

# **THE REGULATION OF SELF MANAGED SUPERANNUATION FUNDS: AN EVOLUTION IN THE COMMISSIONER OF TAXATION'S ADMINISTRATIVE APPROACH**

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2015



## **Abstract**

This thesis explores the regulation of self-managed superannuation funds and, in particular, the role of the Commissioner of Taxation in that regulatory regime. In this context, current problems in applying a regulatory approach that had been developed to deal with tax evasion in the cash economy sector are identified. The thesis then explores whether modifying the Commissioner's current regulatory approach to more overtly pursue the goals underpinning the superannuation system as a whole could address these problems. Were such an approach adopted, the thesis examines whether the Commissioner's general powers of administration can be effectively utilised to implement the change .

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## Acknowledgements

In developing this thesis I have been fortunate to have a number of people provide their valuable advice, the benefit of their experience, and constant support.

I would like to take this opportunity to thank Robert Olding, my manager at the ATO when the idea for this thesis first occurred to me. Your support in assisting me to obtain the Commissioner of Taxation Postgraduate Scholarship to commence writing the thesis and your unwavering support along the way was invaluable. My thanks to Trevor Jones, at the ATO, who was always at the ready with a word or two of encouragement.

My thanks also to my supervisors: firstly to George Syrota who was always able to ground my wayward thoughts in reality and provide the direction I needed to progress the thesis. To Professor Dale Pinto, whose enthusiasm, unwavering support over the years and keen eye to detail have improved the thesis beyond anything I could have done on my own. To Ian Murray, who agreed at short notice to take over as supervisor once George retired, and whose support, guidance and advice has helped me over the line! To Professor John Tarrant, my thanks for providing feedback in such short timeframes. To Professor Holly Cullen for her advice and timely assistance on all things relating to the postgraduate program.

Thanks to my family and friends for their part in this journey, particularly listening when I thought there was no end in sight, providing support and light relief when needed and for proofreading my draft chapters when asked. Finally my thanks and love to my husband Ross, without whom I would not have been able to find the time to finish this thesis; to my son Max, for his ability to play at my feet whilst I typed frantically away and my daughter Adele, for her timely arrival after the thesis was finished.



## Declaration

I declare that this thesis is my own composition, all sources have been acknowledged and my contribution is clearly identified. The thesis has been completed during the course of enrolment in this degree at the University of Western Australia and has not previously been accepted for a degree at this or another institution.

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Signed

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Date



## Chapter 1: Introduction

Superannuation, or its absence, ultimately affects all Australians. Further, decisions made many years earlier, whilst working, can have a significant impact in retirement. Indeed, not only does superannuation impact on all Australians, but as at 30 June 2014 superannuation assets in Australia totaled \$1.85 trillion,<sup>1</sup> making it a very significant part of the Australian economy. Given its importance, the superannuation system has been the subject of much policy and legislative change by successive governments. The ever-changing landscape is a source of dissatisfaction for many Australians.<sup>2</sup> In fact, Robert French, Chief Justice of the High Court of Australia, observed:

There are few areas of the law which engage more strands of Australia's national legal, social, economic, industrial and political history than superannuation. There are few areas of practice which engage more extensively with the common law, equity and statute law. There are few which change with such rapidity.<sup>3</sup>

The focus of this thesis is on the Commissioner of Taxation's approach to regulation of self managed superannuation funds (SMSFs) in a way that promotes the underlying policy of the superannuation system whilst providing as much stability from an administrative basis as possible. The scope of the thesis is therefore focused on regulatory theory and administrative approaches rather than

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<sup>1</sup> Australian Prudential Regulation Authority, *Quarterly Superannuation Performance*, June 2014, 4.

<sup>2</sup> Association of Superannuation Funds Australia, *Consumer attitudes to superannuation and super policy issues*, November 2011, 6 and Box 1.

<sup>3</sup> Robert French, Chief Justice of the High Court of Australia, 'Superannuation – a confluence of legal streams' (Speech delivered at the Law Council of Australia Superannuation Committee Conference, Canberra, 26 February 2009).

examining whether further legislative change is required or warranted. In order to provide the relevant context for this discussion, a short history of the evolution of the superannuation system is provided in Chapter 2. Following that, Chapter 3 outlines the institutional and legal framework that applies to SMSFs.

Having provided this context, this thesis explores the ways in which the Commissioner can, through his approach to regulation of SMSFs, achieve a shift in attitude across the SMSF sector to garner an outcome that results in a natural attrition in the rate of breaches by SMSF trustees. The trust structure, which is a central feature of the Australian superannuation system, is said to provide the fund trustees, who in the case of an SMSF are often also the beneficiaries, with maximum flexibility and control.<sup>4</sup> However, such flexibility and control may more easily allow trustees of SMSFs to fall into error and breach their duties as trustees of their own superannuation fund.<sup>5</sup> The nature of an SMSF, where all trustees are also beneficiaries presents certain challenges for the regulation of such funds. In an environment where the Commissioner is charged with ensuring trustee compliance with prudential requirements, it is argued that utilization of the enforcement pyramid in the same way as for taxation matters may be inadequate.<sup>6</sup>

Chapter 4 examines the limitations of the responsive regulation theory, which underpins the Commissioner's current compliance approach to SMSFs. Having identified issues applying the current construct of the compliance model, which

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<sup>4</sup> Super System Review, Commonwealth of Australia, *Final Report: Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System* (2010).

<sup>5</sup> See e.g., *Deputy Commissioner of Taxation (Superannuation) v Fitzgeralds* [2007] FCA 1602 where the trustees of an SMSF were fined for breach of the rules in *SISA 1993 s 62* in relation to the sole purpose test. The trustees had provided financial assistance to themselves from the assets of the SMSF.

<sup>6</sup> See Michelle Welsh, 'Civil Penalties and Responsive Regulation: The Gap Between Theory and Practice' (2009) 33 *Melbourne University Law Review* 908 for discussion on similar issues relating to Australian Securities and Investment Commission's use of civil and criminal penalties.

was developed to deal with tax avoidance in the context of the cash economy and not to address trustee behaviour in an SMSF context, the chapter suggests a possible supplementary theory which could be used to evolve the application of that compliance model. A modification to the current compliance model in the way suggested is intended to increase SMSF trustees' voluntary compliance with the superannuation laws.

Chapter 5 examines the legal basis for adopting a modified compliance model approach, as discussed in Chapter 4, in the Commissioner's regulation of SMSFs. Given the constitutional context of the development of the Commonwealth's superannuation laws, finding a source of power to support an administrative approach is necessary. The potential for the general administrative powers vested in the Commissioner by the *Superannuation Industry Supervision Act 1993* (Cth)<sup>7</sup> to provide such legislative support, both in terms of providing the Commissioner with the requisite power to undertake certain administrative action as well as the limitations of that power are examined. Beyond the terms of the statute, the administrative law constraints that might apply to such an approach are also investigated, with emphasis on rule of law boundaries and administrative law review grounds.

The thesis concludes that although there may be a perceived conflict between a pragmatic approach supported by an application of a modified compliance model and the rule of law, there is sufficient rigour within the terms of the general administrative powers and the existence of administrative law constraints, to resolve such perceived conflict. Further, the application of such a modified

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<sup>7</sup> The Acts administered by the Commissioner of Taxation general contain a provision which states that 'the Commissioner shall have the general administration of this Act': see for example, *ITAA 1936*, s 8 and *TAA 1953*, Sch 1 s 356-5 and *SISA 1993*, s 6.

compliance model would provide a better basis on which the Commissioner could influence SMSF trustee behaviour so as to achieve the intended policy outcomes of the Australian superannuation system being the provision of support to Australians during their old age in a way which does not impose an undue burden on current or future generations of taxpayers.



## Chapter 2: Brief history of superannuation in Australia

This chapter considers aspects of the historical development in superannuation leading to the Commissioner of Taxation's role as re

gulator of self managed superannuation funds (SMSFs). An examination of the evolution of the superannuation regime provides an important historical context against which the issues considered in this thesis are examined. The analysis includes an examination of the constitutional basis for the legislative regimes applying to superannuation funds and the use of the trust structure for superannuation funds. As part of that discussion the reasons for the close links between the taxation provisions<sup>1</sup> and the prudential and reporting standards<sup>2</sup> is outlined. The role of each of the regulators is discussed. Finally, the challenges facing the Commissioner of Taxation as regulator of self managed superannuation funds are identified.

### **2.1 The retirement income system in Australia: the three pillars**

The Australian retirement incomes policy comprises three pillars: publicly funded means tested age pension; mandatory employer sponsored superannuation saving through the superannuation guarantee system; and voluntary (superannuation) savings.<sup>3</sup> The legislative framework for the regulation of superannuation evolved

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<sup>1</sup> See e.g., *ITAA 1997*, s 295-325; s 995-1(1) definition of 'complying superannuation fund' and *SISA 1993*, s 45.

<sup>2</sup> See, *SISA 1993*, *SISR 1994* and the *CA 2001*.

<sup>3</sup> See generally Australia's Future Tax System Review Panel, Commonwealth Government of Australia, *The retirement income system: Report on strategic issues* (May 2009), 5-7.

over time in response to political, social and economic factors.<sup>4</sup>

### **2.1.1 First pillar: Publicly funded age pension**

The first jurisdiction in Australia to introduce an old-age pension was New South Wales in 1900, with Victoria and Queensland following suit soon after. Following passage of the *Australian Constitution* which provided the Commonwealth Government with power to legislate with respect to old-age pensions, a nationwide old-age pension scheme came into effect in 1909.<sup>5</sup> The Commonwealth scheme was similar to the New South Wales scheme except that it introduced a means test for eligibility to receive the age pension. The flat-rate publicly funded age pension scheme adopted in Australia in 1909 was a departure from the national insurance schemes<sup>6</sup> in place at that time in countries such as Germany.<sup>7</sup> In 1938 New Zealand adopted a universal age pension scheme, similar to Australia's except that it was not means tested for persons over 65 years of age, providing a publicly funded universal pension to those meeting that criteria.<sup>8</sup>

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<sup>4</sup> Commonwealth Treasury, *Towards higher retirement incomes for Australians: a history of the Australian retirement income system since Federation*, Centenary Edition of Economic Roundup, 2001, 66.

<sup>5</sup> See generally Australian Department of Social Security, Policy Review Branch, Owen Donald, *Government support of retirement incomes in Australia : a submission from the Department of Social Security to the Senate Standing Committee on Social Welfare Inquiry into Retirement Income Systems* (April 1984), Appendix A.

<sup>6</sup> The key features of these national insurance schemes, referred to as the 'Bismarckian model', require mandatory employment-related contributions to a national insurance scheme for the provision of pensions funded on a 'pay go system' – that is by contemporaneous contributions: see generally Australian Department of Social Security, 'Retirement Income Provisions Overseas' (Research Paper No. 26, Research and Statistics Branch, 1984), 65-71.

<sup>7</sup> Hazel Bateman, Geoffery Kingston and John Piggot, 'Equity, Efficiency and the Superannuation Guarantee' in David Knox (ed.), *Superannuation: contemporary issues* (Longman Professional, 1994), 40, 43.

<sup>8</sup> Australian Department of Social Security, 'Retirement Income Provisions Overseas' (Research Paper No. 26, Research and Statistics Branch, 1984), 107.

The purpose of the age pension was as a safety net for those in retirement to provide a modest level of comfort.<sup>9</sup> However, even at that level, the cost to the Commonwealth Government of providing an age pension was shown to rise at a rapid rate over a short period of time.<sup>10</sup> In 1977, the majority of the National Superannuation Committee of Inquiry recommended a national social insurance scheme which would have required compulsory contributions in the form of taxation.<sup>11</sup> This recommendation was rejected by the Government for reasons such as 'loss of Budgetary flexibility which would result from the introduction of earmarked taxes and doubts about the ability and willingness of the taxpayer to meet the increased costs of universal pensions'.<sup>12</sup>

The Commonwealth Government did not consider a national superannuation scheme again after 1977. However, developments in the area of occupational superannuation, particularly as a result of industrial relations action by trade unions in the 1970s,<sup>13</sup> lead to the introduction of compulsory occupational superannuation, which is discussed below.

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<sup>9</sup> Commonwealth Treasury, above n 4, 72.

<sup>10</sup> See, eg, Commonwealth Government, *National Superannuation in Australia: Interim Report of the Committee of Inquiry*, National Superannuation Committee of Inquiry (1974), 22 where it was shown that for the financial years 1971/72 to 1973/74 it was estimated that expenditure on age pensions would increase by approximately 30% each year.

<sup>11</sup> Commonwealth Government, *Occupational Superannuation in Australia: Final Report of the National Superannuation Committee of Inquiry* (1977).

<sup>12</sup> Australian Department of Social Security, Policy Review Branch, n 8 above, A5. See also Leslie Nielson, 'Chronology of superannuation and retirement income in Australia' (Background Note, Parliamentary Library, Parliament of Australia, 2009-10), 3.

<sup>13</sup> Commonwealth Treasury, above n 4, 67-68.

The age pension remains a prominent feature within Australia's retirement income system given it is relied upon by most low to middle income earners and 'provides protection against investment, inflation and longevity risk'.<sup>14</sup>

### **2.1.2 Second pillar: compulsory occupational superannuation - the superannuation guarantee**

Although employer sponsored contributions to superannuation have existed since 1900, the concept of compulsory occupational superannuation did not emerge until the mid-1980's. Employment-based superannuation in the private sector grew following passage in 1915 of Commonwealth legislation allowing employers to deduct superannuation contributions against assessable income.<sup>15</sup> However, despite these taxation incentives, in 1984, superannuation coverage in the private sector at 36% was well below that in the public sector at 66%.<sup>16</sup>

Broader coverage of occupational superannuation occurred as a result of the *National Wage Case 1986*.<sup>17</sup> In September 1985, the Australian Council of Trade Unions was successful in including references to superannuation in its agreement with the Hawke Labor Government that dealt with wages and taxes (commonly referred to as the Accord Mark II). The Accord Mark II formed the basis for the ACTU's claims at the national wage case due to be decided in November 1985. However, employer groups were strongly opposed to the claim for occupational

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<sup>14</sup> Australia's Future Tax System Review Panel, above n 3, 10.

<sup>15</sup> Senate Select Committee on Superannuation, Parliament of Australia, *Safeguarding Super: the Regulation of Superannuation* (1992), 10. See also, *Income Tax Assessment Act 1915* (Cth), s 18(1)(j) which provided for an allowable deduction given certain conditions were met, such as the Commissioner of Taxation being satisfied that the rights of the employees were fully secured.

<sup>16</sup> Advisory Committee on Prices and Incomes, Department of Employment and Industrial Relations, *Retirement Incomes* (1986), 10.

<sup>17</sup> *National Wage Case* (1986) 14 IR 187.

superannuation. The Australian Chamber of Manufactures and the Victorian Employers Federation, made an application to the High Court for orders nisi for prohibition to prevent the Commission from considering the superannuation claim as part of its *National Wage Case 1986* decision.<sup>18</sup>

The basis of the challenge was that superannuation claims could not give rise to 'industrial disputes' within s. 51(xxxv) of the *Constitution* and did not comprise disputes as to an 'industrial matter' within the meaning of the *Conciliation and Arbitration Act 1904* (Cth). However, in its unanimous decision, the Full Court of the High Court rejected the application.<sup>19</sup> Following the decision, the Conciliation and Arbitration Commission announced in June 1986, that although it was not prepared to arbitrate to provide for superannuation during the life of the package, it would certify agreements or make consent awards providing for employer superannuation contributions for employees.<sup>20</sup> As a result, superannuation coverage for all employees rose from around 40% to 79% in the 4 years following the Commission's decision.<sup>21</sup>

With this increase in employee participation rates in superannuation, the size of funds under management also grew. In 1987, total superannuation fund assets were \$41.1 billion.<sup>22</sup> By March 1992, total Superannuation fund assets had risen to \$148 billion.<sup>23</sup> In preparing its case for the Conciliation and Arbitration Commission, the ACTU highlighted a number of issues with the lack of government

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<sup>18</sup> *Re Manufacturing Grocers' Employees Federation (Aust); Ex parte Australian Chamber of Manufacturers* (1986) 169 CLR 341.

<sup>19</sup> *Re Manufacturing Grocers'* (1986) 169 CLR 357.

<sup>20</sup> *National Wage Case* (1986) 14 IR 224-5

<sup>21</sup> Australian Prudential Regulation Authority, 'A recent history of superannuation in Australia' (2007) 2 *APRA Insight*, 3.

<sup>22</sup> Insurance and Superannuation Commission, *Annual Report* (1988-1989).

<sup>23</sup> Insurance and Superannuation Commission, *Annual Report* (1991-1992).

intervention in relation to superannuation regulation. The issues highlighted by the ACTU included the lack of vesting of superannuation benefits which could often result in employees losing their entitlements to superannuation on termination of employment, no rules requiring preservation of benefits so that employees could receive concessional tax lump sum payments at termination of employment rather than having the benefits preserved until retirement, and lack of portability of benefits between employers.<sup>24</sup> Issues such as vesting, preservation of benefits and portability had been considered in a number of Government reviews before 1986.<sup>25</sup>

To address these issues, and in keeping with the Accord Mark II agreement, in December 1987 the *Occupational Superannuation Standards Act 1987* ('OSSA') was passed. The provisions of the OSSA introduced operating standards for superannuation entities and prescribed standards for the vesting of benefits from employer and employee contribution; preservation of benefits until age 55; more member involvement in the control of superannuation funds; and security of members' benefits.

## **Introduction of superannuation guarantee**

Despite the passage of the OSSA legislation, there were still a number of problems with award-based superannuation. These included compliance and enforcement

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<sup>24</sup> Australian Council of Trade Unions, *Back to where it all began. Superannuation: the great leap forward* <http://www.actu.org.au/ACTUSuperSite/SuperannuationNews/BackToWhereItAllBeganSuperannuationTheGreatLeapForward>.

<sup>25</sup> See e.g., Commonwealth Committee on Taxation, Commonwealth Government of Australia, *Report of the Commonwealth Committee on Taxation* (1961) (the 'Ligertwood Report'); Taxation Review Committee, Commonwealth Government of Australia, *Taxation Review Committee: Full Report* (1975) (the 'Asprey Report'); National Superannuation Committee of Inquiry, Commonwealth Government of Australia, *Occupational Superannuation in Australia: Final Report Part Two* (1977) (the 'Hancock Report'); and Commonwealth Taskforce, Commonwealth Government of Australia, *Occupational Superannuation* (1983).

issues, which resulted in not all employees who were entitled to award superannuation receiving it. This was partly because compliance could only be enforced through a case mounted before the Australian Conciliation and Arbitration Commission.<sup>26</sup> In 1991, the compliance issues lead the Australian Industrial Relations Commission<sup>27</sup> to reject an application by both the ACTU and the Government for a further 3% increase in award superannuation. Instead, the Commission recommended that the Government convene a national conference on superannuation.<sup>28</sup>

The Government rejected the Commission's recommendation, and instead announced that from 1 July 1992, employers would be required to make tax-deductible superannuation contributions on behalf of their employees. Employers who failed to provide the required level of superannuation support for individual employees would be liable for a non-deductible superannuation guarantee charge.<sup>29</sup> The compulsory savings pillar of the retirement income system is encapsulated in the Superannuation Guarantee legislation.<sup>30</sup>

The superannuation guarantee charge was imposed on employers who failed to make the minimum level of contributions for their employees.<sup>31</sup> Broadly the minimum rate of contribution commenced at 3% in 1992-93 and increased

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<sup>26</sup> Australian Prudential Regulation Authority, above n 21, 3-4.

<sup>27</sup> The Australian Industrial Relations Commission replaced the Australian Conciliation and Arbitration Commission in 1988 (see *Industrial Relations Act 1988* (Cth)). The AIRC was subsumed into Fair Work Australia in 2009 (see *Fair Work Act 2009* (Cth)).

<sup>28</sup> *National Wage Case April 1991* (1991) 36 IR 120, 181.

<sup>29</sup> Commonwealth, *Parliamentary Debates*, House of Representatives, 20 August 1991, 13 (John Kerin, Treasurer).

<sup>30</sup> *Superannuation Guarantee (Administration) Act 1992* (Cth) (*SGAA 1992*) and the *Superannuation Guarantee (Charge) Act 1992* (Cth) (*SGCA 1992*).

<sup>31</sup> *SGAA 1993*, s 16.

gradually over a 10 year period to 9% in 2002-03.<sup>32</sup> Superannuation contributions made by employers were tax deductible<sup>33</sup> whereas payment of the superannuation guarantee charge was not<sup>34</sup>, hence providing an incentive for employers to make voluntary superannuation contributions.

The introduction of the superannuation guarantee system broadened the coverage of superannuation savings to more employees than under the award-based system.<sup>35</sup> Higher participation meant that more money was invested in superannuation than ever before. For example, from June 1996 through June 2006, superannuation assets grew at a rapid rate from \$245 billion to \$912 billion.<sup>36</sup> In view of the rapid growth of investment in superannuation assets, and the larger proportion of the population with superannuation coverage, further tightening of the regulation of superannuation funds was required. The heightened need for Government intervention in the prudential regulation of superannuation funds, together with some concerns in relation to the constitutional validity of the OSSA, lead to the introduction of the *Superannuation Industry (Supervision) Act 1993 (SISA 1993)*.

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<sup>32</sup> *SGAA 1993*, former s 19(2).

<sup>33</sup> *ITAA 1997* s 290-60, (prior to 1 July 2007, *Income Tax Assessment Act 1936* (Cth) (*ITAA 1936*), former s 82AAC).

<sup>34</sup> *ITAA 1997* s 26-95, (prior to 1 July 2006, *ITAA 1936*, former s 51 (9)).

<sup>35</sup> Australian Bureau of Statistics, 'Trends in Superannuation Coverage', *Australian Social Trends*, March 2009, 41.

<sup>36</sup> Australian Prudential Regulation Authority, 'Highlights from 10 years of superannuation data – 1996-2006', (2007) 2 *APRA Insight*, 11.



### **2.1.3 Third pillar: encouraging individual contributions to private retirement savings**

The third pillar of Australia's retirement income system was to encourage private savings by individuals towards provision for their own retirement. This was achieved through taxation incentives. In 1915, the first provision for deductibility of employer contributions made on behalf of employees, up to a prescribed limit, was introduced and superannuation fund earnings were also made exempt from taxation.<sup>37</sup> Provisions were later introduced which allowed self-employed persons to claim deductions for amounts paid for premiums for life assurance and to superannuation funds.<sup>38</sup>

However, the combination of allowing employers a deduction for contributions made on behalf of employees, the tax exempt status of superannuation fund earnings and the lack of regulatory control over access to money invested in superannuation funds lead to a number of tax avoidance schemes. Examples of tax avoidance schemes in the late 1950's included having multiple contributions made by associated companies for the benefit of a single employee to avoid the caps on contributions, and employers making contributions for seasonal workers who, upon leaving the service of the employer forfeited their rights in the fund, which were then spread amongst selected employees.<sup>39</sup> These issues lead the Ligertwood Committee to recommend a tightening of the taxation rules<sup>40</sup>. However, even after the Ligertwood Committee recommendations were implemented, abuse of the

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<sup>37</sup> *Income Tax Assessment Act 1915* (Cth).

<sup>38</sup> *Income Tax and Social Services Contributions Act 1936* (Cth), s 82H.

<sup>39</sup> Ligertwood Report, above n 25, 152. Further discussion of this Committee's work and the resulting changes to the superannuation system is contained in Chapter 3.

<sup>40</sup> Ligertwood Report, above n 25, 153.

concessional tax treatment of superannuation continued. This led the Asprey Committee to recommend amendments in relation to the contribution concessions and the taxation of benefits, to protect against Commonwealth revenue leakage.<sup>41</sup>

Despite recommending a tightening of the rules, the Asprey Committee noted that 'superannuation and life insurance are structured so that they can offer the assurance that saving undertaken through them is long term. In this respect they are the avenues of private savings most deserving of tax assistance'.<sup>42</sup> This sentiment continues through to the present day, where it is recognised that the current taxation system has a bias against long-term saving, particularly lifetime savings such as superannuation.<sup>43</sup>

Hence, concessional taxation treatment of superannuation savings continues as a feature of the taxation policy, and remains an important part of Australia's retirement income system. Examples of where the taxation power has been used by the Commonwealth Parliament to encourage investment by individuals include tax deductible contributions<sup>44</sup>, and concessional treatment of salary sacrifice arrangements into superannuation.<sup>45</sup> A person who makes a contribution to a complying superannuation fund for the benefit of his or her spouse is entitled to a tax offset.<sup>46</sup> The Commonwealth Government will match contributions made by

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<sup>41</sup> Asprey Report, above n 255, [21.1]-[21.133]

<sup>42</sup> Asprey Report, above n 25, [21.7].

<sup>43</sup> Australia's Future Tax System Review, *Australia's future tax system: Report to the Treasurer* (2009) 96-97. The two reasons given by the Review for favourable taxation treatment of superannuation is that taxing superannuation earnings means that the effective rate of tax on the real value of savings increases the longer an asset is held, and secondly that superannuation income is a form of deferred income, such that a person should be taxed on superannuation at the rate that would apply if their income had been spread over their entire life rather than merely their working life.

<sup>44</sup> *ITAA 1997*, s 290-150.

<sup>45</sup> *TAA 1953*, Sch 1 s 16-182(2).

<sup>46</sup> *ITAA 1997*, s 290-230.

specified low income earners to their superannuation funds (referred to as Government co-contributions).<sup>47</sup> The various measures have been considered to be effective in encouraging investment by individuals in their own retirement savings,<sup>48</sup> albeit the benefit of the concessions are skewed towards high income earners.<sup>49</sup>

## **2.2 Constitutional law issues**

The Commonwealth Parliament does not have a specific power to legislate in relation to superannuation. There were some inherent safeguards in the superannuation model given that the majority of superannuation funds were set up as trusts. This potentially afforded the superannuation fund members, as beneficiaries of a trust, recourse to remedies, including restitution or compensation, where there had been a breach of trust<sup>50</sup>.

However, there were other issues such as the vesting of superannuation benefits, preservation of benefits until retirement and portability of superannuation entitlements between employers or funds that could not be addressed by reliance on the common law of trusts alone. Concerns in relation to these issues lead to the

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<sup>47</sup> *Superannuation (Government Co-contribution for low income earners) Act 2003* (Cth) s 9. The benefit provided under the co-contributions scheme is capped and subject to income tests. For the 2014/15 financial year the maximum government superannuation co-contribution is \$500 for a \$1,000 eligible personal superannuation contribution.

<sup>48</sup> Australia's Future Tax System Review, above n 43, 15.

<sup>49</sup> David M. Knox, 'Taxation support of Superannuation in Australia: Its Costs, Equity and Efficacy' (Research Paper No. 7, Australian Tax Research Foundation, 1987), 45.

<sup>50</sup> J D Heydon and M J Leeming, *Jacob's Law of Trusts in Australia* (LexisNexis Butterworths, 7<sup>th</sup> ed, 2006), 592-5 [2201]-[2203].

introduction of standards for superannuation funds which were linked to the tax concessions provided for superannuation funds<sup>51</sup>.

### **2.2.1 Use of the taxation power in the *Constitution* as a basis for regulation**

Historically, it was thought that given the absence of a specific power to allow the Commonwealth Parliament to legislate with respect to superannuation, the only available power was the taxation power in s 51(ii) of the *Constitution*. The Commonwealth Parliament's capacity to regulate superannuation funds through the taxation power was confirmed by the unanimous High Court decision in *Fairfax v Federal Commissioner of Taxation*.<sup>52</sup> This case involved a challenge to the constitutional validity of certain provisions of the ITAA 1936 that imposed tax on investment earnings of a superannuation fund in circumstances where the trustees of the superannuation fund failed to invest a specified proportion of the available funds in Government bonds. In upholding the validity of the section 121D of the ITAA 1936 as a law with respect to taxation, the Court noted that the fact that the motives and policy framework underpinning the laws inserted into the ITAA 1936 were directed at encouraging the investment choices of superannuation fund trustees was irrelevant in characterizing those laws.<sup>53</sup> Rather, the relevant inquiry was whether in substance the law in question was a law with respect to taxation.<sup>54</sup>

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<sup>51</sup> Superannuation funds were required to meet the standards set in the *Occupational Superannuation Standards Act 1987* (Cth) (*OSSA*) in order to access concessional taxation treatment under the *ITAA 1936*.

<sup>52</sup> *Fairfax v Federal Commissioner of Taxation* (1965) 114 CLR 1.

<sup>53</sup> *Fairfax* (1965) 114 CLR 13 per Kitto J.

<sup>54</sup> *Fairfax* (1965) 114 CLR 16 per Taylor J.

This decision confirmed the Commonwealth's ability to regulate superannuation funds through the taxation power. The taxation power has been and continues to be used extensively in the superannuation area to encourage particular behaviour<sup>55</sup>. The prudential standards in the OSSA were legislated by reference to the taxation power in s 51(ii) of the *Constitution*.<sup>56</sup>

What this meant though was that the only penalty that could be imposed by a regulator in situations where the trustees failed to comply with the prudential standards, which in turn made the superannuation fund a 'non-complying fund', was that the fund lost its access to tax concessions.<sup>57</sup> The trustee breach was not an offence for the purposes of the legislation, although it might amount to a breach of the trustee's duties under trust law. This method of regulation was found to be unsatisfactory because the penalty of loss of access to tax concessions punished the members who might also be the victims of the breach.<sup>58</sup> In recognition of this deficiency, the OSSA allowed the penalty to be waived in cases of less serious offences, which effectively allowed the breach to go unpunished.<sup>59</sup>

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<sup>55</sup> See discussion under encouraging individual contributions to private retirement savings above.

<sup>56</sup> See discussion at 2.2.1 on constitutional issues above.

<sup>57</sup> *ITAA 1997*, s 295-325, and prior to 1 July 2007, *ITAA 1936*, s 288A. Broadly, in the year the superannuation fund becomes non-complying, the fund is taxed at the highest marginal tax rate on the market value of its assets less any undeducted contributions. The top marginal tax rate is for the 2014-15 income year is 46.5%.

<sup>58</sup> Senate Select Committee on Superannuation, Australian Parliament, *Safeguarding Super: the Regulation of Superannuation* (1992), [3.14].

<sup>59</sup> *OSSA* s 13. In 1991, the Insurance and Superannuation Commission noted that approximately 4,000 schemes had received the tax concession each year even though those schemes did not comply: Australian Law Reform Commission and the Companies and Securities Advisory Committee, Commonwealth Government of Australia, *Collective Investments: Superannuation*, Report No 59 (1992), [7.3].

## 2.2.2 Use of the corporations and old-age pensions powers in the

### ***Constitution to regulate superannuation funds***

In a joint Report, the Companies and Securities Advisory Committee (the Committee) and the Australian Law Reform Commission (ALRC) concluded that there was no single comprehensive power within the *Constitution* that would provide an appropriate basis for the Commonwealth to fully and effectively achieve its policy goals in relation to superannuation.<sup>60</sup> In view of this conclusion, it recommended that the tax incentives remain an essential element in the regulatory scheme and that those incentives should only be granted to schemes that bring themselves clearly within the Commonwealth's legislative power.<sup>61</sup> The Committee and the ALRC recommended that a combination of the taxation power, the trading or financial corporation power and the old-age pension power be used to support a regulatory framework for the supervision of superannuation funds.<sup>62</sup> The Senate Select Committee on Superannuation later endorsed this recommendation.<sup>63</sup>

To implement the recommendation of the Senate Select Committee on Superannuation, the *Superannuation Industry (Supervision) Act 1993 (SISA 1993)* was brought into effect to replace the *OSSA*. Under the terms of the *SISA 1993*, superannuation funds that elected to be regulated under the *SISA 1993* were

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<sup>60</sup> Australian Law Reform Commission and the Companies and Securities Advisory Committee, above n 59, [7.19].

<sup>61</sup> Australian Law Reform Commission and the Companies and Securities Advisory Committee, above n 59, [7.20].

<sup>62</sup> Australian Law Reform Commission and the Companies and Securities Advisory Committee, above n 59, [7.20]-[7.21].

<sup>63</sup> Senate Select Committee on Superannuation, above n 58, 27.

entitled to concessional taxation.<sup>64</sup> Only those superannuation funds that have a constitutional corporation as a trustee or a fund that provides that the sole or primary purpose of the fund is the provision of old-age pensions can elect to be regulated under the *SISA 1993*, thus bringing those superannuation funds within the Commonwealth Parliament's legislative powers.<sup>65</sup> The constitutional validity of such an approach to the regulation of superannuation entities has never been tested.<sup>66</sup>

When originally introduced, the *SISA 1993* included measures which:

- set out the basic duties and responsibilities of trustees and ensured that they had adequate powers to carry out these responsibilities;
- improved disclosure requirements; enlarged the role of auditors and actuaries;
- introduced more direct enforcement powers; and
- improved audit resources for the Insurance and Superannuation Commission.<sup>67</sup>

Each of these areas of regulation addressed concerns previously raised by various groups in relation to the vesting, preservation and portability of superannuation

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<sup>64</sup> *SISA 1993*, s 19.

<sup>65</sup> *SISA 1993*, s 19(3).

<sup>66</sup> However, in *Roy Morgan Research Pty Ltd v Commissioner of Taxation & Anor* [2010] FCAFC 52, [98]-[109] the Full Court of the Federal Court had cause to consider whether the legislation requiring the Commissioner of Taxation to make payments of the superannuation guarantee shortfall only to those superannuation funds which complied with the *SISA 1993* was constitutionally valid. The Full Court concluded that the superannuation guarantee legislation in this respect was valid by reference to the old-age pension power in s 51(xxiii) of the *Constitution*.

<sup>67</sup> Australian Prudential Regulation Authority, above n 211, 6.

benefits. Also, by using the corporations and pensions power in the *Constitution*, the Parliament was able to subject trustees to a range of civil and criminal penalties without the need to make the fund non-complying for taxation purposes, avoiding adverse consequences for superannuation fund members in many cases.<sup>68</sup>

The use of a number of different constitutional powers appears to have dealt with the issues confronting the Commonwealth Parliament in legislating for effective regulation of superannuation funds. It has however significantly increased the complexity of the taxation legislation and the regulatory burden on superannuation fund trustees and employers.<sup>69</sup> The recommendations of each Committee further shaped the superannuation industry, by creating more specialized Government regulators than had previously been the case<sup>70</sup> and by introducing measures to assist to reduce the regulatory burden on superannuation funds and business alike.<sup>71</sup>

### **2.3 Prudential supervision of superannuation funds: the three regulators**

Following the deregulation of Australia's financial system in the early 1980's, the Howard Coalition Government commissioned a review into Australia's financial

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<sup>68</sup> Ibid, see also Australian Law Reform Commission and Companies and Securities Advisory Committee, above n 59, [7.21].

<sup>69</sup> See e.g, Financial Services Inquiry Committee, The Australian Treasury, *The final report of the Financial Services Inquiry* (1997); Taskforce on Reducing Regulatory Burdens on Business, Commonwealth of Australia, *Rethinking Regulation* (2006); Australia's Future Tax System Review, *Australia's future tax system: Report to the Treasurer* (2009); and Super System Review, Commonwealth of Australia, *Final Report: Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System* (2010).

<sup>70</sup> Financial Services Inquiry Committee, above n 69.

<sup>71</sup> Taskforce on Reducing Regulatory Burdens on Business and Super System Review, above n 69.



system, including superannuation, with the aim of improving market conduct, disclosure, safety, stability, competition and competitiveness. That review, headed by Mr Stan Wallis, submitted its final report to the Government in March 1997 ('the Wallis report').<sup>72</sup> As a result of the recommendations made in the Wallis report, the regulation of the superannuation industry was significantly restructured to an arrangement which involved three regulators each with slightly different duties.

Following the recommendations of the Wallis report, the Australian Prudential Regulation Authority (APRA) was formed and replaced the ISC.<sup>73</sup> APRA was vested with ensuring that superannuation funds, pooled superannuation trusts and approved deposit funds, other than excluded funds, operated consistently with the prudential standards contained in the *SISA 1993* and supporting regulations.<sup>74</sup>

The Wallis report recommended that regulation of excluded funds (later to be legislated as 'self-managed superannuation funds'), be vested in the Australian Taxation Office (ATO).<sup>75</sup> It was suggested that such funds did not require the same level of regulation as larger industry funds because all members of excluded funds would have equal control of the fund assets. To ensure that all members were given equal control of the superannuation fund assets, it was recommended that each member also become trustee of the fund.<sup>76</sup> The Wallis report also

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<sup>72</sup> Financial Services Inquiry Committee, above n 69.

<sup>73</sup> The Australian Prudential Regulation Authority was created by under the *Australian Prudential Regulation Authority Act 1998* (Cth).

<sup>74</sup> *SISA 1993*, s 6(1)(a), (b) and (2B).

<sup>75</sup> Financial Services Inquiry Committee, above n 69, 46-47.

<sup>76</sup> *Ibid.* To implement this recommendation, the *SISA 1993* was amended by *Superannuation Legislation Amendment Act (No. 3) 1999* to establish a new category of fund called 'self managed superannuation funds' and to confer regulation of such funds on the Commissioner of Taxation. See also *SISA 1993* s 6(1)(e), (f) and (2A).

recommended that there should be more responsibility placed on trustees and auditors in relation to excluded funds.

The Australian Securities and Investment Commission (ASIC) was created on 1 July 1998, replacing the former Australian Securities Commission.<sup>77</sup> ASIC was invested with responsibility for consumer protection in various financial services industries including superannuation. Broadly, ASIC has the general administration of the *SISA 1993* in respect of the keeping of reports and disclosure of information to members of funds and disclosure of information about funds.<sup>78</sup>

The overlapping responsibilities and duties of each regulator may be seen to cause some administrative burdens on trustees, auditors and members of superannuation funds. The superannuation regulatory framework is considered in more detail in Chapter 3.

#### **2.4 Use of the trust structure in superannuation**

It was noted above that safeguards have been built into the superannuation model through the use of a trust structure for the majority of superannuation funds. However, the origin of the use of a trust structure for superannuation purposes is not clear. It has been suggested that since the introduction of the *OSSA*, requiring that the rights of members to receive benefits must be fully secured at all times, the use of a trust was an efficient means to comply with that requirement.<sup>79</sup>

Although the question has been raised as to whether the trust structure was an

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<sup>77</sup> *Australian Securities and Investments Commission Act 1989*. This Act was later repealed and replaced by the *Australian Securities and Investments Commission Act 2001*.

<sup>78</sup> *SISA 1993*, s 6(1)(c) and (d).

<sup>79</sup> Senate Select Committee on Superannuation, above n 15, 29.

appropriate vehicle for superannuation, the preference of the industry and policy makers alike has been to retain trusts as the preferred superannuation vehicle.<sup>80</sup>

Generally, superannuation funds are constituted as express trusts.<sup>81</sup> An express trust is a trust is where the creator has used language which expresses an intention to create a trust.<sup>82</sup> The conduct of the trustee of a superannuation fund is thus subject to trust law obligations such as the fiduciary obligation not to profit from the trust, to avoid conflicts of interest, as well as the duties to act honestly, impartially, and with due care, skill and diligence.<sup>83</sup> As noted above, if the superannuation fund trustee breaches such duties, the beneficiaries may have recourse to certain equitable remedies.

However, the strength of the trust structure in protecting the superannuation fund beneficiaries' interests is subject to the terms of the trust deed. Those trust deeds (referred to in the context of superannuation as the governing rules of the fund) may provide that the trustee may change the terms of the trust at any time. The interests of the beneficiaries are theoretically at risk if total reliance were to be placed on trust law to protect the assets invested.<sup>84</sup>

In recognizing this risk, Parliament has supplemented and in some cases codified trust law concepts within the *SISA 1993*. Those provisions are contained in Part 6

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<sup>80</sup> Senate Select Committee on Superannuation, above n 15, 30 and in a self-managed superannuation fund context, see Super System Review, Commonwealth of Australia, *Self-Managed Super Solutions: Phase Three Preliminary Report* (2010) 4.

<sup>81</sup> M Scott Donald, *What contribution does trust law make to the regulatory scheme shaping superannuation in Australia?* [http://www.apra.gov.au/Careers/upload/Scott-Donald\\_What-contribution-does-trust-law-make-to-the-regulatory-scheme-shaping-superannuation-in-Australia](http://www.apra.gov.au/Careers/upload/Scott-Donald_What-contribution-does-trust-law-make-to-the-regulatory-scheme-shaping-superannuation-in-Australia), 4.

<sup>82</sup> Heydon and Leeming, above n 500, [306].

<sup>83</sup> Donald, above n 81, 4.

<sup>84</sup> Donald, above n 81, 12.

of the *SISA 1993* and include a list of covenants which were intended to codify the essential obligations of trustees in a way that is non-excludable and irrevocable.<sup>85</sup>

The use of a trust structure arguably also increases the complexity of the administrative considerations which must be taken into account when regulating SMSFs. These include how to address potential breaches by some but not all of the trustees of an SMSF where a decision, such as making the fund non-complying, will affect the interests of all beneficiaries who are also trustees.

## **2.5 Conclusion**

The legislative scheme incorporating and directly linking taxation to the prudential regulation of superannuation entities has placed the Commissioner of Taxation in a unique situation. It is important to understand the legal basis upon which the Commissioner regulates SMSFs to identify the legal boundaries of any discretions provided to him. An understanding of the statutory framework is also necessary to determine the scope of judicial review of decisions made by the Commissioner and the circumstances in which the Commissioner may be able to take action on behalf of beneficiaries. The next chapter examines in more detail the legislative framework within which the Commissioner regulates SMSFs.

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<sup>85</sup> Donald, above n 13. See e.g., *SISA 1993*, ss 52 (trustee covenants), 57 (adjustment to terms of trust deed) and 62 (sole purpose test).

## Chapter 3: Statutory framework for the regulation of superannuation funds

This chapter provides an overview of the statutory framework<sup>1</sup> for the supervision of superannuation funds.<sup>2</sup> It is important to understand the legal basis upon which the Commissioner regulates SMSFs to identify the legal boundaries of any actions undertaken or discretions provided to him. An understanding of the statutory framework is also necessary to determine the scope of judicial review of decisions made by the Commissioner and parameters within which the Commissioner must operate as the regulator of SMSFs.

### 3.1 *The need for regulation of superannuation funds*

#### 3.1.1 Defining ‘prudential’ supervision and the reasons why it is required

The term ‘prudential supervision’ has been used in much of the literature in relation to superannuation but its meaning is not immediately clear from the term itself. In considering the different types of regulation or supervision applying in the finance sector, former Deputy Governor of the Reserve Bank of Australia, G. J. Thompson stated: ‘To put it rather baldly, prudential supervision is about techniques of risk management...’.<sup>3</sup> The primary objective of prudential

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<sup>1</sup> Contained in the *SISA 1993*, *SISR 1994*, *ITAA 1997* and the *ITAR 1997*. All legislative references are to the law as at 1 July 2014 unless otherwise stated.

<sup>2</sup> The statutory framework applies to regulated superannuation funds, approved deposit funds and pooled superannuation trusts (collectively referred to as ‘superannuation entities’: *SISA 1993* s 10 (definition of ‘superannuation entity’)). The analysis in this thesis is restricted to ‘superannuation funds’ as defined in *SISA 1993* s 10.

<sup>3</sup> G. J. Thompson, ‘Prudential Supervision and the Changing Financial System’, (1996) April *Reserve Bank Bulletin* 30, 32.

supervision is to focus on individual institutions with the aim of protecting their solvency or viability. To this end, prudential supervision is also concerned with ensuring system-wide stability by preventing problems in one institution from spreading more widely through the financial system.<sup>4</sup> Many of the provisions in the *SISA 1993* reflect this underlying prudential purpose. A prudential supervisor is focused on encouraging and promoting prudent behaviour in the managers of financial institutions.<sup>5</sup>

Past Government reviews into the superannuation system have identified the main reasons why prudential supervision of superannuation entities is necessary.<sup>6</sup> Those reasons are discussed further below.

## **Reducing pressure on the national economy in terms of funding age pensions**

Superannuation investment<sup>7</sup> is important to the national economy in terms of boosting national savings, hence reducing the need for the government to borrow to fund its age pension liabilities, as well as providing an opportunity for individuals to enjoy a higher standard of living in retirement.<sup>8</sup> Private provision for retirement is a cornerstone of the Government's overall retirement incomes policy.

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<sup>4</sup> Ibid 30-31.

<sup>5</sup> Ibid 30.

<sup>6</sup> See e.g. Australian Law Reform Commission and Companies and Securities Advisory Committee, Commonwealth Government, *Collective investment schemes: superannuation* (Discussion Paper No 50, January 1992), [4.4]; Senate Select Committee on Superannuation, Commonwealth Parliament, *Safeguarding Super* (1992), 31 (Figure 4.1); Productivity Commission, Commonwealth Government, *Review of the Superannuation Industry (Supervision) Act 1993 and certain other legislation* (Inquiry Report, 10 December 2001), xvii.

<sup>7</sup> For the purposes of this discussion, 'superannuation investment' refers to both employer funded superannuation contributions made for the benefit of their employees and contributions made by individuals to their own retirement savings.

<sup>8</sup> John Dawkins, Treasurer, *Strengthening Super Security: new prudential arrangements for superannuation* (1992), 1.

Private superannuation savings have become accepted by the public as a major source of income in retirement,<sup>9</sup> hence from the public's point of view the conduct of superannuation funds must be subject to some form of regulation.

## **No government guarantee for superannuation member benefits**

The size of superannuation savings has dramatically increased since the Labor Government introduced the mandatory superannuation guarantee charge,<sup>10</sup> which required employers to make superannuation contributions for the benefit of their employees.<sup>11</sup> Despite the fact that the Government's retirement policy mandated provision of retirement savings to be funded by the private sector, it also made it clear that it would not provide either an implicit or explicit guarantee or safety net for superannuation benefits to members.<sup>12</sup> In such circumstances, a prudential framework is required to give added protection to superannuation savings and to promote a more effective superannuation industry. Relying on a non-legislative approach alone, such as an industry code of conduct, would most likely be unacceptable to the public and could potentially expose the vast amount of superannuation assets to higher risks than under a prudential framework.

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<sup>9</sup> In 2007 of those employed people aged 45 years who intended retire, about 25% expected that taxpayer-funded income support to be their main source of income: Australian Bureau of Statistics, Commonwealth Government, (2009) *Australian Social Trends* 39, 44.

<sup>10</sup> At March 1992, total superannuation fund assets were estimated at \$148 billion (Insurance Superannuation Commission, *Annual Report*, 1991-92). As at 30 June 2013, total superannuation fund assets were estimated at \$1.8 trillion (Australian Prudential Regulation Authority, *Annual Superannuation Bulletin*, June 2013 (revised February 2014), 6).

<sup>11</sup> *Superannuation Guarantee (Charge) Act 1992* (Cth) ('SGCA 1992') and *Superannuation Guarantee (Administration) Act 1992* (Cth) ('SGAA 1992').

<sup>12</sup> John Dawkins, above n 8, 3. However, note that for regulated superannuation funds, other than SMSFs, there is provision in the *SISA 1993* for an application for assistance to be made to the Minister where the fund has suffered loss as a result of fraudulent conduct or theft: *SISA 1993* Part 23.

## **Protect government revenue against exploitation of tax concessions**

The substantial tax concessions given to superannuation entities provide an incentive to invest in private superannuation savings. However, protection against fraud and maladministration by trustees is required for those savings to be preserved until retirement. If those savings were eroded, then a future generation of taxpayers would have to fund increased social security payments for retirees who were unable to rely on their superannuation savings and who have little chance to rebuild sufficient assets to fund their retirement. Those savings were supported by tax revenue foregone in the form of taxation concessions during the period the savings were accumulated.<sup>13</sup> It would be unacceptable to future taxpayers if the reason for the loss of those superannuation savings was insufficient prudential controls.

### **3.1.2 Defining the role of the regulators**

The main three regulators operating in the superannuation system are<sup>14</sup>:

- the Australian Taxation Office (ATO). The ATO is responsible for taxation collection (which includes administering concessional treatment of superannuation fund income and assessment of contribution limits), administration of the government superannuation co-contributions scheme, ensuring employers comply with their superannuation guarantee

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<sup>13</sup> Australian Law Reform Commission and Companies and Securities Advisory Committee, above n 6, 26 [4.6] referring to the Treasurer's statement, *Prudential Supervision* (Federal Treasury Paper No 1, 20 August 1991).

<sup>14</sup> The responsibilities of each regulator in relation to superannuation is outlined in *SISA 1993*, s 6.



obligations, maintenance of the lost member register and supervision of self managed superannuation funds

- the Australian Prudential Regulation Authority (APRA). APRA is responsible for the prudential regulation of all superannuation entities, other than SMSFs, under the *SISA 1993* including those entities offering retirement savings accounts and pooled superannuation trusts; and
- the Australian Securities and Investment Commission (ASIC). ASIC is responsible for administering the *SISA 1993* provisions regulating disclosure, consumer protection and member complaints.

Each regulator is jointly and severally responsible for the supervision not only of the superannuation trustees within their specified sectors but also the other participants in the broader superannuation system. This includes auditors,<sup>15</sup> advisors,<sup>16</sup> actuaries, and more recently, promoters of illegal early release schemes.<sup>17</sup> These broader responsibilities reflect the expectation of the Parliament that the regulators operate to ensure the health of the superannuation system as a whole so as to protect member's interests.

It is important to note that APRA is also the regulator of other financial institutions such as banks and credit unions and the legislative direction outlined above applies equally to APRA's supervision of those entities as well as superannuation

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<sup>15</sup> For example, it is an offence for an auditor to fail to notify the relevant regulator when the auditor forms the opinion that the financial position of the entity may be, or may be about to become, unsatisfactory: *SISA 1993* s 130(4)-(5).

<sup>16</sup> Persons providing investment services to superannuation fund trustees, referred to as investment managers, may also be subject to civil and criminal penalties: see e.g. *SISA* s 109, s 122 and s 125.

<sup>17</sup> *SISA 1993* s 68B.

funds. This focus is apparent from the legislative direction given to APRA in discharging its supervisory functions:<sup>18</sup>

In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.

Amongst other obligations, ASIC is equally charged with the responsibility ‘to maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy’.<sup>19</sup>

There is no equivalent legislative direction given to the Commissioner in his capacity as regulator of SMSFs. This is because Commissioner of Taxation is a statutory office established to perform functions under taxation law.<sup>20</sup> As was discussed in the previous chapter, it was considered appropriate that the Commissioner regulate SMSFs given that trustees of such entities are investing in that structure at their own risk. This is contrasted with APRA-regulated funds where the bulk of members solely rely on compulsory employer-funded contributions which necessitates a different regulatory focus.

The differences between the basis for the Commissioner’s regulation of SMSFs and APRA’s regulation of other superannuation funds is explored further below to illustrate reasons why a different regulatory approach is required in the context of

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<sup>18</sup> *Australian Prudential Authority Act 1998* (Cth) s 8.

<sup>19</sup> *Australian Securities and Investment Commission Act 2001* (Cth) s 1(2)(a).

<sup>20</sup> *TAA 1953* s 4.

SMSFs. ASIC's role in the regulation of the superannuation industry relates to products and services which superannuation trustees may undertake. Given this difference in focus, ASIC's approach to regulation is not within the scope of this thesis.

## **APRA's approach to regulation of superannuation entities**

APRA's approach to regulation of superannuation entities has been described as: 'forward looking, primarily risk-based, consultative, consistent and in line with international best practice'.<sup>21</sup> Hence, APRA places the most resources where it has identified the highest risk. In preference to using the stronger sanctions such as criminal prosecutions and civil penalties, APRA works with trustees to address areas of concern in relation to the fund's internal risk management practices and procedures. In reviewing the risk management practices of a particular superannuation fund, APRA not only has regard to the decision making processes within the fund but also to the profile of investments made by the fund to identify areas of potential future risk to the financial viability of the fund. It is necessary for APRA to take on such a role given the bulk of employees have their compulsory superannuation guarantee contributions made to APRA-regulated funds where those employees have very little control over the investments made with their contributions. Therefore, members of APRA-regulated funds are in a position where they cannot address potential risks and must therefore rely on the regulator to do so on their behalf.

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<sup>21</sup> Senate Select Committee on Superannuation and Financial Services, Commonwealth Parliament, *Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services* (2001), 39.

## Commissioner's approach: 'non-prudential' regulation of SMSFs

In contrast to members of APRA-regulated funds, members of an SMSF are also its trustees and as such they are in a unique position to be able to protect their own interests.<sup>22</sup> Hence, investors in such vehicles did so entirely at their own risk.<sup>23</sup> This policy basis for the regulation of SMSFs has defined the boundaries of the Commissioner's regulatory role which is focused on ensuring that funds are paying the correct tax and that their sole purpose is to meet members' retirement income objectives.<sup>24</sup> Whilst the Commissioner is responsible for administering certain provisions in the SISA 1993 which have a 'prudential flavour',<sup>25</sup> that role does not extend, for example, to determining whether the investment strategy<sup>26</sup> and specific investment decisions made by an SMSF trustee is in accordance with the *SISA 1993*. It also does not extend to determining whether an SMSF is financially viable or an appropriate investment choice has been made for the individuals involved.<sup>27</sup> In

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<sup>22</sup> Financial System Inquiry, Australian Government, *Financial System Inquiry: Final Report* (1997) (Wallis Inquiry), 334.

<sup>23</sup> This policy rationale is reflected in the *SISA 1993* where SMSFs trustees are excluded from being able to apply to the Minister for financial assistance in respect of loss suffered by the fund as a result of fraudulent conduct, or theft: *SISA 1993* s 229.

<sup>24</sup> Matt Bambrick, 'Update from the ATO on recent compliance activity, areas of concern with SMSFs and the ATO's future priorities' (Speech delivered at the CPA Learn from the Masters SMSF Conference and Expo 2014, Sydney, Thursday, 17 July 2014 and Melbourne, 24 July 2014).

<sup>25</sup> See e.g. *SISA 1993* s 126A (application of fit and proper person test in disqualification of individual); s 126D (waiver of disqualification in certain circumstances); s 133 (power to suspend or remove individuals from acting as trustee, investment manager or custodian who undertake conduct which may result in financial position of entity becoming unsatisfactory). See also Australian National Audit Office, Commonwealth Government, *The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds* (Audit Report No. 52, 2006-07) 49-56 where it was observed that the Commissioner's role may include some elements of 'prudential regulation'.

<sup>26</sup> All trustees of a regulated superannuation entity, including SMSFs are required to have an investment strategy and to review the investments made against that investment strategy regularly: *SISA 1993* s 52(2)(f), and *SISR 1994* reg 4.09 makes this requirement an operating standard, the contravention of which is an offence punishable by a maximum of 100 penalty units: *SISA 1993* s 34(2).

<sup>27</sup> This is reflected in number of 'small-sized' SMSFs, that is funds with \$200,000 or less in assets, which were estimated to have made up 26% of the SMSF population. These smaller-sized SMSFs were found to lack investment diversification, suffer higher relative costs and to underperform larger-sized SMSFs. The Super System Review, whilst noting its concerns about the number of

respect of its limited 'regulatory' role, the ATO has further noted that it does not have the same legislative protection afforded to APRA under its Act to be protected from liability in respect of anything done, or omitted to be done, in the exercise of powers, functions or duties under a law of the Commonwealth.<sup>28</sup>

However, at a broad public policy level, the Commissioner is charged with ensuring public confidence in the system such that the taxation concessions provided to SMSFs are appropriately applied only to those entities which comply with their statutory duties. In order to discharge this duty, the Commissioner must have regard to whether the actions of the trustees, investment managers and auditors may put at risk the retirement benefits of the members. Some elements of this exercise could be seen to require the application of prudential supervision. Hence, it could be said that whilst the focus of the Commissioner's role is the protection of retirement incomes, that analysis can only be done in some circumstances by taking into account prudential considerations in relation to the viability of the fund.

### **3.2 *The purpose of superannuation fund regulation***

Having established the need for regulation of superannuation funds, and the role of each of the regulators, the purpose of such regulation must also be examined. Without guiding policy parameters to which the regulator of superannuation funds can refer, the application of the statutory framework would lack cohesion,

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smaller-sized SMSFs, decided not to recommend a mandated minimum SMSF size because it acknowledge their existence is generally due to the conscious choice of members and that all members take ultimate responsibility for their retirement needs: Super System Review, Commonwealth Government, *Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System: Final Report* (2010) ('Cooper Review'), 222-3.

<sup>28</sup> *Australian Prudential Regulation Authority Act 1998*.

consistency and might lead to inequitable treatment between superannuation funds.

In introducing the *SISA 1993*, the Labor Government outlined the goal of prudential supervision of the superannuation industry.<sup>29</sup> In short, the purpose of prudential supervision is two-fold: firstly, to ensure that superannuation remains a secure, efficient and viable means by which people can provide for their own retirement and secondly to also ensure that the superannuation industry contributes to the Government's broader economic goals of promoting savings, efficient investment and sustainable economic growth.<sup>30</sup>

There has been much written on whether or not these overarching goals have been met by the statutory framework, and it appears that views are divided.<sup>31</sup> It is clear that SMSFs, given their rapid growth in terms of numbers as well as asset values, have attracted much attention from commentators and the Government alike. Concerns have been continually raised as to whether superannuation savings continue to be at risk of either fraud or mismanagement.<sup>32</sup> Recent Government initiated reviews, such as the Cooper Review<sup>33</sup> and the Henry Review,<sup>34</sup> have considered the statutory framework with a view to improving its application and efficiency. However, as the focus of this thesis is on whether the administration of

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<sup>29</sup> Ibid. See also John Dawkins, above n 8, 1.

<sup>30</sup> *SISA 1993* s 3(1).

<sup>31</sup> Dan Scheiwe, 'Why Australia's pension system is not a good international model' (Discussion Paper No PI-9912, Pensions Institute, April 1999); Australia's Future Tax System Review, Commonwealth Government, *Australia's future tax system The retirement income system: Report on strategic issues* (May 2009) ('Henry Review'); Super System Review, above n 27.

<sup>32</sup> See e.g. Arie Freiberg, 'Superannuation Crime in the 1990's' (1996) 24(3) *Australian Business Law Review* 217; Tom Valentine, 'Is superannuation safe' (2003) 36(1) *The Australian Economic Review* 108.

<sup>33</sup> Super System Review, above n 27.

<sup>34</sup> Australia's Future Tax System Review, above n 27.

the legislative framework as it is currently enacted can be improved or enhanced, a detailed analysis of whether the intended purpose of the supervisory framework has been achieved is beyond the scope of this thesis.<sup>35</sup>

### **3.3 An overview of the SISA 1993 and associated regulations**

The superannuation legislative framework has been described as being 'long, detailed, complicated and prescriptive in some parts'.<sup>36</sup> The complexity of the legislation has been attributed to a number of factors including the fact that it contains provisions not only for the prudent management of superannuation entities but also provisions directed at the prevention of abuse of tax concessions. The fact that these provisions have been changed so often, necessitating the inclusion of grandfathering rules, has added to its complexity.<sup>37</sup>

A discussion on the background to every provision contained in the *SISA 1993* is not feasible or necessary for the purposes of this thesis because the focus of the analysis is on the Commissioner's role as the regulator of SMSFs. Hence, following a brief introduction to the structure of the statutory framework, the following analysis will only examine in detail those areas specifically relevant to SMSFs.

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<sup>35</sup> For more detailed discussion of these issues, see e.g. Josephine Cleary, *The evolution of the regulation governing superannuation funds since 1936* (PhD Thesis, 2010) and Allan Borowski, 'Back at the Crossroads: The Slippery Fish of Australian Retirement Income Policy' (2008) 43 (Winter) *Australian Journal of Social Issues* 311; Cortese, CL & Glynn, J, 'Taxation and the Australian Superannuation System: An International Comparison' (2006) 16(2) *Australian Accounting Review* 77; Michael Ntalianis and Victoria Wise, 'The Australian superannuation framework : implications for retirement savings' [2010-12] 2(1) *Global Business & Economics Anthology* 54.

<sup>36</sup> Productivity Commission, above n 6, 32.

<sup>37</sup> *Ibid* 35.

### 3.3.1 Overview of statutory framework

Trusts have generally been the preferred vehicle for superannuation funds.<sup>38</sup> Broadly, only those superannuation entities constituted as trusts<sup>39</sup> can become subject to supervision under the superannuation statutory framework.<sup>40</sup> The structure of the legislative provisions maintains at its core the notion that the primary responsibility for the viability and prudent operation of the superannuation industry rests with the trustees.<sup>41</sup> Hence, the general law of trusts is supplemented, and in some instances overridden,<sup>42</sup> by the *SISA 1993* and *SISR 1994*. This is achieved within that statutory framework by codifying some of the general law obligations placed on trustees; dictating how superannuation funds are to operate including who can make contributions and prescribing a 'sole purpose' test for the fund, imposing requirements for the preservation and vesting of members' interests, portability and how and when benefits can be paid;<sup>43</sup> and making provision for criminal and civil sanctions for breaches of those rules. These statutory provisions cannot be excluded or modified by the governing rules<sup>44</sup> of the superannuation fund.<sup>45</sup>

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<sup>38</sup> Submissions to the Senate Select Committee on Superannuation, above n 6, 30 [4.5] noted a strong preference for retaining the structure and more recently it has been confirmed that trusts are preferred structure for superannuation: Super System Review, above n 27, 219-220.

<sup>39</sup> *SISA 1993* s 19(2).

<sup>40</sup> The *SISA 1993* is deemed to apply to exempt public sector superannuation schemes which are generally created by an Act of Parliament: see e.g. *SISA 1993* s 46.

<sup>41</sup> John Dawkins, above n 12, 1.

<sup>42</sup> See e.g. the law against perpetuities deemed not to apply: *SISA 1993* s 343.

<sup>43</sup> Referred to as 'operating standards', the detail of which is contained in the *SISR 1994*: *SISA 1993* s 31. Trustees are required to comply with the operating standards: *SISA 1993* s 34.

<sup>44</sup> 'Governing rules' in relation to a fund, scheme or trust means any rules contained in a trust instrument, other document or legislation, or combination of them; or any unwritten rules; governing the establishment or operation of the fund, scheme or trust: *SISA 1993* s 10 (definition of 'governing rules').

<sup>45</sup> *SISA 1993* s 7.



Further safeguards are included in the legislation by way of licensing of certain trustees,<sup>46</sup> requiring annual audits of the superannuation entity's accounts by approved auditors<sup>47</sup> and the certification of the value of fund assets by auditors.<sup>48</sup>

Trustees of superannuation funds are given an additional incentive to comply with the conditions outlined in the *SISA 1993* and *SISR 1994* because only those funds that have been notified by the relevant Regulator as a 'complying superannuation fund'<sup>49</sup> are eligible for concessional taxation treatment. The concessional taxation treatment consists of a taxation rate of 15% on the taxable income of the superannuation fund, other than special income,<sup>50</sup> and includes an exemption for income derived from assets used to support payment of a member's pension.<sup>51</sup> Only complying superannuation funds can accept superannuation guarantee contributions.<sup>52</sup> This condition on its own is sufficient incentive for a superannuation fund, particularly the larger APRA-regulated funds, to be a complying superannuation fund, given the bulk of the assets under management derive from superannuation guarantee contributions.<sup>53</sup>

Where a contravention of the regulatory provisions has occurred, the Regulator may choose to treat the superannuation fund as being 'non-complying'. A fund that ceases to be a 'complying superannuation fund', because of a contravention of a

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<sup>46</sup> *SISA 1993* Parts 2A-2B.

<sup>47</sup> *SISA 1993* Part 4.

<sup>48</sup> *SISA 1993* Part 16.

<sup>49</sup> Complying superannuation fund status is determined under *SISA 1993* s 42 (for APRA-regulated funds) and s 42A (for SMSFs).

<sup>50</sup> *Income Tax Rates Act 1986* s 26. The concept of 'special income' is discussed below at 3.3.5.

<sup>51</sup> *Income Tax Assessment Act 1997* ('*ITAA 1997*') s 295-385 and s 295-390.

<sup>52</sup> *SGAA 1992* s 22 and s 23.

<sup>53</sup> In 2007 44% of employees were relying solely on employer contributions: Australian Bureau of Statistics, above n 9, 43.

regulatory provision, remains under the prudential supervision of the relevant regulator.<sup>54</sup> Non-complying superannuation funds are subject to a much higher rate of tax than complying superannuation funds<sup>55</sup> and contributions made to them cannot be taken into account for the purposes of the superannuation guarantee legislation.

### **3.3.2 Types of entities subject to supervision**

The *SISA 1993* can only apply to superannuation funds where the trustee of the fund is a constitutional corporation pursuant to a requirement contained in the governing rules or where the governing rules provide that the sole or primary purpose of the fund is the provision of an old-age pension.<sup>56</sup> These requirements are imposed because the statutory framework contained in the *SISA 1993* is based on the corporations and old-age pension powers contained in the *Constitution* (Cth).<sup>57</sup>

### **Definition of ‘superannuation fund’**

A ‘superannuation fund’ is defined as a fund that is an indefinitely continuing fund<sup>58</sup> and is a provident, benefit, superannuation or retirement fund.<sup>59</sup> A public sector superannuation scheme is deemed to be a ‘superannuation fund’ for the

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<sup>54</sup> *SISA 1993* s 19(5).

<sup>55</sup> Generally the income of non-complying superannuation funds is taxed at the highest individual marginal rate, currently 46.5%: *Income Tax Rates Act 1986* s 26.

<sup>56</sup> *SISA 1993*, s 3(2).

<sup>57</sup> Refer to Chapter 2 for discussion of the Constitutional issues.

<sup>58</sup> A fund which included in its governing rules a provision to avoid a breach of the rule against perpetuities is still able to satisfy the definition of a superannuation fund: *SISA 1993* s 14. The rule against perpetuities is excluded from operation in relation to superannuation entities: *SISA 1993* s 343.

<sup>59</sup> *SISA 1993*, s 6 (definition of ‘superannuation fund’).

purposes of the *SISA 1993*.<sup>60</sup> Although the definition of ‘superannuation fund’ has changed over time, the main purpose of superannuation funds that are subject to regulation has remained the same and that is to provide benefits to the members at retirement or for the member’s dependents on the member’s death.

An SMSF is a fund that has fewer than 5 members, all of whom are also trustees of the fund or directors of the corporate trustee (where relevant). No member of the fund may be an employee of another member unless they are relatives. Further, no trustee or director of a corporate trustee of the fund may receive remuneration from the fund or any person for any duties or services performed by the trustee or director in relation to the fund.<sup>61</sup> Certain exceptions to the membership rules are provided to deal with situations where the members are under a legal disability either through age or mental disability<sup>62</sup> or in circumstances where the member dies.<sup>63</sup>

A superannuation fund that ceases to satisfy any of the conditions outlined above at any time in an income year will cease to be an SMSF for the purposes of the *SISA 1993*. A time limit is provided in the legislation within which the fund can rectify the failure.<sup>64</sup> Maintaining the status of an SMSF is important because even though the fund may have failed to meet the definition of an SMSF, it remains a regulated superannuation fund subject to the conditions of the *SISA 1993*. This means that once a fund ceases to be an SMSF and fails to rectify that breach in time, it becomes subject to the full range of prudential requirements under the Act, which may be

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<sup>60</sup> Ibid.

<sup>61</sup> *SISA 1993* s 17A(1).

<sup>62</sup> *SISA 1993* s 17A(3)(b), (c).

<sup>63</sup> *SISA 1993* s 17A(3)(a).

<sup>64</sup> Generally SMSF trustees have 6 months from the time of the failure to rectify the breach: *SISA 1993* s 17A(4).

both time consuming and costly for the fund.

A 'regulated superannuation fund' is defined as a superannuation fund with a trustee or trustees who have given the relevant regulator a written notice electing that the *SISA 1993* is to apply in relation to the fund. Such an election is irrevocable.<sup>65</sup> Superannuation entities that do not elect to be regulated under the *SISA 1993* are therefore outside the scope of the Act.<sup>66</sup> However, those entities will not be entitled to concessional taxation treatment nor will such funds be eligible to receive superannuation guarantee contributions.

### **3.3.3 Trustee duties and responsibilities**

Central to the statutory framework for the regulation of superannuation funds is the policy parameter that the trustee remains ultimately responsible for the management and success of the superannuation fund.<sup>67</sup> Trustees of superannuation funds are subject to the general law of trusts, as well as the trustee legislation in each of the States and Territories.<sup>68</sup> Each of these Acts applies to a person in their or an entity in its capacity as trustee and does not make a distinction between a superannuation fund trustee and trustees of other kinds of trust, for example a unit trust. Given the Commissioner is not responsible for the administration of the State and Territory trustee legislation, a discussion of those provisions is outside the scope of this thesis.

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<sup>65</sup> *SISA 1993* s19(5).

<sup>66</sup> *SISA 1993* s 3(3).

<sup>67</sup> This is implicit in the provision which specifically overrides the rule against perpetuities in relation to superannuation entities but does not mention other features of trust law: *SISA 1993* s 343, and the specific provision preserving the application of State and Territory laws which are capable of operating concurrently with the *SISA 1993*: *SISA 1993* s 350.

<sup>68</sup> *Trustee Act 1925 (ACT)*; *Trustee Act 1925 (NSW)*; *Trustee Act 1893 (NT)*; *Trusts Act 1973 (Qld)*; *Trustee Act 1936 (SA)*; *Trustee Act 1898 (Tas)*; *Trustee Act 1958 (Vic)*; *Trustees Act 1962 (WA)*.

## **Trustee duties under general law**

Under the general law, which in many cases is codified in the States' and Territories' trustee legislation, the overarching fiduciary duty of the trustee is to act honestly and in good faith and in the best interests of the members of the scheme.<sup>69</sup> The standard of care applied is that of an ordinary prudent businessman.<sup>70</sup> A higher standard of care is applied to professional trustees, for example trustee companies.<sup>71</sup> This fiduciary duty translates to a number of specific duties which include the duty to account to beneficiaries;<sup>72</sup> to act personally and not fetter or delegate his or her discretion;<sup>73</sup> to avoid situations where his or her own interests may conflict with the duties as trustee, which would include not receiving remuneration for discharge of trustee duties unless expressly provided for in the trust deed;<sup>74</sup> to act impartially;<sup>75</sup> and to invest trust moneys as authorised in the trust instrument or by statute.<sup>76</sup>

## **Need for superannuation trustee duties to be codified**

In 1991, as part of a broader review of the regulatory framework for prescribed interests and like collective investments, the Attorney-General tasked the Law Reform Commission and the Companies and Securities Advisory Committee (the

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<sup>69</sup> Law Reform Commission and Companies and Securities Advisory Committee, *Collective investment vehicles – superannuation*, (Discussion Paper No 50, January 1992), 19.

<sup>70</sup> *In re Speight* (1883) 22 Ch D 727, 739-740 (Jessel MR), *affd Speight v Gaunt* (1883) 9 App Cas 1 (House of Lords). The decision of the House of Lords was followed in *Austin v Austin* (1906) 3 CLR 516.

<sup>71</sup> G E Dal Pont, *Equity and Trusts in Australia* (Lawbook, 5<sup>th</sup> ed, 2011) 636 [22.25].

<sup>72</sup> *Ibid* 636-7 [22.34].

<sup>73</sup> *Ibid* 638-43 [22.40]-[22.65].

<sup>74</sup> *Ibid* 643-49 [22.70]-22.115].

<sup>75</sup> *Ibid* 649-54 [22.120]-22.170].

<sup>76</sup> *Ibid* 654-61 [22.175]-22.220].

Law Commission Review') to provide an interim report on superannuation issues.<sup>77</sup> The interim report was completed in 1992.<sup>78</sup>

The Law Commission Review noted that the statutory framework for superannuation entities lacked any specific reference to trustee duties which was considered to be a deficiency given the principles of trust law were often poorly understood, and could be diluted by specific provisions placed in the trust deeds.<sup>79</sup> It recommended that a statutorily mandated set of fiduciary responsibilities be introduced which clearly defined and identified a minimum standard of trustee behaviour.<sup>80</sup> The advantages of such an approach included a better understanding and awareness of trustees' legal responsibilities which would not be subject to erosion by exemptions in the trust deed; the enhanced ability of a regulator to enforce the statutory fiduciary obligations; and the ability to modify general law trust principles which the legislature may have considered inappropriate in a superannuation context.<sup>81</sup> The Government agreed with this recommendation and a number of general law trustee duties were codified into the *SISA 1993*. The prescribed covenants were deemed to be part of the governing rules of the superannuation fund and could not be removed by the terms of those rules.<sup>82</sup>

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<sup>77</sup> Australian Law Reform Commission and Companies and Securities Advisory Committee, Commonwealth Government, *Collective Investment Schemes* (Issues Paper No 10, 1991).

<sup>78</sup> Law Reform Commission, *Discussion Paper No 50*, above n 6.

<sup>79</sup> Law Reform Commission, *Discussion Paper No 50*, above n 6, 49-50.

<sup>80</sup> *Ibid* 50.

<sup>81</sup> *Ibid* 49.

<sup>82</sup> *SISA 1993* s 8.

## **Trustee covenants included in governing rules of the superannuation fund**

The trustee covenants that are incorporated into the governing rules of the superannuation fund are contained in section 52 of the *SISA 1993*. Although most of the covenants outlined above reflect general law principles, it is arguable that the covenants requiring an investment strategy to be formulated and how to deal with reserves, if any, consistently with that strategy do not reflect any identifiable principle, but rather are a function of the prudential framework.<sup>83</sup>

The investment strategy plays a central role in the ability of the relevant regulator to ascertain whether the trustee of the fund is taking a prudential approach to the administration of the superannuation fund.<sup>84</sup> Despite this, and the stated purpose of the *SISA 1993* as a whole,<sup>85</sup> a contravention of these covenants does not constitute an offence, and only persons affected by the contravention can take action, which in most cases will be the members of the superannuation fund.<sup>86</sup> This is important because such a contravention does not automatically lead to the fund becoming a non-complying fund for the purposes of the income tax concessions noted earlier. Hence, a contravention by a trustee of the covenants prescribed in section 52 of the *SISA 1993* may lead to action against the trustee personally but does not automatically lead to any adverse consequences for the beneficiaries' interest in the fund assets.

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<sup>83</sup> *SISA 1993* s52(e) and (f); see also G E Dal Pont, above n 71, 813-4 [28.80].

<sup>84</sup> Although the prudential requirements are relevant to APRA-regulated funds only, these trustee covenants are applicable to all superannuation entities regulated under the *SISA 1993*. Therefore, trustees of an SMSF must also develop and maintain an investment strategy.

<sup>85</sup> *SISA 1993* s 3(2).

<sup>86</sup> *SISA 1993* s 55.

### 3.3.4 Sole purpose test

The sole purpose test is an obligation placed on the trustee to ensure that the fund is maintained solely for the ‘core’ purposes,<sup>87</sup> or alternatively for one or more core purposes and for one or more ‘ancillary’ purposes.<sup>88</sup> The core purposes essentially relate to providing retirement or death benefits for, or in relation to, members of the fund. The ancillary purposes relate to the provision of benefits on the cessation of a member’s employment and other death benefits and approved benefits not specified under the core purposes.<sup>89</sup> It is the Commissioner’s view, that the sole purpose test requires strict compliance and that ‘[t]he test requires exclusivity of purpose, which is a higher standard than the maintenance of the SMSF for a dominant or principal purpose’.<sup>90</sup>

Given the control that members of an SMSF have as trustees of the SMSF, there is greater potential in the context of SMSFs for a breach of the sole purpose test than in larger superannuation funds. An example where the sole purpose test has been breached involved the use of the SMSF’s assets in the members’ business and hence providing the members the benefit of the assets of the fund before they reached preservation age.<sup>91</sup> In such circumstances, the Commissioner has been provided with a specific discretion to overlook breaches of the sole purpose test.<sup>92</sup>

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<sup>87</sup> *SISA 1993* s 62(1)(a).

<sup>88</sup> *SISA 1993* s 62(1)(b).

<sup>89</sup> It is interesting to note that such benefits were considered to be within the scope of the earlier iterations of the sole purpose test, such as that under *ITAA 1936* s 23(j)(i) because provision of benefits to a member’s dependants on his or her death was considered to be one way of benefiting the employee: *Compton v Federal Commissioner of Taxation* (1966) 116 CLR 233, 248 per Menzies J.

<sup>90</sup> Australian Taxation Office, *Self Managed Superannuation Funds: the application of the sole purpose test in section 62 of the Superannuation Industry (Supervision) Act 1993 to the provision of benefits other than retirement, employment termination or death benefits*, SMSFR 2008/2 (16 July 2008), [7].

<sup>91</sup> *JVNQ and Commissioner of Taxation* (2009) 74 ATR 730.

<sup>92</sup> *SISA 1993* s 42A(5).



The Commissioner has outlined the approach he will adopt when considering this discretion which is further discussed below.<sup>93</sup>

### 3.3.5 Investment choices of the trustee

As was noted above, the trustee of the superannuation fund is ultimately responsible for the outcomes of the superannuation fund. The way the statutory framework is constructed specifically acknowledges that the Parliament can never legislate to completely remove the possibility of fraudulent or criminal behaviour.<sup>94</sup> It was expressly stated at the time the *SISA 1993* package of amendments was announced that ‘supervision [of the superannuation industry] is not designed to override the commercial investment decisions of trustees and managers’,<sup>95</sup> a policy sentiment that has not changed in the 18 years since the *SISA 1993* was introduced. The Assistant Treasurer and Minister for Financial Services and Superannuation at the time of the Cooper review into Superannuation<sup>96</sup> noted that, ‘[a]s investment decisions are rightly a matter for trustees, the Government will not require superannuation fund trustees to make particular investments’.<sup>97</sup> These sentiments have been endorsed recently by the current Government.<sup>98</sup>

However, there are some circumstances in which statutory intervention is required to adjust trustee investment choices. These rules are collectively

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<sup>93</sup> Australian Taxation Office, *Practice Statement Law Administration: self managed superannuation funds - notice of non-compliance*, PS LA 2006/19 (30 November 2006).

<sup>94</sup> See John Kiern, *Prudential supervision* (Federal Treasury paper No. 1, 20 August 1991) [10]; Treasurer, ‘Budget announcement’ (Press release, No. 73, 20 August 1991); John Dawkins, above n 8, 3.

<sup>95</sup> John Dawkins, above n 8, 1.

<sup>96</sup> Super System Review, above n 27.

<sup>97</sup> Commonwealth Government, *Stronger Super* (Policy Announcement, 2010), 13.

<sup>98</sup> Jennifer Hewett, Interview with Assistant Treasurer, Arthur Sinodinos (Financial Services Council AMP Breakfast, 28 November 2013).

'designed to limit the risks associated with superannuation fund investments and to ensure that superannuation savings are preserved until retirement and not accessed for current use.'<sup>99</sup> The focus of the discussion below is on those measures of particular relevance to SMSFs.

### **Limit placed on 'in-house' asset investment**

The 'in-house' asset rule limits the amount of assets a superannuation fund trustee could lend or invest in the sponsoring employer or an associate of the employer to 5% of the costs of the assets of the fund.<sup>100</sup> This provision addressed concerns that if a superannuation trustee were to invest a large proportion of assets in a sponsoring employer's business, the superannuation entitlements of the employees would be at risk in the event the employer's business failed.<sup>101</sup> Not only would the employees lose their jobs in such a situation but also their superannuation entitlements.<sup>102</sup> This rule also limits the extent to which businesses can access relatively cheap and tax-advantaged working capital, especially in the small business sector.<sup>103</sup>

Although a breach of the in-house asset test is possible in the context of larger APRA regulated funds,<sup>104</sup> it is noted that the closely held nature of SMSFs provides

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<sup>99</sup> Productivity Commission, above n 6, 124.

<sup>100</sup> *SISA 1993* s 81-83.

<sup>101</sup> National Superannuation Committee of Inquiry, Commonwealth Government, *Occupational Superannuation in Australia* (1977), 104 [7.13]; Committee of Inquiry into the Australian Financial System, Commonwealth Government, *Australian Financial System: final report of the Committee of Inquiry* (1981), 349 [20.126]; Commonwealth Taskforce on Superannuation, Commonwealth Government, *Occupational Superannuation* (Parliamentary Paper No. 27, 1983), 36 [4.30].

<sup>102</sup> Instances of this dual loss of employment and superannuation benefits occurred in the early 1960's: National Superannuation Committee of Inquiry, above n 101, 104 [7.13].

<sup>103</sup> Super System Review, above 27, 243 [8.2.1].

<sup>104</sup> *Australian Prudential Regulation Authority v Holloway* [2000] FCA 579.

for a higher risk profile in terms of those types of investments, which have the potential to undermine the sector as a whole.<sup>105</sup> For this reason, the Super System Review Panel recommended that the *SISA 1993* be amended to remove the ability of SMSFs to make in-house asset investments.<sup>106</sup> The Government did not support this recommendation stating that to remove the ability of SMSFs to invest in in-house assets would too severely restrict investment choice for SMSF trustees, especially in view of the fact that there is no evidence that in-house investments were detrimental to SMSFs.<sup>107</sup> The Government response, consistent with the prudential regulation approach, treats the trustee's responsibilities, including investment choices, as central to the viability of the superannuation industry.

### **'Non-arm's length income' rules**

In order to understand the intended policy underpinning the 'non-arm's length income' rules,<sup>108</sup> the history and background to the enactment of the predecessor provisions is required. This rule was introduced at a time when superannuation fund income was not subject to tax.<sup>109</sup> Further, at that time, private companies were subject to tax on any undistributed profits retained by them, and it was evident at the time that dividend stripping schemes were being used and contested.<sup>110</sup>

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<sup>105</sup> Super System Review, above n 27, 244 [8.2.1].

<sup>106</sup> Super System Review, above n 27, 244 [Rec 8.12].

<sup>107</sup> Commonwealth Government, *Stronger Super*, above n 97, 49.

<sup>108</sup> *ITAA 1997* sub-div 295-H.

<sup>109</sup> *ITAA 1936* former s 23(j).

<sup>110</sup> See e.g. *Hancock v Federal Commissioner of Taxation* (1961) 108 CLR 258. 'Dividend stripping' in this sense was an arrangement whereby the company owners accessed profits in a tax advantaged way thereby avoiding the imposition of the undistributed profits tax.

The dual problems identified in these arrangements were firstly, the opportunity afforded taxpayers to reduce tax payable on transactions through the combined effect of the unrestricted income tax exemption for superannuation funds and the undistributed profits tax imposed on private companies. Secondly, the income tax exemption for superannuation funds coupled with the concessional tax treatment for superannuation lump sum benefits<sup>111</sup> presented an opportunity for taxpayers to redirect earnings to be received in a virtually tax-free form, thereby inflating income beyond what would otherwise have been received by the taxpayer.<sup>112</sup> This was often achieved through dealings between the superannuation fund and an associate on non-arm's length terms.

To address this anomaly, the Government introduced provisions that required the Commissioner of Taxation to examine each individual case involving private company dividends to determine whether such dividends should be taxed in the hands of the superannuation trustee, irrespective of any exemption that would otherwise apply.<sup>113</sup> These provisions became known as the 'special income' rules.<sup>114</sup>

As part of the Government's overhaul of the superannuation system in 2007,<sup>115</sup> the special income provisions were transferred into the *ITAA 1997*<sup>116</sup> with one significant change. In the *ITAA 1997* provisions, the Commissioner's discretion was

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<sup>111</sup> *ITAA 1936* former s 26(d).

<sup>112</sup> Committee on Taxation, Commonwealth Government, *Report of the Commonwealth Committee on Taxation* (1961) (Ligertwood Committee), [741].

<sup>113</sup> Commonwealth, *Parliamentary Debates*, House of Representatives, October 1963 (Harold Holt).

<sup>114</sup> *ITAA 1936* s 273, as inserted by *Taxation Laws Amendment Act (No 2) 1989* (Cth) sch 1 item 9.

<sup>115</sup> Commonwealth Government, *A plan to simplify and streamline superannuation* (Policy announcement, 9 May 2006).

<sup>116</sup> *ITAA 1997* s 295-550. 'Special income' under the *ITAA 1997* provisions is referred to as 'non-arm's length income'.

replaced by an objective test requiring the amount received to be consistent with an arm's length dealing.<sup>117</sup> The provision continues to apply to private company dividends and income derived from a scheme that is more than what would have otherwise been expected.

It is clear that the focus of the special income rules was to protect the Commonwealth revenue from potential leakage as a result of tax avoidance schemes using superannuation funds. In such circumstances, the protection of member's benefits was of secondary concern — a reasonable approach given that the persons undertaking the schemes were most likely to profit from them in their capacity as members of the superannuation fund in question. There continues to be tax avoidance schemes involving inflated income or a diversion of income from private companies to concessional taxed superannuation funds.<sup>118</sup> The existence of these schemes presents challenges to the Commissioner in his administration of the taxation laws as well as in his role as the regulator of SMSFs. These challenges will be discussed further in Chapter 4.

### **Leveraged investments: prohibition on borrowing**

The purpose of superannuation is to invest assets for the benefit of members in their retirement. Necessarily this objective requires that some limitations be placed in the way in which the assets of the fund can be invested. One such restriction imposed statutorily was the prohibition against the trustee of a

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<sup>117</sup> An 'arm's length' dealing is broadly defined to require an examination of any connection between the parties and any other relevant circumstances: *ITAA 1997* s 995-1(1) (definition of 'arm's length').

<sup>118</sup> Australian Taxation Office, *Taxpayer Alert: Distribution to Superannuation Fund from Interposed Fixed Trust*, TA 2003/1, 11 February 2003; Australian Taxation Office, *Taxpayer Alert: Self-managed superannuation funds deriving income from certain uncommercial trusts*, TA 2008/4, 28 March 2008.

superannuation fund borrowing money except in very specific and limited circumstances.<sup>119</sup> A number of exemptions were included in the statutory regime in acknowledgement that the trustee may be justified in limited circumstances to borrow money. The first exemption inserted into the legislation applied in circumstances where the trustee obtained temporary finance to overcome cash flow problems in the payment of superannuation benefits.<sup>120</sup> A transitional provision was put in place to allow those superannuation funds that had outstanding borrowings to conform with the prohibition by 30 June 1995.<sup>121</sup> This exception continues to exist, albeit in a varied form in the *SISA 1993*.<sup>122</sup>

The purpose of the prohibition is clear: if a trustee were able use the assets of the fund to secure a borrowing of money it would put the assets of the fund at unacceptable risks in the event of default. Hence, this prohibition limits the methods which the trustee of the fund may use to invest the assets of the fund. It is another example where the Government has determined that it was necessary to intervene to limit the discretion of trustees of superannuation funds.

More recently, due to developments in the fund investment market, a further exception was legislated. That exception allowed trustees of superannuation funds to borrow money under a limited recourse borrowing arrangement, generally using an instalment warrant, to acquire assets for the superannuation fund.<sup>123</sup>

Under such arrangements an investor, in this case the trustee of the

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<sup>119</sup> OSSR 1987 reg 16(1)(c), repealed and replaced by *SISA 1993* s 67-67B. See also Australian Taxation Office, *Self Managed Superannuation Funds: the meaning of 'borrow money' or 'maintain an existing borrowing of money' for the purposes of section 67 of the Superannuation Industry (Supervision) Act 1993*, SMSFR 2009/2, 8 April 2009.

<sup>120</sup> OSSR 1987 reg 16(5).

<sup>121</sup> OSSR reg 16(3), (3A)(b).

<sup>122</sup> *SISA 1993* s 67(2).

<sup>123</sup> *SISA 1993* s 67A-67B, inserted by *Superannuation Industry (Supervision) Act 2010* sch 1 item 1.

superannuation entity, purchases an asset by means of one or more instalments. The asset is held on trust for the superannuation trustee to provide limited security for the outstanding loan. The benefits of ownership, for example dividends or rent, flow to the trustee as beneficial owner of the asset. If there is a default, the rights of the lender are limited to the asset the subject of the arrangement, thus protecting the other assets held by the superannuation trustee.<sup>124</sup>

It is apparent from this description that provided the specified conditions are met, the other assets of the superannuation fund would not be put at risk. This is because the only asset to which the lender has recourse in the event of a default is the asset under the instalment warrant. A breach of the prohibition, perhaps by way of failure to satisfy the conditions of this limited exception, may expose the trustee of the fund to civil and criminal sanctions.<sup>125</sup> It may also result in the superannuation fund becoming a non-complying fund and losing its tax concessions.<sup>126</sup>

What is interesting about this exception is that the provisions specifying the conditions for the exception require the Commissioner of Taxation, as the regulator of SMSFs, to examine the details of the arrangement entered into between the trustee and the lender to determine whether the exception applies. In effect, the Commissioner is required in practice to approve of the investment that the trustee has made. This creates a situation that is somewhat unique in the context of the other provisions in the *SISA 1993* and the basis of the statutory framework, which is predicated on the assumption that sole responsibility for

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<sup>124</sup> Explanatory Memorandum, Superannuation Industry (Supervision) Bill 2010 [1.3].

<sup>125</sup> *SISA 1993* s 67(7), 193 and Part 21.

<sup>126</sup> *SISA 1993* s 42 (for superannuation funds other than SMSFs) and s 42A for SMSFs.

investment decisions rests with the trustee. The scope of the exemption has been the subject of numerous discussions between the superannuation industry and the Australian Taxation Office and continues to be an issue of contention.<sup>127</sup> Whether this shift in Government policy has broadened what trustees can do or whether it has, in effect, subjected trustees to further scrutiny by the regulator is discussed further in Chapter 4.

### **3.3.6 Preservation and vesting of benefits**

As noted in Chapter 2, under the *ITAA 1936* lump sum payments made to employees on resignation or cessation of work were taxed at concessional rates. Superannuation benefits were not preserved until retirement and were often paid out to leaving employees as a lump sum. Such practices created an expectation in employees that superannuation provisions were a form of deferred remuneration rather than a store of savings to be accessed only on retirement or disablement. Depending on the terms of the governing rules of the superannuation fund, former employees may not in fact receive any benefit on leaving an employer, and the entitlements accrued would be incorporated into the benefits to be paid to the remaining members. Further, the amount of the superannuation benefits paid, even on retirement, at times did not fully reflect entitlements accrued to the member.

In 1979, the Fraser Government established a Task Force to consider occupational superannuation and review the need to make standards for the operation of such

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<sup>127</sup> See e.g. Australian Taxation Office, 'National Tax Liaison Group Superannuation Technical Sub-group minutes' (Minutes of meeting, 8 December 2010), agenda item 6.



schemes.<sup>128</sup> That Task Force in its 1983 report made recommendations that mandatory vesting and preservation rules should be included in the standards imposed on superannuation funds.<sup>129</sup> The Government accepted those recommendations.<sup>130</sup>

The most notable law change made was the removal of concessional taxation treatment for lump sums paid from superannuation funds to a member who had ceased work for a particular employer, unless the lump sum was transferred to another superannuation fund or similar investment vehicle.<sup>131</sup> The current provisions of the *SISR 1994* maintain the standards in relation to preservation and vesting in the form of benefit protection standards containing rules such as minimum benefits payable and payment standards which specify conditions of release of benefits.<sup>132</sup>

The preservation and vesting standards are of particular relevance to SMSFs given the closely-held nature of those entities. Recently promoters of schemes directed at early release of superannuation benefits, using SMSFs to access those benefits, were prosecuted by ASIC and given jail terms.<sup>133</sup> The problem of early illegal release continues to be a challenge for the regulators and the Government alike.<sup>134</sup>

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<sup>128</sup> John Howard, *Superannuation* (Press Release No. 68, 12 July 1979).

<sup>129</sup> Commonwealth Task Force, Commonwealth Government, *Occupational Superannuation* (1983).

<sup>130</sup> Commonwealth Government, *Economic Statement* (Policy Statement, 19 May 1983).

<sup>131</sup> *Income Tax Assessment Amendment (No. 3) Act 1984*, s 15.

<sup>132</sup> *SISR 1994* Parts 5-6 respectively.

<sup>133</sup> During 2010, sentences were handed down to two scheme operators: one, who retained \$605,000 in commissions, received two-years imprisonment, and a promoter who distributed more than \$260,000 to nine people and received over \$70,000 in commissions received 12 months jail: Australian Securities and Investment Commission, 'Sydney man sentenced on early access to super charges' (Media Release, 10-66AD, 29 March 2010).

<sup>134</sup> See e.g. Michael D'Ascenzo, 'Self-managed super: making sure it works for you and the community' (Speech delivered at the SMSF Professionals Association of Australia (SPAA) 2011 National Conference, Brisbane, 23 February 2011; Senate Select Committee on Superannuation and Financial Services, Commonwealth Parliament, *Early Access to Superannuation Benefits* (2002).

These issues are discussed further in the context of the regulator's powers below.

### **3.3.7 Obligations placed on third parties**

A large number of SMSF trustees engage third parties to assist with various aspects of the management of the fund. The statutory framework extends to regulation of the behaviour of and imposes responsibilities on third parties such as auditors, actuaries and investment managers.<sup>135</sup> Approved auditors in particular play a crucial role in the regulation of superannuation funds, in particular the SMSF sector. The accounts of an SMSF must be audited annually before the SMSF's annual return is lodged with the Commissioner. If an auditor uncovers a breach of a regulatory provision, the breach must be reported to the Commissioner. The Commissioner has acknowledged the role auditors play in the supervision of SMSFs, particularly by reference to the sheer number of SMSFs.

The important function auditors serve was specifically noted by the Cooper Review,<sup>136</sup> which noted that concerns had been raised as to whether there was a sufficient skill level obtained by SMSF auditors and whether there was sufficient independence of auditors from the SMSF which they were auditing. In order to address these issues, the Review recommended that a minimum level of skill be required of an approved auditor in order to conduct an audit of an SMSF and that disclosures should be made as to the relationship of the auditor to the SMSF and other third parties the SMSF trustees may have engaged (such as investment managers).<sup>137</sup> These recommendations have been accepted in principle by the

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<sup>135</sup> *SISA 1993* Parts 4, 16, 26.

<sup>136</sup> Super System Review, above n 27.

<sup>137</sup> Super System Review, above n 27, 238 [Rec 8.8].

Government, but are subject to further recommendations from a working group formed to examine the recommendations made in relation to SMSFs as a whole.<sup>138</sup>

### **3.3.8 Other provisions**

Other matters covered in the *SISA 1993* are focused on disclosure by larger APRA-regulated funds to their members and include provisions dealing with how the accounts and statements of such entities must be maintained and the information which must be made available to members either on taking up a particular product offered by the fund or on the request of the member. There are also provisions dealing with tax file number matters.<sup>139</sup>

Financial assistance is provided to certain superannuation entities in the event of theft and fraud.<sup>140</sup> Importantly, SMSFs are not entitled to any financial assistance under these provisions. This reflects the Government's policy that SMSF members should bear all the risks of investing in such a vehicle.

## ***3.4 Tools available to the regulator to address contravention of regulatory provisions***

In order to address breaches of the *SISA 1993*, combat schemes entered into by superannuation fund trustees to take advantage of tax concessions and deter those wanting to promote such schemes, the *SISA 1993* includes whistle blower provisions, imposes requirements in relation to record keeping and includes powers of investigation by the regulator. To enforce compliance with those

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<sup>138</sup> Commonwealth Government, *Stronger Super*, above n 97, 48.

<sup>139</sup> *SISA 1993* 25A, 32.

<sup>140</sup> *SISA 1993* Part 23.

obligations, the regulators are able to seek civil and criminal penalties through court action.<sup>141</sup> The specific type of sanction will vary depending on the relevant provision contravened.

In addition to the civil or criminal sanction specified in the relevant provision, the regulator is also able to revoke the superannuation fund's complying status, which results in the removal of income tax concessions.<sup>142</sup> The regulator is also able to disqualify the trustee from that role;<sup>143</sup> freeze the fund's assets if there is a risk of member's benefits being eroded<sup>144</sup> and accept a court enforceable undertaking from the trustee to rectify the contravention.<sup>145</sup> Whether the current breadth of sanctions available to the regulators is effective in the superannuation context is considered against the backdrop of responsive regulation theory in the next section.

### **3.4.1 Administrative directions and penalties**

#### **Enforceable undertakings**

The enforceable undertaking provision in the *SISA 1993* mirrors similar provisions in section 87B of the *Trade Practices Act 1974* and section 93AA of the *Australian Securities and Investments Commission Act 1989* ('ASIC Act'), and was designed to provide the Regulator with a flexible and efficient enforcement tool. This compliance tool has proven to be useful in the context of SMSFs: in 2009-10 the

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<sup>141</sup> *SISA 1993* Part 21.

<sup>142</sup> *SISA 1993* s 42 for APRA-regulated funds and *SISA 1993* s 42A for SMSFs. Each regulator has a discretion to continue to treat the superannuation fund as a complying fund in specified circumstances.

<sup>143</sup> *SISA 1993* s 126A.

<sup>144</sup> *SISA 1993* s 264.

<sup>145</sup> *SISA 1993* s 262A.

ATO entered into 207 enforceable undertakings.<sup>146</sup> There are guidelines the ATO follows when determining whether to accept an enforceable undertaking.<sup>147</sup> It is there noted that ‘an undertaking will not be accepted if the contravention cannot be rectified, there are criminal consequences, the behaviour of the trustee indicates the trustee is unlikely to comply or the nature and the seriousness of the contravention indicates it would be inappropriate to accept an undertaking’.<sup>148</sup>

What is peculiar about the enforceable undertaking provisions is that the offer to rectify and the terms of the undertaking must come from the trustees of the superannuation fund.<sup>149</sup> The regulator, the Commissioner in the case of SMSFs, then may accept or reject the undertaking. In deciding whether to accept an enforceable undertaking, the regulator must satisfy itself that the action that is proposed will rectify the contravention and ensures that breaches are not repeated.<sup>150</sup> It has been established that Administrative Appeals Tribunal’s powers extend to deciding, in an appropriate case, that the Commissioner should accept a written undertaking.<sup>151</sup>

If the issue becomes one where the Administrative Appeals Tribunal is involved, the regulatory tool becomes much less cost-effective. Such an approach is also premised on the assumption that the SMSF trustee properly understands his or her

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<sup>146</sup> Australian Taxation Office, Australian Government, *Annual Report 2009-10* (7 October 2010), 94.

<sup>147</sup> Australian Taxation Office, Commonwealth Government, *Self-managed superannuation funds – enforceable undertakings* (Practice Statement PS LA 2006/18, 30 November 2006).

<sup>148</sup> *Ibid* [19].

<sup>149</sup> This is apparent from the terms of *SISA 1993* s 262A(1) which states that the regulator ‘may accept a written undertaking given by a person in connection with a matter in relation to which the Regulator has a function or power under this Act’.

<sup>150</sup> *ZDD and Commissioner of Taxation* [2011] AATA 3, [101].

<sup>151</sup> *Australian Securities and Investments Commission v Donald* [2003] FCAFC 318; *Re XPMX and Commissioner of Taxation* [2008] AATA 981. Further, in the context of the *ASIC Act* ss 93A and 93AA, it has been determined that the Administrative Appeals Tribunal can decide the terms of the undertaking: *Daws and Australian Securities and Investment Commission* [2006] AATA 246.

*SISA 1993* obligations and the nature of the contravention such that a proposed course of action can be suggested to the regulator, which is capable of rectifying such a breach. In some cases, this is not the reality and without the prerequisite knowledge, the enforceable undertaking tool cannot be applied.

The scope of activities that may be offered under an enforceable undertaking could include undertaking education, withdrawing from trusteeship for a period of time or compensating fund members or others whose interests have been harmed by the contravention.

### **Rectification directions**

For contraventions after 1 July 2014, in addition to the enforceable undertaking mechanism, the Commissioner may decide to issue rectification directions for breaches of the *SISA 1993*.<sup>152</sup>

### **Education directions**

For contraventions after 1 July 2014, where the contravention has occurred due to a lack of knowledge or understanding by the trustee, an education direction may be appropriate.<sup>153</sup> This administrative direction provides the Commissioner with a more flexible tool to address those contraventions which may have been made inadvertently by SMSF trustees who are generally compliant but are perhaps relatively new to being an SMSF trustee or who have not been aware of changes to the superannuation rules.

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<sup>152</sup> *SISA 1993*, s 159.

<sup>153</sup> *SISA 1993*, s 160.

## Administrative penalties

Where a trustee contravenes a specific provision of the *SISA 1993*, an administrative penalty will be imposed.<sup>154</sup> For example a maximum of 60 penalty points can be applied to breaches of the in-house asset test or the restrictions on borrowing outlined above. These penalties are in addition the administrative penalties imposed under the *Taxation Administration Act 1953* ('*TAA 1953*') to circumstances where trustees of SMSFs have failed to lodge documents or have made false and misleading statements on or after 1 July 2007.<sup>155</sup>

Prior to these amendments, the only sanction available to the Commissioner in circumstances where the trustee failed to lodge documents or made a false or misleading statement in a document was to commence court action, which required him to establish that the trustee had intentionally not lodged the return in order to have a criminal fine imposed.<sup>156</sup> The standard of proof was the criminal standard – beyond a reasonable doubt – which was very difficult to prove. Hence, the effectiveness of the penalty was lost because of the regulator's inability to use it in practice. The only other sanction available prior to the amendments in 2007 was for the Commissioner to make the SMSF a non-complying fund, thereby removing the fund's access to taxation concessions. This sanction also appeared too harsh for the type of contravention involved and would unduly impact on the members of the SMSF.

The introduction of an administrative penalty framework allows the

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<sup>154</sup> *SISA 1993*, s 166.

<sup>155</sup> *TAA 1953* s 288-75(5)-(6) and s 288-85; *SISA 1993* s 38A(ab).

<sup>156</sup> *SISA 1993* s 35D.

Commissioner more flexibility in applying his compliance model in an SMSF context. This is discussed in more detail in Chapter 4.

### **3.4.2 Civil penalty provisions**

#### **Outline of the civil penalty provisions in the SISA 1993**

Certain regulatory provisions in the *SISA 1993* may attract a civil penalty when contravened. These provisions include the sole purpose test, the prohibition against providing loans to members, the limitations on borrowings by trustees, the in-house asset rules and the requirement that investments by trustees be at arm's length.<sup>157</sup>

A Regulator may apply to a court for the application of a civil penalty order against a trustee or director of a corporate trustee who has contravened a civil penalty provision.<sup>158</sup> If the court determines that a person has by a specified act or omission contravened a civil penalty provision, then the Court is to make a declaration to that effect. Only where the contravention is 'serious' can the Court make an order imposing a monetary penalty.<sup>159</sup> When a contravention is a serious one is not specified in the legislation. Hence, the term takes its ordinary meaning, which has been held to mean 'not trifling or superficial'.<sup>160</sup> Most cases to date have

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<sup>157</sup> See *SISA 1993*, s 193 for a full list of provisions which, if contravened, may attract a civil penalty. Each of the listed provisions is discussed in Chapter 3.

<sup>158</sup> *SISA 1993* s 197(1). If the matter is also a criminal offence under *SISA 1993* s 202, then the Commonwealth Director of Public Prosecutions may be the relevant applicant: *SISA 1993* s 197(3). A 'Regulator' is defined as APRA, the Commissioner of Taxation or ASIC depending on whether the specific provision falls within the agency's general administration as specified in *SISA 1993* s 6. Note that only APRA and the Commissioner have the general administration of the civil penalty provisions: *SISA 1993* s6(1)(a)(ix) and 6(1)(e)(v) respectively.

<sup>159</sup> *SISA 1993* s 196(3) & (4).

<sup>160</sup> *Olesen v MacLeod* [2011] FCA 229, [47] ('*MacLeod*'), see also *Olesen v Eddy* [2011] FCA 13, [21]-[22] ('*Eddy*').



involved a breach of the sole purpose, the in-house asset or the prohibition against lending to members and associates - provisions that are considered to be 'integral to the regulatory scheme' in the SISA.<sup>161</sup>

The maximum amount of monetary penalty for each contravention is 2,000 penalty units, which equates to \$340,000.<sup>162</sup> Quite often, the same conduct by the trustee could result in the contravention of multiple provisions of the *SISA 1993*, however, the courts have applied the totality principle in determining the appropriate level of penalty. The totality principle in sentencing was explained by Weinberg J in *Australian Prudential Authority v Derstepanian*.<sup>163</sup> In that case the Court found that the trustees had contravened the sole purpose requirement and the duty to invest at arm's length,<sup>164</sup> both of which are civil penalty provisions. In determining the amount of penalty to impose, Weinberg J stated:

In essence, ss 62(1) and 109(1) are simply different ways of characterising the same misbehaviour. It is a well-recognised principle of sentencing that a person not be punished twice for what is, in substance, the same conduct, even if that conduct can be viewed as giving rise to two separate offences.<sup>165</sup>

This concept of a single contravening course of conduct, which has the effect of limiting the maximum penalty under the civil penalty provisions to \$340,000 has been applied in subsequent cases involving SMSF trustees. Hence, despite the trustee having illegally accessed the amounts in his SMSF on 160 separate

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<sup>161</sup> *MacLeod* [2011] FCA 229, [47], see also *Eddy* [2011] FCA 13, [21]-[22].

<sup>162</sup> *SISA 1993* s 196(3) read with *Crimes Act 1914* (Cth) s 4AA.

<sup>163</sup> [2005] FCA 1121.

<sup>164</sup> *SISA 1993* s 62(1) and s 109(1) respectively.

<sup>165</sup> *Australian Prudential Authority v Derstepanian* [2005] FCA 1121, [31] ('*Derstepanian*').

occasions over a period of years, the Federal Court in *Olesen v Eddy*<sup>166</sup> applied the totality principle such that the various contraventions were said to be properly seen as one contravening course of conduct to which the trustee should be liable to a maximum penalty, which at the time was \$220,000.<sup>167</sup>

## **Statutory defences**

Certain statutory defences are available to a person (the 'defendant'), against whom civil penalty declarations are sought. The onus of proof is on the defendant to show that the contravention was due to reasonable mistake; or reasonable reliance on information supplied by another person; or was due to an act or default of another person, or an accident or some other cause beyond the defendant's control and that in those circumstances the defendant took reasonable precautions and exercised due diligence to avoid the contravention.<sup>168</sup> In respect of civil penalty proceedings where the proceeding is not for an offence, the person may also apply to the Court for an exercise of discretion to relieve the person wholly or partly from the penalty which would otherwise be imposed. In this case, the Court must have determined that the person acted honestly and, having regard to all the circumstances of the case, the person ought fairly to be excused for the contravention.<sup>169</sup>

The application and interaction of these defences was considered in *Dolevski v*

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<sup>166</sup> [2011] FCA 13.

<sup>167</sup> *Eddy* [2011] FCA 13, [32]. The same principle was applied in *Ralene Vivian, suing in her capacity as the Deputy Commissioner of Taxation (Superannuation) v Fitzgeralds* [2007] FCA 1602, [31]-[32] ('*Fitzgeralds*').

<sup>168</sup> *SISA 1993* s 323.

<sup>169</sup> *SISA 1993* s 221.

*Hodpik Pty Ltd* ('*Hodpik*').<sup>170</sup> The parties to this proceeding included *Hodpik Pty Ltd*, the corporate trustee of a SMSF and the two directors of that corporate trustee as persons involved in the contraventions,<sup>171</sup> which were essentially contraventions of the sole purpose requirement, the in-house asset test and the arm's length investment rules, which are all civil penalty provisions.<sup>172</sup>

The defendants argued that the contraventions were due to reasonable reliance on information supplied by another person or were due to reasonable mistake, and alternatively, absent any such defences, they acted honestly and having regard to all the circumstances the Court should find that each of them ought fairly be excused for the contraventions.

Yates J held that the fact that the defendants did not consult the trust deed before or after they had been given the information by their accountant did not mean that their reliance on that information was not reasonable in all the circumstances.<sup>173</sup> The Court further noted that a contravention of the civil penalty provisions is a serious matter, but that the legislation provides a specific defence, which indicated that in certain circumstances despite the seriousness of the contravention a person who has acted honestly should be relieved from the consequences of such action.<sup>174</sup> Hence, to the extent that the person cannot rely on the other defences specified in the *SISA 1993*, if the person can establish that they were acting honestly, then the Court may exercise its discretion to excuse them from the consequences of the contravention.

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<sup>170</sup> [2011] FCA 54.

<sup>171</sup> *SISA 1993* s 194.

<sup>172</sup> *SISA 1993* ss 62(1), 84(1) and 109(1) respectively.

<sup>173</sup> *Dolevski v Hodpik Pty Ltd* [2011] FCA 54, [63].

<sup>174</sup> *Ibid* [71]-[73].

The result of the *Hodpik* case might suggest that so long as an SMSF trustee, or indeed any superannuation fund trustee, can provide evidence that they relied on advice given to them they may be able to escape the consequences of what are considered generally to be serious contraventions. Such a result brings into question the effectiveness of the civil penalty provisions as a deterrence tool, particularly in relation to the SMSF sector where many of the trustees had set up and are running their SMSFs on the basis of professional advice.<sup>175</sup> These issues are also important within a SMSF context, partly because the civil penalty provisions in the *Corporations Act 2001* provided the model on which the civil penalty provisions in the *SISA 1993* have been developed, and hence could be vulnerable to the same weaknesses now being exposed, but also because SMSF trustees which are constitutional corporations are also subject to the *Corporations Act 2001* requirements. The effectiveness of the civil penalty provisions contained in the *Corporations Act 2001 (Cth)* and use of those sanctions within the enforcement pyramid are discussed further below.

### **When a contravention of a civil penalty provision is a criminal offence**

Where a person contravenes a civil penalty provision dishonestly, and intending to gain (whether directly or indirectly) an advantage for themselves or another person; or the person is intending to deceive or defraud someone, then the person is guilty of a criminal offence and may be imprisoned on conviction for not longer

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<sup>175</sup> The reliance that SMSF trustees place on professional advisors was a specific issue examined in the Super System Review, which made recommendations that advisors, in particular tax agents and accountants, obtain a financial services license from ASIC before they can advise on SMSF issues: Super System Review, above n 27, 235. The Government's response to this issue is part of its *Future of Financial Advice* reforms: Commonwealth Government, *Stronger Super* (Information Pack, 21 September 2011), 17.

than 5 years.<sup>176</sup> Criminal charges cannot be pursued in the Federal Court, but rather must be commenced in either the Local or District Court of the relevant State in which the contraventions were said to have occurred.<sup>177</sup> The concepts of 'dishonesty', 'deception' and 'fraud' are all determined by reference to Chapter 2 of the *Criminal Code 1985 (Cth)*.<sup>178</sup>

The criminal offence provisions have been applied successfully on two occasions in the case of Atan Ona Kassongo in 2008 and Gerard Little in 2009. In each case, the trustee of an SMSF was convicted of dishonestly failing to ensure that the fund was maintained in accordance with the sole purpose test. In the first matter, Mr Kassongo was the promoter of an illegal early release scheme whereby the preserved benefits of 192 superannuates, totaling approximately \$4.055 million was transferred from 56 complying superannuation funds to the Kassongo Superannuation Fund (KSF). Mr Kassongo then used the KSF to withdraw and distribute the funds to the superannuants and agents engaged by him to assist in the early release scheme. He had received \$600,000 by way of commission for his services. Mr Kassongo was sentenced on 29 March 2010 to two years imprisonment, to be released after eight months, with release conditional upon entering a \$1,000 security to be of good behaviour for a period of three years.<sup>179</sup>

Although these convictions were secured under the offence provisions in the *SISA 1993*, it is apparent that illegal early access schemes continue to be marketed and

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<sup>176</sup> *SISA 1993* s 202.

<sup>177</sup> *SISA 1993* s 202(3).

<sup>178</sup> *SISA 1993* s 9A.

<sup>179</sup> Australian Securities and Investment Commission, 'Sydney man sentenced on early access to super charges' (Media Release, AD10-66, 29 March 2010).

remain a concern for the Commissioner.<sup>180</sup> Historically, part of this is due to the fact that those superannuates who secured the early release of their retirement benefits through such schemes are subject to the same taxation rules as those who have obtained early access to their benefits legally under the special release rules contained in the *SISA 1993*.<sup>181</sup> Although such persons may also be subject to penalties and interests for not declaring the income on their individual tax returns, it has been suggested that such sanctions are not effective deterrents.<sup>182</sup>

For schemes entered into on or after 18 March 2014, a system of penalties applies to promoters of illegal early release schemes.<sup>183</sup> Both the terms ‘promote’ and ‘scheme’ have been defined broadly in an attempt capture any future innovations in this area.<sup>184</sup> These provisions are yet to be tested.

### **3.4.3 Strict liability, fault liability and two-tier criminal liability provisions**

The *SISA 1993* contains 5 types of criminal penalty provision: civil penalty, strict liability, fault liability, two-tier strict and fault liability and civil liability. Criminal penalties may apply to contraventions of *SISA 1993* provision imposing notification,

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<sup>180</sup> Michael D'Ascenzo, Australian Taxation Office, ‘Self-managed super: making sure it works for you and the community’ (Speech delivered at SMSF Professionals Association of Australia (SPAA) 2011 National Conference, Brisbane, 23 February 2011); Stuart Forsyth, Australian Taxation Office, ‘Self-managed super funds in the post-reform landscape’ (Speech delivered at Small Independent Super Funds Association SMSF Forum, Melbourne, 5 September 2011).

<sup>181</sup> The situations in which a superannuant is able to access superannuation savings before retirement or permanent disability are subject to the terms of the trust deed of the particular fund. In certain specified circumstances, APRA may authorize early release of superannuation benefits on compassionate grounds: *SISA 1993* s 31(2)(h). Amounts received from the superannuation fund are included in the superannuant’s assessable income and assessed at the person’s marginal tax rate: *Income Tax Assessment Act 1997 (Cth)* s 304-10(4).

<sup>182</sup> Super System Review, above n 27, 256-7.

<sup>183</sup> *SISA 1993*, s 68B.

<sup>184</sup> *SISA 1993*, s 68B(3).

reporting, disclosure, licensing and record keeping requirements.<sup>185</sup> The *Criminal Code Act 1995* ('*Criminal Code*'), in particular Chapter 2 of the *Criminal Code*, applies to all offences under the *SISA 1993*.<sup>186</sup>

## **Fault liability provisions**

Under the *Criminal Code* there is a distinction between the physical acts constituting the offence, referred to as the 'physical elements' of the offence,<sup>187</sup> for which there is an accompanying *mens rea* or the 'fault elements' of the offence.<sup>188</sup> For example, under the *SISA 1993*, a trustee may be guilty of an offence if the prosecution can establish that he or she contravened a prescribed operating standard intentionally or recklessly.<sup>189</sup> The physical element of this offence is the contravention of the prescribed operating standard, which can be described as either conduct or the result of conduct undertaken by the trustee. The fault elements of this offence refer to the trustee's state of mind or intention when undertaking that conduct – in this case, the trustee meant to engage in that conduct<sup>190</sup> or the trustee was aware of a substantial risk that the result will occur and having regard to the circumstances known to him or her, it is unjustifiable to

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<sup>185</sup> Stronger Super Governance Working Group, Commonwealth Government, *Issues paper on providing APRA with an administrative power to impose fines* (April 2011), 4-11 contains a complete list of provisions under the *SISA 1993* which attract a criminal penalty.

<sup>186</sup> *SISA 1993*, s 9A.

<sup>187</sup> A physical element of the offence is defined to mean: conduct; or a result of conduct; or a circumstance in which conduct or a result of conduct occurs: *Criminal Code*, Ch 2 cl 4.1.

<sup>188</sup> There are four types of fault elements specified: intention, knowledge, recklessness or negligence, although a customized fault element may be created in a Commonwealth statute: *Criminal Code*, Ch 2 cl 5.1. The default fault elements prescribed in the *Criminal Code* are intention where the physical element is conduct, and recklessness where the physical element is a circumstance or a result of conduct: Ch 2 cl 5.6.

<sup>189</sup> *SISA 1993*, s 34(2).

<sup>190</sup> *Criminal Code*, Ch 2 cl 5.2.

take the risk.<sup>191</sup>

## **Strict liability provisions**

The *Criminal Code* also makes provision for the establishment of strict liability offences. These types of offences are defined by the absence of any fault elements and the availability of the defence of mistake of fact in addition to the general defences.<sup>192</sup> As noted above, in 2001, many fault offences were amended to become strict liability or two-tier liability offences. The reason for this was because of the difficulties the Regulators had in bringing prosecution action where the breach appeared to be blatant and deliberate but the Regulator was unable to prove the fault elements, such as intention or recklessness, of the offence.<sup>193</sup> Further, APRA contended at the time that many of the fault liability offence provisions, which involved conduct such as a failure to act were virtually unenforceable because the evidence as to intention or recklessness was often difficult to obtain.<sup>194</sup>

It has been noted that the value in using strict liability offences is that it makes prosecution of offenders more straightforward, but that this advantage needs to be weighed against the inability to differentiate between persons that intentionally flout the law and those that make their best efforts to comply, which may lead to

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<sup>191</sup> *Criminal Code*, Ch 2 cl 5.4.

<sup>192</sup> *Criminal Code*, Ch 2 cl 6.1.

<sup>193</sup> Senate Select Committee on Superannuation and Financial Services, Commonwealth Parliament, *Report on the provisions of the Financial Sector Legislation Amendment Bill (No. 1) 2000* (August 2000), 9.

<sup>194</sup> *Ibid.* See also Explanatory Memorandum, Financial Sector Legislation Amendment Bill (No. 1) 2000, 19



resentment on the part of the latter.<sup>195</sup> However, the *Criminal Code* does specifically provide for the defence of mistake of fact to be applied in such circumstances so as to provide trustees with the opportunity to explain the circumstances of the breach.<sup>196</sup> The advantage of using such a defence is that if established on the balance of probabilities, the onus reverts to the prosecution to prove beyond reasonable doubt that subjectively the belief was not held, or that objectively it was not a reasonable belief to hold in the circumstances.<sup>197</sup>

## **Two-tier strict and fault liability provisions**

In order to address some of the evidentiary issues encountered by the Regulators in prosecuting fault liability provisions,<sup>198</sup> a new type of criminal offence was introduced into the *SISA 1993*. The two-tier structure maintained the fault liability offence within the relevant provision but added as an alternative a strict liability offence that imposed a lower rate of penalty. The Regulator must choose which of the offences it will commence prosecution action under. If the Regulator is unsuccessful, it cannot then pursue action under the alternative limb.

The advantage for the Regulator in this structure is that the prosecution for the offence can be tailored to the evidence the Regulator is able to collect. Also, depending on the nature of the contravention, that is whether it is a breach of the reporting requirements or a failure to give information to the Regulator, the sanction applied can be proportionate to the offence.

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<sup>195</sup> Treasury, Commonwealth Government, *Review of Sanctions in Corporate Law* (Consultation Paper, April 2007), 15.

<sup>196</sup> *Criminal Code*, Ch 2 cl 9.2. The defence of mistake of fact is established where a person considered whether or not facts existed, and is under a mistaken but reasonable belief about those facts; and had those facts existed, the conduct would not have constituted an offence.

<sup>197</sup> *Criminal Code*, Ch 2 Div 13.

<sup>198</sup> Senate Select Committee on Superannuation and Financial Services, above n 193, 9.

### 3.4.4 Loss of taxation concessions

#### **Overview of income tax concessions available to complying superannuation funds**

As was explained above, generally, during the period when superannuation savings are accumulated in the fund, the income of the fund is taxed at a concessional rate of 15%,<sup>199</sup> and the fund is also entitled to a refund of franking credits on dividend payments made in relation to share investments.<sup>200</sup> It is also eligible for a discount in relation to any capital gains incurred on disposal of assets.<sup>201</sup> Once the fund commences to pay a pension<sup>202</sup> to its members, then the income derived from assets used to support the payment of the pension, including any realised capital gains from the disposal of the assets, is exempt from income tax.<sup>203</sup>

Given the company tax rate is 30%, and a fully franked dividend would carry a credit for tax paid at the company level at that rate, it is conceivable that a superannuation fund could construct an investment strategy which would minimize additional tax payable during the member's accumulation phase, and produce tax-free returns to members once they commence receiving a pension. Taking into account the fact that persons over 60 receive superannuation

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<sup>199</sup> *Income Tax Rates Act 1986*, s 26(1) ('ITRA'). Note that the non-arms length component of a complying superannuation fund's income is taxed at the highest marginal rate of 45%: *ITRA*, s 26(2). The income of a superannuation fund includes employer contributions and individual contributions where the individual has elected to claim a deduction for the contributions: *Income Tax Assessment Act 1997*, s 295-160 and s 295-190 respectively ('ITAA 1997').

<sup>200</sup> *ITAA 1997*, s 67-25 and Div 207.

<sup>201</sup> *ITAA 1997*, Div 115.

<sup>202</sup> Otherwise referred to as a 'superannuation income stream' from 1 July 2007: *ITAA 1997*, s 995-1, definition of 'superannuation income stream'.

<sup>203</sup> *ITAA 1997*, ss 295-385 – 295-390.

payments tax-free,<sup>204</sup> whilst also enjoying tax exempt returns within the superannuation fund, the taxation advantages of superannuation investments are obvious.

However, a superannuation fund that becomes a non-complying superannuation fund in a year of income is taxed at the highest marginal rate, that is 45%, on the total market value of its accumulated assets less any undeducted contributions.<sup>205</sup> This amounts to a claw-back of the taxation concessions received by the superannuation fund whilst it was treated as a complying fund – a taxation result which can be described not merely as a recoupment of tax foregone by the Revenue but to also have a punitive element. Further, the fund loses access to other taxation concessions such as the exemption for income derived from assets used to support payment of a pension, the capital gains tax discount and the ability to accept employer contributions under the *Superannuation Guarantee (Administration) Act 1992 (Cth)*.

A superannuation fund may continue to be treated as complying even if the trustee contravened a regulatory provision so long as the entity did not fail the culpability test if is an APRA-regulated fund,<sup>206</sup> or the Commissioner exercises his discretion to continue to treat the fund as a complying fund.<sup>207</sup> In exercising this discretion, the Commissioner is required to take account of the taxation consequences which would arise if the SMSF were to become a non-complying fund, the seriousness of

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<sup>204</sup> *ITAA 1997*, s 301-10.

<sup>205</sup> *ITAA 1997*, 295-325; *ITRA 1986*, s 26(3).

<sup>206</sup> *SISA 1993* s 42(1).

<sup>207</sup> *SISA 1993* s 42A(5)(b).

the contravention and all other relevant circumstances.<sup>208</sup>

Whether a contravention is a serious one is determined by reference to all of the facts and circumstances of the case. It has been held that the fact that the fund may have not suffered any loss as a result of the contravention does not mean that the contravention itself is not serious if a substantial amount of the fund's assets have been put at risk.<sup>209</sup> Further the number of contraventions<sup>210</sup> and whether the contravention could be considered to be serious in the context of the legislative framework as a whole are other relevant considerations.<sup>211</sup> Other relevant circumstances which may be taken into account are whether the trustee has rectified the contravention; the trustee's level of skill and knowledge; the compliance history of the fund before and after the contravention; and the events which led to the contravention and whether these influenced the trustee's decision.<sup>212</sup>

## **Limitations on Commissioner's discretion**

Loss of a superannuation fund's complying status could cause the fund to lose the bulk of its assets in taxation. Therefore, the Commissioner does not lightly impose this sanction.<sup>213</sup> The potentially catastrophic consequences of a fund becoming

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<sup>208</sup> The Commissioner's views on the circumstances he will take into account in deciding whether to issue a notice of non-compliance is contained in: Australian Taxation Office, Commonwealth Government, *Self-managed superannuation funds – notice of non-compliance* (Practice Statement, PS LA 2006/19, 30 November 2006).

<sup>209</sup> See e.g. *Re QX971 and Australian Prudential Regulation Authority* [1999] AATA 6.

<sup>210</sup> See e.g. *Re Preuss and Australian Prudential Regulation Authority* [2005] AATA 748 ('Preuss').

<sup>211</sup> See e.g. *Holloway* [2000] FCA 1245.

<sup>212</sup> Australian Taxation Office, above n 208, [36].

<sup>213</sup> Australian National Audit Office, Commonwealth Government, *The Australian Taxation Office's Approach to Managing Self Managed Superannuation Fund Compliance Risks* (Performance Audit Report No. 13, 1 November 2007), 99.

non-complying, through actions of the trustees which, when viewed objectively were not undertaken with any purpose to exploit the taxation concessions available to superannuation funds, is illustrated in cases where the fund fails the residency requirements in the *ITAA 1997*.<sup>214</sup> As residency is determined by reference to where the decision making authority of the relevant fund is located,<sup>215</sup> SMSFs with trustees who have moved overseas are more likely to breach this aspect of the definition of a complying superannuation fund, despite not committing any contraventions of the regulatory provisions. The Commissioner's discretion to continue to treat the fund as a complying fund has been interpreted as not extending to such situations because it amounts to a failure of the fund to maintain its residency status rather than a contravention of a regulatory provision that is an offence, a civil penalty provision or a breach of the specified *TAA 1953* provisions. Whether the Commissioner may have other avenues available to him in such circumstances to continue to treat the fund as a complying fund, in the context of the general power of administration will be examined in the next chapter.

### **3.4.5 Civil liability provisions**

As the result of an investigation commenced in circumstances where the Regulator suspects that a contravention of the *SISA 1993* may have occurred or is occurring; or where the financial position of the fund may be unsatisfactory; or where the trustee or trustees have failed to give effect to a decision of the Superannuation

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<sup>214</sup> *SISA 1993*, s 10 definition of 'resident regulated superannuation fund' referring to *ITAA 1997*, s 295-95(2) definition of 'Australian superannuation fund'.

<sup>215</sup> Based on the application of the 'central management and control' test applied in the context of directors of companies: see generally Australian Taxation Office, Commonwealth Government, *Income tax: meaning of 'Australian superannuation fund' in subsection 295-95(2) of the Income Tax Assessment Act 1997* (Taxation Ruling, TR 2008/9, 10 December 2008).

Complaints Tribunal, the Regulator, including the Commissioner where relevant may take civil action on behalf of the members of the fund.<sup>216</sup> Under such an action the Regulator may seek to obtain monetary compensation for loss occasioned by the actions of the trustees or other persons, such as an investment manager. Such action can only be commenced when it appears to the Regulator that it is in the public interest to do so. This may be in addition to any other sanctions available to the Regulator in respect of a contravention of the *SISA 1993*. To date, there is no record of the Commissioner having commenced such action on behalf of SMSF members.

#### **3.4.6 Freezing assets of the SMSF**

As part of an investigation, the Commissioner may seek a freezing order from the Court if he believes that there is a risk of member benefits being eroded.<sup>217</sup> The Commissioner has used this provision in the context of illegal early release schemes where the members of an APRA-regulated fund were encouraged to enter into schemes to roll-over their benefits to SMSFs in order to illegally access their funds.<sup>218</sup> Criminal action against promoters of such schemes has also been taken, resulting in jail terms for offenders.<sup>219</sup> This type of sanction is useful in that it is immediate and arguably has the effect of stopping scheme promoters from being able to access preserved superannuation entitlements illegally.

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<sup>216</sup> *SISA 1993*, s 298.

<sup>217</sup> *SISA 1993*, s 264.

<sup>218</sup> In 2010, the Commissioner had \$1.3 million of funds under a freezing order in relation to such schemes: Stuart Forsyth, 'ATO Regulation of SMSFs', (Speech delivered at the Taxation Institute of Australia, Superannuation Intensive Conference, 2 June 2010).

<sup>219</sup> Australian Securities and Investment Commission, 'Sydney man sentenced on early access to super charges' (Media Release No. 10-66AD, 29 March 2010).

### 3.4.7 Disqualification, suspension or removal of trustees

There are three circumstances in which the Commissioner may disqualify a person from certain roles within the superannuation industry.<sup>220</sup>

Firstly, the Commissioner has the power to disqualify an individual from being a trustee, investment manager or custodian where that individual has contravened either the *SISA 1993* or the *Financial Sector (Collection of Data) Act 2001* ('the relevant Acts') and the nature or seriousness of the contravention, or the number of contraventions provides grounds for disqualifying the individual.<sup>221</sup>

Secondly, where an individual is a responsible officer<sup>222</sup> of a body corporate that is a trustee, investment manager or custodian, the Commissioner may disqualify the individual where the body corporate has contravened the relevant Acts on one or more occasions; and at the time of the contravention the individual was a responsible officer; and the nature or seriousness of the contraventions provides grounds for the disqualification of the individual.<sup>223</sup>

Finally, the Commissioner may disqualify an individual if satisfied that the individual is not otherwise a fit and proper person to be a trustee, investment

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<sup>220</sup> A person may also be disqualified by operation of law: *SISA 1993* s 120. Disqualification by operation of the law has been held not to be a sanction or an additional punishment but rather it is designed to protect the investing public against the risk that people with a track record of misconduct will offend again: *The Taxpayer and Commissioner of Taxation* [2002] AATA 1233, [12] (*Taxpayer*). The individual in such circumstances can apply to the Commissioner to have the disqualification waived: *SISA 1993* ss 126B-126D.

<sup>221</sup> *SISA 1993* s 126A(1). The circumstances in which the Commissioner will consider disqualifying an individual under *SISA* s 126A is contained in Australian Taxation Office, Commonwealth Government, *Self-managed superannuation funds – disqualification of individuals to prohibit them from acting as trustees of a self-managed superannuation fund* (Law Administration Practice Statement, PS LA 2006/17, 30 November 2006).

<sup>222</sup> A 'responsible officer' is defined to mean a director, secretary or executive officer of the body corporate: *SISA 1993* s 10.

<sup>223</sup> *SISA 1993* s 126(2).

manager or custodian or a responsible officer of a body corporate that undertakes one of those roles.<sup>224</sup>

Each of these circumstances operates as a separate and distinct basis for disqualification.<sup>225</sup> Hence, if it can be established that a person had contravened a provision of the *SISA 1993* and the seriousness of the contravention justified the disqualification of the individual as a trustee of an SMSF, then there is no need to also establish that the person was not a 'fit and proper' person to be a trustee. However, failure amounting to a contravention could also indicate that a person was not a 'fit and proper' person to hold such an office, such that the circumstances may overlap and are not necessarily mutually exclusive.<sup>226</sup>

## **Consequences of disqualification**

Where the Commissioner has disqualified an individual, notice must be given to that person and details of the disqualification must be published in the *Gazette*.<sup>227</sup> A decision to disqualify an individual is a reviewable decision<sup>228</sup> that may be appealed to the Administrative Appeals Tribunal.<sup>229</sup> An individual who acts as a trustee, investment manager, custodian or a responsible officer knowing that they are a disqualified person commits an offence.<sup>230</sup>

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<sup>224</sup> *SISA 1993* 126A(3).

<sup>225</sup> *Pruess* [2005] AATA 748, [87].

<sup>226</sup> *VBN and Australian Prudential Regulation Authority* [2006] AATA 710, [526]-[528] ('*VBN*').

<sup>227</sup> *SISA 1993* s 126A(6) & (7).

<sup>228</sup> *SISA 1993* s 10(qa) definition of 'reviewable decision'.

<sup>229</sup> *SISA 1993* s 344.

<sup>230</sup> *SISA 1993* s 126K.



## Power to remove or suspend trustee

The Commissioner also has the power to suspend or remove an individual from being a trustee of a superannuation fund where that individual has been disqualified.<sup>231</sup> Further, suspension or removal of an individual may be warranted where it appears to the Commissioner that the conduct that has been, is being, or is proposed to be engaged in by the trustee may result in the financial position of the entity becoming unsatisfactory.<sup>232</sup>

## 'Fit and proper' person test

The term 'fit and proper person' is not defined in the *SISA 1993*. High Court authority in the context of the *Broadcasting Act 1942* (Cth) has been applied in the context of the *SISA 1993*.<sup>233</sup> It was there stated that the expression 'fit and proper person' standing alone has no precise meaning and so it takes its meaning from the context in which it appears.<sup>234</sup> Within the context of the *SISA 1993* the term has been found to include 'elements of reputation; a proper knowledge of applicable laws; a practical ability to carry out duties competently; and overall competence, integrity and honesty'.<sup>235</sup> Each of these elements is to be viewed in the context of the person's actions overall and not only restricted to actions as a trustee of a superannuation entity. This is because the provision is 'designed to protect the

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<sup>231</sup> *SISA 1993* s 133(1).

<sup>232</sup> *SISA 1993* s 133(2). The power of the Commissioner to remove or suspend a trustee in circumstances where the conduct may result in the financial position of the entity becoming unsatisfactory requires the Commissioner to take account of the financial viability of the SMSF – a function which could be described as 'prudential' in nature.

<sup>233</sup> *VBN* [2006] AATA 710, [529] applying *Australian Broadcasting Tribunal v Bond and Others* [1990] HCA 33 ('*Bond*').

<sup>234</sup> *Bond* [1990] HCA 33 per Toohey and Gaudron JJ [36].

<sup>235</sup> *Preuss* [2005] AATA 748, [94].

investing public against risk that people with a track record of misconduct will offend again.<sup>236</sup>

The Commissioner is of the view that he is able to disqualify a person as a preventative measure before that person becomes a trustee of an SMSF if that person presents a future compliance risk.<sup>237</sup> Although initially this might seem strange, when viewed in the broader context of the provisions, such an action by the Commissioner may well be appropriate in certain circumstances. The focus of the provision is on prudential management of funds and the quarantining of risks for beneficiaries of superannuation entities from persons ill-equipped to undertake duties as a fiduciary. Earlier conduct or behaviour is a relevant indicator as to the capacity of an individual to undertake such a position of trust.

#### **3.4.8 Exemption declarations**

The Commissioner also has the power in respect of some parts of the *SISA 1993* to make a modification declaration to alter the way the legislation applies in respect of certain entities. In effect this provision gives the regulator a power to alter the way the legislation applies to a particular taxpayers. The Commissioner does not appear to have exercised this power in relation to SMSFs.

### **3.5 Conclusion**

The regulatory framework applying to superannuation funds is lengthy and complex. The discussion in this chapter has illustrated that the provisions in the *SISA 1993* and associated regulations administered by the Commissioner are

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<sup>236</sup> *Taxpayer* [2002] AATA 1233, 12.

<sup>237</sup> Australian Taxation Office, above n 220, [20]-[21].

directed towards ensuring that SMSF trustees maintain the SMSF for the purpose of retirement savings rather than the broader purpose of ensuring stability in the superannuation system and enhancing competition in that sector. Those later objectives are the responsibility of APRA and ASIC.

Despite having administrative sanctions and penalties as well as access to criminal penalties available to address breaches of the *SISA 1993*, there does not appear to be sufficient leverage being obtained through the deterrent effect of applying these tools in the SMSF context. For example, illegal early release schemes continue to be of concern to the ATO as are dividend stripping arrangements.<sup>238</sup> The fact that these issues remain of concern and continue to threaten the viability of the SMSF sector requires the Commissioner to continually review and improve administration in this area. The next chapter considers the current administrative approach applied by the Commissioner, with a particular focus on the use of the compliance model and whether that model requires adjustment or adaptation in the SMSF context in order to be more effective in encouraging voluntary compliance.

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<sup>238</sup> Matthew Bambrick, above n 24. For example, In 2012-13 the ATO prevented 191 SMSFs suspected of being part of an illegal early release scheme from entering the system and removed 438 suspect funds from the ATO's superannuation fund look-up list.

## Chapter 4: Challenging the theoretical basis of the superannuation regulatory framework

### 4.1 Introduction

The previous two chapters examined the historical development of the superannuation system to give a context to the current legislative regime, the key areas of law that apply to SMSFs; and the tools available to the Commissioner in enforcing the provisions of the *SISA 1993*. This chapter examines the practical administration of the superannuation regulatory regime with a particular focus on the Commissioner and APRA.<sup>1</sup> In attempting to increase voluntary compliance with the *SISA 1993* and associated legislation, it is suggested that the regulators should firstly engage with superannuation fund trustees and advisors in terms of goals of the superannuation system as a whole. It is argued that this approach would better encourage voluntary compliance, and hence reduce the number of breaches of the statutory requirements by trustees. The approach would involve the regulators clearly articulating a set of overarching goals that they would have reference to in their administration. Such an approach is considered to have a better chance of leveraging higher levels of voluntary compliance than an administrative approach

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<sup>1</sup> It is unnecessary in this context to discuss the issues relating to ASIC due to its focus on market disclosure and licensing – issues not directly relevant to SMSFs. However, it is acknowledged that the regulatory models and theories discussed here apply equally to ASIC. For discussion of the application of regulatory theory to the work of ASIC see generally: The Treasury, Commonwealth Government, *Review of Sanctions in Corporate Law* (Discussion Paper, 2007); Michelle Welsh, 'Civil Penalties and Responsive Regulation: The Gap Between Theory and Practice' (2009) 33 *Melbourne University Law Review* 908; George Gilligan, Helen Bird and Ian Ramsay, 'The Efficacy of Civil Penalty Sanctions Under the Australian Corporations Law' (Issues Paper No 136, Australian Institute of Criminology, 1999).

which is reactionary and focused only on the particular behaviour of a single trustee.

## **4.2 Theoretical basis for regulatory models adopted by the Commissioner and APRA**

The focus of the regulators within the superannuation industry is on ensuring compliance with the legislated rules. This type of regulation is referred to in the literature as the 'command and control' method of regulation. Both the Commissioner and APRA take a 'risk-based' approach to regulation, and employ a responsive regulation enforcement model to leverage compliance from the superannuation industry. The theoretical basis for these approaches and how the enforcement models have been applied in practice is examined below.

### **4.2.1 Strategic regulation theory**

'Strategic regulation theory' applies an economic theory of regulation, which views the role of enforcement sanctions from a 'macro' level so as to provide a basis for achieving regulatory compliance by recognizing that it is not possible for regulatory agencies to detect and enforce every contravention of the law.<sup>2</sup> In order to best achieve regulatory compliance, there are two schools of thought: the 'deterrence' model and the 'accommodative' model.<sup>3</sup>

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<sup>2</sup> Vicky Comino, 'The challenge of corporate law enforcement in Australia' (2009) 23 *Australian Journal of Corporate Law* 233, 236.

<sup>3</sup> Kristina Murphy, 'Moving towards a more effective model of regulatory enforcement in the Australian Taxation Office' (Working Paper No. 45, Centre for Tax System Integrity Research School of Social Sciences Australian National University, November 2004), 2.

## The deterrence model

The 'deterrence' model advocates that individuals and corporations are seen to be 'rational actors' who are motivated entirely by profit seeking. Hence, they will carefully assess opportunities and risks to determine when the probability of being caught is small compared to the gains to be made from their non-compliance. Therefore, harsh sanctions and penalties should be used to ensure compliance. During the 1970's this method of regulatory enforcement was applied where regulatory officers were more likely to issue notices of violation and fines in cases where there was a detected breach of the law. The problem with this approach is that it fosters resistance to regulation in that what is seen as unreasonable responses by regulators to contravention of the law can generate resistance to compliance. Further, aside from building negative attitudes towards compliance within well-intentioned individuals, the methods of punishment are often time consuming and expensive.<sup>4</sup>

An example of this approach to regulation in the *SISA 1993* relates to APRA's use of its powers of disqualification of trustees. As noted above, the regulator's power to disqualify individuals from being trustees, investment managers or custodians was introduced in 2001. At that time APRA had the power to disqualify individuals without reference to the Federal Court. In 2008, amendments were introduced to remove that power and require APRA to apply for a Federal Court order.<sup>5</sup> The

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<sup>4</sup> Ibid; R. A. Kagan & J. T. Scholz, 'The criminology of the corporation and regulatory enforcement strategies' in K. Hawkins & J. M. Thomas (eds), *Enforcing Regulation* (Kluwer-Nijhoff Publishing, 1984).

<sup>5</sup> *Financial Services Legislation Amendment (Review of Prudential Decisions) Act 2008* (Cth).

reason provided for this change was to align the disqualification provisions with the equivalent provisions under the *Corporations Act 2001* (Cth).<sup>6</sup>

It has been suggested that the amendments were also triggered by events, which culminated in the Administrative Appeals Tribunal (AAT) overturning APRA's disqualification of seven directors of the AXA Australia Superannuation Fund.<sup>7</sup> In that case, the directors of the corporate trustee for the AXA Australia Superannuation Fund were faced with a difficult decision, which would lead to a potential reduction in the future benefits of a particular class of member but also provide relief for another class of member. APRA disqualified the seven directors on the basis of a breach of the trustee covenants in section 52 of the *SISA 1993*, in particular the 'best interest' and 'prudent person' covenants, because there was a failure to properly disclose the nature of the decision to the affected members. The AAT held that although it was not in the best interest of the class of members not to be told of the change in policy, the directors' decision was nonetheless in the best interest of the plan members as a whole. As a consequence, the directors were found not to have breached the covenants and hence could not be disqualified as directors.<sup>8</sup>

Following this decision, criticisms were made that APRA had been 'too harsh in judging the actions of the trustee and overzealous in issuing disqualification orders'.<sup>9</sup> Some in the industry view this case to be the reason why amendments were made to the *SISA 1993* which removed APRA's powers to disqualify trustees

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<sup>6</sup> Explanatory Memorandum to Financial Services Legislation Amendment (Review of Prudential Decisions) Bill 2008, 6.

<sup>7</sup> Shuana Ferris and Peter Gillies, 'The legal obligations of superannuation fund trustees: The VBN v APRA litigation' (2010) 21 *Journal of Banking and Finance Law and Procedure* 214, 244.

<sup>8</sup> *VBN* [2006] AATA 710.

<sup>9</sup> Ferris and Gillies, above n 7, 243.

and replaced it with a requirement to apply to the Federal Court for such an order.<sup>10</sup> However, the Explanatory Memorandum to the bill which introduced the requirement for APRA to apply to the Federal Court for a disqualification order does not make such references and instead states the need to have a consistent framework in relation to disqualification regimes across relevant statutes and to ensure that the process is transparent and efficient.<sup>11</sup>

## **The accommodative model**

Under the alternative ‘accommodative’ approach, individuals and corporations are viewed as ‘social actors’, who are inclined to comply with the law because of self-interest in maintaining a good community reputation and belief in the rule of law.<sup>12</sup> Regulatory authorities applying this model seek results through cooperation rather than coercion, so are more likely to give second chances and give advice about how to comply with the law. The authorities see themselves more like consultants rather than strict law enforcers. However, adopting a purely accommodative approach has also been found to be ineffective, because it fails to recognise that not all individuals and corporations are good and honest and that there are those who will take advantage of being presumed to be so.<sup>13</sup> A purely accommodative model would only be effective if all regulated players had the same attitude to compliance. It is naïve to suggest that the regulated industry does not have some proportion of persons who will look to advantage themselves even if that meant that they would not comply with the rules.

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<sup>10</sup> Law Council of Australia, Submission to the Treasury, Commonwealth of Australia, *Consultation Paper – Strengthening APRA’s Crisis Management Power*, 12 December 2012, [3.1(f)].

<sup>11</sup> Explanatory Memorandum, Financial Sector Legislation Amendment (Review of Prudential Decisions) Bill 2008, Part 1 [1]-[5].

<sup>12</sup> Kristina Murphy, above n 3, 3.

<sup>13</sup> *Ibid* 5.



#### 4.2.2 The 'responsive regulation' theory

The 'responsive regulation' theory, developed by Ayres and Braithwaite,<sup>14</sup> seeks to combine features of both the deterrence and accommodative models. Within this model, it is argued that regulation should respond to industry structure and industry conduct. Different structures will be conducive to different degrees and forms of regulation and how effectively industry self-regulates should channel the regulatory strategy to determine the level of government intervention.<sup>15</sup> It is argued that a regulatory agency is more likely to secure broader compliance when it displays an explicit enforcement pyramid. The tougher and more various the sanctions within that enforcement pyramid, the greater the success of the regulator. The regulator should have access to severe punishments but should rarely use them in practice, preferring to persuade and educate when a breach occurs hence promoting self-regulation and the wish to preserve reputation.<sup>16</sup>

Responsive regulation theory has been applied in a wide range of contexts, both in Australia and overseas.<sup>17</sup> For example, in Australia, the theory has been applied in the areas of Australia and New Zealand food safety regulation,<sup>18</sup> the regulation of gene technology<sup>19</sup> and within financial system regulation.<sup>20</sup> In an international

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<sup>14</sup> I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, 1992).

<sup>15</sup> *Ibid.*, 4.

<sup>16</sup> *Ibid.*, 24.

<sup>17</sup> Charlotte Wood, Mary Ivec, Jenny Job & Valerie Braithwaite, 'Applications of Responsive Regulatory Theory in Australia and Overseas' (Occasional Paper No. 15, Centre for Tax System Integrity Research School of Social Sciences, Australian National University, June 2010).

<sup>18</sup> See e.g. Productivity Commission, Commonwealth Government, *Performance Benchmarking of Australian and New Zealand Business Regulation: Food Safety Research Report* (2009).

<sup>19</sup> See e.g. Office of the Gene Technology Regulator, Commonwealth Government, *Monitoring and Compliance Framework: In accordance with the Gene Technology Act 2000 (Cth)* (2002).

<sup>20</sup> See e.g. Grant, R., Parliamentary Library of Australia, 'ASIC's regulatory strategy' in *Australia's corporate regulators – the ACCC, ASIC and APRA* (Research Brief no. 16, 2004-05).

context, the advantages of the responsive regulation theory were examined in two regulation reviews in Britain<sup>21</sup> which resulted in recommendations that legislative amendments be made to enable regulators to access a broader range of sanctions so as to achieve better compliance in a range of areas. In Canada, the largest securities regulator has applied responsive regulation theory to its approach to enforcement<sup>22</sup> and in the European Union manufacturers and importers of chemicals are regulated using responsive regulation theory.<sup>23</sup>

#### **4.2.3 APRA's approach to regulation of superannuation entities: 'risk-based regulation'**

The majority of employees have their compulsory superannuation guarantee contributions made to APRA-regulated funds where those employees have very little control over the investments made with their contributions. Therefore, members of APRA-regulated funds are in a position where they cannot address potential risks to their mandatory investment which may arise from behaviour entered into by the trustees of the funds to which they contribute and must therefore rely on the regulator to do so on their behalf.

APRA applies a 'risk-based regulation' approach which has been described as the management of the regulatory risk that it will not achieve its objectives.<sup>24</sup> This

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<sup>21</sup> P Hampton, HM Treasury, *Reducing administrative burdens: effective inspection and enforcement* (2005); R Macrory, Cabinet Office, *Regulatory Justice: Making Sanctions Effective* (2006).

<sup>22</sup> K Marquis, 'Responsive Securities Regulation: An Assessment of the Enforcement Practices of the Ontario Securities Commission', (Regulatory Governance Initiative Working Paper, 2009).

<sup>23</sup> M Fuhr and K Bizer, 'REACH as a paradigm shift in chemical policy – responsive regulation and behavioural models' (2007) 15(4) *Journal of Cleaner Production* 327.

<sup>24</sup> Julia Black, 'Managing Regulatory Risk and Defining the Parameters of Blame: a Focus on the Australian Prudential Regulation Authority' (2006) 28(1) *Law & Policy* 1, 4. Black contrasts this form of 'risk-based regulation' with other forms such as that used in food safety and health and safety regulation which focuses on the regulation of risks to society.

process involves assessing an individual entity's probability of failure with the potential impact that failure may have on the wider system.<sup>25</sup> An entity's risk rating is determined by taking into account a range of factors which can be grouped into three areas represented by inherent risks including but not limited to asset quality, balance sheet and liquidity risks; management and control structures and the adequacy of its capital support.<sup>26</sup> The risk rating is then applied to determine the relative frequency and intensity of actions taken by APRA in relation to that entity,<sup>27</sup> through the use of a supervisory action plan. It is the content of these supervisory action plans that emulates elements of the responsive regulation theory.

Once APRA has determined the attitude of a particular entity towards its obligations to comply with the *SISA 1993*, that entity will be allocated a 'stance' by APRA and that 'stance' will determine where on the regulatory pyramid APRA will commence its actions.<sup>28</sup> For those entities which are allocated a 'normal' stance, APRA will limit its activities to data collection and making routine site visits. At the other end of the spectrum is the 'restructure' stance where APRA will immediately apply its full enforcement powers including removal of licenses; removal of persons or advisors and placing the company into liquidation or receivership.<sup>29</sup>

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<sup>25</sup> Referred to as the Probability and Impact Rating System (PAIRS) and the Supervisory Oversight and Response System (SOARS). For further discussion see e.g. Julia Black, above n 24, 10-21; Australian National Audit Office, Commonwealth Government, *APRA's Prudential Supervision of Superannuation Entities* (Audit Report No. 6, 2003-04), 46-66.

<sup>26</sup> Australian National Audit Office, above n 25, 49-51.

<sup>27</sup> Australian Prudential Regulation Authority, Commonwealth Government, *Annual Report 2009*, 43.

<sup>28</sup> Australian Prudential Regulation Authority, *Supervisory Oversight and Response System*, November 2010.

<sup>29</sup> Ibid.

In allocating a risk rating to small APRA regulated funds (SAFs),<sup>30</sup> which are the closest type of superannuation fund to an SMSF regulated by the Commissioner, APRA applies the analysis to the trustee of the SAF as it is usually the case that the trustee will be trustee for a number of SAFs. Those trustees with a different investment strategy to the general class of SAFs are risk rated individually.<sup>31</sup>

#### **4.2.4 The ATO's compliance model applied in regulating SMSFs**

The ATO has used responsive regulation theory, in combination with the motivational posturing model to develop its Compliance Model. That model, was first developed to assist the Commissioner to deal with the tax risks arising from the cash economy and is now applied across all compliance work undertaken by the ATO in determining the appropriate response to non-compliance with the laws the Commissioner administers.<sup>32</sup>

The motivational posturing theory asserts that individuals signal to the regulator how much social distance they wish to place between themselves and the regulator. This distance is understood in terms of the degree to which a regulator threatens an individual's sense of self. Within the context of the regulatory pyramid, de-escalation corresponds to emergence of more cooperative postures.<sup>33</sup>

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<sup>30</sup> These are generally former SMSFs which have failed the definition in *SISA 1993* s 17A, and for which a trustee who holds an RSE license is appointed: *SISA 1993*, ss 10 & 17A(4).

<sup>31</sup> Australian National Audit Office, above n 25, 54-55.

<sup>32</sup> Valerie Braithwaite and Jenny Job, 'The theoretical base for the ATO Compliance Model' (Research Note 5, Centre for Tax System Integrity Research School of Social Sciences Australian National University, 2003), 1.

<sup>33</sup> Valerie Braithwaite and Jenny Job, above n 32, 8-9; see also Valerie Braithwaite, Kristina Murphy and Monika Reinhart, 'Taxation Threat, Motivational Postures, and Responsive Regulation', (2007) 29(1) *Law & Policy* 137.

Although developed within the context of the compliance issues faced by the cash economy taskforce between 1996 to 1998,<sup>34</sup> the Compliance Model has been applied by the ATO across all areas of taxation administration, including the Commissioner's role as the regulator of SMSFs.

## **Challenges in regulating SMSFs**

Given the large number of SMSFs it is impractical for the Commissioner to build close working relationships with each trustee of an SMSF. Further, the Commissioner faces difficulties in identifying contraventions given the closely held nature of SMSFs. This may be because apparently legitimate transactions are in fact contraventions arising from deliberate and calculated conduct,<sup>35</sup> or that simply in such a large sector, it takes time to identify the contraventions. In this regard, the Commissioner relies heavily on approved auditors to report contraventions of the *SISA 1993* soon after they occur so as to provide the Commissioner with as much notice of such behaviour as possible.

When the ATO commenced as the regulator of SMSFs in 1999, it was taking responsibility for a sector of the superannuation industry which had been suspected of high levels of non-compliance with the *SISA 1993*, and which had not received close supervision by the previous regulators.<sup>36</sup> At this time, the ATO

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<sup>34</sup> Australian Taxation Office, Commonwealth Government, *Cash Economy Task Force, Improving Tax Compliance in the Cash Economy* (1998). See also V Braithwaite and J Braithwaite, 'An evolving model for tax enforcement' in N Shover and J Wright (eds.), *Crimes of Privilege: Readings in White-Collar Crime* (Oxford University Press, 2000) 405.

<sup>35</sup> See for example comments made in relation to 'white collar crimes' by Finkelstein J in *ASIC v Vizard* (2005) 54 ACSR 394, [37].

<sup>36</sup> Australian National Audit Office, Commonwealth Government, *The Australian Taxation Office's Approach to Regulating and Registering Self Managed Superannuation Funds*, Audit Report No. 52 (2006-07), 47. It was noted in this report that in 1997 the Insurance and Superannuation Commission (ISC) undertook a survey of 1,000 excluded funds (the predecessor to SMSFs) which found compliance issues with approximately 20% of funds surveyed.

established that SMSF trustees were unaware or insufficiently educated about their *SISA 1993* obligations. The ATO considered that the best compliance strategy to address this issue was to educate trustees. This approach was consistent with its Compliance Model and responsive regulation theory, and was thought to be the most effective way of obtaining trustee compliance.<sup>37</sup> Part of this process was the New Trustee Education Campaign, which was directed at new SMSF trustees and intended to provide those new trustees with a better understanding of their obligations. The campaign appeared to be successful and the evaluation surveys conducted by the ATO soon after its implementation suggested that when trustees were informed of their roles and responsibilities, the trustees were more likely to comply with their obligations.<sup>38</sup> This finding illustrates the successful use of the responsive regulatory theory in the context of the handover of regulatory responsibility from APRA to the ATO. However, as explained above, a strategy based solely on education and persuasion may not be successful in ensuring integrity and confidence in the superannuation system.

For the period from 1999 until the 2003-04 income year, identified contraventions of the *SISA 1993* were handled by persuasion and education. For the more severe breaches, the ATO would consider entering into an informal arrangement with the SMSF trustees whereby the trustees would undertake to rectify the breaches as soon as possible.<sup>39</sup> In 2003-04, the ATO adjusted its compliance strategy to focus on 'active compliance'. This means that the ATO would actively address areas of risk it identified within the SMSF sector, by way of audits and active engagement

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<sup>37</sup> Australian National Audit Office, Commonwealth Government, *The Australian Taxation Office's Approach to Managing Self Managed Superannuation Fund Compliance Risks*, Audit Report No. 13 (2007-08), 68.

<sup>38</sup> *Ibid*, 70.

<sup>39</sup> Australian Taxation Office, Commonwealth Government, *Self-managed superannuation funds – enforceable undertakings* (Practice Statement PS LA 2006/18, 30 November 2006), [32]-[36].

with SMSF trustees. Where a breach is detected, the ATO will assess the sanctions available to it and determine which would be the most appropriate to apply to address the breach that has occurred and to achieve future compliance.

As SMSFs are privately managed superannuation savings, it is considered appropriate to benchmark the current supervisory framework applying to them against the internationally endorsed principles to highlight areas within the current administrative framework that could require adjustment or revision in order to be consistent with world's best practice.

### **4.3 Criticisms of the responsive regulation approach**

It is apparent that each of the prudential regulators has invested a considerable amount of time and expertise in devising the regulatory models currently applied to the supervision of the superannuation industry. The models adopted by each of the regulators appear to match well against international best practice for pension supervision.<sup>40</sup> Despite the measurable increase in compliance levels within the superannuation industry, there remains a public perception that the superannuation industry still requires substantial changes in order to make it work better (the number of recent reviews attest to this view).<sup>41</sup> Although an enforcement technique applying the responsive regulation theory has been

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<sup>40</sup> In particular see principles 4, 5 and 6 of the IPOS Principles for Private Pension Supervision: International Organisation of Pension Supervisors, *IPOS Principles of Private Pension Supervision* (November 2010), 7-10.

<sup>41</sup> Examples of recent reviews include Super System Review, Commonwealth Government, *Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System* (2010); Australia's Future Tax System Review, Commonwealth Government, *Australia's Future Tax System Review: Final Report* (2010); The Australian Financial Centre Forum, Commonwealth Government, *Australia as a Regional Centre: Building on Our Strengths* (2009).

somewhat successful in the context of addressing tax risks identified in the cash economy sector,<sup>42</sup> there have been some criticisms made of the model.

Black and Baldwin observe that the criticisms of the responsive regulation model arise from three different perspectives: conceptual, practical and constitutional.<sup>43</sup>

Central to the responsive regulation model is the escalation of responses by the regulator to the behaviour of the regulated – the more aggressive or non-compliant the behaviour the more severe the sanction. However, it is observed that such lineal escalation may not be appropriate in all circumstances and the better response in some cases may be to apply the most severe sanction to the regulated despite there being no previous contraventions. Further, it is suggested that moving up the pyramid may prejudice the relationship between the regulator and the regulated, which then makes moving down the pyramid more difficult.<sup>44</sup> The responsive regulation model is premised on the relationship between the regulated and the regulator without any external influences affecting the actions of either party. However, empirical studies of the application of the responsive regulation model in the enforcement of the civil penalty sanctions under the *Corporations Act 2001* and its predecessor demonstrate that the decision making process of the regulator may be influenced by external pressures such as public perceptions and political pressure,<sup>45</sup> restraints imposed by the courts,<sup>46</sup> and

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<sup>42</sup> Kristina Murphy, 'Moving towards a more effective model of regulatory enforcement in the Australian Taxation Office' (Working Paper No. 45, Australian National University Centre for Tax System Integrity, 2004), 19-21, 29.

<sup>43</sup> Robert Baldwin and Julia Black, 'Really Responsive Regulation' (Working Paper 15/2007, London School of Economics and Political Science, 2007), 6.

<sup>44</sup> *Ibid.*

<sup>45</sup> See e.g.: Michelle Welsh, 'Civil Penalties and Responsive Regulation: The Gap Between Theory and Practice' (2009) 33 *Melbourne University Law Review* 908; Vicky Comino, 'The challenge of corporate law enforcement in Australia' (2009) 23 *Australian Journal of Corporate Law* 233.

<sup>46</sup> Vicky Comino, 'Effective regulation by the Australian Securities and Investments Commission: The Civil Penalty Problem' (2009) 33 *Melbourne University Law Review* 802.



indeed the personal professional experience and expertise of the officer involved.<sup>47</sup> These influences appear to affect the type of sanction applied in cases of contraventions that according to the model should have produced a lesser response than that actually sought. Arguably, the model does not accommodate these external influences that may lead to unpredictable and inconsistent treatment of the regulated. Yeung argues that the 'tit-for-tat' enforcement strategy central to the responsive regulation model focuses the regulator's decision between punishment and persuasion in any given case by reference to whether the regulated firm has co-operated and not by reference to the seriousness of the contravention.<sup>48</sup> Hence, the model fails to take account of what Yeung terms 'constitutional values' of proportionality and consistency<sup>49</sup> – themes which will be discussed further below.

Further, there are still complaints made that there is inconsistent treatment between different sectors of the superannuation industry, in particular the way in which the *SISA 1993* provisions are administered by the Commissioner and APRA. This perceived disconnect between the administration of the same legislative provisions by the regulators may in part be explained by the different regulatory techniques adopted but it may also stem from the underlying assumption in those models that the regulatory exercise is constituted solely by reference to the relationship between the regulated and the regulator.<sup>50</sup> The discussion below challenges this assumption and suggests that a change in focus in approach to the

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<sup>47</sup> George Gilligan, Helen Bird and Ian Ramsay, 'The Efficacy of Civil Penalty Sanctions Under the Australian Corporations Law' (Issues Paper No 136, Australian Institute of Criminology, 1999).

<sup>48</sup> Karen Yeung, *Securing Compliance* (Hart Publishing, 2004), 168.

<sup>49</sup> *Ibid*, 169-170.

<sup>50</sup> Albeit with some influence from interested third parties.

application of the compliance model may assist in leveraging a better regulatory outcome.

#### **4.4 Challenging the assumptions supporting the current regulatory approaches**

There is vast amount of literature on regulatory theory and the basis for regulation, and it is beyond the scope of this thesis to examine it in any detail.<sup>51</sup> Much of the literature focuses on regulation of the financial markets, but very few studies have attempted to conceptualise regulation specifically within the context of superannuation. The following discussion will focus on the assumptions that currently underpin the financial services regulation in Australia, as the superannuation system forms part of that arena, and challenge those assumptions by reference in particular to the concept of the 'regulatory space' and an analysis of the regulatory process from a public interest perspective. Particular observations are made about the application of the alternative theories of regulation, particularly based on socio-economic ideas, in the context of superannuation in Australia.

##### **4.4.1 Rationale for financial market regulation**

The rationale given for financial market regulation is usually to address market failures, and often changes to the regulatory regime are in response to crises

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<sup>51</sup> See e.g. Robert Baldwin, Colin Scott and Christopher Hood (eds.), *A Reader on Regulation* (Oxford University Press, 1998); Robert Baldwin and Martin Cave, *Understanding Regulation: Theory, Strategy and Practice* (Oxford University Press, 1999); Leigh Hancher and Michael Moran, *Capitalism, Culture and Economic Regulation* (Clarendon Press, 1989) for an introduction to regulatory theory.

occurring within those markets.<sup>52</sup> As a result of the implementation of the recommendations of the 1997 Wallis Inquiry,<sup>53</sup> the current financial market regulatory regime in Australia is undeniably based on this rationale. In its blueprint for reform, that Committee stated that '[t]he ideal regulatory scheme requires a balance between preventing market failure and allowing financial markets to perform efficiently the functions for which they were designed.'<sup>54</sup>

The relevance of the literature on financial market regulation for the purposes of superannuation supervision in Australia lies in the fact that the Committee considered that from an economic viewpoint, superannuation investment should be treated as a form of collective investment, to be treated no differently within the financial system to other collective investments, such as units in a unit trust. In the recent interim report for the Financial System Inquiry,<sup>55</sup> this proposition does not appear to be challenged. In fact the increasing significance in the financial sector of superannuation investment since the time of the Wallis Report and the stabilizing effect of superannuation investment in the context of the global financial crisis was highlighted.<sup>56</sup> However, the Inquiry did note that there were features of the current superannuation system that may impact on its ability to provide that stabilizing influence in the future.<sup>57</sup> These statements establish the importance of

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<sup>52</sup> See e.g: V Edwards and T Valentine, 'From Napier to Wallis: Six Decades of Financial Inquiries' (1998) Sept *Economic Record* 297; Vijaya Nagarajan, 'From 'Command-and-Control' to 'Open Method Coordination': Theorising the Practice of Regulatory Agencies' (2008) 8 *Macquarie Law Journal* 5; Iris H-Y Chiu, 'Enhancing responsibility in financial regulation – critically examining the future of public-private governance: part I' (2010) March *Law and Financial Markets Review* 170.

<sup>53</sup> Financial System Inquiry, Commonwealth Government, *Financial System Inquiry: Final Report Overview* (1997).

<sup>54</sup> *Ibid* 14.

<sup>55</sup> Financial System Inquiry, Commonwealth Government, *Financial System Inquiry: interim report* (July 2014).

<sup>56</sup> *Ibid* 1-17.

<sup>57</sup> *Ibid* 2-81 – 2-85.

viewing the superannuation system as part of the broader financial market in Australia.

In examining the theory and practice of pension fund<sup>58</sup> supervision on an international basis, Hinz utilizes market failure analysis to justify the intervention of the state in correcting deficiencies which would compromise the welfare gains intended by a system of private pensions.<sup>59</sup> The theory of the market failure approach is that regulation of the market is only to be contemplated in areas where the market is unable to produce desirable economic or social outcomes.<sup>60</sup> However, that intervention is always seen to be second best to the allocation achieved through market forces. Indeed much of the impetus for the 'better regulation' debate in Australia has been to examine how to reduce that state intervention which is seen to add unnecessary costs to businesses, which left to their own devices would establish much more efficient allocation of resources.<sup>61</sup> In this context, regulation is understood to be undertaken by the state, usually using a specialized body – in this case APRA and the Commissioner, 'using legal rules backed by (often criminal) sanctions'.<sup>62</sup> This method is often referred to as 'command-and-control' regulation, which is reflective of the perception underpinning the market failure rationale for regulation which is that State intervention is an intrusion on the private rights of consumers and the forces working within the relevant regulated market.

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<sup>58</sup> 'Superannuation' is a uniquely Australian term, and much of the international literature refers to 'pension funds' and 'pension supervision'.

<sup>59</sup> Richard Hinz, 'Supervision of pension funds: theory and practice' in *Supervising Private Pensions* (OECD Publishing, 2004), 78-81.

<sup>60</sup> Tony Prosser, 'Regulation and Social Solidarity' (2006) 33(3) *Journal of Law and Society* 364, 366-67.

<sup>61</sup> See e.g. Regulation Taskforce, Commonwealth Government, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (2006).

<sup>62</sup> Julia Black, 'Critical Reflections on Regulation' (2002) 27 *Australian Journal of Legal Philosophy* 1, 2.

The influence of market failure theory is apparent in the scheme of the *SISA 1993* and the associated legislation. Trustees of superannuation funds are specifically placed in the centre of the regulatory scheme and given wide discretion as to how to conduct the superannuation fund for which they are responsible – to a point. The specific ‘market failures’ identified in the legislation relate to information asymmetry in relation to larger funds such as industry or employer-sponsored funds,<sup>63</sup> and systemic risks mostly in relation to investments that have an arguably higher level of risk than the general public are willing to accept.<sup>64</sup> Further, the importance of nurturing market forces and limiting interference through regulation can be detected in APRA’s mandate, which is to ensure that it promotes financial system stability through balancing the objectives of financial safety and efficiency, competition, contestability and competitive neutrality.<sup>65</sup>

In contrast, the Commissioner’s focus in relation to SMSFs is to ensure that the trustees maintain such funds for the sole purpose of providing for their retirement and issues such as ensuring financial system stability are not as relevant in this sector. However, where there are risky investments being made which threaten the viability of a fund, it is arguably within the scope of the Commissioner’s responsibility to address those risks.<sup>66</sup>

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<sup>63</sup> Which is evidenced in the provisions relating to auditing, reporting and record keeping: *SISA 1993* Part 4; and the requirement for equal representation for employers and members on the board of employer-sponsored funds: *SISA 1993* Part 9.

<sup>64</sup> Refer to discussion on restrictions on investment choices in Chapter 3, and see e.g. *SISA 1993* Part 8.

<sup>65</sup> *Australian Prudential Authority Act 1998* (Cth) s 8(2).

<sup>66</sup> The Commissioner does do this through the issue of ‘taxpayer alerts’ designed as an early warning sign to the tax community, used in the SMSF context to warn SMSF trustees as to the dangers in certain types of transactions or investments. See for example, Australian Taxation Office, *Taxpayer Alert TA 2012/7: Self managed superannuation funds arrangements to acquire property which contravene superannuation law* (2012).

#### 4.4.2 Criticisms of the market failure model

This rationale for regulation is not without its critics. Shearing challenges the assumption that markets are self-ordered and that regulation is an external force that should only be exerted where there is a need to correct market outcomes as flawed.<sup>67</sup> Rather, he argues that markets are actually constituted from the regulatory scheme which is put in place by the state, and that there is no market ordering which will replace the need to regulate.<sup>68</sup> This alternative conception of regulation appears particularly relevant to superannuation in Australia. The 'market' for retirement income products was relatively small prior to the introduction of the superannuation guarantee.<sup>69</sup> Subsequent to that regulatory regime being put in place, the market grew exponentially which in turn required further regulatory intervention in the form of the *OSSA 1987* and its replacement, the *SISA 1993*.

A further criticism of the market failure relates to the assumption that regulation of markets is to be avoided as it is inferior to the outcomes produced by market forces. Prosser observes that the problem with this assumption is that it reduces the task of regulation to a 'technical matter of making rules'.<sup>70</sup> Viewing regulation in this way leads to a confusion between the techniques used to establish a regulatory framework and the goals of regulation itself, which Prosser argues is a

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<sup>67</sup> Clifford D Shearing, 'A Constitutive Conception of Regulation' in Peter Garbosky & John Braithwaite (eds) *Business Regulation and Australia's Future* (Australian Institute of Criminology, 1993) 68-71.

<sup>68</sup> *Ibid* 72.

<sup>69</sup> See Chapter 2. Even before the introduction of the superannuation guarantee, the market constituting superannuation funds was developed in response to, or arguably created by, the various taxation concessions applying to lump sum payments.

<sup>70</sup> Tony Prosser, above n 60, 372.

reflection of different social values.<sup>71</sup> This problem goes to the heart of the question of why regulation is needed in the first place, and it is argued that it is not merely to correct market failures but it is to ultimately produce the kind of society in which we, as citizens as opposed to consumers, wish to live.<sup>72</sup>

Indeed, one of McVea's criticisms of market failure theory in the financial services area is that it takes no account of the values held by people as citizens, which cannot be easily priced, and treats as paramount their preferences as consumers.<sup>73</sup>

In assuming that regulation and competition are diametrically opposed, the market failure theory fails to take account of the legitimate role of the State in structuring the market to reflect what we value as a society.<sup>74</sup> McVea convincingly argues that what we may prefer as a consumer may not necessarily reflect what we want as a citizen. He uses the example of a fund manager maximizing the value of his fund – as a consumer an increase in his material wealth is welcomed but as a citizen he may have concerns about how the fund manager has gone about creating that wealth and whether those practices were indeed desirable once the consequences of such action were taken into account.<sup>75</sup>

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<sup>71</sup> Ibid.

<sup>72</sup> Ibid 375.

<sup>73</sup> Harry McVea, 'Financial Services Regulation under the Financial Services Authority: A Reassertion of the Market Failure Thesis?' (2005) 64(2) *Cambridge Law Journal* 413, 439.

<sup>74</sup> Ibid.

<sup>75</sup> Ibid 442. McVea acknowledges that the consumer/citizen distinction is not clear cut and there may be a mix between consumer and collective citizen values, and that these preferences are also heavily influenced by context but notes that in practice this distinction remains of significant importance in the context of financial services regulation: 442-44.

In conceptualizing regulation, McVea argues that this distinction is fundamental and should be given due weight. He goes further to opine:

In view of the complex technical nature of financial markets and the significance, and sensitivity, of the issues to which such markets give rise, it is incumbent upon the designated regulator of the financial services sector – acting, as it does, in its capacity as agent of the democratic state – to sponsor (and where necessary act as the arbiter of) citizenship values. That is to say, in view of the inability of citizens to become meaningfully involved in the regulatory process, the FSA has in effect a duty to act at times as a “surrogate citizen”, sponsoring values that are too important to be left to the whim of undemocratic markets and which are unlikely to be given due weight within the market failure paradigm.<sup>76</sup>

Consistent with this theme, in examining the concept of the ‘financial citizen’ in the context of the Australian superannuation system, Donald suggests that the member of a superannuation fund who is conceived as a financial citizen is ‘responsible for contributing to the governance of the systems in which they participate.’<sup>77</sup> However, Donald notes that despite there being some acknowledgement of the public nature of superannuation, the evidence to date seems to suggest that individuals may be more inclined to support government intervention than to act directly themselves.

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<sup>76</sup> Ibid 445. The ‘FSA’ is the Financial Services Authority in the United States which has responsibility for regulation of the financial markets.

<sup>77</sup> M Scott Donald, ‘What’s in a name? Examining the Consequences of Inter-legality in Australia’s Superannuation System’ (2011) 33 *Sydney Law Review* 295, 314. For a more in-depth discussion of the concept of a ‘financial citizen’, see Dimity Kingsford Smith, ‘Regulating Investment Risk: Individuals and the Global Financial Crisis’ (2009) 32(2) *UNSW Law Journal* 514, 520-6.



Donald suggests that the reasons for this include the lack of mechanisms within the legal framework which allow members to hold relevant persons, such as trustees or investment managers, to account; low levels of financial literacy which will affect the ability of members to assert their own rights or champion society's values; and perceived reluctance of the courts to encourage pursuit by members of rights which are not directly related to their role as superannuation fund beneficiaries.<sup>78</sup>

These issues arise in the context of APRA regulated funds because there is a separation of trustees from members, although there does not appear to be a prohibition on members also being trustees in these types of funds.<sup>79</sup> However, the issues outlined by Donald are highlighted because of this separation of members from the control of the fund. It may be thought that the same issues do not arise in a SMSF context, given the SMSF trustees are arguably more engaged and theoretically operate in that capacity in their own self interest. However, this is not always the case in funds where there are two or more members. This is illustrated in *Deputy Commissioner of Taxation (Superannuation) v Fitzgeralds* where the Federal Court imposed penalties on the trustees of an SMSF for breach of the SISA.<sup>80</sup> In that matter, one of the trustees, Mr Fitzgerald benefited from the breach as a member of the SMSF, to the detriment of Mrs Fitzgerald who was the other

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<sup>78</sup> Ibid 315-7.

<sup>79</sup> In fact, members were encouraged to participate in the management of their fund in the second reading speech of the then Treasurer when introducing the SIS Bill: John Dawkins, *Strengthening Super Security: New Prudential Arrangements for Superannuation*: Statement by the Honorable John Dawkins, M P, Treasurer of the Commonwealth of Australia, 21 October 1992 (Australian Government Publishing, 1992) 3.

<sup>80</sup> *Deputy Commissioner of Taxation (Superannuation) v Fitzgeralds* [2007] FCA 1602.

member. However, the Court imposed a penalty on both trustees because it felt it was unacceptable for a trustee to be a passive participant in the breaches.<sup>81</sup>

Therefore, even in the context of SMSFs and the Commissioner's regulation of them, the issues outlined by Donald provide some insight into the potential issues which may need to be addressed in attempting to shift the focus of the regulators from solely rule enforcement, which remains an important task to ensure confidence in the system, to championing the underlying values of the superannuation system, which may engender higher levels of voluntary compliance.

Adjusting the focus of the financial regulator to sponsor the relevant citizenship values is consistent with the changes to the public service recommended by recently endorsed report *Ahead of the Game: Blueprint for Reform of Australian Government Administration* (the 'Moran Report').<sup>82</sup> One of the key recommendations was to develop and implement new approaches to enable citizens to collaborate with government on policy and service design.<sup>83</sup> The challenge is to develop ways in which this aspiration can become a reality.<sup>84</sup> The first step is to gain a better understanding of the 'regulatory space' within which regulation occurs and the relationships between the actors occupying this space. This is the topic of the next section.

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<sup>81</sup> Ibid, [45].

<sup>82</sup> Department of Prime Minister and Cabinet, Commonwealth Government, *Ahead of the Game: Blueprint for Reform of Australian Government Administration* (2010). Further, and consistent with this theme is the vision in the *ATO's Strategic Statement 2010-15* is that "Australians value their tax and superannuation systems as community assets, where willing participation is recognised as good citizenship."

<sup>83</sup> Department of Prime Minister and Cabinet, above n 82, 39.

<sup>84</sup> For detailed discussion on the issue of citizen engagement flowing from the recommendations of the Moran Review, see Brenton Holmes, Department of Parliamentary Services, Parliament of Australia, 'Citizen's engagement in policymaking and the design of public services' (Research Paper No. 1 2011-12, Parliamentary Library, July 2011).

#### **4.5 The regulatory space – a shift in focus to values as regulatory goals**

The concept of ‘regulatory space’ was developed by Hancher and Moran in the context of economic regulation.<sup>85</sup> It is an analytical construct or image that can be used to conceptualise what constitutes regulation in a particular context. Once the interactions within and influences on the regulatory space are better understood then changes to it, for example taking a different approach to the interdependent relationships within it, may shift the entire regulatory system towards better efficiency and effectiveness.

A number of observations can be made about the construct which reflect what is arguably a more realistic reflection of the interdependence of the parties involved in the regulatory process. The first is that because the construct is a space, it is available for occupation.<sup>86</sup> In the context of the *SISA 1993*, that space is somewhat crowded and is occupied by numerous actors representing both private and public interests – these are the regulators (Commissioner, APRA and ASIC, as well as the Commonwealth Director of Public Prosecutions); the superannuation fund trustees; their advisors including but not necessarily limited to accountants, lawyers, financial advisors; the auditors and actuaries; the various representative bodies<sup>87</sup> and the courts and tribunals. The important role that auditors and

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<sup>85</sup> Leigh Hancher and Michael Moran, ‘Organizing Regulatory Space’ in Leigh Hancher and Michael Moran (eds) *Capitalism, Culture and Economic Regulation* (Clarendon Press, 1989).

<sup>86</sup> Ibid 277.

<sup>87</sup> For example, the Small Independent Superannuation Funds Association; SMSF Professional Association of Australia Limited; Law Council of Australia; CPA Australia and the Taxation Institute of Australia.

advisors play, particularly in the SMSF sector,<sup>88</sup> has been noted and as part of the latest Government review of the superannuation system, substantial changes have been recommended to ensure that these advisors are appropriately regulated.<sup>89</sup> Whether there is effective supervision of the superannuation industry, or if improvements could be achieved through changes in regulatory approach or focus, therefore necessarily requires reference to the regulator's activities not only in relation to the superannuation trustees themselves but also the third party advisors those trustees engage.

There are numerous actors within the regulatory space between whom the space is unevenly divided, and the proportion of space occupied by the actors can shift over time. This is not to suggest that the regulators can be made subordinate to the private interests or held 'captive' to those interests,<sup>90</sup> but rather what is conveyed here is the concept that the activity of regulation is defined by the interdependent relationships between those who occupy it.<sup>91</sup> It is argued that although the reality of economic regulation involves the enforcement of rules, that occurs in a broader framework which involves consideration of the activities undertaken by all the actors within the space – that is, enforcement of the rules may not be required because the firm the subject of the rules is already applying the law in its routine

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<sup>88</sup> It has been noted that given the ATO's limited resources and the large number of SMSFs it would need to rely heavily on auditors to report identified contraventions of the *SISA 1993* by SMSF trustees: Australian National Audit Office, Commonwealth Government, *The Australian Taxation Office's Approach to Managing Self Managed Superannuation Fund Compliance Risks* (Performance Audit Report No. 13, 1 November 2007), [2.56]. Further it was noted that accountants play a significant gatekeeper role in advising potential members into the SMSF product: Super System Review, above n 41, 233-34.

<sup>89</sup> Super System Review, above n 41, 230-40.

<sup>90</sup> A concept often referred to as 'regulatory capture' where the regulator becomes aligned with the interests of the firm or industry being regulated at the expense of the public interest. For further discussion on 'regulatory capture' see e.g. Peter Grabosky and John Braithwaite, *Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies* (Oxford University Press, 1986) 198-99; T Makkai and J Braithwaite, 'In and Out of the Revolving Door: Making Sense of Regulatory Capture,' in Robert Baldwin, Colin Scott and Christopher Hood (eds), above n 51, 173.

<sup>91</sup> Hancher and Moran, above n 85, 275.

application of its standard operating procedures, or that the superannuation fund member is able to bring the fund trustee to account through the Superannuation Complaints Tribunal without any interference or reference to a public regulator.<sup>92</sup> That activity in itself comprises the broader regulatory framework, or the 'regulatory space' within which the regulator is operating. The amount of space taken up by any particular actor, whether it be regulator, superannuation fund trustee, or advisor will shift depending on a number of factors. One such factor is time. For example, the regulators and the state will occupy more of the regulatory space where there is a crisis (for example, the collapse of a large superannuation fund) in an attempt to address the perceived deficiencies in the market by adding further rules. A further factor is the place at which the regulation occurs. It cannot be overlooked that the laws applying to superannuation funds include the laws of the States and Territories, for example the various Trustees Acts. Finally, a factor which will influence the amount of space a particular actor will occupy depends on the sector of the superannuation industry under consideration as the issues affecting the occupants of the regulatory space, and the identity of the actors will change depending on whether the relevant fund is an SMSF or a larger APRA fund.

Prosser refers to this vision of regulation as 'regulation as an enterprise' where regulation is undertaken in collaboration between regulatory agencies and overlaps with other actors within the regulatory space.<sup>93</sup> In this conception of regulation, a key characteristic is that the activity of regulation is delegated from the State, so that there is no such thing as 'self-regulation' by actors other than the

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<sup>92</sup> For a relevant discussion on the role of financial literacy in regulating the financial markets see Gail Pearson, 'Reconceiving Regulation: Financial Literacy' (2008) 8 *Macquarie Law Journal* 45.

<sup>93</sup> Tony Prosser, 'Models of Economic and Social Regulation' in Dawn Oliver, Tony Prosser and Richard Rawlings (eds) *The Regulatory State: Constitutional Implications* (Oxford University Press, 2010) 38.

public regulator. In the context of the *SISA 1993* scheme, the work undertaken by auditors and advisors is seen to be a further delegation of the regulatory function to leverage better efficiencies and to provide scope for learning from the 'private' actors.<sup>94</sup>

Another feature of the 'regulatory space' construct is that it can encompass a particular sector of the community, such as the superannuation industry, or it can be defined by reference to the issues which are to be the subject of the regulation within that sector.<sup>95</sup> For example, it can be used to consider issues such as illegal early release of superannuation entitlements as the subject of the regulation, rather than focusing on the relevant actors who may participate in that activity. This use of the construct is useful in analyzing the regulatory approach for issues which cross over areas of responsibility – such as the issue of making a superannuation fund non-complying which has the attendant negative taxation consequences attached to it.

It is apparent from the discussion above in relation to the criticisms of market failure and 'regulatory space' that the activity of regulation is more complex than the responsive regulation framework would suggest. There is emerging literature suggesting that regulation is in fact becoming 'de-centered' from the State and dispersed amongst the different actors within the regulatory space.<sup>96</sup> This is not to say that the responsive regulation framework should be done away with altogether, but rather this line of reasoning suggests that it must be recognised that the context within which that enforcement strategy is implemented which

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<sup>94</sup> Ibid.

<sup>95</sup> Hancher and Moran, above n 85, 277.

<sup>96</sup> For a detailed discussion of a 'de-centered' conception of regulation see Julia Black, 'Critical Reflections on Regulation' (2002) 27 *Australian Journal of Legal Philosophy* 1.

then influences how it is to be applied.<sup>97</sup> This suggests that what is needed is a clear statement of the goals of the regulatory system as a whole, in this case the superannuation system as opposed to the piecemeal approach in the current legislative scheme which has a clear purpose outlined for APRA but not the Commissioner<sup>98</sup>. How those goals are to be identified and ordered is the subject of the next section.

#### **4.5.1 Which values underpin Australia's retirement incomes system?**

Prosser, referring to social theory as a basis on which the rationale for regulation could be based, suggests that a regulator that adopts a technique that appreciates and supports values may be more effective than one that operates on the basis of individualized incentives.<sup>99</sup> This leads to the further observation that such an approach, which necessarily must take into consideration a range of values, necessitates a change in tools used to influence the behaviour of those subject to the regulation – a more sophisticated approach which accepts that the behaviour of those within the 'regulatory space' is affected by more than just economics but also culture and ethos. The constraints, within which the regulator must operate, including the legal framework, are not necessarily restraints on this change in approach. The decision-making model that the regulator applies can be crafted to

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<sup>97</sup> Chiu has placed the different concepts of contemporary regulation theory on a spectrum ranging from a framework where there is no formal regulation, allowing market forces to determine the outcomes of transactions to a strict liability framework where the sole purpose is to impose regulatory rules by the use of (sometimes severe) sanctions: Iris H-Y Chiu, *Enhancing responsibility in financial regulation – critically examining the future of public-private governance: Part I* (2010) *March Law and Financial Markets Review* 170, 181.

<sup>98</sup> See discussion in Chapter 3 in relation to the role of the regulators in the superannuation system at [3.1.2].

<sup>99</sup> Prosser, above n 60, 384-85.

respond to multiple values and be responsive to its environment (which is not necessarily solely focused on the actions of the regulated).<sup>100</sup>

The question remains, however, as to how to identify those values so that they are adopted by all actors within the regulatory space and are seen as relevant guiding principles which define the way in which interactions are to be undertaken. It is suggested that the objectives of the retirement income system, as outlined by the Henry Review,<sup>101</sup> can provide the basis for the regulatory goals or values to which the regulators can have regard when refocusing their administration. This is because these goals have already been the subject of public consultation and there appears to be support of these objectives from the relevant 'private' actors in the regulatory space.<sup>102</sup> The five goals identified by the Henry Review retirement income report were that Australia's retirement incomes system should be: *broad and adequate; acceptable* to individuals and equitable and not inappropriately bias other saving decisions; *robust* so that it can deal with various risks; *simple and approachable* to allow individuals to make decisions in their own best interests; and *sustainable* so that it is financially sound into the future and detracts as little as possible from economic growth.<sup>103</sup>

That is not to say that the policy objectives of the superannuation system are not relevant. However, the focus of the exercise here is to assist the Commissioner to establish clear guidelines in how he will interact with others in the regulatory

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<sup>100</sup> Ibid 386.

<sup>101</sup> Australia's Future Tax System Review Panel, Commonwealth Government, *The retirement income system: report on strategic issues* (2009), 7.

<sup>102</sup> Ibid. The consultation paper drew submissions ranging from the large superannuation fund trustees, financial system advisors, associations representing the various areas of the superannuation industry including SMSFs, commentators and self funded retirees. Access published submissions at <http://taxreview.treasury.gov.au/content/submission.aspx?round=3>.

<sup>103</sup> Australia's Future Tax System Review, Commonwealth Government, *Australia's future tax system retirement income consultation paper* (2008), 6.



space by identifying a set of values common to all actors within that space. The legislation and the accompanying policy are one set of values which must be taken into account. It is relevant to note in this context that it was recognised by the recent Financial System Inquiry that there is a lack of an agreed *policy* framework for the superannuation system, which affects the efficiency of the system as a whole and that such a situation needs to be rectified in order to ensure efficiency in the superannuation system.<sup>104</sup> The Financial System Inquiry suggested that the primary objective of the superannuation system should be ‘to provide income in retirement to substitute or supplement the Age Pension.’<sup>105</sup>

Further empirical work would be needed to determine whether the objectives identified by the Henry Review and the Financial System Inquiry are in fact reflective of the values that citizens feel should be championed through the superannuation system. These objectives have been chosen as the starting point for this debate because they represent the goals of the *retirement* income system as a whole, encompassing not only the specific supervisory framework contained in the *SISA 1993* but also the income tax incentives contained in the *ITAA 1997* and the age pension provisions. Such an approach is reflective of the reality of the regulatory space within which the Commissioner must discharge his duties as the regulator of SMSFs as well as the Commissioner of Taxation. It presents a common language with which the regulators may interact with the individuals who are intended to be influenced by the regulatory scheme.

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<sup>104</sup> Financial System Inquiry, Commonwealth Government, *Financial System Inquiry: Final Report* (Nov 2014), 95-100.

<sup>105</sup> *Ibid* 95.

To expand on this, the effect of the illegal early release of retirement savings has a broader community effect in that those involved in such schemes, whether or not they are eventually identified and sanctioned, will then become reliant on the age pension adding further pressure on government funding. Despite the implementation of better vetting procedures for newly registered SMSFs and the improved information sharing arrangements between the ATO and APRA, there continues to be individual involvement in such schemes.<sup>106</sup> This could be an indication of the lack of awareness by the broader community of the effect such practices have on the broader regulatory space. As consumers, the individuals may be attracted to such schemes as a further source of income, but as citizens there may be greater concern for the promulgation of such schemes and the effect they have on the broader retirement income system affecting the values of sustainability and equity within the retirement income system. Designing specific educational materials which focus on the connections between the age pension, and the issues in relation to its adequacy in supporting those in retirement, and the private retirement savings pillars of the retirement incomes systems may encourage individuals, as citizens, to take more responsibility for their actions in this area.<sup>107</sup>

Further, such an approach provides the Commissioner, who has often overlapping obligations as regulator of SMSFs and as the Taxation Commissioner, with a mechanism to employ in resolving these complex issues in a principled way – that is, by reference to values which are in common with others in the regulatory space.

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<sup>106</sup> Neil Olesen, 'Regulatory issues emerging from self-managed super fund cases' (Speech delivered at Self-Managed Super Fund Professionals' Association of Australia Annual Conference, Adelaide, 11 March 2009).

<sup>107</sup> The Super System Review recommended compulsory trustee education as one of the sanctions which could be applied in circumstances where there was a minor contravention of the *SISA 1993* provisions: Super System Review, above n 41, 228.

This is particularly relevant in circumstances where the Commissioner has discretion as to how he will apply a particular provision. In the *SISA 1993* context, the Commissioner has discretion in certain circumstances to continue to treat an SMSF as a complying superannuation fund despite a contravention of the legislation.<sup>108</sup> This discretion is to be exercised by reference to specifically listed criteria, one of which is broadly stated as ‘all other relevant circumstances’.<sup>109</sup> The Commissioner interprets this criterion to encompass other relevant actions of the trustee in relation to the contravention, such as whether there have been steps taken to rectify the contravention and the trustee’s previous compliance history.<sup>110</sup>

Taking a view of regulation where part of the Commissioner’s role is to promote the citizenship values underpinning the superannuation system, the question is whether another relevant circumstance that should be taken into account is whether making the SMSF non-complying would promote, or indeed undermine, those values. Taking an even more pervasive view of the importance of promoting such values, a further question is whether, even if there is no specific discretion within the relevant provisions to take those values into account, the Commissioner’s general powers of administration could support such considerations in applying those provisions.

#### **4.6 Conclusion**

Much of the current practice in regulatory enforcement, at least in the financial services sector, is exemplified in a command and control approach. This stems

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<sup>108</sup> *SISA 1993* s 42A(5).

<sup>109</sup> *SISA 1993* s 42A(5)(iii).

<sup>110</sup> Australian Taxation Office, Commonwealth Government, *Self managed superannuation funds – notice of non-compliance*, PS LA 2006/19, 30 November 2006, [36]-[37].

from the rationale for regulation in this area being based on a market-failure theory. That is, regulation or intervention by the State is inferior to outcomes achieved when the markets are left to their own devices, and should only be resorted to where there are identified market failures. An alternative rationale for regulation recognizes that the reality is more complex and is constituted by more than just the market, indeed it suggests that it is only by virtue of State regulation that the markets exist in the first place. The context within which regulation occurs is conceived as a regulatory space where each of the actors is interdependent on the others. In such a construct, it is possible to refocus the goals of regulation from correction of market failures to promotion of socially endorsed citizenship values. Regulators potentially have the power within their statutory frameworks to adopt such a change in focus.

However, before such a major paradigm shift in the approach to regulation can be implemented, or seriously considered, an analysis is required as to whether such a change falls within the legal powers of the Commissioner (and the other regulators within the superannuation system).<sup>111</sup> Yeung cautions against the pursuit of regulatory goals at the cost of constitutional values such as the rule of law, certainty and stability, accountability and transparency, procedural fairness and proportionality, consistency and rationality.<sup>112</sup> It is clear that the Commissioner is bound to follow the law he is charged with administering and act fairly between taxpayers. However, he has limited resources and thus must make decisions as to the best allocation of those resources to leverage the best outcome from the

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<sup>111</sup> It is noted here that such a change in approach to focusing on promoting citizenship values which underpin the superannuation system requires the commitment of all three regulators (APRA, ASIC and the ATO) within the superannuation area, otherwise such change may appear to introduce more disparity in administration between the regulators rather than improving levels of voluntary compliance.

<sup>112</sup> Karen Yeung, *Securing Compliance: A Principled Approach* (Hart Publishing, 2004) 49-51.

community's perspective. The scope of this power, commonly referred to as the general administrative power, is discussed in detail in the next chapter.

There are also the competing public law values that must be considered in relation to the Commissioner's administrative approach, including rule of law and accessibility to merits or judicial review of the decisions of the Commissioner.<sup>113</sup>

Without these safeguards, those affected by decisions of the Commissioner would have less confidence in the system and would be less inclined to participate willingly. How these public law concepts confine the potential actions the Commissioner can take under the *SISA 1993* is also a focus of the next chapter.

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<sup>113</sup> See e.g. Justice Robert French, 'Administrative law in Australia: Themes and values' in Matthew Groves and H. P. Lee (eds) *Australian Administrative Law: Fundamentals, Principles and Doctrines* (Cambridge University Press, 2007).

## Chapter 5: Administrative law context of SMSF regulation

### 5.1 Introduction

In the previous chapter the rationale for economic regulation was explored in the context of the Australian superannuation system. It was suggested that the Federal Government's agenda of moving the public service towards a 'citizen-centric' model<sup>1</sup> provided an opportunity to revisit the basis of the Commissioner's regulatory approach to SMSFs. Rather than do away with the responsive regulation model in relation to SMSFs, it was argued that the application of compliance action taken within the context of that model be driven by a focus on the promotion of values underpinning the retirement system as a whole. This approach is aimed at proactively addressing potential areas of breach rather than operating mostly on a reactionary basis to shape SMSF trustee behaviour.

The focus of this chapter is to describe and explain the administrative law context in which the Commissioner regulates SMSFs. Issues discussed in this chapter are: whether a pragmatic decision making model is consistent with the rule of law (Parts 5.2 and 5.3) and with general administrative law principles, which are explored by way of a detailed examination of justiciability (Part 5.4); the grounds of review available to affected parties (Part 5.5) and the availability of any remedies (Part 5.6).

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<sup>1</sup> Commonwealth of Australia, *Ahead of the Game: Blueprint for the Reform of Australian Government Administration* (2010), 39.

## 5.2 Overview of administrative law issues

Justice French observed that:

Administrative law defines the proper scope of governmental executive power. It is the ether in which private law moves in a regulated society.<sup>2</sup>

Given the pervasiveness of administrative law and the way in which it affects all citizens within a society in relation to their private lives, Justice French argues that it is possible to simplify administrative law into a number of themes and values which can then be used to inform a wider understanding of the operation of the rule of law in contemporary society. In so doing, reference to such themes and values can then at the very least give rise to an instinctive awareness that a public law issue has arisen without the need to refer to specific legal precedents nor for the person to have a background in law. Those themes are lawfulness, good faith, rationality and fairness.<sup>3</sup>

It is this theoretical approach which informs the basis of the proposition in the previous chapter that in order to garner better voluntary compliance for SMSF's the Commissioner should adjust or adapt the current responsive regulation model to focus on a set of values which underpins the broader retirement system. In placing those values at the centre of the Commissioner's administration of the superannuation system it is argued that he will increase the levels of voluntary compliance by SMSF trustees. The legislative framework would be better understood on an instinctive level by the trustees under such an approach rather

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<sup>2</sup> Justice Robert French, 'Administrative law in Australia: Themes and Values' in Matthew Groves and H.P. Lee (eds), *Australian Administrative Law: Fundamentals, Principles and Doctrines* (Cambridge University Press, 2007), 16.

<sup>3</sup> Ibid.

than a strategy focused on explaining the complex set of legal precedents. In this way, each person within the superannuation regulatory sphere would be working from the same fundamental values or principles, so increasing voluntary compliance over all.

However, this raises the question of whether it is open to the Commissioner to administer the superannuation system by reference to a set of values that are not explicitly stated in the relevant legislation. Although those values could be gleaned from the policy underpinning the legislation, their adoption is influenced by the administrative law themes mentioned above. After all, identifying such values necessitates consideration of the practical outcomes of applying the law in particular situations and, in that context, ensuring that an interpretation of the law that the Commissioner adopts is consistent with the identified values which underpin the superannuation system.

Taking such an approach to the administration of the superannuation system is consistent with the Commissioner's approach to 'pragmatic' administration.<sup>4</sup> In particular it takes into account the practical implications of taking a particular view of the law to ensure that a sustainable and as much as possible 'future proof' view of the law is adopted.

In the context of interpreting tax law, Duff refers to this statutory interpretation approach as a 'consequential analysis' approach.<sup>5</sup> Under this method, which is said

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<sup>4</sup> Chris Jordan, Commissioner of Taxation, *Reinventing the ATO*, (Speech delivered at Taxation Institute National Convention, Hobart, 27 March 2014).

<sup>5</sup> David G Duff, 'Interpreting the Income Tax Act - Part 2: Toward a Pragmatic Approach' (1999) 47 *Canadian Law Review* 471. In Australia, s 15AA of the *Acts Interpretation Act 1901* (Cth) mandates an approach which would promote the purpose or object of an Act over one that does not. For general discussion on statutory interpretation see Dennis Charles Pearce and Robert Stanley Geddes, *Statutory interpretation in Australia* (LexisNexis Butterworths, 8<sup>th</sup> ed, 2014); Francis Alan



to be an extension of the purposive approach to statutory interpretation, the practical outcome or effect of a particular interpretation is taken into account. In the Australian context, this type of analysis is apparent from the case law. Barnes notes that this may well lead to inconsistent outcomes because a court adopting, for example, a literal *interpretation* of a provision is not necessarily applying a literal *approach* to that statute.<sup>6</sup> Further, Burton suggests that in taking such a pragmatic approach to statutory interpretation, judges are in fact making value judgments which are subjectively based, and that in itself brings into question whether in fact the rule of law is a myth.<sup>7</sup>

In this context, the question arises as to whether the Commissioner, in placing values at the centre of his administration of SMSFs is in fact adding to that complexity and inconsistency taking a pragmatic approach to his administration of the *SISA 1993*. Robertson is critical of the Commissioner's 'policy intent' approach to interpretation of the tax law, arguing that it is not an application of the purposive approach to statutory interpretation but rather a 'most dangerous and fallacious approach'.<sup>8</sup> He refers to the Commissioner's 'policy intent' approach as one which takes a view on the underlying policy intent of the law in preference to examining the text itself. This is to be distinguished from the purposive approach to statutory interpretation which requires that the text of the law be given a

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Roscoe Bennion and Oliver Jones (eds.) *Bennion on statutory interpretation* (LexisNexis, 6<sup>th</sup> ed, 2012) and Judicial Commission of New South Wales *Statutory interpretation : principles and pragmatism for a new age* (2007).

<sup>6</sup> Jeffery Barnes, 'Statutory interpretation, law reform and Sampford's theory of the disorder of law – Part one' (1994) 22 *Federal Law Review* 116, 135-137.

<sup>7</sup> Mark Burton, 'The Rhetoric Of Tax Interpretation - Where Talking The Talk Is Not Walking The Walk' (2005) 1 *Journal Of The Australasian Tax Teachers Association* 1, [30].

<sup>8</sup> Mark Robertson 'The Dangers of the ATO's "Policy Intent" Approach to the Construction of Tax Acts (2014) 43 *Australian Tax Review* 22, 30.

meaning consistent with the purpose or objects of the Act in preference to a meaning which does not.<sup>9</sup>

The issues with such a pragmatic approach to the Commissioner's administration of the SISA 1993 as it relates to SMSFs is the focus of the discussion in this chapter. The first issue examined is whether such an approach is indeed consistent with the rule of law.

### **5.3 The rule of law and pragmatic administration**

As noted by Justice French, 'official decisions [must be] authorised by statute, prerogative or constitution'.<sup>10</sup> In the context of the Commissioner's duty as regulator of SMSF's, this raises the issue of whether placing a set of agreed values at the centre of the Commissioner's regulation of SMSFs can be supported by statute, prerogative or constitution.

#### **5.3.1 Regulation by reference to values – consistent with the rule of law?**

In the previous chapter the concept of a regulatory space was introduced. Central to this notion was the idea that there is no longer a direct 'command and control' relationship between the regulators and the regulated. McDonald describes the 'regulation job' as one shared between both public and private institutions.<sup>11</sup> The superannuation sphere involves multiple regulators, with legislative requirements

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<sup>9</sup> See *Acts Interpretation Act 1901* (Cth), s 15AA and *CIC Insurance Ltd v Bankstown Football Club Ltd* (1997) 187 CLR 384, 408. On the different approaches to statutory interpretation more generally see Dennis Pearce and Robert Geddes, *Statutory Interpretation in Australia* (Butterworths, 8th ed, 2014).

<sup>10</sup> French, above n 2, 23.

<sup>11</sup> Leighton McDonald, "The Rule of Law in the "New Regulatory State"" (2004) 33 *Common Law World Review* 197.

for private auditors to certify that certain behaviour has been adhered to by superannuation fund trustees. In recognition of this multi-dimensional context it was suggested that a commonly agreed set of values would go far in achieving voluntary compliance. However, recognizing that in reality the regulatory space is shared between the actors, rather than having the regulators directly control the regulated, McDonald has questioned whether the rule of law can co-exist with the 'new regulatory state'.<sup>12</sup>

The rule of law is a concept that is not easily defined.<sup>13</sup> The essence of the rule of law has been described as 'safeguarding individual liberty and integrity against government oppression'.<sup>14</sup> It has been suggested that there are three core principles that lie at the heart of the rule of law:

First, the polity must be governed by general rules that are laid down in advance. Secondly, these rules (and no other rules) must be applied and enforced. Thirdly, disputes about the rules must be resolved effectively and fairly.<sup>15</sup>

Saunders and Le Roy acknowledge that there may be some controversy about these core principles, in that in reality the rule of law is rarely, if ever, a discrete legal principle in its own right, but rather 'an approach to governance on which the efficacy of law, and constitutionalism rests'.<sup>16</sup> However for current purposes, these core principles serve to illustrate the focus of the rule of law on those rules made

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<sup>12</sup> Ibid, at 197-199.

<sup>13</sup> For a summary of the various formulations of the rule of law, see K Mason, 'The Rule of Law' in P Finn (ed), *Essays on Law and Government, Vol 1* (Law Book, 1995) and Chief Justice Murray Gleeson, 'Courts and the Rule of Law' (Speech delivered at the Rule of Law Series, Melbourne University, 7 November 2001).

<sup>14</sup> John McMillan, 'The Ombudsman and the Rule of Law' (2005) 44 *AIAL Forum* 1, 2.

<sup>15</sup> Catherine Saunders and Katherine Le Roy (eds), *The Rule of Law* (Federation Press, 2003), 5.

<sup>16</sup> Ibid.

by the Parliament, and rules or practices developed by a regulator, such as the Commissioner, may be viewed as impinging on the purity of those rules.<sup>17</sup>

The importance of this conclusion cannot be understated. Regulation by its very nature requires a framework of rules against which certain behaviour can be measured. For example, any action that is to be undertaken by the Commissioner in relation to the behaviour of SMSF trustees must be based in law. This must be the case, else confidence in the system as a whole would be impinged. However, it is argued that rather than taking a reactive stance in relation to taxpayer behaviour there is scope to evolve the application of the compliance model as it relates to SMSFs. That evolution of the model attempts to influence SMSF trustee behaviour by explicitly recognizing that the trustees are equally responsible for the SMSF system as is the Commissioner – that is both parties are actors within the SMSF regulatory space rather than having a direct, and perhaps confrontational, relationship as the regulator and the regulated. By putting a set of values at the centre of the interaction between the Commissioner and other actors within the regulatory space, the implications of certain actions, which are seen to be inconsistent with the stated values, could arguably be anticipated by all parties affected. The question then is, whether such an approach is consistent with the rule of law.

### **5.3.2 Compliance model and the rule of law**

Let us start by examining rule of law concerns in the context of the compliance model that is currently used by the Commissioner. Burton suggests that a key

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<sup>17</sup> Compare this with McDonald above n 11, at 221 where it is suggested that the current system of regulation raises the question of the guidance function of the rules in securing the values that underlie the system or area that is regulated.

issue with the compliance model is not that it is inconsistent with the rule of law, but that it makes certain unfounded assumptions about the determinacy of the laws the Commissioner administers.<sup>18</sup> In this regard, the proponents of the responsive regulation model accept that the concept of a clear, well understood and consistently applied law is central to that model. Without such an assumption, it wouldn't be possible to determine whether the taxpayer is taking an 'aggressive standpoint' in relation to their compliance with the law. Burton points to a superannuation example of the uncertainty inherent in legislation, where the Commissioner's application of the general anti-avoidance provisions appeared to be surprising.<sup>19</sup>

Superannuation re-contribution arrangements involve taxpayers taking a superannuation benefit, within the eligible termination tax-free threshold, and subsequently 're-contributing' that amount as an undeducted contribution to their superannuation fund. This had the effect of reducing tax paid on the retirement benefits and thus increasing the net amount of those benefits. The Commissioner has stated that such re-contribution strategies did not involve tax avoidance.<sup>20</sup> Burton argues that although such a position could be defended on the basis of superannuation policy, it seemed inconsistent with the broader tax policy and particularly the Commissioner's views on the application of Part IVA of the *Income Tax Assessment Act 1936* as outlined in the Commissioner's own practice statement

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<sup>18</sup> Mark Burton, 'Responsive Regulation and the Uncertainty of Tax Law – Time to Reconsider the Commissioner's Model of Cooperative Compliance' (2007) 5(1) *eJournal of Tax Research* 71.

<sup>19</sup> *Ibid*, 88-89.

<sup>20</sup> Commissioner of Taxation, 'Guidance on re-contributions to superannuation' (Media Release Nat 04/058, 4 August 2004). The ATO has since confirmed that certain re-contribution strategies will not attract the anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936*, although such strategies would be less tax effective following the simpler superannuation changes effective from 1 July 2007 - Minutes of Superannuation Technical Committee of agenda item 6.4 and ATO Private Ruling No. 1012443439489.

which outlined the indicia of an aggressive tax planning scheme.<sup>21</sup> In particular, it appears that such recontribution schemes appear to satisfy those indicia: specifically, an arrangement which is artificial involving a round robin of payment with an absence of a non-tax justification.

Burton notes that 'this apparently arbitrary application of the general anti-avoidance rules may foster cynicism among tax advisors.'<sup>22</sup> In fact, some tax practitioners at the time of the Commissioner's statement in 2004 had advised against undertaking such recontribution strategies<sup>23</sup> and subsequently, and as recently as 2011, fund managers had refused to allow such amounts to be recontributed given concerns in relation to the application of Part IVA.<sup>24</sup>

This specific example illustrates the issues that arise where the perceived policy rationale for one set of provisions for which the Commissioner is responsible, in this case the taxation of superannuation benefits, appears to conflict with another part of the income tax provisions (Part IVA). These perceived conflicts arise perhaps not from the rules themselves but rather from the application of those rules by the Commissioner, which illustrates the indeterminacy of the law. The different context of the superannuation regulatory provisions for SMSFs in the SISA gives rise to an additional layer of complexity. Much of the SISA provisions are directed towards regulating the behaviour of trustees of superannuation funds and their advisors. The implications for failing to comply with the standard of behaviour set in the SISA are translated into a taxation liability.

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<sup>21</sup> In particular Burton points to the Commissioner's practice statement PS LA 2001/15 (which has been withdrawn and replaced by PS LA 2005/13).

<sup>22</sup> Burton, above n 18, 90.

<sup>23</sup> Ibid.

<sup>24</sup> Minutes of ATO Superannuation Technical Committee, above n 20, agenda item 6.4.

A way to address Burton's concerns that the compliance model assumes that the law is certain when in fact it is more often than not indeterminate is to recognise the fact that the Commissioner is specifically charged with responsibility for administering the income tax and SISA provisions. Each Act that the Commissioner administers contains a 'general administrative power'. In the *SISA* the provisions broadly state that the Commissioner of Taxation has the 'general administration' of the SISA to the extent it relates to SMSFs and, where relevant, to the extent that administration is not conferred on ASIC or APRA.<sup>25</sup> There are equivalent provisions in the *Income Tax Assessment Acts*<sup>26</sup> and other taxation legislation.<sup>27</sup>

It is arguable that the essence of this duty to administer the relevant Acts provides a legislative basis for the Commissioner, in circumstances where it may appear that there are two competing policy objectives, to adopt an interpretation which provides the best pragmatic outcome which supports the integrity of the system as a whole. Effectively this approach would be a values-focused administration of the provisions which would better cope with the inherent indeterminacy of tax law and provide a consistent approach to the application of the provisions, albeit the results in particular circumstances may not always be perceived to be consistent. However, this suggested alteration to the focus of the compliance model as the Commissioner currently applies it would be at least more consistent with rule of law than the current regulatory approach which could be described as backward looking and reactionary.

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<sup>25</sup> *SISA* ss 6(1)(e), (f), (2A), (2B) and (4).

<sup>26</sup> *ITAA 1997* (Cth) s 1-7; *ITAA 1936* (Cth) s 8.

<sup>27</sup> See e.g. *Superannuation Guarantee (Administration) Act 1992* (Cth) s 43; *Small Superannuation Accounts Act 1995* (Cth) s 6; *Sales Tax Assessment Act (No. 1) 1930*, s 4.

Although those elements of the compliance model must remain to apply a consistent approach to those who are deliberately not complying with the law, an adjustment in focus would allow for the Commissioner to be more proactive and anticipate potential breaches in the future. Given the Commissioner's limited resources, building a partnership with others in the superannuation regulatory space, based on the common language of values, would garner the best leverage in these circumstances. Despite these benefits, there may remain a concern that the compliance model itself is inconsistent with the rule of law. This issue is considered in the next section.

### **5.3.3 Overview of the scope of the general administrative power**

There has been little analysis in Australian jurisprudence about the scope of the Commissioner's general administrative powers in the context of the *SISA 1993*.<sup>28</sup> The equivalent provision in the income tax provisions has had some, but not extensive, judicial consideration. These cases are relevant to determining whether the general administrative power in the *SISA* could support an administrative approach based on agreed values which underpin the superannuation system.

It has been recognized that due to the Commissioner's limited resources he must take a pragmatic approach to administration of the Acts for which he is responsible.<sup>29</sup> In *Macquarie Bank Limited v Commissioner of Taxation*<sup>30</sup> the Federal Court considered the scope of the general administrative power in the context of

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<sup>28</sup> A passing reference was made to *SISA* s 6 by the Full Federal Court in *Interhealth Energies Pty Ltd as Trustee of the Interhealth Superannuation Fund v Commissioner of Taxation* [2012] FCAFC 185, at [21]-[24].

<sup>29</sup> See for example *Grofam v FCT* 97 ATC 4656, 4665 for statements relating to income tax matters, and *Precision Pools Pty Ltd v FC of T & Anor*; *Qld Pool & Spa Const Pty Ltd v FC of T & Anor* (1992) 37 FCR 554 for discussion in the context of the former sales tax regime.

<sup>30</sup> *Macquarie Bank Limited v Commissioner of Taxation* [2013] FCA 887.



published guidelines which had been expressed by the Commissioner as mandatory for staff to follow. Those guidelines, in the form of a practice statement, provided procedures for circumstances where the Commissioner had taken a position in relation to the law that was different to that which he had previously held or was taken to have held by reference to his conduct.<sup>31</sup> Macquarie had been the subject of a number of audits, at the conclusion of which the Commissioner had issued assessments, together with reasons for his decision. Macquarie argued that the Commissioner had acted against his own guidelines, and hence contrary to the general administrative power, in retrospectively applying the Commissioner's views formed during the audit. It sought declaratory relief under section 5 of the *Administrative Decisions (Judicial Review) Act 1977* (Cth) and s 39B of the *Judiciary Act 1903* (Cth).

At first instance, Edmonds J noted that the general administrative power, whilst properly described as a power, is more accurately referred to as a duty.<sup>32</sup> In this sense, Edmonds J went on to say, it is not a power that can create, extinguish or modify the legal rights of taxpayers, nor does it allow for the power to promulgate rules that create legal rights or immunities such as delegated legislation.<sup>33</sup>

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<sup>31</sup> Commonwealth of Australia, Commissioner of Taxation, *Law Administration Practice Statement PS LA 2011/27: Matters the Commissioner considers when determining whether the ATO view of the law should only be applied prospectively*.

<sup>32</sup> *Ibid* at [76].

<sup>33</sup> *Ibid*.

On appeal the Full Federal Court agreed with these statements and went on to say:

The power of general administration in such provisions is not a discretion to modify, or which modifies, the liability to tax imposed by the statute: **the power in such provision for general administration (coupled with whatever discretion they may contain) affects the administration of the Acts and not the Commissioner's duty to act according to law and to assess taxpayers to the correct amount of liability imposed by the legislation.**<sup>34</sup> (emphasis added)

These statements are clearly made in the context of the Commissioner's duties under the income tax legislation – the core obligation of which is to collect the right amount of tax 'not a penny more, not a penny less'.<sup>35</sup> However, the Commissioner's duties under the *SISA* have a very different focus. As was outlined earlier,<sup>36</sup> the *SISA* is enacted under a combination of the taxation, corporations and old-age pensions powers of the Constitution.<sup>37</sup> This unique mix was required because there was no specific head of power under the Constitution in relation to 'superannuation'. The provisions the Commissioner enforces as regulator of SMSFs are directed at behaviour, and more specifically ensuring prudent behaviour, from SMSF trustees.

If under income tax laws it is recognised that the general administrative power allows the Commissioner the discretion to reassess and consider evidence he is willing to accept as constituting the 'taxable facts', this flexibility is all the more powerful in a regulatory sense. The 'taxable facts' are taken into account to

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<sup>34</sup> *Macquarie Bank Limited v Commissioner of Taxation* [2013] FCAFC 119 at [11] per Middleton, Pagone and Davies JJ.

<sup>35</sup> *Lighthouse Philatelics Pty Ltd v. FCT* (1991) 32 FCR 148 at 155 per Lockhart, Burchett and Hill JJ.

<sup>36</sup> See discussion in Chapter 2.

<sup>37</sup> Constitution, ss 51(ii), 51(xx) and 51(xxiii) respectively.

determine the liability of the taxpayer under the law. In the context of the *SISA*, the equivalents of the 'taxable facts' are the actions and circumstances under which an SMSF trustee undertakes certain decisions. Although there is a specific power to ignore breaches of the *SISA* by SMSF trustees,<sup>38</sup> the aim of taking a more proactive compliance approach is to avoid such breaches in the first place.

The proposition here is not to have the Commissioner attempt to fill in gaps in the law that are perceived to give rise to anomalous outcomes. This type of power has been referred to an 'extra-statutory concession power'. Such a power exists, for example in the *Corporations Act 2001 (Cth)*, where the relevant provisions are directed at regulating behaviour. However, in a taxation context, it has been recognised that such a power, which would require legislative change, would cause uncertainty in relation to a taxpayer's taxation liability for any particular period.<sup>39</sup>

Similar issues have arisen in the context of the equivalent administrative provisions administered by Her Majesty's Revenue and Customs (HMRC), which have been applied in a more expansive fashion than in Australia. An examination of the wider application of the UK equivalent of the general administrative power is therefore instructive in determining the extent to which such a power could be used to support an evolution of the compliance model in an Australian SMSF context.

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<sup>38</sup> Which itself is limited by reference to specific factors – see *SISA 1993* s 42A(5).

<sup>39</sup> The issue of whether the Commissioner should be given an extra-statutory concession power in a taxation context was raised in the Treasury discussion paper 'An 'extra-statutory concession' power for the Commissioner of Taxation?' (12 May 2009). Concerns were raised in submissions on this discussion paper by the Taxation Institute of Australia, Submission to Commonwealth Treasury, 'An extra-statutory concession power for the Commissioner of Taxation?' (15 July 2009), 1.

The UK equivalents of the Commissioner's general powers of administration are contained in two acts, and are generally referred to as the 'powers of care and management'. Section 13 of the *Inland Revenue Regulation Act 1890* (UK) provides:

The Commissioners shall collect and cause to be collected every part of inland revenue, and all money under their care and management.

Section 1 of the *Taxes Management Act 1970* (UK) states

Income tax, corporation tax and capital gains tax shall be under the care and management of the Commissioners of Inland Revenue.<sup>40</sup>

Her Majesty's Revenue & Customs (HMRC) have used the powers of care and management to develop a system of administrative rules which have been referred to as 'extra-statutory concessions'. Those are described by HMRC as:

...In certain circumstances where remission or repayment of revenue is not provided for by law, the department may allow relief on an extra-statutory basis. ESCs are remissions of revenue that allow relief in specific sets of circumstances to all businesses falling within the relevant conditions. They are authorised when strict application of the law would create a disadvantage or the effect would not be the one intended.<sup>41</sup>

At face value, that statement appears to suggest that the HMRC's powers of care and management are wider in application than being limited to decisions of a managerial nature, but that they can extend to allow some taxpayers concessions which would have the effect of reducing tax otherwise payable. However, in a series of court decisions, the perception was displaced.

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<sup>40</sup> Not unlike the situation in Australia, similar formulation of the 'care and management' power is contained in the other taxes administered by the Inland Revenue Commissioners such as the Value Added Tax, stamp duties, car taxes, betting and gaming taxes, insurance premium tax, and oil taxes.

<sup>41</sup> HM Revenue & Customs *VAT Notice 48: extra statutory concessions* (21 March 2012).

In *IRC v National Federation of Self- employed and Small Businesses Ltd*<sup>42</sup> (the *Fleet Street Casuals* case) it was considered that in the exercise of the HMRC's functions of the care, management and collection of income, corporation and capital gains tax, the Commissioners had a 'wide managerial discretion' to determine the best means of obtaining the highest return for the exchequer having regard to the staff available and the costs of collection.<sup>43</sup> However, if the Commissioners were proposing to exercise those powers or refrain from exercising those powers not for reasons of 'good management' but for some extraneous or ulterior reason, that action or inaction of the Board would be *ultra vires* and would be a proper matter for judicial review.<sup>44</sup>

Subsequently, the House of Lords again considered the extent of the wide managerial discretion in *Al Fayed v Advocate General for Scotland (representing the IRC)*.<sup>45</sup> The House of Lords observed that the ability to make extra-statutory concessions was limited and there was no ability to make a concession where it would conflict with the statutory duty of the Commissioners.<sup>46</sup>

The legality of extra-statutory concessions was more recently tested in the case of *R v IRC, ex parte Wilkinson*.<sup>47</sup> Lord Hoffman there stated that whilst the Commissioners were able to use the relevant power to make pragmatic decisions about the collection of taxes due, that power did not allow for the Commissioners to provide a concession which Parliament could have granted but did not. These

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<sup>42</sup> *IRC v National Federation of Self- employed and Small Businesses Ltd* [1982] AC 617; [1981] UKHL 2 (*Fleet Street Casuals* case ).

<sup>43</sup> *Fleet Street Casuals* case [1982] A.C. 617, 623.

<sup>44</sup> *Ibid.*

<sup>45</sup> *Al Fayed v Advocate General for Scotland (representing the IRC)* [2004] ScotCS 278.

<sup>46</sup> *Ibid.*, [78].

<sup>47</sup> *R v IRC, ex parte Wilkinson* [2005] UKHL 3.

statements further clarify the scope of the *Al Fayed* decision in that the powers of care and management are to be exercised for the proper management of the *collection* of taxes where that obligation was established under law and not for any extraneous motives or reasons. If the Revenue had acted to provide Mr Wilkinson with an extra-statutory concession for the purpose of general equity it would have acted *ultra vires* to its general powers of administration.

#### **5.3.4 Application of the general administrative power in the context of the SISA**

As can be seen from the decision in *Macquarie* discussed above, similar issues as those identified in the UK HMRC cases arise in relation to the Commissioner's administration of the taxation laws. However, it is arguable that there is more flexibility in the context of the *SISA 1993* given those provisions are directed at regulating *behaviour* rather than collecting an amount of revenue, the liability for which is established under the taxation laws.

It is not asserted that in the context of the *SISA* there is ability for the Commissioner to essentially ignore the law but rather that he is able to apply those provisions having regard to the set of values that have been developed by reference to the policy underpinning the SMSF provisions in the *SISA*. Such an approach is consistent with consequential analysis which Duff advocates, and would apply a more pragmatic outcome in many cases. The difference in focus of the regulatory provisions, that is on behaviour, allows for this flexibility and in doing so, the Commissioner would not be tying his hands or binding himself to

apply the law other than as he finds it.<sup>48</sup> This suggested application of the general administrative power then leads to the question of whether administration of the SISA based on values can in fact be legally challenged. This issue is considered in the next section.

#### **5.4 Justiciability – is the Commissioner’s administrative approach open to judicial review?**

There is a question as to whether the actions undertaken by the Commissioner in the ‘good management’ of the laws that he administers could generally be subject to judicial review. Bevacqua suggests that in the context of a tortious or equitable claim against the Commissioner, there may be a range of circumstances in which a court may find the issue non-justiciable.<sup>49</sup> One example provided is where a decision to grant damages may result in the taxpayer either directly or indirectly paying less tax than is legally due. Another reason advanced is that a Court decision that substitutes a different policy approach to that adopted by the Commissioner, may be seen to restrict or modify the role of the Commissioner himself.<sup>50</sup>

In contrast to this position, Finn argues that issues involving policy as set by the relevant administrator can be subject to judicial review provided the issues put before the court can be phrased in terms of the effect of a particular decision made

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<sup>48</sup> Which was one of the issues in the *Al Fayed* and *Re Preston* cases referred to in the context of the UK equivalent provisions discussed above in part 5.3.3.

<sup>49</sup> John Bevacqua, ‘The plaintiff-proof barrier – the justiciability of activities of the Commissioner of Taxation in tortious and equitable estoppel taxpayer claims’ (2008) 1 *Journal of The Australasian Law Teachers Association* 365, 366.

<sup>50</sup> *Ibid* 366.

by reference to those polycentric policy issues.<sup>51</sup> Whilst it is recognised that a decision of a court may have broader implications for the administration of the relevant system and influence the approach the administrator might otherwise take, the actual issue in dispute between the parties would generally not involve the court resolving such complex policy issues.

Although these views may seem diametrically opposed, it appears that they can practically be reconciled. This is because, as Finn points out, generally a court would not be asked to resolve such complex policy issues but rather the questions put before it would more likely be whether any particular cause of action could be made out in the specific circumstances.<sup>52</sup> Bevacqua implicitly agrees with this conclusion, in that he argues that in cases where the court has determined a particular issue to be ‘not justiciable’, the reasons given should be direct, consistent and transparent about whether the question put to the court is in fact asking the court to review a policy decision or consider the relevant system in operation.<sup>53</sup>

The question of how the Commissioner should go about administering the SISA in respect of SMSFs gives rise to extremely complex polycentric policy issues. A challenge against the Commissioner’s administrative approach to SMSFs, even if the challenge were narrowed to the question of whether that approach was consistent with the rule of law and hence whether the Commissioner was acting *ultra vires*, would likely fail given it would ask the court to determine an administrative policy issue. That is, how the Commissioner chooses to administer

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<sup>51</sup> Chris Finn, ‘The justiciability of administrative decisions: a redundant concept?’ (2002) 30 *Federal Law Review* 239, 244.

<sup>52</sup> *Ibid* 245-246.

<sup>53</sup> John Bevacqua, above n. 49, 376.



the SISA provisions as they relate to SMSFs is a question wholly within the Commissioner's control and, due to the separation of powers doctrine, an area where a court will not venture.

The judicial decisions discussed in the section above in relation to the general administrative power have all arisen in a context of a specific application of the Commissioner's practices to a taxpayer's specific circumstances. In essence the question is whether the relevant application of the law, including the general administrative power, which translated into the practical steps that the Commissioner took, was within the Commissioner's powers. That is, whether the specific actions taken by the Commissioner, as opposed to the overarching approach, were sanctioned by the statute in question.

Flowing from this conclusion, the question then becomes on what grounds could an action be based? Further, who can bring an action against the Commissioner where it is perceived that his application of the law, as guided by the values applied in the context of the compliance model could give rise to unintended outcomes. If standing in such cases can be established, then consideration of the available and appropriate remedies is required.

## **5.5 Grounds of review**

The specific circumstances in which a particular person who is 'affected' by a decision of the Commissioner can object are specified in the relevant SISA and *Taxation Administration Act 1953* (Cth) (TAA) provisions.<sup>54</sup> However, these grounds of review are focused on a particular taxpayer's specific circumstances by

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<sup>54</sup> SISA, s 344 and TAA, Part IVC.

reference to particularized 'reviewable decisions'. As such those provisions are not conducive to supporting a review by a court or tribunal based on an approach which the Commissioner may choose to take to administer the superannuation system as it relates to SMSFs more generally.

### **5.5.1 Common law actions**

The High Court has made it clear that in cases involving a valid tax assessment, the taxpayer is restricted to challenging such assessments in proceedings commenced under Part IVC of the *TAA 1953*.<sup>55</sup> However, the Court also acknowledged that there was scope for challenge under the common law, although it would appear that the appropriate avenue in these cases would be an action seeking a prerogative writ under the *Judiciary Act* s 39B or the Constitution s 75(v).<sup>56</sup> These avenues of appeal are discussed below. However, at a more general level there is an issue of whether a decision made by the Commissioner in respect of an SMSF within a value-based compliance model could be the subject of a collateral attack under the common law.

A collateral attack in these circumstances is used in the sense of a person asserting invalidity in the Commissioner's decision as a preliminary step in proceedings where damages are claimed.<sup>57</sup> It may be possible to do so in the context of the *SISA 1993* as there is no equivalent provision as that found in the *ITAA 1936*, s 175 and 177 of which validates an assessment for tax despite any omissions made by the

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<sup>55</sup> *Commissioner of Taxation v Futuris Corporation Ltd* [2008] HCA 32, [25].

<sup>56</sup> *Ibid* [56].

<sup>57</sup> For detailed analysis of collateral attack see Enid Campbell, 'Collateral Challenge of the Validity of Governmental Action' (1998) 24(2) *Monash University Law Review* 272.

Commissioner in the course of issuing that assessment.<sup>58</sup> Affected persons, such as trustees of superannuation funds who may have been disqualified by the Commissioner may seek damages in an attempt to recoup some of the value lost from their fund as a result of actions taken by the Commissioner under the *SISA 1993*.

Whether a Court would entertain such an action is another question. Bevacqua suggests that given the past judicial stance on whether the Commissioner could be subject to a tortious or equitable claim, which in his opinion is heavily skewed towards protection of the revenue, there is a 'largely impenetrable and invisible barrier'.<sup>59</sup> As was noted by Kitto J in *Federal Commissioner of Taxation v Wade*, 'no action on the part of the Commissioner can operate as an estoppel'.<sup>60</sup>

As noted above arguably there may be more scope to challenge on common law grounds the Commissioner's decisions under the *SISA* given the focus of the provisions is to regulate behaviour rather than collect revenue.<sup>61</sup> The potential in this circumstance for a common law or civil action for damages is supported by the fact that both APRA and ASIC have provisions in their Acts which protect officers from civil actions for damages where they act in good faith in the discharge of their duties under the relevant legislation (including the *SISA*).<sup>62</sup> What is interesting is

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<sup>58</sup> The operation of *ITAA 1936* s 175 and 177 were central to the discussion in *Futuris* [2008] HCA 32.

<sup>59</sup> Bevacqua, above n. 49, 377.

<sup>60</sup> *Federal Commissioner of Taxation v Wade* (1951) 84 CLR 105, 117.

<sup>61</sup> For example, a decision to disqualify or remove a trustee of an SMSF from office (*SISA 1993* s126A) or to enter into an enforceable undertaking are made and enforced by the Commissioner under the *SISA* (*SISA 1993* s262A) without any income tax implications. Compare this with the example of where a SMSF is made non-complying which automatically results in tax being applied to the market value of the fund's assets as determined at the start of the relevant income year (*ITAA 1997* s 295-325).

<sup>62</sup> See eg *Australian Securities and Investments Commission Act 2001* (Cth), s 246; *Australian Prudential Regulation Authority Act 1998* (Cth), s 58.

that the Commissioner of Taxation does not have similar protection under the terms of the SISA. The former provision which would have covered all regulators under the SISA was repealed following the Financial Sector Reforms.<sup>63</sup>

Although the effect of the assessing provisions in the income tax context would provide the Commissioner and his officers with a similar protection in relation to the tax consequences which may flow from a decision made under the SISA,<sup>64</sup> this will not always be the case. However, it would arguably be difficult to establish an action in tort, say for breach of duty of care, or as an equitable claim for damages where the challenge is to the Commissioner's broad approach to administering the SISA for SMSFs. One of the difficulties of such a claim, provided the relevant plaintiff has standing to bring the action in the first place – the issue discussed in the next section – is to establish that there was in fact any duty of care owed to that person in particular in relation to the Commissioner's adopting of a particular administrative approach and how that could translate into a loss incurred by that particular person.

The same difficulties arise in relation to the tort of misfeasance in public office.<sup>65</sup>

This tort applies specifically to a public officer in the purported exercise of his or her duties; the act or conduct must have been done either maliciously or knowing

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<sup>63</sup> SISA, former s 340 repealed by *Financial Sector Reform (Amendments and Transitional Provisions) Act 1998* (Cth) Sch 16, item 24. The equivalent provisions were included in the relevant acts establishing ASIC and APRA per n. 51 above. The fact that the Commissioner and his officers, as regulator of SMSFs, was not provided with a similar protection was not discussed in the explanatory materials which accompanied the relevant Bill.

<sup>64</sup> See ITAA 1936, ss 175, 175A and 177(1) and the High Court decision in *Federal Commissioner of Taxation v Futuris Corporation Ltd* [2008] HCA 32 (*Futuris*).

<sup>65</sup> For a detailed analysis of the tort of misfeasance in public office see Mark Aronson, 'Misfeasance in Public Office: a very peculiar tort' (2011) 35 *Melbourne University Law Review* 1. For an outline of the principles of this tort see Sarah Hannett, 'Misfeasance in Public Office: the principles' (2005) 10 *Judicial Review* 227 and Duncan Fairgrieve, 'Damages claims against public bodies: The role of misfeasance in public office' (2007) 12 *Judicial Review* 169.

that the impugned act or conduct was unauthorized and it was foreseeable that it would cause loss or harm to the claimant.<sup>66</sup> The High Court has specifically acknowledged that this tort may still be applied in the context of the Commissioner making assessments of tax even though there is a specific provision in the law which effectively ignores errors made by the Commissioner in issuing the assessment.<sup>67</sup> Given there are no equivalent provisions in the SISA providing the same level of protection to the Commissioner in the context of his decisions under that act, it follows that the tort could also apply in that circumstance. However, it would be difficult for a plaintiff to prove any personal loss suffered, or more accurately that it would be foreseeable that a loss would be suffered by that particular person when the Commissioner adopted his administrative approach to regulating SMSFs.

### **5.5.2 Statutory causes of action**

Similar challenges present themselves when considering the grounds of review available under *Judiciary Act 1903* (Cth), section 39B (a section 39B application) or an action under the *Administrative Decisions (Judicial Review) Act 1977* (Cth) (the ADJR Act). Whether a decision by the Commissioner to adopt a particular administrative approach is open to challenge under either of these provisions depends on the specific requirements of each Act.

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<sup>66</sup> *Three Rivers District Council v Bank of England (No. 3)* [2001] UKHL 16, 191-193.

<sup>67</sup> *Futuris* [2008] HCA 32, [59]-[60].

### 5.5.2.1 Application for review under *Judiciary Act*, s 39B

There is limited case law in relation to challenges to a statement of policy by the Commissioner as opposed to a type of collateral attack on an assessment issued by the Commissioner in respect of a particular taxpayer. Generally in the latter case, in order to gain the relief sought in a section 39B application, the taxpayer must show that the assessments were made in exercise of abuse of power and for improper purposes, or in other words, bad faith.<sup>68</sup>

In relation to the former situation, in *Young v FC of T*<sup>69</sup> (*Young*) the taxpayer challenged a policy statement by the Commissioner in relation to the application of penalties and the anti-avoidance provisions in Part IVA of the *ITAA 1936*. In concluding that the policy statement was not generally reviewable, Gyles J stated:<sup>70</sup>

There is also a real question as to whether the relief is not premature and the question hypothetical. Whilst I have found that the Policy is, in the relevant sense, inflexible, and it is clear that the Commissioner threatens to carry it out, the Policy as such is not generally reviewable by the Court. The administration of the Act is vested in the Commissioner and he is not answerable to the Court for that administration. Judicial review, it must be recalled, is rooted in the notion of ultra vires (*Corporation of the City of Enfield v Development Assessment Commission* [2000] HCA 5 (10 February 2000), par 43 and 44; *Xu v Minister for Immigration & Multicultural Affairs* [1999] FCA 1741 (17 December 1999) par 41 and 42). The judiciary has no role in matters of administration.

These statements provide some basis for concluding that any challenge by a taxpayer to the Commissioner adopting a particular approach to administration of

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<sup>68</sup> *Deputy Federal Commissioner of Taxation v Richard Walter* [1995] HCA 23; see also *Futuris* [2008] HCA 32 and references to the Hickman principle which is contained in the High Court's decision in *R v Hickman; ex parte Fox & Clinton* [1945] HCA 53.

<sup>69</sup> *Young v FC of T* [2000] FCA 122.

<sup>70</sup> *Ibid* [18].

the SISA would similarly fail, as it is purely a matter of administration and not a question of making a specific decision in relation to a particular taxpayer. It is only a result of the application of that administrative approach, which results in a particular decision by the Commissioner to, for example make a fund complying or non-complying, that could potentially be challenged. Even in those circumstances, section 39B applications would be limited to those where bad faith is alleged in respect of making an assessment or some error of law on the part of the Commissioner is said to have been committed.

Such an error may be that he took into account irrelevant considerations or failed to take account of a relevant consideration when making a decision under a particular provision of the SISA. Whether this basis of administrative error can be made out is determined on a case by case basis. In these circumstances, it may be more attractive to affected SMSF trustees to appeal the assessments issued in the Administrative Appeals Tribunal as comprehensive merits review is available in circumstances where the relevant fund is found to be non-complying, given that the tax consequences flow directly from this decision by the Commissioner.<sup>71</sup>

A question arises as to whether an equivalent protection applies to decisions made by the Commissioner under the SISA in relation to SMSFs which do not result in a tax assessment being issued. For example, it is possible for a section 39B application to be commenced by the trustee of an SMSF where the Commissioner has decided to remove or suspend that trustee, even if the trustee had already appealed that decision under SISA, subsection 344(8). In *Bonnell v DCT*,<sup>72</sup> a

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<sup>71</sup> See *Income Tax Assessment Act 1997* (ITAA 1997), s 295-320 which effectively recoups all income tax concessions the fund had received during the time it was a complying superannuation fund.

<sup>72</sup> *Bonnell v DCT* [2008] FCA 60.

taxpayer was able to challenge the Commissioner's decision not to remit a penalty under *Judiciary Act*, section 39B, despite the fact that he had not been successful in an earlier appeal to the Administrative Appeals Tribunal on the same issue previously. The taxpayer was able to bring such an action because at issue was whether the Commissioner should have remitted additional tax in the form of a penalty and that amount did not affect the amount of tax properly payable by the taxpayer in relation to an assessment.

Although the cause of action may be able to be utilized in such a case, whether the Court would be willing to examine the issue would depend on whether the applicant could show that the application of the administrative approach has had some effect on the individual taxpayer involved and not a general or hypothetical consequence.

#### **5.5.2.2 Application for review under the ADJR Act.**

The scope of review available under the ADJR Act is limited to a 'decision of an administrative character made ... under an enactment'.<sup>73</sup> Certain decisions of the Commissioner have been challenged on the basis that they were made under the ITAA 1936, section 8, which is the equivalent of SISA, section 6. These cases are relevant in determining whether a person could commence proceeding under the ADJR Act to challenge the validity of the Commissioner's administrative approach to regulating SMSFs. There are no cases on the application of SISA, section 6, in the context of the ADJR Act.

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<sup>73</sup> ADJR Act, s 3.



Many of the cases deal with specific actions of the Commissioner in the particular circumstances of a taxpayer. For example, the decision to send a letter to a taxpayer advising that they were exempt from tax under a specific provision was held to be a decision of an administrative character under ITAA 1936, section 8.<sup>74</sup>

What is interesting is that it does not appear as though any taxpayer has attempted to challenge the Commissioner's adoption of the compliance model in his administration of the taxation system. Equally, there do not appear to be any cases where the administrative approach of APRA or ASIC, as distinct from a particular decision taken using that administrative approach, has been challenged under the ADJR Act. There has been a challenge in the context of the ITAA 1936, section 8 and the outcome of that case may have dissuaded such an argument being run under the other Acts, including the SISA, for which the Commissioner has the general administration.

In *Knuckey v Commissioner of Taxation*<sup>75</sup> a tax agent challenged the Commissioner's ability to set up a work related expenses program which was aimed at improving compliance through working with tax agents to better educate and monitor work related expense claims of their clients. The tax agent challenged the creation of the program itself as an improper use of power under ITAA 1936, section 8.

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<sup>74</sup> *Australian Wool Testing Authority Ltd v Commissioner of Taxation* [1990] FCA 361. Note however some reservations were expressed about this conclusion in *Hutchins v Deputy Commissioner of Taxation* [1996] FCA 1358, per Black CJ at [17].

<sup>75</sup> *Knuckey v Commissioner of Taxation* [1997] FCA 939; 97 ATC 4911 (first instance). This part of the decision was not considered on appeal: *Knuckey v Commissioner of Taxation* [1998] FCA 1143.

In concluding that the decision to set up the program was not a 'decision made under an enactment', Sundberg J stated:

The Commissioner's decision to establish the Program and to include the applicant in it is neither expressly nor impliedly required by the Act. It is authorised by the Act, but only in a very general way, by s 8. In my view the connection between s 8 and the decision is too remote for it to be said that the former makes provision for the latter.<sup>76</sup>

A similar argument would apply in the case of the Commissioner's adoption of the compliance model in regulating SMSFs, as modified to include a set of values which reflects the policy basis for the prudential framework applying to SMSFs and superannuation funds more generally. In a general way, SISA section 6, would support such an approach but it could not be said that there was any imperative on the Commissioner to actually take any specific approach to administration of the SISA at all. As was noted in *Young*, the Commissioner is not answerable to the Court for his administration of the system.

Hence to be successful in bringing an action under the ADJR Act, a person must be able to establish that a specific decision has been made under a particular section of the SISA. For example, the decision to make an SMSF non-complying would be a decision of an administrative character made under a specific provision of the SISA.

However, for many such decisions there is a specific avenue of appeal to the Administrative Appeals Tribunal (AAT) that allows for a full merits review of the decision itself.<sup>77</sup> There is a question, in such situations, as to whether an appeal

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<sup>76</sup> *Knuckey* 97 ATC 4911, 4918.

<sup>77</sup> SISA, s 10 definition of 'reviewable decision' and s 344(8).

under the ADJR Act having regard to the remedies available,<sup>78</sup> provides the relevant person with a benefit when compared with a merits review in the AAT.

## **5.6 Accessibility: standing to sue for differential treatment**

The provisions of the SISA apply to all superannuation funds that either have a corporate trustee or individual trustees, where the purpose of the fund is to provide for old age pensions.<sup>79</sup> As discussed previously,<sup>80</sup> the responsibility for administration of the SISA is divided between APRA, ASIC and the Commissioner. If the Commissioner were to take a different administrative approach to his application of the provisions to SMSFs, others, such as the trustee of a large APRA regulated fund, may consider that they are disadvantaged by such an approach. The question arises as to whether such a person would have standing to take action against the Commissioner.

In *Re Preston*<sup>81</sup> it was alleged that an agreement was reached between Mr Preston and the Commissioners about his outstanding tax debts, but that the agreement had failed to be honoured. Although Mr Preston could not ultimately prove that such an agreement existed, the House of Lords did conclude that the Inland Revenue was required to act 'fairly' and that if such an agreement existed, there would be an obligation on the Inland Revenue to honour such an agreement. Failure to do so would be seen as the Inland Revenue acting unfairly and would have amounted to an abuse of their statutory powers. Whilst this decision may be

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<sup>78</sup> ADJR Act, s 16. Although the Court has some flexibility in the orders it can make, it cannot step into the shoes of the Commissioner, as the AAT can, and make a different decision to that made by the Commissioner.

<sup>79</sup> SISA, s 19 definition of 'regulated superannuation fund'.

<sup>80</sup> See Chapter 4.

<sup>81</sup> *Re Preston* [1985] AC 835; [1984] UKHL 5.

seen as contrary to the decision in *Al Fayed*<sup>82</sup> it is viewed by some as the start of the substantive legitimate expectation doctrine in the UK.<sup>83</sup> In short, substantive legitimate expectations go beyond the traditional concept of the legitimate expectation doctrine to require government agencies to fulfill the expectations that they have created rather than only ensuring that there are correct procedures in place for their administrative decision making.

In the context of the modified compliance model argued for in this thesis, the decision in *Re Preston* gives rise to an interesting issue. If the Commissioner were to articulate the values underpinning the Australian retirement system in consultation with the other actors in the regulatory space (including trustees of all superannuation funds, auditors, fund managers and tax advisors) would such a consultation amount to an agreement between the parties? If so, would it be possible for any one of those actors in the regulatory space to establish standing to sue the Commissioner for a perceived inequity in his application of those values in the administration of the SISA?

According to Groves, the doctrine of substantive legitimate expectations would not be adopted in Australia because of the separation of powers doctrine.<sup>84</sup> A court exercising federal jurisdiction may be seen to have exceeded its judicial powers if it required the Commissioner to give effect to a certain party's legitimate expectation. That this is the case is supported by the recent decision in *Macquarie*

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<sup>82</sup> *Al Fayed* [2004] ScotCS 278.

<sup>83</sup> Matthew Groves, 'Substantive Legitimate Expectations in Australian Administrative Law' [2008] 32 *Melbourne University Law Review* 470.

<sup>84</sup> *Ibid* 521-523.

and the discussion on justiciability earlier in this chapter.<sup>85</sup> It also brings into question whether, in fulfilling a particular party's legitimate expectation the Commissioner would be asked to do something which is contrary to law. Although the compliance model may be seen by some to be somewhat inconsistent with the rule of law, decisions made within its framework are always referable to the relevant provisions. Taking into account these considerations, it would be unlikely that a Court would recognise any type of binding agreement between the parties in the context described above.

## **5.7 Conclusion**

The Commissioner has limited resources with which to regulate the taxation and superannuation systems. Having a framework in place under which he makes decisions about resource allocation as well as the views that he will be applying of the law, and which is openly shared with the other actors in the regulatory space goes a fair way to enhancing voluntary compliance. However much freedom the Commissioner may have to implement strategies to ensure compliance with the law, he is still constrained to apply the laws as he finds them.

The discussion in this chapter establishes that the Commissioner can make decisions using the compliance model, suitably modified to apply to his role as regulator of SMSFs, with the support of the general administrative power. There may be further flexibility to adapt the administrative approach to anticipate and deal with future compliance issues in the context of the *SISA 1993* because the focus of those provisions is on the behaviour of SMSF trustees, investment

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<sup>85</sup> For detailed discussion of the concept of legitimate expectation in Australian law, see Groves, above n 83, 472-475.

managers and auditors. This is contrasted with the restrictions inherent in the taxation system which is premised on the notion that a person will be liable for a particular amount of tax.

Despite that flexibility it is noted that actions taken by the Commissioner in the context of the SISA 1993 is still open to challenge. Such action could be either at common law, under the Judiciary Act or the ADJR Act or, the most likely scenario, the specific review mechanisms provided for in the SISA itself. These review mechanisms are of utmost importance as they ensure fairness and consistency in decision-making by the Commissioner in respect of those being regulated, thereby promoting confidence in the superannuation system.

## Chapter 6: Conclusion

Superannuation is an issue many of us are aware of but pay little attention to until the time to retire draws nearer. Decisions made at the start of a person's working life influence their wealth in retirement. Aside from the family home, a person's superannuation investment is typically the next most valuable asset they hold. As of 30 June 2014 there were 534,176 SMSFs with a total of over 1 million members, compared with 5 years ago when there were 399,386 SMSFs with a total of 758,589 members.<sup>1</sup> As at 30 June 2013, \$506 billion in superannuation assets were held by SMSFs,<sup>2</sup> making that sector an important part of the Australian economy.

Given the exponential growth in the SMSF sector, it is timely to consider the Commissioner's role in regulating SMSFs and how he can influence SMSF trustee behaviour, in particular to garner higher levels of voluntary compliance with *SISA 1993*. This is important because the Commissioner has limited resources to commit to enforcement of the superannuation laws, and so must strive to leverage the highest possible level of voluntary compliance within those restricted resources.

Although there are issues with the current operation of the superannuation provisions,<sup>3</sup> the focus of the thesis is on the regulatory approach which the

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<sup>1</sup> Australian Taxation Office, *Self managed superannuation fund: Statistical report*, June 2014, population table – quarterly data.

<sup>2</sup> Australian Prudential Regulation Authority, *Annual Superannuation Bulletin*, June 2013 (revised February 2014), 6.

<sup>3</sup> An issue which is exemplified by the sheer number of reviews into the superannuation system which have been undertaken in the recent past, each of which has resulted in legislative change (see for example Chapter 2 above n 6 for a list of such reviews).

Commissioner could adopt in order provide a basis for improving levels of voluntary compliance through administrative action. The Commissioner must administer the law as he finds it but it is recognised that the role of the Commissioner, although differently defined from that of APRA and ASIC, is equally important in influencing the actions of key participants in the superannuation regulatory space. Adopting the construct of a regulatory space in which there are several participants or actors who each have an influence over actions of others within that space is an important step in identifying the weaknesses in the application of the responsive regulation model in a superannuation context.

At the core of that weakness is the assumption that there is a direct relationship between the regulated and the regulator such that actions by one directly influence the other and vice versa. Once it is recognised that this is not necessarily the case in a superannuation context, the issue becomes how the Commissioner's current compliance approach to SMSFs might be modified to better deal with the unique circumstances of the superannuation regulatory space. However, it is acknowledged that the Commissioner's role in regulating SMSFs is not to guide or arbitrate on the SMSF trustee's investment decisions but rather to ensure their sole purpose is to meet members' retirement income objectives. Hence the application of the compliance model is still considered appropriate, although the focus of the model should be changed to adopt a value based approach. Such an approach would leverage better voluntary compliance than relying on the responsive regulation method alone as the former engenders ownership of the system by the relevant affected participants rather than having the regulator focus solely on actions of the SMSF trustees with a view to only identifying breaches of



the regulatory provisions. These issues were the focus of the discussion in Chapter 4 of the thesis.

Of course, it is necessary to ascertain the legal basis for adopting such an approach, because any actions taken by the Commissioner in applying the modified compliance model must still be consistent with the law. As explored in Chapter 5, the general administrative power contained in the *SISA 1993* could support such an approach.<sup>4</sup> However, the scope of the general administrative power in a *SISA* context has not been examined in any detail in the current literature.

Nevertheless, there is some discussion and limited judicial consideration of the scope of the general administrative power in a tax law context, that informs the analysis of the scope of that power in a superannuation context. It is argued that there appears to be more flexibility to apply the general administrative power in a superannuation context because the provisions seek to regulate behaviour of SMSF trustees, investment managers and auditors rather than ensuring the correct amount of tax is collected.

However, that power does not allow the Commissioner to step beyond the boundaries of the law and hence any action he does take in applying the modified compliance model must still stand up to scrutiny before a court. In this respect, the avenues of review under administrative law as well as statute, including the *SISA 1993*, the Administrative Decisions (Judicial Review) Act, the Judiciary Act and the Constitution are still relevant in defining and limiting the scope of the Commissioner's actions.

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<sup>4</sup> See discussion in Chapter 5.

The next step to progress these ideas is to identify those values that are accepted by all participants or actors in the regulatory sphere as forming the basis of the superannuation system. This task will be one in balancing the various interests of the different actors, keeping in mind that there are in fact three regulators involved, each with a different mandate; a large industry of advisors and auditors who are also charged with different responsibilities under the legislative scheme; as well as the relevant government of the day which may be tempted to use superannuation as a political platform to advance its own agenda.

It is imperative for the sustainability of the superannuation system that all the actors work together towards the objectives of that system. This can only be achieved if all actors within the regulatory sphere agree to a unifying set of values to which each is committed to adhering and promoting.

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