges an ACR with the Tax Office. Approved auditors interviewed during the ANAO's audit noted that it was not the principal consideration when lodging an ACR.

The Tax Office's approach to selecting high-risk SMSF compliance cases

2.85 The Tax Office's approach to selecting high-risk SMSFs for investigation has continued to develop since 2004. As part of the audit the ANAO examined the:

- Tax Office's past approach to selecting high-risk SMSFs for investigation; and
- introduction of Operational Analytics.

The Tax Office's past approach to selecting high-risk SMSFs for investigation

2.86 The Tax Office's past approach to selecting high-risk SMSFs for further investigation through its active compliance activities has included:

- the use of a superannuation Risk Assessment Profiling (RAP) tool to identify SMSF non-compliance; and
- SMSF special projects.

Past use of the RAP tool

2.87 The RAP tool was introduced by the Tax Office in July 2004 to identify SMSFs at risk of not complying with their obligations. The RAP tool allowed the Tax Office to automatically assess the compliance risk of individual SMSFs based on the information contained in their registration forms, income tax and regulatory returns, MCS and ACRs. It also allowed the Tax Office to rate the overall compliance risk of the SMSF market at a given point in time by combining the results of the individual risk assessments.

2.88 Where a fund failed a predetermined number or type of compliance tests[50] and received a high score, it was considered a high-compliance risk. SMSFs posing a high-compliance risk were forwarded to senior Superannuation Line compliance staff for further assessment and possible selection as an active compliance case.

2.89 The ANAO considers the RAP tool provided a useful capability to assist the Tax Office with the identification of SMSFs at a high-risk of not complying with their obligations. However, based on our examination of the RAP tool during the audit, the ANAO concluded that the RAP tool was not capable of selecting and ranking effectively the highest risk SMSFs for further compliance action (for example Tax Office audits). In particular:

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[50] The Tax Office has assigned various 'weightings' to its compliance tests. That is, some compliance tests (if failed) will increase the SMSFs risk score more than other tests.

- *The Tax Office could not assess the effectiveness of the RAP tool as a means of selecting high-risk SMSF compliance cases.* While various internal reviews were completed in relation to the application of various RAP criteria and tests, the Tax Office did not routinely record which SMSF cases originated from the RAP tool, compared to other case selection mechanisms.[51] This prevented the Tax Office from distinguishing how well its different case selection mechanisms were at identifying legitimate SMSF non-compliance based on the results of its active compliance activities;

- *The RAP tool did not identify a large number of SMSFs that may have had serious breaches of the SISA.* As discussed in paragraphs 2.8 to 2.23, using compliance levels established in the 2003–04 Benchmarking Project, there may be up to 30 000 SMSFs with multiple serious breaches of the *SISA.* To ensure only a comparatively small and manageable number of SMSFs were selected for further investigation, the Tax Office limited the amount of 'risk points' it applied to each compliance test;

- *SMSFs not lodging fund income tax and regulatory returns were not identified as high-risk compliance cases by the RAP tool.* The RAP tool relied on information contained in these forms to assess the compliance risk of SMSFs;

- *The RAP tool did not store and assess SMSF compliance histories.* Each month the RAP tool was run, prior period risk scores (and potential compliance breaches) were deleted. This prevented the Tax Office from being able to examine a SMSF's compliance behaviour (risk scores) over time, and consequently recidivist non-compliant SMSF behaviour was not considered in a SMSF's current period risk score; and

- *The RAP tool did not use a 'whole of client' approach to assessing SMSF compliance risks.* The RAP tool did not assess levels of SMSF member non-compliance with the other tax obligations (for example the GST). The Tax Office considers a 'whole of client approach' is a necessary aspect of assessing the overall compliance risk of SMSF clients.

2.90 The development of the RAP tool represented significant progress made by the Tax Office in developing a system based methodology to identify SMSFs not complying with their *SISA* obligations. However, the large numbers of SMSFs selected by the RAP tool, and the comparatively small number of

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[51] See paragraph 2.94

compliance resources available to the Superannuation Line, meant manual case selection processes overrode the RAP tool as an audit selection mechanism.

2.91 Development of the RAP tool effectively ceased in mid–2006. From this time, the RAP tool has been used as an interim measure to support case selection while the Tax Office develops its Operational Analytics capability. The other principal SMSF case selection mechanism used by the Tax Office at the time of the RAP tool was special projects.

SMSF special projects

2.92 As noted in paragraph 2.12, since 2003–04 the Tax Office has also undertaken special projects that have included reviews (and audits) of individual SMSFs. The Tax Office advised that risk identification processes separate from the RAP tool were undertaken when selecting cases for these projects.

2.93 During 2005–06, projects were completed on approved auditors, ACRs and early access.[52] Compliance action was initiated against approximately 69 approved auditors, 1367 SMSFs with ACRs and 12 early access schemes run by 24 scheme promoters. Five hundred and twenty of the 819 compliance reviews undertaken for early access (or 63 per cent) were cases of confirmed early access.

2.94 Based on our examination of the RAP tool and SMSF special projects it is difficult to determine whether the number of cases selected as part of special projects should have taken precedence over those selected by the RAP tool. Without collecting, analysing and reporting relevant information[53] to support its overall case selection approach, it is difficult for the Tax Office to provide definitive assurance it utilised its limited compliance resources effectively or to demonstrate it used a systematic and transparent approach to selecting SMSFs for further compliance action.

2.95 The Tax Office acknowledged the need to improve its case selection approach for high-risk SMSFs as part of its decision to introduce an Operational Analytics capability for the Superannuation Business Line. In addition to improving the transparency and defensibility of its case selection approach the Tax Office considers Operational Analytics will reduce the level

[52] Additional information on early access and the Tax Office's challenges in identifying non-compliance in this area can be found in Appendix 4 to this report.

[53] Such as the overall number of SMSFs identified as high-risk, the criteria used to select high-risk SMSFs, the number of SMSFs subject to compliance activity, and the results of that compliance activity.

of manual review and the potential for inconsistent case selection decision processes relative to the risks identified.

Introduction of Operational Analytics

2.96 During the second half of 2006 the Tax Office commenced developing an Operational Analytics[54] (OA) capability for the Superannuation Business line. The development of OA at this time was impacted by the need for case selection processes to interface directly with the Tax Office's new Siebel case management system during the 2006–07 year.[55]

2.97 The Tax Office intends that OA will improve the selection of cases for treatment by its active compliance activities, and will be on a Tax Office wide risk-based approach. The Tax Office also intends that SMSF cases will be selected on the basis of compliance priorities and other available information including behaviours, risk, and compliance history. The Tax Office considers this will lead to greater profiling of SMSFs.

2.98 The Tax Office advised in March 2007 that it was still in the early stages of developing models to support its OA capability. During 2006–07 its focus when selecting high-risk SMSF cases was to meet its commitments under its 2006–07 Compliance Plan.

2.99 The selection of SMSF compliance cases during 2006–07 was consistent with key SMSF risk areas and used a combination of OA models, 'bulk uploads[56]' and cases carried forward from the previous year. Specifically:

- *thirty-one per cent of cases have been allocated using OA models (the models developed to date have predominately focused on investment restriction breaches identified in ACRs);*
- *thirty–nine per cent of cases have been allocated using the 'bulk upload' process;* and
- *thirty per cent of cases have been carried forward from 2005–06.*

54 Operation analytics uses statistical data and analytical techniques to provide intelligence and select cases.

55 Siebel case management system was rolled out in August 2006 as part of Release 2 of the Tax Office Change Program.

56 "Bulk uploads' where undertaken for a number of key SMSF risk areas in lieu of an OA model. A combination of RAP tool criteria and additional filters and methodologies were applied in order to select the highest risk cases.

2.100 The ANAO considers it important the Tax Office continue to develop OA models for all relevant SMSF compliance risk areas previously addressed using a combination of the RAP tool and special projects. In particular, the Tax Office needs to implement a uniform approach for future case selection delivering on the intentions for OA and avoiding the previous shortcomings of the RAP tool.

2.101 The ANAO considers the additional compliance resources obtained by the Tax Office as part of *Simplified Superannuation* are likely to significantly improve the Tax Office's ability to examine SMSFs at a high-risk of not complying with their obligations. For this reason it is important the Tax Office fully develops its OA capability to improve the likelihood that the effectiveness of these new compliance resources is maximised.

Recommendation No.3

2.102 To continue to improve the selection of high-risk SMSFs for Tax Office compliance action (including Tax Office audits) and to better utilise its compliance resources, the ANAO recommends the Tax Office:

- continue to refine and fully implement its Operational Analytics capability to enable a systematic and consistent risk-based approach to identifying SMSFs that do not comply with their *Superannuation Industry (Supervision) Act 1993* obligations;
- as part of the development of Operational Analytics, utilise the information contained in other relevant Tax Office systems to obtain a 'whole of client' compliance assessment for all SMSFs, including an analysis of SMSF compliance histories; and
- develop procedures to assess the performance of Operational Analytics to identify high risk cases and report on the results of this performance assessment to identify potential improvements to the case selection approach.

Tax Office response

2.103 Agreed

2.104 The Tax Office agrees with this recommendation. As recognised in this report, the Tax Office is already moving its case selection and exception processing from manual candidate identification to analytical based case selection. This method is designed to select the highest risk cases, with the longer term objective of allocating resources between competing risk pools. Superannuation Active Compliance currently selects compliance cases from either SMSF operational analytic models or by way of manual candidate identification.

2.105 The Tax Office has commenced work on the development of a risk rating engine for SMSFs using Analytics, which will analyse the entire SMSF population and identify risk areas for further analysis and case selection. As part of this development, a whole of client approach is being adopted so that a holistic model for risk rating the full SMSF population can be undertaken.

2.106 Superannuation currently reports against corporate measures of performance dictated through approved corporate processes. As part of its compliance regime, the Tax Office continually assesses its effectiveness to the extent to which actual outcomes are aligned with desired outcomes. And, as a consequence, it will be developing procedures to assess the performance of Operational Analytics to identify high risk cases and report on the results of this performance assessment to identify potential improvements to the case selection approach.

3. Mitigating and Reporting Compliance Risk Cases

In 2003–04 the Superannuation Line changed its compliance approach from focusing on educating new trustees, to a more rigorous one including Tax Office audits and reviews. This Chapter examines the Tax Office's current approach to remedying SMSF non-compliance.

Introduction

3.1 Achieving a well balanced approach to mitigating high-risk SMSF compliance risk cases is challenging, particularly in an environment where the Tax Office has limited compliance resources, and where there are large numbers of funds that may not be meeting their *SISA* and income tax obligations. Not mitigating these compliance risk cases adequately may result in funds illegally accessing their retirement benefits early, or receiving taxation benefits to which they are not entitled.

3.2 The Tax Office's Compliance Model[57] specifies the Tax Office's (and the Superannuation Line's) methodology to achieving a well balanced compliance approach. The model specifies that a variety of compliance approaches and products are required to address the various types and severity, of non-compliant behaviour. These approaches and products can range from SMSF trustee support and assistance (such as education products and rulings) to Tax Office audits and reviews.

3.3 As discussed in Chapter 2, intelligence derived from its Compliance Benchmarking Projects led the Tax Office to revise its approach to compliance from one focusing predominantly on education to one focussed on 'active compliance'[58] in 2003–04. This Chapter examines the Tax Office's current approach to examining and taking action against high-risk SMSFs, and whether current approaches are equitable and appropriate. Specifically the ANAO examined the:

- education of SMSF trustees and relevant intermediaries;
- active compliance approach to SMSF compliance; and
- SMSF penalty framework and its application.

[57] This model is depicted in Appendix 5.

[58] Active compliance includes compliance measures such as Tax Office audits and reviews.

The education of SMSF trustees and relevant intermediaries

3.4 When the Tax Office assumed regulatory responsibility for SMSFs in late 1999, it identified[59] a knowledge deficiency among trustees of small funds in relation to their obligations. The Tax Office considered that a compliance strategy based on education products was the most effective way of obtaining assurance that SMSF trustees understood, and were therefore more likely to comply, with their obligations. This was particularly important given the Tax Office's limited resources, at the time, the ongoing and significant changes to the *SISA* and SIS Regulations, and the large number of new SMSFs being registered by the Tax Office annually.

3.5 To date the Tax Office's approach to SMSF education has comprised a wide range of products to assist with compliance. These products include:

- the New Trustee Education Campaign;
- other SMSF educational material including publications, seminars and conferences; and
- recently introduced superannuation interpretative decisions to clarify its position on a number of SMSF issues.

The effectiveness of the New Trustee Education Campaign

3.6 An important part of the Tax Office's compliance approach was the New Trustee Education Campaign (NTEC).[60] The NTEC involved Tax Office employees contacting new SMSF trustees to discuss their roles and responsibilities. It was intended that these discussions would prompt trustees to evaluate whether they had the knowledge and skills to manage a SMSF effectively. The Tax Office also used the NTEC discussions to distribute packages of Tax Office education publications which were tailored to the individual obligations of the trustees involved.

3.7 As part of the NTEC project the Tax Office contacted 11 555 SMSF trustees and sent out 140 291 education packages. Although accurate costings are not available, the Tax Office advised that approximately

[59] The Tax Office used information from a variety of sources to assess SMSF trustee knowledge. These information sources include APRA, workshops conducted with superannuation fund professionals and Tax Office research.

[60] The NTEC was originally undertaken on a sample of 7000 funds in 2000. Following the success of this project as a means to inform trustees of their obligations and disseminate relevant education information, the Tax Office established NTEC in 2002 as a more established part of its compliance strategy.

30 Superannuation Line staff[61] were involved with NTEC[62], with non-staff costs of approximately $42 000. This indicates that the NTEC was a comparatively cost effective mechanism to make trustees aware of their obligations.

Was NTEC effective?

3.8 To assess whether NTEC was effective, the Tax Office surveyed trustees on their perceptions of the campaign. This survey indicated 93 per cent of respondents found the information provided in the education packages useful and 64 per cent found the initial Tax Office telephone call useful. In addition, 94 per cent of respondents indicated that they learnt something new from the process.

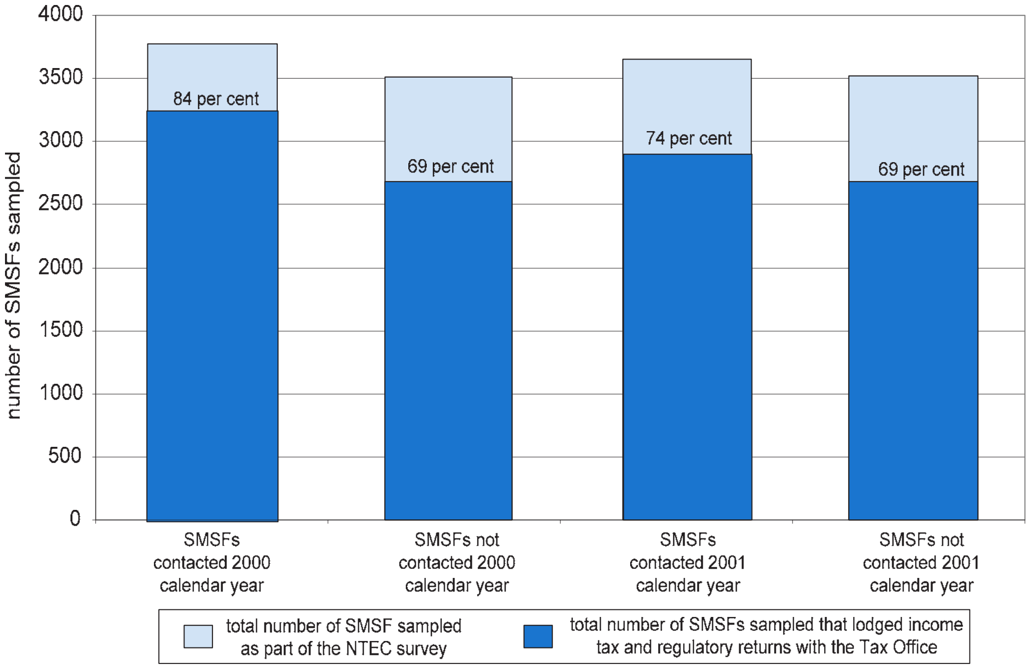
3.9 The Tax Office sought to determine whether the NTEC was contributing to good trustee compliance behaviour. The lodgement behaviour of SMSFs subject to NTEC telephone contact, was examined and compared to those funds that had not received NTEC contact. Figure 3.1 shows the results of this comparison for the 2000 and 2001 calendar years.

[61] The Tax Office advised that the amount of time these 30 staff devoted to NTEC was equivalent to 0.95 FTE annually (or 720 hours annually).

[62] The Tax Office advised that these staff did not work full time on NTEC, and had other SMSF compliance responsibilities.

Figure 3.1

NTEC evaluation regarding the lodgement of fund income tax and regulatory returns for SMSFs subject to NTEC



Source: ANAO analysis of NTEC results.[63]

3.10 Figure 3.1 shows for the 2000 and 2001 calendar years, SMSF trustees that had NTEC contact were more likely to lodge than those that did not have this contact. The evaluation also found those funds that were contacted via the NTEC were less likely to receive an approved auditor qualification than those not contacted.

3.11 Based on the results of the NTEC evaluation and relevant surveys, the NTEC appeared to indicate when informed of their roles and responsibilities, SMSF trustees were more likely to comply with their obligations. The ANAO notes also, anecdotal evidence provided by some of the professional accounting organisations suggested many of their members found the NTEC valuable.

3.12 In 2003–04, as part of the Tax Office's decision to adjust its compliance strategy to focus more on 'active compliance' approaches, the resources allocated to NTEC were diverted to active compliance functions. The ANAO

[63] The Tax Office noted that the results of the evaluation are indicative only. Although random samples were taken, evaluation documentation did not indicate whether they were statistically valid.

considers the Tax Office would benefit from revisiting products similar to NTEC as part of a revised approach to educating SMSF trustees (this is discussed further from paragraph 3.23).

Other SMSF educational material including publications, seminars and conferences

3.13 Since becoming the regulator for SMSFs, the Tax Office has developed a range of education material to assist SMSF trustees and intermediaries to understanding their rights and obligations under the *SISA* and income tax legislation. This includes: publications; guides; fact sheets found on the Tax Office website; joint media releases with the other regulators; seminars and provision of written advice (POWA) including the production of private and class rulings.

3.14 Table 3.1 show the range and amount of educational products and services provided by the Tax Office to SMSF trustees and practitioners in 2005-06.

Table 3.1

SMSF education products and services provided during 2005–06

Educational product	Number distributed
SMSF publications	22 811
Tax Office fact sheets	15 224
Superannuation related rulings	62
POWA issued	3200
Phone enquiries	83 000
SMSF seminars	130

Source: ANAO analysis of Tax Office information.

3.15 The ANAO considers the Tax Office has responded well to the information needs of SMSF trustees and intermediaries on their obligations in regards to SMSFs. This was confirmed by the majority of key industry stakeholders, and representatives of the professional accounting organisations interviewed during the audit.

3.16 A number of these stakeholders and representatives considered three products in particular: *DIY Super It's your money… But not yet!; Roles and responsibilities of trustees*; and *Roles and responsibilities of approved auditors* were particularly useful. The ANAO notes the first two of these products are sent to all new SMSFs once they have been registered.

The Tax Office's interpretative decision process

3.17 An important element of the Tax Office's role as regulator is to clearly articulate to SMSF trustees and intermediaries its interpretation of the *SISA* and relevant income tax legislation. As this legislation is complex, and in some instances open to differing interpretations, it is important the Tax Office has an effective system to communicate its interpretative decisions regarding the *SISA*, and these decisions address SMSF trustee and intermediary issues and concerns.

Tax Office proposals to improve its SISA interpretative decision process

3.18 The Tax Office advised the ANAO it will begin issuing *SISA* interpretive decisions for SMSFs as from September 2007. Unlike its administration of taxation laws, it is not able to issue legally binding interpretative decisions regarding the *SISA* provisions. Consequently, it is not able to provide legally binding interpretative advice in a similar form to the advice it issues through its tax rulings framework.[64]

3.19 To avoid public uncertainty about the role and function of the new *SISA* based superannuation rulings regime, the new non-binding superannuation rulings should be clearly differentiated from the existing regime of taxation rulings which are legally or administratively binding on the Tax Office. The Tax Office will also need to clarify:

- the processes it intends to use to develop the new superannuation rulings, including any public consultation processes;
- the consultative processes with the other superannuation regulators (APRA and ASIC), to ensure interpretative decisions are applied consistently by all regulators; and
- to what extent the Commissioner is bound by the new superannuation rulings, despite not having a legal or administrative obligation to be bound.

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[64] As part of its reforms to make the tax system fairer and more certain, the Commissioner of Taxation has the capacity to issue legally binding advice to taxpayers. This function is achieved through the *Taxation Laws Amendment (Self-Assessment) Act 1992.*

Other issues regarding SMSF interpretative advice

3.20 While the Tax Office cannot issue legally binding interpretative advice on matters concerning the *SISA*, it can issue such advice on taxation related matters regarding superannuation funds (including SMSFs). It is therefore important when the Tax Office issues rulings on taxation related matters it clearly states that these rulings relate only to its interpretation of taxation legislation and not to its interpretation of the *SISA*.

3.21 This matter became important in 2002, when the Tax Office issued a number of product rulings on the income tax consequences of investing in instalment warrants. Although the product rulings referred only to the income tax arrangements applicable to instalment warrants, indirect reference was made by the Tax Office to superannuation funds being a 'participant' in these warrants. Stakeholder feedback received by the ANAO during the audit suggested that, as a result, some investors saw the product rulings as an endorsement of instalment warrants as legitimate SMSF investments under the *SISA*, when this was not the intention of the rulings.

3.22 Similarly, the ANAO considers that to provide clarity for SMSF trustees and intermediaries, the Tax Office should clearly state in all taxation rulings applicable to SMSFs, the ruling relates to tax law and does not relate to the Tax Office's role as a superannuation regulator.

A revised approach to educating SMSF trustees

3.23 One of the more important findings arising from the Benchmarking Projects was that SMSFs operating for more than two years were more likely to have trustees not complying with their *SISA* obligations. The Tax Office speculated two reasons for this outcome were:

- the Tax Office's compliance activity, which was largely focused on education at the time, had a positive impact on new trustee compliance; and
- SMSF trustees were becoming complacent after running a SMSF for two years and were not meeting their obligations.

3.24 These findings support an education strategy targeting SMSF trustees at all stages of the fund lifecycle,[65] rather than only new trustees. This approach has the following advantages:

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[65] As outlined in Figure 1.1, the fund lifecycle is the period from when the fund registers with the Tax Office to when it winds-up.

- *Coverage*. As discussed in Chapter 2, the Tax Office does not have enough resources to examine in detail all funds identified as high compliance risk. An educative compliance approach would allow the Tax Office to potentially contact and inform large numbers of SMSFs of their obligations;
- *Cost.* As noted at paragraph 3.7 the cost associated with an educative approach to SMSF non-compliance appears to be lower for each SMSF trustee or intermediary contacted, compared to the estimated cost of an active compliance approach; and
- *Contact.* Providing SMSF trustees with ongoing educative compliance products following registration increases the visibility of the Tax Office in the SMSF industry and may be a deterrent to non-compliant SMSF behaviour.

3.25 An educative compliance approach could leverage off existing intelligence sources to more accurately target education compliance products at funds that are a high-risk of not complying with their obligations and that are not able to be examined as part of the Tax Office active compliance approach. An educative approach would also complement a robust active compliance approach.

Recommendation No.4

3.26 To further refine existing Tax Office SMSF education products and approaches, the ANAO recommends the Tax Office examine the costs and benefits of:

- developing and implementing approaches to deliver educative compliance products to trustees that are targeted to address identified compliance risks;
- developing educative products targeted towards the obligations of SMSF trustees during the various stages of the fund lifecycle; and
- periodically assessing the effectiveness of these targeted SMSF educational products using client surveys or other evaluative methods.

Tax Office response

3.27 Agreed

3.28 The Tax Office already has in place initiatives which address this recommendation. Since we took on responsibility for SMSFs we have continued to tailor and improve our approach to educating SMSF trustees as to their statutory obligations.

3.29 For instance the Tax Office has a proactive strategy to provide help and education to new trustees of SMSFs. New trustees are being targeted because in the past it has been shown that new SMSF trustees that have contact with the Tax Office in the first instance are more likely to voluntarily comply with their obligations than those that did not. The strategy includes: contacting 3 000 new registrants in 2007–08; requiring approved auditors to report all contraventions in the first year of operation; the provision of a new registrant start-up kit; and the signing by new trustees of a trustee declaration.

3.30 Educational products that explain obligations at the various stages of a SMSF's lifecycle are being developed. These include the establishment of a quarterly SMSF web-based newsletter; the introduction of superannuation seminars to the community; the publication of a large number of fact sheets; the publication of non-binding rulings; and the updates of existing publications which include all aspects of a fund's lifecycle. We have a set of flagship products aimed at trustees which have wide industry support and usage.

3.31 The effectiveness of the educational products directly goes to the Tax Office's business intent of optimising voluntary compliance with the superannuation and income tax laws. Consequently, it continually assesses the effectiveness of these products using a variety of methods including: the use of a useability laboratory (the Simulation Centre) that allows the Tax Office to test products and services and the way they come together to provide the whole client experience; client surveys; and through formal Tax Office committees, such as the Superannuation Consultative Committee, Simulation Centres, direct feedback and various client surveys.

An active compliance approach to SMSF compliance

3.32 The ANAO's examination of the Tax Office's active compliance approach to SMSF compliance included:

- what encompasses Tax Office SMSF active compliance activity;
- assessing the performance of the SMSF active compliance approach; and
- Tax Office procedures documentation and quality assurance process.

What is Tax Office SMSF active compliance activity?

3.33 Since 2003–04 the Tax Office has steadily increased the amount of SMSF active compliance activity it undertakes each year. To determine whether the Tax Office's active compliance 'coverage' has also increased, the ANAO reviewed the activities that comprise SMSF active compliance activity.

3.34 The Tax Office advised broadly, SMSF active compliance activities involve the systematic examination of a SMSF affairs by the Tax Office to determine whether SMSF trustees or SMSF intermediaries have complied with their income tax and *SISA* obligations. As the conduct of Tax Office SMSF audits is not governed by any statutory provisions, it is up to the Tax Office to determine what these activities examine. Consequently, the content of Tax Office SMSF active compliance activities can range from detailed examinations of all of a SMSF's affairs, to the confirmation of specific pieces of information contained in fund income tax and regulatory returns.

3.35 Given these circumstances, a significant challenge for the Tax Office is to formulate a methodology to accurately assess and report on the overall levels of compliance it is obtaining through its SMSF active compliance activities. This challenge is also complicated when reporting information publicly, as there may be different perceptions of what constitutes Tax Office active compliance activity in statistics that are released publicly.

3.36 Based on the information provided to the ANAO during the audit, the ANAO analysed (Table 3.2) the different types of SMSF active compliance activities used by the Tax Office to mitigate high-risk SMSF compliance cases.

Table 3.2

Tax Office SMSF active compliance activities

Greater ← Level of assurance and cost — Lesser

	Field	Correspondence	Outbound calls
Comprehensive Audit	Covers multiple issues and may cover multiple periods (years). Some fieldwork undertaken by Tax Office staff at the client's premises.	Covers multiple issues and may cover multiple periods (years). Casework undertaken by Tax Office staff from their desks via mail and telephone calls.	Not applicable
Comprehensive Review	Covers multiple issues and may cover multiple periods (years). Allows reviewee to voluntarily disclose breaches of their obligation to avoid or minimise Tax Office compliance action. Some case work undertaken at the client's premises.	Covers multiple issues and may cover multiple periods (years). Allows reviewee to voluntarily disclose breaches of their obligation to avoid or minimise Tax Office compliance action. Casework undertaken by Tax Office staff from their desks via mail and telephone calls.	Not aplicable
Specific Issues Audit	Focuses on one or more specific issues, and has a restricted focus. Some casework undertaken at the client's premises.	Focuses on one or more specific issues, and has a restricted focus. Casework undertaken by Tax Office from their desks via mail and telephone calls	Not applicable
Specific Issues Review	Focuses on one or more specific issues, and has a specific focus. Allows reviewee to voluntarily disclose breaches of their obligations to avoid or minimise Tax Office compliance action. Some casework undertaken on the client's premises.	Focuses on one or more specific issues, and has a restricted focus. Allows reviewee to voluntarily disclose breaches of their obligation to avoid or minimise Tax Office compliance action. Casework undertaken by Tax Office staff from their desks via mail and telephone calls.	Focuses on one or more specific issues, and has a restricted focus. Generally involves confirmation of information contained on income tax and regulatory returns via telephone.

Level of assurance and cost (Greater ↑ Lesser)

Source: ANAO's analysis of Tax Office information.

3.37 Table 3.2 shows a significant difference between the levels of assurance provided by each SMSF active compliance product. For example, a comprehensive audit provides a much higher level of assurance a SMSF is complying with its obligations than would a specific issue review based on an outbound telephone call from the Tax Office.

Monitoring and reporting the effectiveness of the Tax Office's active compliance approach

3.38 To assess the effectiveness of the Tax Office's active compliance approach, the ANAO examined the Tax Office's external and internal reporting against its active compliance commitments. The Tax Office's active compliance commitments are contained in Table 3.3.

Table 3.3

Tax Office compliance commitments

Source of commitment	Commitment	2002–03	2003–04	2004–05	2005–06
a) 2002–03 to 2004–05 Tax Office Output Pricing Agreement (2002–03 Budget)	Action 1000 compliance cases (audits) per annum from 2002–03	1000	1000	1000	1000
b) Compliance Challenges (2003–04 Budget)	Action 2 600 compliance cases (audits) per annum and collect $1.3 million per annum in 2003–04 and $2.6 million thereafter through amended income tax assessments.	n/a	2600	2600	2600
Total number of compliance cases to be completed (a+b)		1000	3600	3600	3600
Actual number of cases completed (reported in Tax Office annual reports as audits)		**Tax Office unable to provide this information.**	1055	3623	4530

Source: ANAO analysis of Tax Office information.

External SMSF reporting

3.39 The number of SMSF active compliance activities identified as 'commitments' in Table 3.3 are specific undertakings made by the Tax Office to Government to support increases to SMSF compliance funding obtained in the Federal Budget processes.[66]

3.40 To date the Tax Office's performance in delivering against its compliance commitments has been mixed. With the exception of 2002–03 and 2003–04, Table 3.3 indicates the Tax Office has met its commitments to Government regarding the number of SMSF active compliance cases it undertakes annually. However, given the wide variety of activities deemed to constitute 'active compliance,' the nature of assurance these figures provide is questionable.

3.41 For example, in 2005–06, of the 4530 'audits' undertaken by the Tax Office, 1429 (or 31 per cent) were specific issue outbound calls. This compares with the 472 audits (or 10 per cent) comprehensive field audits completed in this year. Also, the Tax Office commenced only 29 new comprehensive audits in 2004–05, which is a significant decrease from 2003-04.[67]

3.42 The ANAO considers that under the Tax Office's current SMSF active compliance framework, it is difficult to determine the nature of assurance the Tax Office is obtaining and then reporting to Government regarding SMSF compliance with their obligations. Specifically, under the Tax Office's SMSF active compliance public reporting framework there is no distinction between the low cost, low involvement SMSF active compliance activities (such as outbound calls) and the high cost, high involvement active compliance activities (such as comprehensive field audits).

3.43 When Government agreed to increase SMSF active compliance funding to fund specific numbers of 'audits', no definition of what constituted an 'audit' was outlined.

3.44 As noted in Chapter 1, the Tax Office has received additional funding as part of *Simplified Superannuation* reforms to increase its active compliance coverage of the SMSF population. The *Simplified Superannuation* changes will

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[66] Additional compliance funding for SMSFs was received by the Tax Office as part of the 2002–03 and 2003–04 Budget process.

[67] The ANAO notes that 97 per cent of comprehensive field audits completed in 2005–06 commenced in prior financial years.

result in an increase in SMSF coverage to 2.9 per cent (or an increase of SMSF audits to about 10 900).

Internal SMSF reporting

3.45 The Tax Office has an obligation to report against the targets agreed with Government, namely: the number of SMSF active compliance activities completed annually; and the aggregate amount of additional revenue raised through adjustments to income tax returns and penalties through non-compliance. While these targets are useful performance measures, by themselves they do not provide the Tax Office with an ongoing and holistic measure of the efficiency and effectiveness of its SMSF active compliance approach.

3.46 The ANAO considers while the Tax Office should strive to achieve its external performance targets, the integrity of a systematic and transparent risk based case selection process should also be maintained. To achieve this, it is important the effectiveness of the selection of SMSF active compliance cases and the activities undertaken to mitigate SMSF risks is measured.

3.47 Since 2004–05 the Tax Office has reported internally on a number of productivity measures[68] for active compliance activities at the Superannuation Line level as part of quarterly Compliance Sub-plan productivity reports. However, similar reporting does not occur within the Superannuation Line at the product level (i.e. for SMSF as opposed to Superannuation Guarantee active compliance activities).

3.48 Assessing the effectiveness of its SMSF case selection process would assist Tax Office management to achieve an 'optimal' balance of its wide range of SMSF active compliance activities, and to provide the highest level of assurance SMSFs are complying with their *SISA* obligations for the lowest cost.

3.49 As noted in Chapter 2, the Tax Office acknowledged the need to improve the transparency and defensibility of its SMSF case selection approach as part of its decision to introduce its OA capability. In further developing its OA capability the ANAO considers the Tax Office should also ensure there are improvements to its internal reporting framework at the SMSF product level which enable it to assess the effectiveness of its SMSF active compliance approach.

68 These include strike rate, return on investment, direct compliance time, coverage and the age of cases.

Tax Office SMSF active compliance procedures documentation and quality assurance process

3.50 Given the complexity of the SMSF active compliance framework, and the broad descriptions of the various activities within this framework it is important comprehensive procedures documentation is available and is used by SMSF active compliance staff. A robust Quality Assurance (QA) process is also needed to provide assurance active compliance staff are adhering to work procedures, and the information they are providing to SMSF trustees and intermediaries is accurate.

3.51 The ANAO noted a wide range of general procedures and education documentation for active compliance staff has been developed which is relevant not only to the Superannuation Line, but for all active compliance areas throughout the Tax Office. The Tax Office has developed comprehensive procedures for its new case management system, Siebel although there have been delays in publishing all material to its intranet site.

3.52 A QA process is in place for SMSF active compliance activities consistent with Tax Office wide QA policy and QA results are periodically reported to Tax Office senior management. The Tax Office has also introduced a Superannuation Compliance Case Leadership Forum to improve the regulation and resolution of complex or contentious SMSF case issues

The SMSF penalty framework and its application

3.53 The application of penalties for non-compliant SMSF trustee behaviour is an essential component of a well functioning compliance framework. Not only do penalties act as a deterrent to non-compliant SMSF behaviour, but they also provide compliant SMSFs with confidence the Tax Office is monitoring compliance with the *SISA* and SIS Regulations, and that there are consequences for those funds not complying with their obligations.

3.54 Since it began regulating SMSFs in 1999, the options available to the Tax Office to penalise a SMSF for contravening the *SISA* have been limited to:

- disqualifying or suspending a trustee, which removes their capacity to operate a SMSF;
- freezing the assets of a SMSF;

- declaring a SMSF non-complying for certain years of income[69]; and
- prosecuting trustees under the civil penalty provisions of Part 21 of the *SISA*.

3.55 The Tax Office did not have a robust active compliance program in place until 2003–04, and as a result, it imposed few penalties on SMSF trustees from 1999–2000 to 2002–03. As shown in Table 3.4, since 2003–04, the Tax Office has also been reluctant to apply penalties on SMSFs for breaches of the *SISA*.

Table 3.4

The number of penalties imposed on SMSF trustees and their intermediaries from 2003–04 to 2005–06[70]

Penalty	2003–04	2004–05	2005–06
Disqualification of trustees	16	6	12
Fund declared non-complying	n/a	5	12
Freezing assets of fund	n/a	0	1
Civil and criminal penalties imposed	n/a	0	3

Source: ANAO data.

3.56 There are a number of other contributing factors to the low number of penalties imposed on SMSFs. These include:

- *The Tax Office can only apply penalties on a fund if it falls within its jurisdiction.* There have been a number of occasions where the Tax Office has decided to apply a penalty and later found the fund did not meet the definition of a SMSF;
- *Prior to 2006, the Tax Office's policy on administering the penalties and protective measures applicable for SMSFs and their trustees was unclear;* and
- *Staff with no SMSF audit experience, were not confident to impose penalties under the SISA.* This resulted in inconsistency between Tax Office sites of the use of penalties to remedy non-compliant SMSF behaviour.

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69 This involves a 45 percent tax rate being applied to all taxable income and assets of a fund under s288 of the *Income Tax Assessment Act 1936*.

70 As at October 2006, the Tax Office had imposed approximately $3 million in penalties and tax on scheme promoters for breaches of the *SISA* and income tax law.

3.57 The Tax Office advised as the regulator of SMSFs, it will take all possible action to ensure circumstances of a fund are taken into account before applying penalties. The Tax Office considers the existing *SISA* penalty regime is not conducive to the effective regulation of SMSFs, as many of the contraventions found in SMSFs are relatively minor and do not justify the costs of prosecution, the harsh tax consequences of making a fund non-complying, or disqualification of the trustee.

3.58 For this reason the Tax Office's preference is to accept an 'enforceable undertaking' from a SMSF trustee that all breaches will be remedied.[71] In 2005-06, the Tax Office finalised 131 enforceable undertakings, which indicates enforceable undertakings are more likely to be used where a SMSF is found to be in breach of its *SISA* obligations than statutory penalties. This is illustrated in the Case Study.

[71] An enforceable undertaking allows the SMSF a period of time to rectify any beaches of the *SISA*. If the fund fails to meet its enforceable undertaking, the Tax Office can then apply *SISA* penalties.

Case Study

Facts

SMSF X was established on the 11 June 1985. On 16 September 1985 the fund purchased a commercial property for approximately $105 500. On 1 October 1985 the fund began leasing the property to the corporate trustee. There was no written lease agreement and the lessee only paid what rent it could afford. The lease ended on the 30 June 2005.

Market rent was determined on 4 May 2006 as being between $2250 to $2500 per month (or $27 000 to $30 000 per annum). The most the company ever paid in rent for one year was $11 091. The lessee also paid for improvements to the property valued between $54 000 to $64 000 during the term of the lease which was considered by the fund to be rental payments.

The fund accountant has advised the lessee is unable to repay any outstanding rent as the company has wound-up and doesn't have any assets. The property is currently being advertised for lease. Two ACRs were lodged for the fund for the years ending 2003 and 2004.

Issue

Has the trustee of the fund contravened the *SISA* as a result of a lease on the property owned by the fund to a related company?

Findings

The fund was not conducted for the sole purpose of retirement (as specified in section 62 of the *SISA*). Rather the fund was used to provide financial support to the company by way of reduced rent. The Tax Office found the fund had contravened section 62 of the *SISA* and section 109 of the *SISA* which requires all transactions of superannuation entities be made on an arm's-length basis.

Outcome

Despite the Tax Office finding the breaches of the *SISA* were of a very serious nature, the Tax Office did not take any further action in relation to the contraventions of the *SISA*. One of the reasons for this was the SMSF trustees ending the leasing arrangement. The trustees gave a commitment not to contravene the *SISA* in the future.

Source: Tax Office case files.

3.59 In November 2006, to clarify its policy on administering the penalties, the Tax Office issued new practice statements for use by its active compliance staff. The new practice statements are available on the Tax Office website and relate to the disqualification of SMSF trustees, accepting enforceable undertakings and issuing a notice of non–compliance. The Tax Office began training its staff on the application of the new practice statements in February 2007.

Simplified Superannuation

3.60 The explanatory memorandum to the *Simplified Superannuation* legislation notes the existing penalty regime for SMSFs has not provided sufficient flexibility for the Tax Office to administer the law.[72] As of 1 July 2007, a new penalty regime for SMSFs was introduced. Generally, the changes brought about by the *Simplified Superannuation* reforms will extend the *Taxation Administration Act (TAA) 1953* administrative penalty regime for certain information to be provided to the Commissioner under the *TAA* and the *SISA*. These include introducing administrative penalties for the following offences:

- trustees making false and misleading statements;
- failure to lodge fund income tax and regulatory returns on time;
- failure to keep and retain records; and
- failure to notify the Tax Office of a change of trustee or other changes in the fund.

3.61 The Tax Office advised the changes should provide it with a more effective, efficient and timely mechanism to enforce the accuracy and completeness of information provided by SMSF trustees and their intermediaries. However, specific penalties were not introduced for offences such as the inappropriate access to funds, failure of SMSF trustees to comply with enforceable undertakings and where investments are in contravention of the *SISA*. As such, the ANAO considers the effectiveness of the new penalty regime introduced by *Simplified Superannuation*, may benefit from an evaluation, after an appropriate period to assess the flexibility the Tax Office has in administering the *SISA* and in applying penalties to SMSF trustees or their intermediaries where appropriate.

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72 Explanatory memorandum to the Tax Laws Amendment (Simplified Superannuation) Bill 2006, paragraph 8.137.

4. Self Managed Superannuation Fund Wind-ups

This Chapter examines the Tax Office's current approach to assist SMSF trustees and their intermediaries to wind-up their SMSFs correctly and assesses Tax Office reporting on SMSF wind-ups.

Introduction

4.1 The wind-up of a self managed superannuation fund occurs when trustees decide to terminate the SMSF, usually resulting in SMSF monies being rolled into another superannuation fund. A SMSF may be wound-up for a number of reasons which may relate to a member's personal circumstances. Alternatively, a SMSF may be forced to wind-up as a result of Tax Office compliance action to resolve the non-compliant behaviour of SMSF trustees.[73]

4.2 The reasons for a SMSF winding-up include: members moving overseas to live; excessive costs encountered when running the SMSF; trustees experiencing poor SMSF returns; and trustees making significant breaches of *SISA* and the SIS Regulations.

4.3 An effective process for winding-up a SMSF assists Tax Office systems to accurately record the number of active SMSFs. To assess the effectiveness of the Tax Office's wind-up process and the integrity of data on Tax Office systems the ANAO examined:

- the number of wind-ups in comparison to registrations;
- legislative requirements for winding-up a SMSF;
- Tax Office processes to assist the wind-up of SMSFs; and
- Tax Office reporting on wind-ups.

Number of SMSF wind-ups

4.4 Tax Office systems indicate since the Tax Office became regulator of SMSFs, 24 295 SMSFs have been wound-up. Around 20 000 SMSFs notified the Tax Office of their intention to wind-up when lodging their fund income tax

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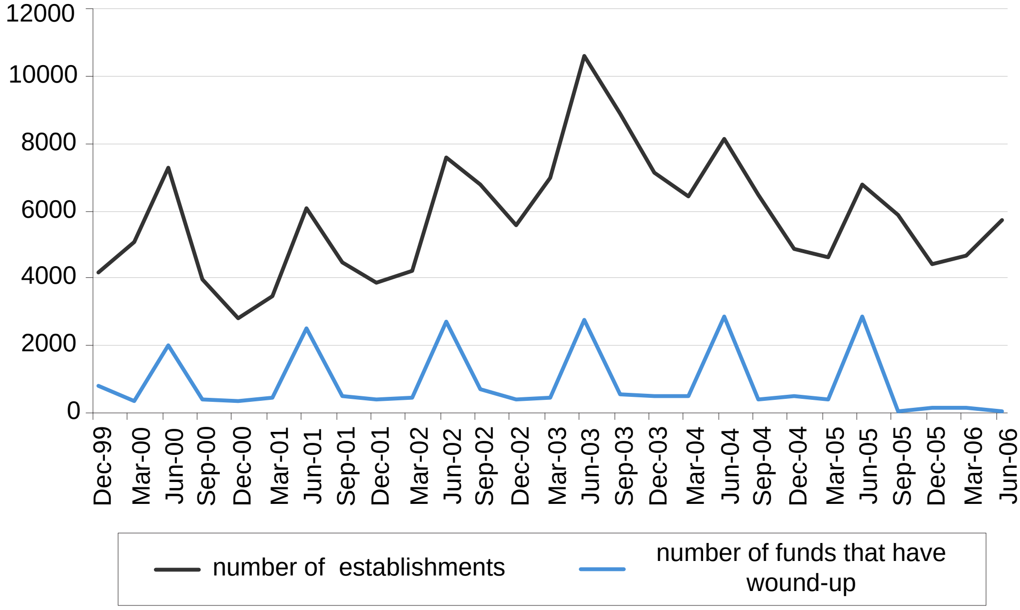
[73] Under the *SISA*, the Tax Office cannot independently wind-up a SMSF. It can remove trustees from a SMSF and appoint an acting trustee, providing directions to wind-up a SMSF. The Tax Office advised that where there are insufficient assets in a SMSF to cover the costs of an acting trustee these costs would be funded by the regulator.

and regulatory return. Figure 4.1 shows a relatively consistent number of SMSFs wind-up from quarter to quarter, with the exception of seasonal increases in wind-ups occurring at the end of each financial year.

Figure 4.1

Number of quarterly wind-ups in comparison to number of quarterly registrations



Source: ANAO analysis of Tax Office data.

4.5 As a number of SMSFs have not lodged fund income tax and regulatory returns for multiple financial years, this may indicate some trustees have effectively wound-up SMSFs but have not notified the Tax Office of the status of the SMSF. Therefore, the number of SMSFs that have actually wound-up may be significantly greater than the number recorded on Tax Office systems (as shown in Figure 4.1) and therefore be less than the total number of active SMSFs reported annually.

4.6 As noted in the first audit report, this will have a direct impact on the number of SMSFs publicly reported by APRA. The Tax Office advised its Lodgement Compliance Program for SMSFs will be assessing the reasons behind the lodgement gap in its work for 2007–08.

Legislative requirements for winding-up

4.7 The *SISA* and SIS Regulations outline a number of responsibilities for members, SMSF trustees and their intermediaries once a decision has been made to wind-up a SMSF. This includes trustees and their intermediaries ensuring all requirements set out in a SMSF's trust deed, together with all taxation and reporting obligations are met before a SMSF winds-up. The *SISA* and the SIS Regulations however, do not outline the specific steps to be taken by trustees to wind-up a SMSF.

4.8 Section 106A of the *SISA* requires a regulated SMSF which ceases to be a SMSF to give notice in writing to a regulator of a decision or resolution to wind-up a SMSF.[74] This must be done before or as soon as is practical, after the winding-up has commenced. This notice must not be more than 21 days after the trustee first has knowledge the fund has ceased to be a SMSF.[75]

4.9 If a fund has effectively wound-up but fails to notify the Tax Office, the Commissioner can cancel the SMSF's Tax File Number. This is referred to as an administrative wind-up and prevents further transactions from occurring between the Tax Office and the fund.

4.10 Figure 4.2 shows the time taken for SMSFs to notify the Tax Office of winding-up.[76]

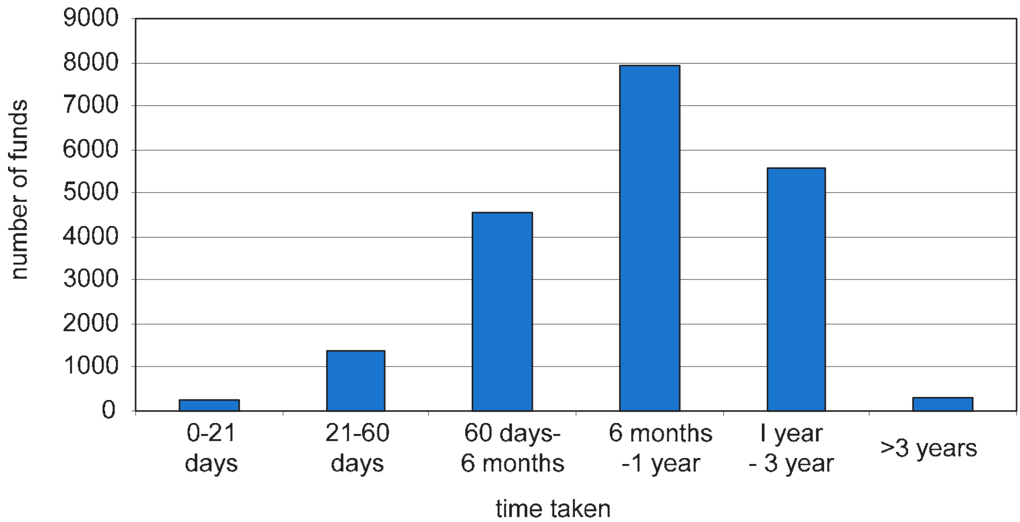
[74] SIS Regulation 11.07A.

[75] Paragraph 106A (2) of the *SISA.*

[76] The data in Figure 4.2 does not include those SMSFs that have notified the Tax Office of winding-up through methods other than through a fund income tax and regulatory return. Therefore, a direct comparison cannot be made between these numbers and the numbers reported in Figure 4.1.

Figure 4.2

Time taken for SMSFs to notify the Tax Office of winding-up from 1 October 1999 to 18 August 2006



Source: ANAO analysis of Tax Office data.

4.11 Figure 4.2 shows since the Tax Office was made responsible for SMSF regulation, of the 20 000 SMSFs notifying the Tax Office of winding-up through the lodgement of a fund income tax and regulatory return, only 251 (1.25 per cent) of these notified the Tax Office within 21 days of winding-up.[77] Figure 4.2 also shows:

- 92 per cent of SMSFs did not notify the Tax Office within 2 months of winding-up;
- 70 per cent notified within a year; and
- 1.6 per cent took more than three years to contact the Tax Office.

4.12 The Tax Office may impose a penalty on a SMSF failing to provide notification of winding-up.[78] The Tax Office has not imposed this penalty on SMSFs despite the majority not meeting the 21 day wind-up notification obligation.

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[77] The ANAO notes that the large proportion of funds that do not notify the Tax Office within a year of winding-up can be explained in part by the lodgement cycle of fund income tax and regulatory returns.

[78] Paragraph 106A (3) of the *SISA.*

4.13 The reasons for SMSFs appearing not to meet the 21 day wind-up notification obligation include:

- *SMSFs trustees or intermediaries waiting to notify the Tax Office of winding-up the SMSF until the lodgement of the fund's last income tax and regulatory return*; and
- *poor quality Tax Office educational material on winding-up SMSFs.*

4.14 If the Tax Office does not take measures to improve SMSF compliance with the 21 day wind-up notification obligation, the trend of funds not meeting the *SISA* requirement and the delay in the Tax Office systems reflecting actual SMSF wind-up information are both likely to continue.

Tax Office educational material for winding-up

4.15 An important aspect of obtaining a level of assurance SMSFs are complying with their *SISA* requirements is that they are aware of their obligations when winding-up a SMSF. Without adequate Tax Office educational material SMSF trustees and their intermediaries may wind-up their SMSFs incorrectly.

4.16 The Tax Office communicates to SMSFs the requirements of winding-up through a number of channels. These channels include the Tax Office's website; publications; and speeches. Although providing educational material through a number of sources encourages voluntary compliance by considering trustees' preferences in receiving information, it is important the information provided is comprehensive and consistent with legislative requirements.

4.17 There are a number of shortcomings with the Tax Office's SMSF educational material on the wind-up process, including:

- *Incomplete material.* A number of Tax Office sources did not set out all the requirements to wind-up a SMSF. One notable example is the Tax Office website that does not specify that SMSFs are required to notify the Tax Office within 21 days of winding-up; and
- *Wind- up information omitted from publications.* A key SMSF compliance publication which is an extension of the Tax Office's Compliance Program, the *DIY…It's your money but not yet* publication, does not address any of the *SISA* requirements of the wind- up process.

4.18 As noted in paragraph 4.13 , inadequate educational material is likely to result in a large number of SMSFs not complying with their *SISA* obligations. The ANAO considers the Tax Office should review its educational material provided to SMSF trustees to assist with wind-ups to ensure the content is appropriate and consistent with the legislative requirements imposed on SMSFs. Information that is complete and informs trustees of the *SISA* requirements, is likely to lead to an increase in the number of SMSFs notifying the Tax Office of winding-up within 21 days of the action.

Recommendation No.5

4.19 The ANAO recommends the Tax Office update the wind-up information available on its website, and from seminars and publications to reflect the requirements imposed on SMSFs by the *Superannuation Industry (Supervision) Act 1993* and Superannuation Industry (Supervision) Regulation 1994.

Tax Office response

4.20 Agreed

4.21 The Tax Office will update the information about winding-up SMSFs on its website. It is also updating its publications to reflect the requirements imposed on SMSFs by the *Superannuation Industry (Supervision) Act 1993* and the *Superannuation Industry (Supervision) Regulations 1994*. Further, the Tax Office will include information about winding-up in future seminars about SMSFs.

Tax Office processes to assist the wind-up of SMSFs

4.22 In its role as SMSF regulator, the Tax Office relies heavily on the integrity of the data held on its systems. It is important therefore, when a SMSF winds-up, the correct processes are followed and relevant systems are updated in order that information reported is accurate. A robust wind-up process is also necessary for providing a level of assurance retirement savings are retained in the superannuation system and are not accessed illegally.

Wind-up project

4.23 In May 2006 the Operations Line conducted a Wind-up project. This project found the methodology for winding-up SMSFs was not comprehensive, leading to inconsistent and incomplete administrative outcomes in a number of cases. It also recognised that too few resources were devoted to the wind-up process.

4.24 The project identified the following shortcomings of the Tax Office's wind-up process:

- *SMSFs were not formally being wound-up on Tax Office systems.*[79] Although there are nine different ways of informing the Tax Office a fund is winding-up, none of the methods guaranteed that a fund had wound-up. This resulted in wound-up SMSFs, repeatedly informing the Tax Office of their status;
- *A backlog of cases to be actioned.* An ill-defined wind-up process resulted in a backlog of funds expected to have wound-up but had not been actioned by the Tax Office. One Tax Office system had 470 un-actioned cases; and
- *Lack of data integrity.* The Tax Office's approach to winding-up SMSFs has affected the data quality in Tax Office systems. For instance, 12 500 SMSFs had wound-up, but still had active Australian Business Numbers on Tax Office systems.[80]

4.25 In response to the issues raised in the project, the Tax Office introduced a number of measures to improve the process for winding-up funds. This included redeveloping internal procedures to wind-up a SMSF and creating additional teams to action wind-up cases.

4.26 The ANAO considers the removal of SMSFs that have been wound-up from Tax Office systems will lead to a reduction in the number of SMSFs considered for compliance action, and the number of active funds reported publicly.[81] However, additional measures could also be explored to improve the process of SMSFs notifying the Tax Office of winding-up.

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[79] Methods employed by SMSFs to notify the Tax Office of winding-up include: correspondence; e-mail; escalation via contact centre and payment of variation advice.

[80] The Tax Office advised in March 2007 that additional work has reduced this number to 389.

[81] The Tax Office's reporting of SMSF asset values and active SMSFs is discussed in the Auditor-General Report No.52 2006–06 *The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds.*

Wind-up form

4.27 As noted above, there are a number of methods available to SMSFs to notify the Tax Office of a change in SMSF status. This has resulted in an administrative burden on the Tax Office as SMSFs have repeatedly notified the Tax Office of winding-up through different methods.

4.28 The current notification process does not meet the SIS Regulation which requires a SMSF notifies the Tax Office in writing of its intention to wind-up. The Tax Office in its educational material, encourages SMSFs to wind-up through the lodgement of a fund income tax and regulatory return.[82] Unlike APRA, the Tax Office does not provide SMSF trustees with a specific wind-up form.[83]

4.29 The ANAO considers a number of benefits would result from the Tax Office reviewing the notification process of winding-up a SMSF, particularly if a separate wind-up form were developed. These benefits include:

- *A standardised method for wound-up SMSFs notifying the Tax Office.* This will reduce in part the current administrative costs to the wind-up process for the Tax Office and improve the quality of Tax Office data;
- *The information on the wind-up form can be used for intelligence purposes, including early access.* The current methods for winding-up seldom result in information being provided to the Tax Office on the reasons a SMSF has wound-up[84]; and
- *Improved reporting of wind-up information*. Capturing intelligence on why SMSFs wind-up will allow the Tax Office to report this information to industry.

4.30 The ANAO also considers a single wind-up form to replace the nine currently available methods for trustees to wind-up their SMSFs would simplify SMSFs reporting obligations and reduce current administrative costs.

[82] This involves a SMSF ticking a box on the fund income tax and regulatory return and specifying the date the fund was wound-up.

[83] Information on the APRA form requires funds to ensure that they have met all outstanding lodgement obligations.

[84] SIS Regulation 11.07A does not require a fund to notify the Tax Office of the reasons why a fund winds up.

Recommendation No.6

4.31 To assist SMSF trustees meet their fund wind-up obligations, and to improve the effectiveness of the wind-up process, the ANAO recommends the Tax Office:

- assess the costs and benefits of current notification options; and
- consider the introduction of a wind-up form for SMSF trustees.

Tax Office response

4.32 Agreed

4.33 The costs and benefits of current notification options will be reviewed as part of the redesign of the wind up of fund form, which is currently underway. Websites and publications will be reviewed following this. The recommendation to introduce a specific form for SMSF trustees will be determined by the outcome of this review.

Tax Office reporting on SMSF wind-ups

4.34 Public reporting on SMSF wind-ups is an important way for the Tax Office to communicate intelligence it has gathered on SMSFs. In the past, this has generally been limited to the number of SMSFs and SMSF asset values. There has been an increasing demand by industry and Parliament for more detailed information on SMSFs.

4.35 In April 2006, the Tax Office's Superannuation Consultative Committee sought feedback from committee members on the SMSF information they would like to be made publicly available. Industry advised it wanted access to information on wind-ups, specifically the:

- number of SMSFs winding-up in comparison to the number of registrations; and
- reasons for SMSFs winding-up.

4.36 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 ANAO notes, this publication should provide relevant stakeholders with some of the additional information they require to meaningfully assess the SMSF market.

Ian McPhee
Auditor-General

Canberra ACT
1 November 2007

Appendices

Appendix 1: Tax Office Response

Australian Government
Australian Taxation Office

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

Dear Mr Crossley

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

We note the ANAO conducted the majority of the fieldwork, on which this report is based, between June 2006 and September 2006. During, and subsequent to, this period the Tax Office continues to improve our comprehensive approach to SMSF compliance, such as enhancing the educational products that were available and improving the compliance activities that were being undertaken. As well, we had been working closely with Treasury to address a number of administrative and compliance issues surrounding SMSFs. Initiatives to address many of these issues formed part of the simpler super measures announced by the Government in September 2006.

Consequently, some of the recommendations found in this report were already being implemented prior to the audit, or alternatively are now being implemented.

Consistent with the objective of Australia's superannuation system - to assist and encourage people to achieve a higher standard of living in retirement than would be possible from the age pension alone – the Tax Office does not automatically make a fund non-complying if there is a breach of the superannuation laws. This was acknowledged by the ANAO in the report. Our role is focussed on retirement income, not revenue protection. We continue to work with trustees to help them meet their superannuation law obligations and preserve their retirement income. In doing so, our aim is to be as least intrusive as possible to the majority of individuals and businesses who want to meet their superannuation law obligations, while at the same time being highly visible to those who are reluctant to comply.

Enclosed are our responses to the six recommendations, as well as our summary response. We agree with the recommendations. As mentioned above, implementation of many of the recommendations is well progressed.

I would like to commend to you the work of Jon 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.

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

Yours sincerely

J Granger

Jennie Granger
Second Commissioner of Taxation
18 October 2007

Enc

Recommendation No. 1	To assist in determining its SMSF compliance programme, the ANAO recommends the Tax Office: • assess the costs and benefits of undertaking periodic benchmarking exercises that indicate overall SMSF compliance levels; and • develop performance indicators for each benchmarking exercise that enable measurement of the success of compliance approaches over time.	***Tax Office Response: Agree*** The Tax Office continually reviews the level of taxpayer compliance and the effectiveness of its compliance approaches. For example, and as recognised in this report, to date two benchmarking exercises have been undertaken to measure SMSF compliance levels. Consequently the Tax Office agrees to assess the costs and benefits of undertaking periodic benchmarking exercises that indicate overall SMSF compliance levels. However, in undertaking these exercises, the Tax Office will not conduct random audits. It will continue to develop performance indicators that measure the success of SMSF compliance in accordance with the Compliance Model by minimising intrusion on the majority of individuals and businesses who want to meet their superannuation law obligations, while at the same time being

		highly visible to those who are reluctant to comply. The Tax Office is also revising the Auditor Contravention Report to collect improved compliance information from approved auditors from July 2008, and developing an electronic tool that will assist auditors to identify the contraventions to be reported. The improved compliance information collected will enhance risk analysis and case selection activities and will provide the basis for a greater understanding of compliance levels.
Recommendation No. 2	To improve the quality of approved auditor information held by the Tax Office, and to increase assurance that all SMSFs are audited only by approved auditors, the ANAO recommends the Tax Office: • undertake processes to cleanse its approved auditor data of erroneous,	***Tax Office Response: Agree*** Work has already commenced on improving the quality of approved auditor data holdings and includes the following: • the cleansing of approved auditor data;

	duplicated and/or incomplete records; and • seek to expand existing working arrangements with the professional organisations including to examine ways to confirm all approved auditors listed on Tax Office systems are valid members of their organisation.	• meetings with the professional organisations on approved auditor issues, including ways to confirm all approved auditors listed on Tax Office systems are valid members of their relevant professional organisations; and • cross matching of approved auditor data against SMSF regulatory returns. This involves reviewing approved auditor details as listed on the regulatory return and confirming, where possible, the identification of a single approved auditor who may have been recorded under different name derivatives. As part of Simpler Super, a new initiative has been commenced with the introduction of the new combined income tax, regulatory return and member contribution statement form, which will be used by trustees of SMSFs from 1 July 2008. This form will improve compliance

		levels, as well as enabling easier identification of approved auditors. This is because it contains more information about auditors, including: • family and first name; • professional body and membership number; • address; and • date audit completed and whether it was qualified. The Tax Office is working with the professional organisations on improving auditor competencies and integrity. There is little evidence that audits are being conducted by unqualified persons. The issue is considered to be low risk and the Tax Office considers the question is one of quality of the information being provided by approved auditors rather

		than one of fraud.
Recommendation No. 3	To continue to improve the selection of high-risk SMSFs for Tax Office compliance action (including Tax Office audits) and to better utilise its compliance resources, the ANAO recommends the Tax Office: • continue to refine and fully implement its Operational Analytics capability to enable a systematic and consistent risk-based approach to identifying SMSFs that do not comply with their *Superannuation Industry (Supervision) Act 1993* obligations; • as part of the development of Operational Analytics, utilise the information contained in other relevant Tax Office systems to obtain	***Tax Office Response: Agree*** The Tax Office agrees with this recommendation. As recognised in this report, the Tax Office is already moving its case selection and exception processing from manual candidate identification to analytical based case selection. This method is designed to select the highest risk cases, with the longer term objective of allocating resources between competing risk pools. Superannuation Active Compliance currently selects compliance cases from either SMSF operational analytic models or by way of manual candidate identification. The Tax Office has commenced work on the development of a risk rating engine

	a ‘whole of client’ compliance assessment for all SMSFs, including an analysis of SMSFs’ compliance histories; and • develop procedures to assess the performance of Operational Analytics to identify high risk cases and report on the results of this performance assessment to identify potential improvements to the case selection approach.	for SMSFs using Analytics, which will analyse the entire SMSF population and identify risk areas for further analysis and case selection. As part of this development, a whole of client approach is being adopted so that a holistic model for risk rating the full SMSF population can be undertaken. Superannuation currently reports against corporate measures of performance dictated through approved corporate processes. As part of its compliance regime, the Tax Office continually assesses its effectiveness to the extent to which actual outcomes are aligned with desired outcomes. And, as a consequence, it will be developing procedures to assess the performance of Operational Analytics to identify high risk cases and report on the results of this performance assessment to identify potential improvements to the

		case selection approach.
Recommendation No. 4	To further refine existing Tax Office SMSF education products and approaches, the ANAO recommends the Tax Office examines the costs and benefits of: • developing and implementing approaches to deliver educative compliance products to trustees that are targeted to address identified compliance risks; • developing educative products targeted towards the obligations of SMSF trustees during the various stages of the fund lifecycle; and • periodically assessing the effectiveness of these targeted SMSF educational products using client surveys or other evaluative methods.	***Tax Office Response: Agree*** The Tax Office already has in place initiatives which address this recommendation. Since we took on responsibility for SMSFs we have continued to tailor and improve our approach to educating SMSF trustees as to their statutory obligations. For instance the Tax Office has a proactive strategy to provide help and education to new trustees of SMSFs. New trustees are being targeted because in the past it has been shown that new SMSF trustees that have contact with the Tax Office in the first instance are more likely to voluntarily comply with their obligations than those that did not. The strategy includes: contacting 3,000 new registrants in 2007–08; requiring approved auditors to report all contraventions in the first year of

		operation; the provision of a new registrant start-up kit; and the signing by new trustees of a trustee declaration. Educational products that explain obligations at the various stages of a SMSF's lifecycle are being developed. These include the establishment of a quarterly SMSF web-based newsletter; the introduction of superannuation seminars to the community; the publication of a large number of fact sheets; the publication of non-binding rulings; and the updates of existing publications, which include all aspects of a fund's lifecycle. We have a set of flagship products aimed at trustees which have wide industry support and usage. The effectiveness of the educational products directly goes to the Tax Office's business intent of optimising voluntary compliance with the superannuation and income tax laws. Consequently, it continually assesses the effectiveness of

		these products using a variety of methods including: the use of a useability laboratory (the Simulation Centre) that allows the Tax Office to test products and services and the way they come together to provide the whole client experience; client surveys; and through formal Tax Office committees, such as the Superannuation Consultative Committee, Simulation Centres, direct feedback and various client surveys.
Recommendation No. 5	The ANAO recommends the Tax Office update the wind-up information available on its website, and from seminars and publications to reflect the requirements imposed on SMSFs by the *Superannuation Industry (Supervision) Act 1993* and the Superannuation Industry (Supervision) Regulations 1994.	***Tax Office Response: Agree*** The Tax Office will update the information about winding up SMSFs on its website. It is also updating its publications to reflect the requirements imposed on SMSFs by the *Superannuation Industry (Supervision) Act 1993* and the

		Superannuation Industry (Supervision) Regulations 1994. Further, the Tax Office will include information about winding up in future seminars about SMSFs.
Recommendation No. 6	To assist SMSF trustees meet their fund wind-up obligations, and to improve the effectiveness of the wind-up process, the ANAO recommends the Tax Office: • assess the costs and benefits of current notification options; and • consider the introduction of a single wind-up form for SMSF trustees.	***Tax Office Response: Agree*** The costs and benefits of current notification options will be reviewed as part of the redesign of the wind up of fund form, which is currently underway. Websites and publications will be reviewed following this. The recommendation to introduce a specific form for SMSF trustees will be determined by the outcome of this review.

Appendix 2: Detailed results of the Tax Office's Compliance Benchmarking Projects

The Tax Office's compliance Benchmarking Projects were detailed and included specific analysis of SMSF non-compliance. The table below provides an overview of the types of compliance issues identified in each Benchmarking Study, and the levels of non-compliance applicable to each issue.

Comparison of 2002–03 and 2003–04 Benchmarking Project results

Issue	2002–03 Benchmarking Project (% of SMSFs not complying with their *SISA* obligations)	2003–04 Benchmarking Project (% of SMSFs not complying with their *SISA* obligations)
Separation of assets	33.6	54.9
Trustee minutes and record keeping	13.5	16.4
Arm's-length transactions	10.9	12.4
Borrowings	5.9	7.6
Non-lodgement of regulatory return	18	8.5
Investment strategy	4.8	8.0
In-house assets	5.4	7.2
Loan/ financial assistance to a member	4.2	6.3
Definition of a SMSF	5	2
Acquisitions from a related party	0.7	1.5

Source: Compliance Review (Benchmarking) Projects 2000–01 and 2001–02.

The results for the Benchmarking Projects show for most areas examined, there was an increase in non-compliance by funds, most notably in the area of separation of assets. Almost 55 per cent of funds examined in the 2003–04 Benchmarking Project, were found to be non-complying in this area, up by 21.3 per cent from the 2002–03 Benchmarking Project.

Appendix 3: Assumptions used by the ANAO to Calculate the Potential Revenue at Risk Through SMSF Non-compliance with their *SISA* Obligations.

4.37 The ANAO has made a number of assumptions to derive the estimates used in Table 2.1. These include:

- *The levels of non-compliance remain the same as those identified in the Tax Office's 2003–04 Benchmarking Project.* While the ANAO notes the Tax Office has not undertaken a Benchmarking Project since 2003–04, the Tax Office used the results from this study to support its claims of serious non-compliance issues with SMSFs in November 2005 and also for subsequent requests for funding from Government in 2006;
- *Funds with multiple serious breaches of the SISA are not entitled to receive tax concessions on their superannuation.* The ANAO has not considered the consequences of the Tax Office taking compliance action and applying penalties against funds displaying high non-compliance with the *SISA* and the SIS Regulations; and
- *Tax concession estimates calculations provided by the Tax Office are accurate.* The ANAO includes in its calculation an estimate from the Tax Office on the total tax concession received by SMSFs.

Similarly, a number of assumptions have been made to derive the estimates for the amount of income tax not reported by active SMSFs. These include:

- *The amount not reported by each SMSF is equal to the average of the income tax amounts remitted for those SMSFs that have lodged;* and
- *APRA reports the active number of SMSFs.* The ANAO notes in the first audit report, the Tax Office is unable to confirm the number of funds that have wound up, but have not advised the Tax Office. This may have a significant impact on the number of active funds reported to APRA and used in their statistical publications.

Appendix 4: The Challenges Confronting the Tax Office's Current Approach to Resolving Non-compliant SMSF Behaviour: Early Access

The Tax Office's Benchmarking Projects indicated potentially high levels of non-compliance among SMSFs. The comparatively small number of SMSF audits the Tax Office is funded to undertake and limited controls to identify non-compliant SMSFs at the registration and wind-up phases of the fund lifecycle have also influenced the current, challenging SMSF compliance environment.

Given the focus early access has received in Tax Office special projects and to illustrate the type of compliance challenges facing the Tax Office, the ANAO examined instances where SMSF trustees could access their superannuation early (and illegally) with minimal chance of being detected by general Tax Office automated and manual controls.

Examples of trustees obtaining early access to their superannuation benefits

Method of early access	Issue with Tax Office controls
Method 1 Trustee X registers a SMSF which is placed on the Register of Complying Superannuation funds (RoCS) by the Tax Office. Trustee X advises their large super fund to roll-over their superannuation assets into the SMSF (which is listed on RoCS as a complying fund). Trustee X provides the large fund with a personal bank account number instead of a separate SMSF bank account (*SISA* paragraph 52(2)(d)). Trustee X takes all (or part of) the superannuation assets and does not roll it into the SMSF.	The Tax Office and APRA do not collect the information from superannuation funds to match superannuation assets rolled out of large funds to SMSFs. The Tax Office and APRA are reliant on the large superannuation funds identifying, and informing them of non-compliant behaviour which in many instances is difficult to detect.[85]

[85] The ANAO notes that the Tax Office will be implementing changes to RoCS from July 2007 that will identify whether the fund listed on the register is complying superannuation fund. Further information on the changes to RoCS can be found in the first audit report.

Method 2 Trustee X lodges his/her fund income tax and regulatory return and declares the fund has wound-up. Ordinarily (and assuming the funds' trustees were in their accumulation phase) the superannuation funds assets should be rolled into another superannuation fund. Trustee X uses a fictional approved auditor, and indicates the fund has been audited and the SMSF audit report has not been qualified. The trustee then accesses the SMSF's assets and does not roll them into another superannuation fund.	The Tax Office is not able to determine whether the SMSF trustee actually rolls the SMSF's assets into another superannuation fund. Legitimate approved auditors should inform the Tax Office if a trustee intends to access their benefits early. In this case however, the trustee created a 'fictional' approved auditor, which the Tax Office is not able to detect with its current systems.
Method 3 Trustee X registers a SMSF legitimately with the Tax Office and rolls superannuation assets into the SMSF. The SMSF winds-up before the funds first fund income tax and regulatory return is lodged and takes the superannuation assets. The fund does not lodge their regulatory return or fund auditor's report.	Because the SMSF winds-up before it lodges its first fund income tax and regulatory return, the operation of the fund under the *SISA* is not subject to Tax Office compliance checks through the Tax Office risk rating tools. The Tax Office has not undertaken significant work to follow-up non lodgers in the past, and so the fund is likely not to be examined.
Method 4 A single member fund with a corporate trustee pays the member of the fund (who is also the director of the corporate trustee) for his/her services. This allows the SMSFs' member to access part of their superannuation assets early.	Under the *SISA*, a fund does not meet the definition of a SMSF where the trustee receives remuneration from the fund or from any person for any duties or services performed by the trustee in relation to the fund.[86] As the member (director) of the fund is not a trustee, he/she may be able to legally receive a fee for their services and access their superannuation assets early. The Tax Office is seeking to clarify this issue with the Treasury.

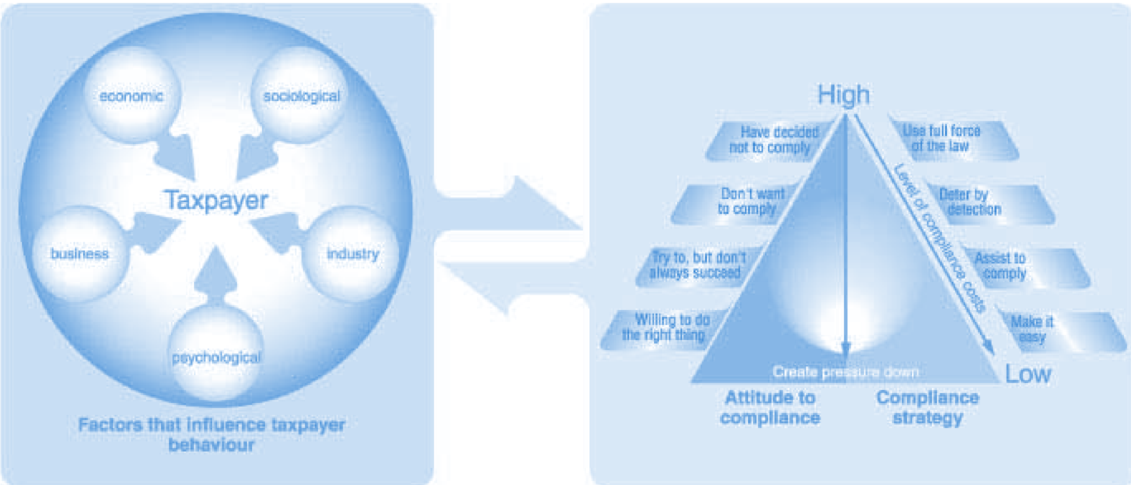
Source: ANAO analysis of Tax Office SMSF controls environment.

The above examples illustrate it was unlikely, particularly in the past, that the Tax Office's controls would have been able to prevent unscrupulous or misinformed SMSF trustees from accessing their superannuation early. The examples also shows it is essential that resources are utilised efficiently and effectively, given the limited resources the Superannuation Line has to examine and take action against non-compliant SMSFs.

[86] See subsection 17(1)(f) of the *SISA*.

Appendix 5: Tax Office Compliance Model

The Compliance Model is a structured way of helping the Tax Office to understand the factors influencing different compliance behaviour. It enables the Tax Office to choose the most appropriate intervention for the circumstances.



Source: Tax Office Compliance Program.

The Compliance Model posits that the majority of taxpayers comply voluntarily with their tax obligations, with no need for Tax Office intervention. Others will not comply in the first instance but will, if prompted further. A smaller proportion will not comply voluntarily and may need enforcement action.

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