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The pros and cons of a SMSF

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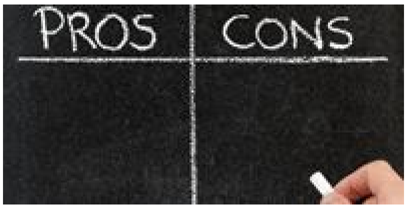
Michael Laurence

Do you think you could have beaten the negative returns that the vast majority of heavyweight super funds recorded over the past year? If your answer is a resounding "yes", you are far from alone.



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Recep Peker, a senior analyst with specialist researcher Investment Trends, says his firm's research shows that when markets are flat or going backwards for a prolonged time, the number of new self-managed super funds (SMSFs) spikes.

As Peker emphasises, the trustees of many new SMSFs are convinced they can outperform the big funds. Indeed, 28% of SMSFs surveyed told Investment Trends that one of the reasons they set up a SMSF is a belief that, "I can make better investments than the big fund managers".

This research appears to be borne out by recently released statistics on SMSF establishments from the Australian Taxation Office, as regulator of self-managed super, and the Prudential Regulation Authority (APRA).

In the year to September 2011, almost 32,000 SMSFs were established – an annual total only exceeded in 2006-07 when the then Federal Government announced it would significantly improve the tax-effectiveness of super. (In short, tax on superannuation pensions and retirement lump sums were abolished from July 2007 – without a limit on the dollar value.)

Despite the GFC and its aftermath, annual SMSF setup numbers have remained more or less steady since the revamping almost five years ago of the tax treatment of super payouts. And although the world's financial woes have taken their toll on contributions to self-managed funds, the determination to establish them hasn't been dented.

Before establishing a SMSF, you should closely compare their possible advantages and disadvantages. Here are a few pointers:

Advantages

1. Means to hold your business premises: Many SME owners hold their business premises in their SMSFs for tax-effectiveness, asset-protection, succession planning (for family enterprises) and security of tenancy.

Your business would have to pay a commercial rent to your SMSF. In turn, your fund would only pay concessional tax on the rent and typically benefit from many of the usual tax breaks available to landlords – including tax deductions for interest on a property loan.

And subject to anti-avoidance provisions in the Bankruptcy Act, fund-held business premises are generally inaccessible to trustees in bankruptcy should a member get into future financial troubles.

2. Ability to quickly buy or sell assets: SMSF members can instantly change their investments and/or the asset allocation of their portfolios. With large funds, there is sometimes a frustrating lag between when investment changes are requested and when those changes are executed.

3. Way to invest differently: SMSFs enable members to invest in a way that is generally not available in most large super funds. For instance, SMSFs can hold direct property, unlisted shares, artwork and other exotic or not-so-common investments.

And SMSFs can invest in their selection of investment fund managers and direct shares – which they can or cannot do with a large fund, depending on its investment choice.

4. Potential to cut costs: SMSFs with larger balances – say, above $200,000 or so – may have lower fees than many large super funds, much depending upon the circumstances.

This is because administration costs of a self-managed fund are more or less fixed – no matter the fund balance. And SMSFs that invest directly rather than through managed investment funds are not liable for fees based on a percentage of their investments.

5. Avoid administrative weaknesses of large super funds: Have you ever had a large fund miscalculate your super balance? Have you ever waited a frustratingly long time for a fund to rollover your super balance to another large fund? And have you had a struggle for a large fund's call centre to give a satisfactorily answer to queries? (It can be pot luck about who picks up the phone.)

With a SMSF, the trustees – meaning you and the other members – are very much in control. You can act decisively when making investment decisions and you can ensure, more or less, that no mistakes are made in the running of your fund.

6. Manage or eliminate CGT: Many SMSFs have a general policy – subject to investment conditions – of trying to minimise the sale of such assets as real estate and shares – until their funds begin to pay a pension. This is because no capital gains tax (CGT) is payable once an asset is backing the payment of a pension.

7. Buy assets you can not otherwise afford: The establishment of a SMSF allows up to four people – commonly family members – to pool their super savings to buy costly assets, such as direct property, that may otherwise be beyond their reach.

And under strict conditions, SMSFs can borrow to invest using instalment warrants or similar arrangements. Gearing is generally not available in large super funds.

8. Flexible estate planning: "For example," writes Stuart Jones book Australian Superannuation Handbook, published by Thomson Reuters, "a member aged 60 or over can quickly withdraw benefits tax-free before death to avoid potential death benefits tax [payable by certain beneficiaries including financially dependent adult children]."

Disadvantages

1. Time-consuming: Operating your own SMSF is quite time-consuming even when using a professional SMSF administration service (as most self-managed funds do) and even if paying a good financial planner to help guide the fund's investments.

By contrast, a large fund takes over all of the administration and many of the day-to-day investment decisions – working within your asset allocation or investment choice.

2. Need for investment knowledge: Ideally, SMSF members should have a much more thorough understanding of at least the basics of sound investment practices than members of big funds.

SMSF members should really understand, for instance, how an appropriately diversified investment portfolio can spread their risks and the potential for returns. And members should understand how excessive investment costs and taxation (perhaps arising from unnecessarily frequent trading) erodes returns. And SMSF members should have enough investment knowledge to quiz their financial advisers.

Ideally, all super fund members – whether in a large fund or SMSF – should have this investment knowledge. However, SMSF members are directly responsible for what happens with their retirement savings. (Under superannuation law, all SMSF members must be trustees of the fund or directors of its corporate trustee.)

3. Penalties for non-compliance: The Tax Office, as regulator of self-managed super, has the power remove a fund's complying status, unleashing a tax shocker. This is one of the ultimate sanctions against wayward funds.

The market value of a non-complying fund, less non-concessional (after-tax) contributions, is taxed at the highest marginal rate. This could destroy much of the retirement savings of every member of a SMSF. And trustees can face civil and criminal sanctions for serious breaches.

4. Risk of poor diversity: Some SMSFs are established specifically to buy a single valuable asset such as business real estate. This means the fate of the fund depends on the performance of that asset.

Depending on what other superannuation and non-superannuation assets the members hold, they may be inadequately diversified for risk and return – a danger that intensifies if an SMSFs sole asset is geared.

5. High costs for small balances: Before setting up a SMSF, members should compare its likely costs with those of a large super fund. SMSFs with small balances are generally not nearly as cost-effective as, say, large industry funds.

Whether a self-managed fund is financially feasible will depend, in part, on the types of investments (whether held directly or through managed investment funds), the expected level of future contributions to boost the balance, the size of the existing balance, and cost of gaining professional assistance such as from financial planners.

6. Hazard of a dominant trustee: Most SMSFs would have one member who is the dominant force in all aspects of running the fund, including its investment decisions.

Apart from signing documents presented to them by the dominant member, passive members typically have no involvement with the fund. And unfortunately, passive members usually do little to safeguard their superannuation interests.

7. Tight control over investment practices: Although a SMSF can provide members with more investment freedom than large funds – much more in certain circumstances – there are stringent restrictions on their investments.

For instance, super funds must be maintained for the sole purpose of providing retirement benefits – not to subsidise pre-retirement lifestyles – and funds are prohibited from providing loans to members and their relatives.

And a SMSF is generally barred from leasing or having investments with related parties involving fund assets that are worth in total more than 5 per cent of the fund's value.

8. Risk of losing interest: Many people setup SMSFs with great ambitions and then lose interest. Perhaps the funds have not performed to their expectations. Perhaps the members have been unable to boost the balance as planned.

And an increasing concern with a rapidly ageing population is that more members will become too frail or ill to adequately look after their SMSFs – particularly after their spouses die.

ATO statistics appear to suggest that countless people are holding onto their self-managed funds well past the funds' used-by date. In the 12 months to September (the latest figures available), almost 31,960 funds were established yet just 2,320 were wound-up. This means only .5% or so of the 450,000-plus funds in existence ceased to operate during that time.

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