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NO. III.A.4**

THE SOLE PURPOSE TEST

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Objective

1. The aim of this Circular is to provide guidance on the underlying policy and operation of the sole purpose test, a fundamental provision of the *Superannuation Industry (Supervision) Act 1993* (SIS).
2. This Circular replaces Superannuation Circular III.A.4 entitled “The Sole Purpose Test” which was released by the Australian Prudential Regulation Authority (APRA) in December 1998. It covers APRA's interpretation of the legislation as it applies to superannuation funds regulated by APRA.

Introduction

3. The sole purpose requirements contained in section 62 of SIS (the “sole purpose test”) limit the provision of superannuation benefits by regulated superannuation funds to a range of prescribed or approved retirement or retirement related circumstances. The test is the legislative expression of the retirement income objective which is the key rationale for superannuation savings.
4. The sole purpose test operates in conjunction with the payment, contribution and accrual standards set out in Parts 6 and 7 of the SIS Regulations. For further explanation of these, refer to Superannuation Circulars I.A.1 “Contribution and Benefit Accrual Standards for Regulated Superannuation Funds” and I.C.2 “Payment Standards for Regulated Superannuation Funds”.
5. The sole purpose test and the associated standards prohibit the use of concessional tax superannuation savings for purposes such as providing pre-retirement benefits to members, benefits to employer-sponsors or facilitating estate planning. The sole purpose test, with the prescribed SIS investment restrictions, ensures that the retirement income objective is paramount.

Sole purpose test principles

Section 62, Regulation 1.03, 13.18

6. The sole purpose test provides that a regulated superannuation fund must be maintained solely for at least one of the legislated **core purposes** or for at least one of those core purposes **and** for one or more of the prescribed or approved **ancillary purposes**. (The core and ancillary purposes are outlined in paragraphs 10 to 29). It is a contravention of the sole purpose test for a superannuation fund to be maintained only for one or more of the ancillary purposes.

7. Essentially the “core purposes” are the provision of benefits on or after the member’s retirement, reaching age 65 or earlier death. Similarly, the “ancillary purposes” are the provision of employment termination insurance, salary continuance (on a member’s cessation of work because of ill health), reversionary benefits and other approved benefits on or after an appropriate condition has been met.

8. The sole purpose test is necessarily couched in very broad terms. It embraces a number of separate definitional elements. These combine to provide a clear statement of the real purpose of the SIS legislation. These elements include:

- **Purpose** - A fund’s purpose is not determined conclusively by what outcomes actually emerge. Rather, its purpose is determined by a judgement of what a fund is organised for and how it achieves this, in the light of an assessment of the totality of its operation.

For example the sole purpose test would be contravened where a fund deliberately operates for a purpose such as:

- providing benefits for persons other than retiring members and their dependants. This may occur where a fund received contributions which were intended to be forfeited and repaid to an employer, and were never intended to produce retirement benefits; or
- providing benefits to be made available to members in circumstances other than those specified in section 62. This could be where a fund has as a purpose the payment of the school fees of members’ children.
- **Maintained** - Maintenance of a fund involves undertaking those tasks which reasonably form part of the total operation of the fund. These could include accepting contributions, recording benefits, investing fund assets, reporting, fund administration, benefit payment, purchasing of professional advice, etc.
- **Provision** - The provision of benefits is wider than merely the ultimate delivery of benefits in accordance with the prescribed payment standards. Provision includes other activities such as the protection of assets which support benefits and the enhancement of benefits through sound investment practices.
- **On or After** - As benefits may be paid on or after the occurrence of a prescribed condition of release - such as retirement, resignation etc (subject of course to payment being made in accordance with the SIS payment standards and the governing rules of the fund) trustees have scope to:
 - retain unrestricted non-preserved benefits in the fund after the occurrence of the event (subject to some specific exceptions). For information on how to determine the preservation status of

superannuation benefits see Superannuation Circular I.C.2 “Payment Standards for Regulated Superannuation Funds”;

- commence or make certain payments out of such “deferred benefits” without the occurrence of a subsequent condition of release;
- accept a rollover for a retired person aged over 65, provided it is done for the purpose of immediately commencing to pay a pension for that member;

without being in breach of the sole purpose test.

- **Each Member** - The core and ancillary purposes envisage the provision of benefits for “each member”. In other words the retirement benefits and other benefits provided by the fund must be provided in accordance with rules that apply equally to each individual member.

For example, where a fund maintains a vesting scale that applied differentially at the trustee’s discretion between different categories of members, then a question may arise as to whether the fund is being maintained for the provision of benefits for each member or whether it is being maintained for the particular benefit of one or some members.

- **Members** - The terms of the sole purpose test also indicate that a fund must confine its benefit provision to persons who are **members** of the fund. Persons who are not members must immediately exit. Generally, any person who has some beneficial interest in a fund is entitled to be recognised as a member and hence subject to the protection of SIS. This includes deferred beneficiaries, pensioners and contingent beneficiaries, eg. persons who may become entitled to benefits on the death of the member.

9. A fund’s governing rules, procedures and practices are the primary sources for judging whether it is maintained consistently with the sole purpose test. The fund’s planning and corporate governance documents also illustrate the fund’s intentions.

The core purposes

Section 62(1)(a), Regulation 13.18

10. Section 62(1)(a) requires that a regulated superannuation fund be maintained solely for one or more of the core purposes. These core purposes operate in conjunction with the payment standards in Part 6 of the SIS Regulations. In essence the core purposes set down the reasons for which a fund may exist and pay benefits whereas the payment standards set down the manner in which such payments may be made. For information on the operation of the SIS payment standards refer to Superannuation Circular I.C.2 “Payment Standards for

Regulated Superannuation Funds”.

11. The core purposes are:

- provision of benefits for each fund member on or after the member's retirement from any business, trade, profession, vocation, calling, occupation or employment in which the member was engaged (whether the retirement occurred before or after the member joined the fund);
- provision of benefits for each fund member on or after the member's attaining age 65 (the age specified in regulation 13.18); and
- the provision of benefits to the legal personal representative and/or the dependants of a fund member on or after the death of the member, provided that the death of the member occurred before he or she retired or attained age 65.

Retirement

Section 62(1), Regulations 6.01(7), 6.27, Schedule One

12. When determining a person’s “retirement” for purposes of the sole purpose test, trustees must have regard to the prescribed payment standards for regulated superannuation funds in Part 6 of the SIS Regulations, and the related definition of “retirement” in regulation 6.01(7). For information on the meaning of “retirement” see Superannuation Circular I.C.2 “Payment Standards for Regulated Superannuation Funds”.

Attaining age 65

Section 62(1), Regulation 13.18, Schedule One

13. The purpose of this provision is to allow a member of a fund to be paid his or her benefits on reaching age 65, even where the person is continuing in employment. It reflects the retirement income policy objective by allowing a draw-down of superannuation savings at the traditional retirement age.

Death benefits

Section 62(1)(a), Regulations 6.21, 6.22, Schedule One

14. A trustee must pay any death benefits upon a member’s death. In doing so the trustee may exercise a discretion to pay benefits on or as soon as practicable after the member's death to either:

- the legal personal representative of the deceased member; or
- any or all of the member's dependants; or

- some combination of the above.

15. Exercise of such a discretion must be in accordance with any relevant provision in the fund's governing rules and with the payment standards under Part 6 of the SIS Regulations. A trustee may pay benefits on or as soon as practicable after the member's death to an individual who the trustee considers should appropriately receive the benefit, but only when the trustee has not, after making reasonable enquiries, found either a legal personal representative or a dependant of the deceased member. Such a situation may arise, for example, when a young person dies intestate, has no dependants and it is unlikely that someone will apply to administer the estate. It may be appropriate in such circumstances for the trustee to pay the benefits to an individual who is neither the legal personal representative or a dependant of the deceased member, such as a parent of the deceased member (see paragraphs 23 to 24 and SIS regulation 6.22(3)).

The ancillary purposes

Section 62(1)(b)

16. Ancillary purposes are those for which a superannuation fund may be maintained in conjunction with at least one of the core purposes set out in section 62(1)(a) of SIS. The ancillary purposes, of course, also operate in conjunction with the payment standards (see Circular I.C.2 "Payment Standards for Regulated Superannuation Funds").

17. The ancillary purposes are as follows:

- the provision of benefits for each member on or after termination of employment (which includes resignation, redundancy, etc.) from an employer who had, or any of whose associates had, at any time contributed to the fund in relation to the member;
- the provision of benefits for each member on or after the member's temporary or permanent cessation of work on account of physical or mental ill-health;
- the provision of benefits in respect of a deceased member, to the member's legal personal representative and/or to dependants of the member, where the member dies after retirement or after reaching age 65 (commonly referred to as "reversionary benefits"); and
- the provision of such benefits as APRA approves in writing (this includes benefits approved previously by the Insurance and Superannuation Commissioner).

Termination of employment

Section 62(1)(b), Regulation 6.01, Schedule One Item 108

18. This ancillary purpose allows payment of benefits to a member upon the termination of their employment from an employer who had, or whose associate had, at any time contributed to the fund in relation to the member. Payment of any preserved benefits on pre-retirement termination of employment must be made in the form of a non-commutable pension or annuity payable for life.

Benefits on cessation of work due to ill-health

Section 62(1)(b), Regulation 6.01, Schedule One Items 103, 109

19. This ancillary purpose allows payment of benefits on cessation of work due to total and permanent incapacity or temporary incapacity.

20. Part 6 of the SIS Regulations further defines the circumstances and manner in which benefits can be paid on temporary incapacity.

Death/reversionary benefits

Sections 62(1)(b)

21. Paragraphs 62(1)(b)(iii) and (iv) provide that superannuation funds may pay benefits to dependants and/or legal personal representatives where the member dies **after** retirement or after attaining age 65. Benefits payable in these circumstances are commonly referred to as reversionary benefits.

Additional ancillary purposes approved by APRA

Section 62(1)(b)

22. APRA has power to approve other ancillary purposes in writing under paragraph 62(1)(b)(v) of SIS. This power was previously held by the former Insurance and Superannuation Commissioner, whose 1 July 1997 approval of ancillary purposes for which benefits may be provided continues to have effect. This document is available in the CCH Superannuation Digest and on the APRA Internet Homepage at www.apra.gov.au. The additional approved ancillary purposes are:

- provision of any benefit permitted or required to be paid under Part 6 of the SIS regulations (refer paragraphs 23 to 24);
- provision of benefits in the event of the hardship or misfortune of a member (refer paragraphs 25 to 26);

- provision of benefits in the case of the member taking long service leave (refer paragraphs 27 to 28); and
- benefits provided on demutualisation (refer paragraph 29).

Benefits under Part 6 of the SIS Regulations

23. The additional approved ancillary purpose relating to the provision of benefits under Part 6 of the SIS regulations addresses tensions which might otherwise arise between the sole purpose test and the payments standards. For example:

- the sole purpose provisions allow for the payment of benefits only to members, dependants or the legal personal representative of the member, whereas regulation 6.22 authorises payment of benefits in certain, very limited, circumstances to any individual; and
- the sole purpose test may prohibit payment of benefits that had become unrestricted non-preserved benefits because of termination of employment, but that had been rolled over to a second fund. The benefits would not then be payable in the second fund owing to the terms of paragraph 62(1)(b)(i), which apply only to funds to which the relevant employer had contributed. However the ancillary purpose approval, together with regulation 6.20 ensures these benefits remain payable at any time.

24. Further information on payment of benefits under Part 6 of the SIS Regulations can be found in Superannuation Circular No. I.C.2 “Payment Standards for Regulated Superannuation Funds”.

Welfare benefits

25. The welfare benefits ancillary purpose approval allows a fund to provide benefits for members to alleviate hardship in very limited circumstances where the trustees are of the opinion that the member is suffering financial hardship, sickness, accident or other misfortune causing hardship. This ground for payment is separate from the severe financial hardship and compassionate grounds discussed in Superannuation Circular I.C.2 “Payment Standards for Regulated Superannuation Funds”.

26. The provision of welfare benefits is contrary to the general principle that superannuation benefits should be used for genuine retirement purposes and is therefore being phased out. The approval applies only to situations where the hardship commenced prior to 1 July 1997 and the fund’s governing rules

authorised payment of the benefits as at 1 July 1988 and continuously until the time the benefits are paid.

Long service leave benefits

27. The long service leave benefits ancillary purpose approval allows, in very limited circumstances, the payment of long service leave in the event of a member taking such leave from an employer-sponsor of the fund. The payment may be made directly to a member or through an arrangement for the reimbursement of the employer-sponsor. Long service leave payments may only be made when expressly authorised in the governing rules of the fund as at 1 July 1988 and continuously until the time the benefits are paid.

28. Like welfare benefits, long service leave benefits are difficult to reconcile with the superannuation policy objective of fostering saving for retirement. Consequently they have effectively been phased out, applying only to long service leave which commenced prior to 1 July 1997.

Benefits provided on demutualisation

29. Ancillary purpose approvals were given to accommodate certain consequences of the demutualisation of certain life insurance offices. The approvals allowed pre-retirement payments direct to members of the additional benefit arising from the process of demutualisation.

The sole purpose test and investments

Part 8, Sections 52(2)(f), 60, 65, 109

30. SIS intentionally avoids overly restrictive regulation of the investment practices of superannuation funds. The onus is on the **trustee** to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity, including the purpose (or purposes) for which it is maintained. Certain kinds of investments are, however, regarded as inconsistent with the Government's superannuation policy objectives and are specifically restricted or prohibited under provisions of SIS. For example:

- section 65 generally prohibits funds from lending or providing financial assistance to members (see Superannuation Circular No. II.D.2 "Lending and Provision of Financial Assistance to Members of Superannuation Entities");

- section 66 prevents the acquisition by a fund of assets belonging to members or their relatives, with certain exceptions (see Superannuation Circular No. II.D.3 “Acquisition of Assets from Related Parties”);
- section 109 requires all investments by a superannuation entity to be made on an “arm's length” basis (see Superannuation Circular No. II.D.5 “Investments to be on an Arm’s Length Basis”); and
- part 8 of SIS stipulates the rules applying to investment in “in-house assets” (see Superannuation Circular No. II.D.6 “In-House Assets”).

31. Contravention of the sole purpose test may arise where there is no retirement purpose behind an investment. It is not the type of investment which must be considered for the purposes of the sole purpose test but rather it is the purpose(s) for which the investment is made and maintained that is relevant to the test.

32. An investment which is undertaken as part of a properly considered and formulated strategy, and which complies with the arm’s length rule and other SIS investment restrictions, is unlikely to cause the fund to fail the sole purpose test unless exceptional circumstances exist.

33. However, the sole purpose test is unlikely to be satisfied in situations where the investments of the fund and those of the employer-sponsor or some other associated person become intertwined. For example, joint ventures where trustees invest in a particular asset or assets with the fund’s employer sponsor (such as an investment in real estate as tenant in common) may not, in certain circumstances, comply with the sole purpose test.

Incidental advantages

34. Care should be exercised by trustees and investment managers when considering investments to ensure that the provision of retirement benefits for members is the overriding consideration behind the investment decision. However, the situation may arise where a properly considered and soundly based investment provides “incidental” advantages to members or other persons which could suggest that the fund is maintained, in whole or part, for an improper purpose.

35. Such incidental advantages would not necessarily, in isolation, amount to a breach of the sole purpose test. For example:

- investment in a well-researched and commercially sound project might incidentally create employment opportunities for members; and

- investment in a holiday property (rented on a commercial basis and for which there is a reasonable expectation that commercial occupancy rates would be achieved) might incidentally be available to members on a commercial basis.

36. An example of how the Administrative Appeals Tribunal approaches the sole purpose test is given in Case No. V94/447, which reviewed a decision of the ISC. It illustrates factors that may be considered in determining whether a fund will be regarded as having breached the sole purpose test:

- in respect of fund assets, whether a trustee has a second purpose to make the assets available for his or her own use and the use of family and friends;
- in respect of information to members, whether there are effective procedures to inform members or whether information concerning the fund is kept from them; and
- in respect of a vesting scale, whether a vesting scale is applied inconsistently and in a way which favours one member over another in the same situation.

The sole purpose test and the provision of services

37. The sole purpose test is sufficiently broad to encompass the normal activities of superannuation fund trustees, including those activities necessary to enable funds to provide retirement benefits. The sole purpose test does not, however, allow the provision of a broader range of financial or other services relating to the non-superannuation interests of members of the fund.

38. Subject to the fund's governing rules and the requirement to protect small accounts (refer Superannuation Circular I.B.1 "Protection of Member Benefits) trustees are able to levy reasonable charges against contributions, accruals or fund assets to reimburse expenses incurred for making services available to members, provided those services are reasonably incidental to the running of the fund. Contributions or fund assets may be used to pay legitimate administrative expenses, including life insurance premiums, which are reasonably incidental to the provision of retirement benefits.

39. Trustees are not permitted to apply members' contributions or fund assets for services provided outside the core and ancillary purposes. Where trustees believe such broader services are appropriate for provision to members, it is open to the trustee itself to provide, or arrange, and pay for, such services rather than the cost being met directly from contributions or fund assets.

40. Whether there has been a breach of the sole purpose test is determined in the light of the overall circumstances of the particular superannuation fund. It is not

possible to state categorically that a particular service or operational practice would always involve a contravention of the sole purpose test. It is not the type of practice that determines a sole purpose contravention, but rather the purpose for which it is undertaken in particular circumstances.

41. It is open to trustees to develop features of their fund which add value to, or differentiate it from, other funds. For example, fund sponsored member awareness, education and financial advice programs, targeted at fund specific issues such as benefit features (including insurance options, the making of binding death benefit nominations etc) or investment choices offered in the fund, may be appropriate. However, fund sponsored programs, including financial planning services, which are targeted at broader, non-superannuation savings and investment opportunities, products or services, such as investment or tax advice and health insurance, are inappropriate.

42. As a guiding principle, there should always be a **reasonable, direct and transparent connection** between a particular scheme feature or trustee action, and the core or ancillary purposes. The more tenuous the linkage between a service or activity and the retirement savings objective, the greater will be the difficulty in the fund meeting the sole purpose test.

Financial planning services

43. Financial planning is now a service which many trustees are considering offering to members. As noted in paragraph 41, if the service is aimed only at a member's interest in the fund, such services would generally fall within the sole purpose test. If, however, broader advice is offered, it would be inappropriate for the cost to be borne by the fund. Trustees wishing to make such broad services available to members may wish to consider other means of funding the service. These means might include, for example, arranging alliances with providers that involve no cost to the fund or, as noted in paragraph 39, the trustee itself (or other service providers) paying for the services without increasing the costs charged to the fund in respect of such extended purposes. This might appropriately be done, for example, from the trustee's discretionary expenditure of moneys received from a trustee fee it charges to the fund.

44. Even where the service relates solely to the options available to members within the fund such as insurance, investment choice, additional voluntary contributions and roll-overs, the trustee would be expected to negotiate arrangements where members are not required to pay fees regardless of their wish to use such services. Where the costs are charged to the members' balances in the fund, trustees must ensure that the services relate exclusively to fund matters.

Where extended services are being made available (the costs being borne outside the fund), this should be made clear to members.

45. Regardless of the source of funding, trustees providing financial advisory services to fund members should review their indemnity insurance cover. They should also make it clear whether their advice is limited to a member's interest in the fund or is given in relation to the member's total financial situation. Where related parties are used to provide a service, appropriate disclosure is required and the trustee must be able to demonstrate due process has been followed to justify the selection of advisers.

Trauma benefits

46. Trauma insurance is a specific example of a possible fund feature which raises questions as to sole purpose compliance.

47. Generally, trauma insurance is a form of insurance whereby an insurer promises to pay the amount insured if the insured person experiences a trauma event covered by the policy. These events are normally major, usually life-threatening, medical problems such as heart attacks, strokes and cancer. Proceeds of a trauma claim are ordinarily paid in the form of a lump sum direct to the insured, regardless of whether the insured person ceases work as a result of the trauma.

48. The acceptability of payment of a trauma benefit provided by a superannuation fund will depend on compliance with the benefit payment standards. If the trauma does not cause termination of employment then the proceeds cannot be paid immediately to the member. If, on the other hand, the trauma provides the basis for a permanent invalidity, then a trigger exists which can allow the payment.

49. The trustee must determine whether the provision of trauma insurance by a superannuation fund is acceptable, having regard to all the circumstances of the fund. This must be able to be substantiated if challenged by the auditor or APRA. Matters to be considered include the design of the trauma insurance and the manner and time in which the trustee intends to distribute any proceeds of the policy.

50. In determining whether to offer trauma insurance, trustees should consider their obligations to members generally and factors such as the proportion of contributions applied to purchase insurance cover. An unreasonable diversion of contributions as premiums for the contingent trauma cover would be difficult to

reconcile with the sole purpose test and the fundamental retirement objective of superannuation.

Penalties

Part 21, Section 42

51. The trustee of a regulated superannuation fund must ensure that the sole purpose test is complied with at all times. A person who contravenes the test is guilty of an offence and significant penalties may apply.

52. Failure to comply with the sole purpose test may also result in the fund becoming a non-complying superannuation fund for taxation and Superannuation Guarantee purposes.