Why do people have SMSFs?

Heffron
SMSF Solutions

Problem solved

Why do people have SMSFs?

Introduction

Depending on what you read, views on self managed superannuation funds range from them being either the greatest invention of the modern age or the most likely cause of the next great financial crisis. Regardless of where you sit in this debate, it is hard to deny their popularity:

- There are over 500,000 funds and more than 1,000,000 individuals belong to one;
- Over one-third of Australia's superannuation wealth sits in one (and the size of our superannuation system is not to be sneezed at – it is one of the largest in the world);
- They continue to grow rapidly – at June 2014 there were over 30,000 more SMSFs than at June 2013 even after allowing for the fact that some were wound up; and
- During 2012/13 (the most recent figures available) SMSF members voluntarily added over $18bn *of their own money* to their funds. This is over and above the money contributed by their employers.

(These figures are all drawn from the ATO's quarterly SMSF statistical report for the June 2014 quarter.)

One of the most common concerns expressed about SMSFs by detractors is that they can be established inappropriately. Certainly the large number of funds with small balances supports this claim – at 30 June 2013, over 10% of SMSFs held less than $100,000 and just under 25% held less than $200,000.

If it is difficult for SMSFs to be cost effective at those levels, why do people have them? Are they being profoundly mislead? Foolish? Or is there something else?

We can't answer that question for every SMSF member in the country but in this article, we share some of the common reasons for establishing a self managed fund that may transcend cost.

1/ Self managed funds are nimble

Self managed funds can adjust almost instantly to legislative developments, new tax strategies and changes in an individual's circumstances.

While some of these may require a change to the Fund's trust deed, this is generally a simple matter, attended to quickly at a low cost. Most specialist SMSF deeds even provide very wide ranging powers and discretions to reflect new legislation even if that legislation is not specifically discussed in the deed. This is simply not practical or possible in a public fund.

It is also not an esoteric benefit that applies only to those operating outside the mainstream. Superannuation law changes from time to time and often the new rules are beneficial. Any new rule or strategy that requires costly system upgrades or procedural changes will potentially take much longer to implement amongst the public funds. For example:

- these days, it is relatively common for SMSFs that are paying pensions to sometimes classify particular payments as lump sums to minimize tax for those between 55 and 60. This strategy was not widely offered until some time after it became common in SMSFs;

- many public funds needed some time to accommodate transition to retirement pensions;
- many were unable to offer contribution splitting and acceptance of government co-contributions immediately when these were legislated

to name just a few.

In fact, the need to attend to system changes has sometimes been an argument put forward by groups representing larger funds for delaying the effective date of very beneficial legislation. SMSF trustees naturally want these changes to be made law as soon as possible!

SMSFs have traditionally played a vital role in encouraging product innovation in the public offer environment. The ability to (say) transition from accumulation to pension phase without having to realise assets and pay capital gains tax is something SMSFs pioneered. Today it is common amongst public funds.

Finally, there are some changes to superannuation law that are simply unlikely to be offered in public funds. For example, all superannuation funds have been permitted to borrow to invest (providing they meet a number of rules) since 2007. To date, only SMSFs have taken advantage of this opportunity. Being able to borrow in a superannuation fund allows the member to buy larger assets that would never be possibly otherwise – for example, property.

2/ Total investment flexibility

SMSFs can offer any investments permitted by superannuation law – they are not limited by an approved menu of investments.

These days many public funds have an extremely broad range of investment options. Products that were unheard of in the public fund environment a few years ago are now available in many large funds – for example, ETFs, term deposits direct equities. Inevitably, though, any fund limited by a menu will have gaps.

Again, this is not an issue restricted to the minority. Even those who fully intend to have mainstream investments may occasionally want to consider:

- direct property
- initial public offerings
- new / boutique managed funds (many of the top performing small cap managers have yet to make it on to the menus of most master trusts and wraps)
- direct bonds, mortgages and term deposits
- unlisted and international shares
- business property

Of course, *some* public funds will offer *some* of these opportunities – but SMSFs have them all. Today.

Even public offer funds with the widest possible investment menu will often limit:

- an individual member's exposure to each investment (for example, many funds will not allow any single investment to account for more than 10% - 20% of the total portfolio); or
- exposure to a single asset class (for example, there may be a cap of 80% on Australian equities). If the exposure exceeds this amount some will have to be sold down.

Public funds have little choice here – their regulator (APRA) takes the view that trustees of all funds have an obligation to ensure that the investments chosen by members are appropriate given those members' circumstances. This responsibility cannot be ducked simply by offering a wide range of choices and placing the onus back on members to select an appropriate mix. In APRA's view, those wanting to invest without externally imposed constraints (other than the law) need a SMSF.

3/ Self managed superannuation funds are "platforms for life"

This is perhaps the most likely explanation for funds with small balances.

It is quite common to see a self managed fund established with a small balance in the expectation that it will grow in the future. It is cheaper and easier to move to a SMSF *before* the balance gets too big.

This is because moving superannuation funds triggers costs such as capital gains tax, even if the underlying investments remain roughly the same. While this is paid by the fund rather than the member personally, it still reduces the balance available to be rolled over to the SMSF. Even where a fund's investments have made losses, moving to a self managed fund can be problematic – the losses cannot be transferred over to the SMSF (and used to offset gains in the future). They are effectively given up and left for the benefit of other members. Many funds give the departing member some value for these losses but it is almost impossible to give full value without compromising other members.

This treatment of capital gains and losses definitely encourages starting a SMSF early and avoiding a costly move later.

It is worth bearing in mind that change is inevitable. Even someone who has a very long standing relationship with a particular adviser may well find that the adviser's preferred suppliers change over time. This could simply be competitive pressure – the best products today might not be the best in 10 years' time. A change in ownership could also be a trigger – often the smaller operators who are nimble and innovative get sold. Having a self managed fund from the earliest possible time means that the inevitable changes can be managed to minimize the cost and disruption. In contrast, moving from one public fund to another requires all assets to be sold, new insurance policies etc.

Given the very substantial tax benefits associated with managing the timing of any asset disposals, this is an extremely important advantage of an SMSF.

4/ Total flexibility in the choice of suppliers

How often have advisers wished they could use a particular wrap, master trust or industry fund but find the administration of that fund poor and wish they could change it? Or change the insurance arrangements? Unfortunately, public funds can only offer limited unbundling of their services – advisers obviously can't choose their own call centre experience and will often have limited choice in relation to cash accounts, insurance and term deposits. SMSFs, of course, give clients and their advisers the flexibility to change suppliers at any time with no cost. Changing accountants is as simple as exchanging records. In the same vein, accountants who refer their SMSF clients to a new adviser can be confident that they haven't just also triggered a capital gains tax bill.

This ability to unbundle services not only gives SMSF members the ability to choose the best providers at every level but it also gives them a unique ability to tailor their service experience to best suit their needs and circumstances at the time.

For example, someone who has limited time and is very comfortable with technology may well use a range of suppliers to do most of the work associated with their SMSF (an adviser might guide them on investment decisions, a specialist administrator might handle all of the compliance requirements), require little personal interaction and be happy to keep track of their affairs on line as and when they consider it necessary.

Others may specifically choose to do most of the work themselves – possibly because they find it interesting or possibly because they wish to minimize costs. Others may want regular meetings with their SMSF adviser(s), highly personalized service and regular input into decision making.

The same individual may prefer different client experiences at different times in their life. Their SMSF gives them this opportunity.

5/ It's all about the members

All superannuation fund trustees act in the best interests of members – this is actually a legal requirement.

A large fund trustee must inevitably consider the interests of the group as a whole and doesn't have the luxury of prioritizing one member over everyone else. SMSFs, on the other hand, are concerned with only a few members. This becomes very evident under a range of circumstances.

For example, imagine the situation where a member dies and a death benefit is to be paid. A large fund must follow a process to ensure it is paid to the right beneficiary(ies). Because they risk legal action if they get the decision wrong, they have to take it slowly and get the right documentation and evidence in place before releasing the money, even in situations where the answer seems quite clear. Contrast this to a SMSF where the surviving spouse could start drawing superannuation benefits immediately.

Similarly, there will be occasions when it something very valuable to one member is put aside because the costs cannot be justified across the group as whole. Returning to death, for example, there are a range of tax strategies available in situations where the member dies young such as paying pensions to their minor children. Few public funds provide this option because it is administratively expensive and relevant in very few cases. It is therefore difficult to justify investing in the systems required to offer this feature.

In the unfortunate event that it becomes valuable to a family group whose superannuation wealth is held within a SMSF, however, it can easily be accommodated.

6/ Greater estate planning certainty

SMSF trustees are permitted to accept binding death benefit nominations that are far more flexible and detailed than public funds.

For example, it is possible to put in place a death benefit nomination that not only binds the surviving trustees as to who receives a death benefit but also the type of benefit to be paid (ie lump sum or regular pension payments).

With SMSFs, specific contingencies can be incorporated into the trust deed to provide greater estate planning certainty, particularly when part or all of a binding nomination fails for some reason. For example you can nominate your death benefit to be paid to your spouse with an additional provision that specifies the death benefit to be split equally between your adult children should your spouse die before you.

7/ Tax planning

While all superannuation funds are generally subject to the same tax rules and concessions there are differences in the way in which different funds account for tax.

With a SMSF tax is typically accounted for based on the specific transactions that happen in the member's account. By contrast, many other super funds account for tax on a pooled basis. A SMSF therefore can provide greater scope for a particular member to influence tax outcomes in relation to their investment choices. For example, a SMSF can help you maximise franking credits and minimise Capital Gains Tax (CGT) far more effectively than a large fund, simply because the only taxpayer being considered is you.

SMSFs also have greater flexibility in how they choose to manage their tax in pension phase. Some SMSF trustees choose to "segregate" the fund's assets when they have both pension and non pension accounts. They consciously choose to earmark some assets for their pension(s) and others for their super that is still accumulating. This is sometimes valuable from a tax planning perspective, regardless of whether the money is in a SMSF or public fund.

In a SMSF it is possible to do this at a ***fund*** level – meaning that if a particular fund has four pension accounts (perhaps two each for two members), there is just one overall set of assets segregated for all pensions. The assets are effectively shared proportionately across all pension accounts. When assets are bought or sold, a single transaction is required and this covers all four pension accounts. Consider the alternative in most public funds where reducing (say) the fund's exposure to BHP shares might involve selling down a little from four separate portfolios.

Alternatively, many SMSFs don't actually separate their pension assets from their non pension assets at all. In ***their*** situation treating the entire fund as a single pool provides the best tax outcome. Importantly, SMSFs provide this flexibility that many public offer funds simply can't match.

8/ Cost

It is obviously not possible to say that SMSFs are more or less expensive than public funds in all cases. What can be said about cost though is:

- most of the costs in a SMSF are fixed rather than determined as a percentage of assets. Naturally, then, those with larger balances tend to find that SMSFs are relatively cheaper. The point at which a particular fund becomes less expensive than a public equivalent depends a lot on how it is being invested, how much work is being done by the trustees themselves rather than sourced (and paid for) externally. For some, the cutover point may be as low as $100,000 while for others it is $1m.
- a SMSF is a single investor which may have multiple members. Hence it is the asset base of the membership group as a whole which is the driver of costs here, rather than any one individual. Consider a couple who each have a pension and accumulation account. Their costs in a public fund may well be determined on the basis of four separate portfolios. If the asset based fees start high but reduce (in % terms) as the asset base increases, the division of their balance between so many separate accounts may well increase their fees dramatically.

9/ It's not an all or nothing situation

This article is not meant to imply that there is nothing good to say about public funds. Just about everyone should start out in one and in fact they often have a valuable long term role to play with part of a member's super balance.

It is common, for example, for SMSF members to retain a small balance in a public fund so that they can keep their insurance. Public funds have far better buying power than a self managed fund and can often offer lower premiums than the SMSF would be able to achieve. The fact that a public fund has a large number of members also means it can often offer terms such as automatic acceptable for insurance up to a certain level. This is hugely beneficial for SMSF members who are not completely confident they would be able to secure adequate insurance if it was subject to a medical examination.

Importantly, having the majority of one's superannuation in a self managed superannuation fund does not preclude this.

Conclusion

Each of the features above could probably be distilled down to "flexibility and control" which are the two words most frequently used in describing why individuals have SMSFs. It is probably still true to say that SMSFs are not for everyone. However, given that superannuation is compulsory and will be a large part of most people's retirement savings, it is entirely predictable that flexibility and control should be highly valued. SMSFs are a natural and logical response to that.

It is perhaps also not surprising that so many people have made the decision to start early – with a small balance.

Disclaimer
While Heffron believes that the information contained herein is reliable, no warranty is given to the accuracy and persons who rely on it do so at their own risk. This publication is intended to provide background information only and does not purport to make any recommendation upon which you may reasonably rely without taking specific advice. In particular, it should not be considered financial product advice for the purposes of the Corporations Act 2001.