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Is maintaining a second SMSF a Part IVA risk?

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This article examines the query of whether having a second or, indeed even more than two, self managed superannuation funds ('SMSFs') would give rise to a Part IVA (of the *Income Tax Assessment Act 1936* (Cth) ('ITAA36')) risk.

Please note that this article is not intended to be a technical analysis of the application of Part IVA but reviews one potential issue in relation to SMSFs that has recently arisen.

Background

The topic of this article was prompted following the ATO's press coverage in April 2017 that a second SMSF may give rise to Part IVA and other regulatory concerns where an ATO spokesperson was quoted as follows (Sally Patten, 'Multiple SMSF strategy may prove illegal', The Australian Financial Review, 24 April 2017, 5):

the ATO cautioned that it would take a dim view of trustees who set up a second fund to reduce their tax bill. 'This type of activity will attract close scrutiny from the ATO. We are concerned about any activity or behaviour undertaken in response to the superannuation changes where the dominant purpose appears to be to create a more tax beneficial outcome for an SMSF or its members,' an ATO spokesperson said.

'Considering the additional administrative costs and processes associated with establishing a separate SMSF and transferring selected assets from an existing SMSF to a newly established SMSF, together with the ongoing costs of maintaining an additional SMSF, prima facie there does not appear to be any explicable reason for doing so other than for the purpose of creating a more beneficial tax outcome under the superannuation new measures that come into effect on 1 July 2017,' the spokesman said.

Funds that fall foul of the law could be required to pay a penalty in addition to repaying the tax shortfall from the strategy. The Tax Office said it would also consider whether trustees had breached the so-called sole purpose test, which ensures that super funds are maintained for the purpose of providing benefits to its members on their retirement. Contravening the sole purpose test can lead to a series of sanctions, including a fund being disqualified.

A number of industry representatives including members of The Tax Institute submitted to the ATO that there were a number of genuine reasons that may relate to maintaining a second SMSF and the ATO's position on this point should be clarified. We do not cover the ATO's comments in relation to the sole purpose test or a fund being disqualified quoted above as these points were not included in the ATO's revised position which followed shortly after the above press coverage 'Super changes – Frequently asked questions', QC 51875 on the ATO's webpage:

I've heard that I can get around the new restriction on using the segregated method to calculate my SMSF's exempt current pension income by setting up a second SMSF. Can I do this?

If you are considering strategies like this we strongly encourage you to seek independent professional advice or approach us for advice beforehand.

Whilst the establishment of a second SMSF by itself does not give rise to compliance issues, we will further examine the circumstances of those cases where it appears that the establishment of a second SMSF has been a pre-cursor to subsequent behaviour intended to manipulate tax outcomes. This behaviour could include, for example, switching each of the respective funds between accumulation and retirement phase.

Broadly, Part IVA is aimed at schemes where a taxpayer has obtained a tax benefit and having regard to certain matters (these are viewed objectively), it would be concluded that a person who entered into or carried out the scheme did so for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit in connection with the scheme. Where Part IVA applies, s 177F of the ITAA36 gives the Commissioner power to cancel the tax benefit.

It is noted that a person's purpose is determined objectively. Further, where a genuine commercial or family reason can be established as the sole or dominant purpose, a Part IVA challenge may not succeed.

While advisers cannot rule out Part IVA being applied by the Commissioner, we note that generally maintaining two SMSFs is not contrived or artificial. The advantages, if any, and the downside risks of maintaining each SMSF will be genuinely borne.

Furthermore, historically, superannuation has received tax concessions as a result of government policy providing tax incentives in the form of tax deductions, concessions and exemptions. Indeed, many would not even wish to contribute or invest via superannuation but for the tax concessions on offer given the substantial regulation, high administration costs and numerous restrictions on superannuation savings. Accordingly, recent ATO comments including the ATO and Treasury's commentary on Part IVA in relation to the transitional capital gains tax ('CGT') relief reflected in LCG 2016/8 are arguably the most assertive comments that have ever been made publicly available in relation to Part IVA and superannuation.

We now examine some reasons why people may wish to maintain a two or more SMSFs. As noted in the ATO's press coverage above, having a second SMSF may increase the fixed costs of fund maintenance. However, there may be possible advantages of maintaining two funds, most of which are rarely discussed. Some of the advantages (such as the saved cost of an averted dispute) can defy simplistic cost-benefit analysis due to difficulties in calculation and personal preferences.

Most of the advantages described below may also be applicable when maintaining one SMSF and an interest in a large public offer superannuation fund.

Segregation of pension assets

If two SMSFs are maintained and one SMSF is wholly or mainly the 'pension' SMSF, and the trustees have sought to separate the higher yielding and growth assets to the pension fund, this could lead to the pension balance growing faster than the accumulation balance.

This can be contrasted to a pooled single SMSF (pension and accumulation) whereby investments earnings are aggregated across the whole fund and then are typically added proportionately to pension and accumulation balances.

This potential advantage of maintaining separate pension and accumulation funds has been considered more attractive given the transfer balance cap of $1.6 million that limits the total amount of superannuation assets a member can transfer to the retirement phase which will be subject to tax-free pension status inside the pension fund. There is no restriction placed on subsequent earnings or capital growth on the assets supporting pensions.

The difficulty in practice of seeking to select and separate the higher yielding and growth assets to the pension fund is that many overestimate their potential investment skills. In practice, what may happen is the (star) investments that are chosen to remain in the pension fund may turn out to be poor performers (dogs). Thus, expert investment and tax advice should be obtained in this area before implementing a second SMSF, especially as the ATO has issued the following comments:

[w]hilst the establishment of a second SMSF by itself does not give rise to compliance issues, we will further examine the circumstances of those cases where it appears that the establishment of a second SMSF has been a pre-cursor to subsequent behaviour intended to manipulate tax outcomes. This behaviour could include, for example, switching each of the respective funds between accumulation and retirement phase.

Indeed, the ATO's comments in the April press coverage suggest it suspects that many may seek to establish a second SMSF predominantly motivated for the potential upside just discussed. So we will examine if there are other sound non-tax reasons that may justify maintaining two or more funds below.

Succession planning

Having a second fund can be used to pass the SMSF assets to two different persons/groups where succession to the control of each SMSF also passes separately to the two groups. In broad terms, the aim is to minimise disputes between the two groups, who could be, for example, a second spouse and children from a previous relationship, or children who do not get along. Of course, even those who get along today may not get along after a parent/spouse dies. By transferring control of each SMSF separately, this can overcome the risk where SMSF money is meant to be left to one person (eg, a child from a previous relationship) but SMSF control is left to another person (eg, a pension paid to a second spouse), which can lead to a temptation to ignore the wishes of the deceased.

Risk quarantining

A further potential advantage of maintaining two SMSFs is that risky investments can be isolated. Otherwise, a liability because of one asset can jeopardise other SMSF assets (eg, public liability for injury or loss on SMSF real estate can expose the other assets to claims). Additionally, a failed property development could leave the other SMSF assets exposed, but on the other hand, had the assets been separated in different SMSFs initially, this would have protected those assets in the other fund not exposed to the development risks.

Children and an SMSF

The SMSF member limit of four generally means that after parents are accounted for, only two children can be included in an SMSF. However, this is not always desirable. Having multiple SMSFs can allow families with more than two children to have all the children included in the SMSF environment. This can also be relevant where a child goes through a relationship breakdown (as superannuation is considered 'property' for the purposes of family law, even in relation to de facto domestic partners) and having separate funds with different children in each fund may assist in minimising the total asset pool that is at risk in relation to a separation claim.

Avoiding disagreements about fund investments and membership

Maintaining two SMSFs may overcome the problems associated with personal disagreements or disagreement about the operation of the fund and investments. Such disagreements usually result in either deadlock (inability to make decisions), or breaking the deadlock based on headcount or by those who have the larger member balance (depending on the SMSF deed and, where applicable, the corporate trustee's constitution). In either case, one or both parties will be unhappy with the result.

It is worth noting here that the law does not authorise a trustee removing a member without their consent (reg 6.28 of *Superannuation Industry (Supervision) Regulations 1994* (Cth)). This is true even if the member is in a dispute with the trustee or is otherwise being uncooperative or unresponsive, and even if they have only a small member balance.

Additionally, a similar problem can arise where one member wants to leave an SMSF quickly but is blocked by the other trustees and members. In this case, a member typically cannot force a trustee to realise assets or roll them out quickly. That is, much to the surprise of some SMSF members, they cannot simply leave when they want to. While the portability rules that allow a member to roll over their super to another fund apply to large superannuation funds, they do not apply to SMSFs.

Possible traps of a second SMSF

While there may be potential advantages of maintaining two or more SMSFs, advisers and clients should be aware of the Part IVA and related risks. Naturally, if there are genuine non-tax reasons for proceeding, these should be appropriately documented and evidence should be maintained in support of those reasons. A suitable disclaimer that the ATO may nevertheless decide to challenge on Part IVA should also be issued unless the adviser is confident this risk would not exist.

It should be noted that CGT events typically occur if transferring assets from one fund to another, and superannuation law prohibits acquisitions of assets from related parties, subject to certain exceptions like listed securities and business real property acquired at market value. Additionally, duty on moving real estate from fund to fund typically applies unless an exemption can be made out.

Finally, every adviser should manage the risk of any recommendation in relation to an SMSF which may be financial product advice that requires an Australian financial services licence, and suitable disclosures or disclaimers should be issued accordingly.

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Note: DBA Lawyers hold SMSF CPD training at venues all around. For more details or to register, visit www.dbanetwork.com.au or call 03 9092 9400.

For more information regarding how DBA Lawyers can assist in your SMSF practice, visit

www.dbalawyers.com.au.

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