Local Tax Club - Melbourne & Geelong

SMSF internal disputes and how to resolve and avoid them

Presented at the Tax Institute's Local Tax Club, 20 February and 21 February 2025

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1. Introduction

Members and trustees of self managed superannuation funds (**SMSFs**) will sometimes become estranged because of disputes involving their family or business relationships. These kinds of internal disputes will often mean that simple day-to-day functions for the SMSF cannot be completed, for example finalising accounts, disposing of investments and paying benefits.

This paper considers various examples of internal disputes that I have seen in practice. The paper then examines a number of mechanisms that can be used to avoid and resolve matters when or before these internal disputes occur.

2. Dispute examples

In practice I have seen quite a few internal disputes within SMSFs. The following is a summary of a few of them.

2.1 The early accessing brother

This matter involved an SMSF with 2 brothers as members. In addition to being in the same SMSF, the brothers were also in business together through various entities outside of super.

The brothers had a falling out and began the process of unwinding their joint ventures. While going through that long and complicated process one of the brothers (our client) discovered that the other brother had accessed his benefits in the SMSF. The other brother was below his preservation age but had accessed his benefits on the basis of some weak arguments that he had met the hardship grounds condition of release (with the assistance of the advice of his financial planner).

Not only had he accessed all of his entitlements, but he had also "overdrawn" his entitlements and effectively taken out benefits belonging to our client.

The amount overdrawn was relatively small and while a concern, our client was more concerned with potentially being subject to penalties under the *Superannuation Industry (Supervision) Act 1993* (**SIS Act**) for being a co-trustee of an SMSF that allowed a member to access their benefits before they had met a condition of release.

On behalf our client, we made a voluntary disclosure to the ATO on the basis that our client would roll his remaining benefits out of the SMSF and that he did not facilitate the early access. That was accepted by the ATO.

2.2 The widow of the dead business partner

This matter involved 2 business partners and their wives in an SMSF. The SMSF held the business real property from which the business operated. The business was held in an entity outside of super. The 4 of them were individual trustees of the SMSF.

One of the business partners died leaving the SMSF with the surviving business partner and his wife and the widow. The wives, including the widow, were not active in the business or the SMSF. Therefore, the widow had no real knowledge or experience of the business or the SMSF.

There was no shareholders agreement or any other agreement that would deal with the exit of the one of the couples out of any of the structures.

The deceased business partner had 3 transition to retirement income streams (**TRISs**) with reversionary pensions and an accumulation account. The deceased's total death benefit balance was below $1.6 million. The SMSF's main asset was the business real property but it also had some cash. The cash was not sufficient to pay out the deceased's death benefits.

A dispute arose around the exit of the widow from the business entities.
About 18 months after the death of the business partner, the accountant for the SMSF (effectively for the surviving business partner) sent a letter to the widow:

- Enclosing a cheque to the widow for a lump sum death benefit equal to the deceased's accumulation account at the date of the deceased's death (ie 18 months ago);
- Confirming the TRISs had automatically been transferred to the widow;
- Enclosing a deed of variation for the SMSF trust deed.

Our response on behalf of the widow included:

- Noting that the trustees had the discretion to pay the death benefits and that the trustees had not made a decision (or even met) to decide how the accumulation benefits were to be paid.
- The purported death benefit based lump sum from the deceased's accumulation account should be based on the current value of the death benefit account (which would have been significantly higher given the appreciation of the property since the death of the deceased).
- The widow wished that the deceased's accumulation account be paid to her as a death benefit account based pension.
- The widow did not agree to the amended deed (as it would have allowed trustee voting based on account balances – meaning the widow could have been outvoted).

Negotiations continue to this day as to how the widow can exit the SMSF given the illiquidity of the SMSF. As the trust deed for the SMSF does not give members the right to exit the SMSF, the exit must be negotiated.

2.3 How do you exit an SMSF with a terms contract and an LRBA?

This matter involved a family law split between the two members. The SMSF held the business real property used in the husband's business. It was agreed that the husband would transfer his benefits and the business real property to a new SMSF.

The problem was that the business real property was held on two parcels. One parcel was subject to an uncompleted terms contract from the wife to the SMSF. The second parcel was subject to a limited recourse borrowing arrangement (**LRBA**) with a bank that did not wish to finance the parcel in the new LRBA in the new SMSF.

All money paid into the SMSF as rent was accessed by the wife as payments under the terms contract and this:

- Created significant cash flow issues for the SMSF
- Meant the SMSF could not satisfy its existing LRBA
- Made it difficult to negotiate with a new lender for the new LRBA

Therefore, we had to negotiate:

- The assignment of the terms contract (both the interest of the vendor from the wife to the husband and the interest of the purchaser from the old SMSF to the new SMSF);
- The transfer of the property subject to the LRBA to the new SMSF with a new LRBA and paying out the old LRBA;
- Applying for a duty exemption for all of the above transactions.

After a bit of back and forth, we were successful in moving the interests in both properties from the old SMSF to the new SMSF, including an assignment of the terms contract, setting up a new LRBA, paying out the old LRBA and receiving the duty exemptions.

2.4 The silent auction

This matter also involved two brothers in an SMSF with their spouses. Again, the brothers had a falling out and they negotiated a separation of their various interests both inside and outside of super.

In relation to super they had an SMSF with units in a “pre-1999” unit trust. The pre-1999 unit trust held 3 properties. It was agreed that each brother would submit an offer for each of the 3 properties and that the brother with the highest bid for each property would take that property. The brother who successfully bid for 2 or 3 of the properties was able to “keep” the SMSF which held units in the pre-1999 unit trust.

The other brother was successful in bidding for 2 of the properties, therefore, we had to structure the exit of our client brother’s property out of the pre-1999 unit trust and out of the old SMSF to the new SMSF.

2.5 The helpful brother

In this matter our client agreed to be the co-trustee of his brother’s SMSF (the brother was the sole member). The member brother accessed his benefits without meeting a condition of release.

The non-member brother sought our advice in relation to his potential exposure to penalties. We noted that as a co-trustee he was liable for SIS Act penalties and tax to the same extent as his brother, even though he had not participated in the illegal access.

We recommended that he resign as trustee and make a voluntary disclosure to the ATO.

2.6 A tale of 2 (out of 4) members – one incapacitated and one missing

In this matter, the SMSF had 4 members who were all individual trustees and were unrelated. One of the members became incapacitated and one trustee went missing.

We acted for the administrator of the incapacitated member. We were asked to advise on:

- Whether the administrator could make any decisions in place of the incapacitated person in their role as trustee;
- Whether the incapacitated member could be paid out their benefits;
- What could be done about the missing member.

The SMSF trust deed did not automatically insert an incapacitated member's administrator into the trustee role and did not automatically remove a trustee upon the trustee becoming incapacitated. The trust deed provided that a quorum was all of the trustees. If all of the trustees did not attend the meeting a new meeting could be called a week later in which case the quorum was the trustees who attended.

In relation to whether the administrator could participate in trustee decisions, it is noted that section 58C of the *Guardianship and Administration Act 1986* (Vic) does grant administrators such rights. However, the administrator was satisfied that the 2 remaining trustees would make the appropriate decisions. They would, however, be required to follow the 2 meeting process.

The SMSF trust deed did not give the member the right to have their benefits paid out or a right to have them rolled out to another super fund. It was noted that regulation 6.34A of the *Superannuation Industry (Supervision) Regulations 1994* did not apply to SMSFs (ie the regulation which compels APRA regulated SMSFs to roll out a member's benefits upon request of that member).

The SMSF trustee had the power to pay or roll out benefits. Therefore, the administrator had to rely on the remaining 2 trustees to pay out the member's benefits (ie via the 2 meeting process).

Likewise, the missing member/trustee could be rolled out of the SMSF by the remaining 2 trustees after they followed the 2 meeting process.

2.7 The rogue daughter-in-law

In this matter we had an SMSF with dad, mum, son and daughter-in-law. They were individual trustees. The SMSF held a mix of assets, some of which were notionally held for the dad and mum and some of which were notionally held for the son and daughter-in-law. The daughter-in-law was the most financially literate and arranged for the SMSF's tax returns and BASs to be lodged and effectively controlled the SMSF's bank accounts.

The son and daughter-in-law separated. The daughter-in-law transferred the assets that were notionally hers and the son's to another SMSF that she solely controlled. She then lodged a final tax return for the SMSF with the ATO and cancelled the SMSF's ABN and TFN.

When the dad and mum caught on to what happened they found that their SMSF was effectively frozen. When we contacted the ATO, the ATO informed us that they would not accept directions from us because we could not establish that all of the trustees had appointed us.

The dad, mum and son therefore had to go through the process of calling a meeting of trustees to appoint us as lawyers of the SMSF and to authorise us to contact the ATO and re-register the SMSF. Long story short, that was ultimately successful.

3. Tools for resolving or avoiding internal disputes

3.1 Separate SMSFs

This is the simple solution.

In particular for unrelated parties. For example, business partners who want to "co-invest" their super could still do so with their own SMSFs whether that be by:

- Co-ownership (tenants in common);
- Investment via an unrelated trust or company;
- Investment via a regulation 13.22C unit trust or company.

Although such co-investment vehicles are not free from trouble in dispute, they are easier to deal with than a dispute within an SMSF.

Even siblings, as a general rule, should avoid being in the same SMSF. Separate sibling SMSFs don't have as much flexibility as unrelated SMSFs would because they will deemed to be related parties and related trusts under Part 8 of the SIS Act. For example, siblings SMSFs would not qualify as an unrelated trust and could not acquire assets from each other unless one of the exemptions under section 66 of the SIS Act applied. However, they can still co-invest via tenants in common or regulation 13.22C unit trust or company arrangements.

Again, children, as a general rule, should be kept out of the SMSFs of their parents.

One of the reasons some parties enter into a joint SMSF is to undertake an LRBA in the joint SMSF. This is often driven by the single acquirable asset rule or the inability to borrow a single asset using multiple SMSFs. In such situations a joint SMSF with a single LRBA may be unavoidable and which case some of the solutions outlined below should be considered.

3.2 Corporate trustee

Some of the issues raised in the second section of this paper arose because the trustees were individuals. Common law provides that, unless the trust deed of the trust provides otherwise, all decisions of trustees must be unanimous. This creates a problem in a dispute context as a rouge minority trustee can hold the majority trustees "to ransom". Of course, the opposite is also true – that an unreasonable majority could seek to use their majority against an unwitting minority.

Whereas, for corporate trustees, the general position is that the majority of directors may make a decision.

Another issue with individual trustees is that each of the trustees are required to sign documents. Therefore, even if the trust deed provides that the majority of trustees can make a decision, if the minority trustee refuses to sign a document then the remaining trustees will be left in a difficult position in deciding how to enforce the trustees' decision.

Another advantage with a corporate trustee is that members do not need to be shareholders. Therefore, the "controllers" of the SMSF could hold the shares and, therefore, could remove rogue directors.

3.3 Tailored trust deeds and associated documents

Where a SMSF's membership will include persons outside of the nuclear family, it would be prudent to prepare documentation at the commencement of the SMSF in relation to how the SMSF will be managed and how parties can exit the SMSF. For example, this would be similar to what you would expect with an investment in a company (ie. via a shareholders agreement) or unit trust (via a unit holders agreement).

This could be incorporated into the SMSF trust deed itself or via a separate agreement. The latter is especially recommended where the SMSF has a corporate trustee as the directors will not necessarily be bound by tailored provisions in the SMSF trust deed.
The provisions could include:

- How meetings are conducted;
- How voting occurs;
- Whether members can compel an exit;
- How an exit will be effected;
- What happens upon the death of a member?
- A dispute resolution provision that is binding on the parties.

3.4 Guardian role

Another method of controlling an SMSF is the use of a "guardian" position in the SMSF. The guardian can have powers (such as the power to appoint and remove trustees or to determine who will receive benefits) or rights of veto (such as a right to prevent the appointment/removal of a trustee or the right to prevent the payment of benefits to a particular person).

The position of guardian could be helpful where children have been appointed as members and trustees/directors. For example, if the surviving parent is predisposed to their children becoming members of their SMSF but that parent wishes to preserve their ultimate control of the SMSF, the parent could be appointed to be the guardian of the SMSF.

The appointment of a guardian will not always solve ‘control issues’ for the trustee. For example if there are no provisions for the succession of the position of guardian after the guardian’s death, guardians are stalemated or there is no dispute mechanism for guardian disputes. Therefore, it is important that the SMSF trust deed appropriately deals with such issues.

4. Conclusion

As seen above, having a joint SMSF can cause issues. What starts out happily can turn nasty. While the easiest way to avoid conflict is to not have joint SMSFs, if, for whatever reason they are desired, then it is important that potential conflicts be considered upfront. Following which appropriate provisions and measures should be put in place to deal and resolve such conflict, should it arise.