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SMSF Case Law 2018 breakdown: how it applies in practice

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SMSF CASE LAW 2018 BREAKDOWN: HOW IT APPLIES IN PRACTICE

Aussiegolfa Pty Ltd (Trustee) v Federal Commissioner of Taxation

[2018] FCAFC 122

Issue:

They key issues in the Aussiegolfa case were whether the arrangement contravened:

- the sole purpose test in section 62 of the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**); and
- the in-house asset provisions in part 8 of the SIS Act.

Facts:

The facts of this case are as follows:

Aussiegolfa Pty Ltd as trustee for the Benson Family Superannuation Fund invested in units in a managed investment scheme called the DomaCom Fund. The Trustee sought declarations that the investment did not contravene the sole purpose test in section 62 of the SIS Act, and was not an in-house asset under section 71(1) of the SIS Act.

The Commissioner of Taxation filed a contingent appeal from the decision of the Administration Appeals Tribunal, on the basis that if the Court found that the investment was not an in-house asset, the Commissioner's determination under section 71(4)(b) of the SIS Act to deem the Trustee's investment to be an in-house asset would stand.

The DomaCom Fund is a registered managed investment scheme which facilitates indirect fractional property investment in a specific property. Each property acquired by DomaCom was purportedly held in a separate sub-fund, with units issued referable to that sub-fund (by way of classes of units). As such, income (less costs and expenses) derived from the specific property held in a sub-fund is payable to the relevant unitholders of that sub-fund. Investors in other sub-funds have no right to any return sourced from that property.

The Trustee (along with two related parties) held 100% of the units in a sub-fund of the Domacom Fund that held a residential property in Burwood, Victoria. The property was leased at market rent to the daughter of the sole member of the Fund.

Decision:

Sole purpose test

The Court held that Domacom leasing the property to the member's daughter did not cause the Fund to contravene the sole purpose test.

The Court stated that there did not appear to be any financial or other non-incidental benefit to be obtained by the Fund or the member by the member's daughter leasing the property rather than another tenant.

In the absence of a financial or non-incidental benefit being obtained, the Court held that the investment in Domacom did not impact on the Fund being maintained for core and ancillary purposes consistent with the sole purpose test in section 62 of the SISA.

'The Court noted that:

'the word 'purpose' in s 62 of the SIS Act is concerned with the way in which the fund is being maintained; the term does not look subject factors actuating the trustee. Further, the statutory context in which s 62 appears does not suggest that a fund will not be treated as being maintained solely for the core purposes, or the core purposes and the ancillary purposes, simply because the trustee enters into a transaction with a related party.'

The Court went on to state that the sole purpose test is not intended to proscribe every related party transaction, as other provisions of the SIS Act assume that an arm's length investment does not infringe the sole purpose test.

The Court noted this conclusion would be different if there was evidence that:

- the rent received by the Fund was less than market value; or
- providing accommodation to the member's daughter had influenced the Fund's investment policy.

An important aspect of this decision was the fact that the property had been acquired and leased to unrelated tenants for two years prior to the property being leased to a related party of the Fund.

In-house assets

The Court held that the Fund’s investment in the sub-fund was an investment in a related trust for the purposes of part 8 of the SIS Act. Accordingly, the investment was an in-house asset under section 71(1) of the SIS Act (and the applicable exceptions did not apply). Further, as the investment was in a sub-fund of Domacom, the investment did not constitute an investment in a widely held unit trust for the purposes of the in-house asset provisions.

The arrangement effectively and in substance created a circumstance whereby a residential property indirectly owned by the Fund trustee was being leased to a related party. The Court noted that had the property been held directly, the lease to the member’s daughter would be an in-house asset under part 8 of the SIS Act.

Therefore, if the market value ratio of the Fund's in-house assets exceeded 5% at the end of the income year, the Trustee would be required to take action under section 82 of the SISA to ensure that the Fund's in-house assets do not exceed the 5% threshold by disposing of all or a proportion of the Fund’s in-house assets.

The decision as to whether the investment was a related trust turned on whether the sub-fund was a separate trust in accordance with general trust law concepts, based on the rights and obligations attaching to the units in the sub-fund under the constitution of Domacom. The Court held that the provisions of the constitution when considered as a whole facilitated the creation of a distinct trust associated with a particular class of units.

Given the Court’s decision that the investment in Domacom constituted an in-house asset, the Court held that the Tribunal had correctly set aside the ATO’s determination to deem the investment to be an in-house asset. However, the Court noted that had the investment not been an in-house asset, the Court would have upheld the Commissioner’s determination.

Practical implications and lessons for advisers:

This case highlights the following key lessons for advisers:

- Ultimately, interposing an unrelated party did not avoid the prohibition on leasing residential property to a related party, albeit indirectly. The terms of the constitution, and the supplementary material such as the product disclosure statement, were fundamental in the Court forming the view that the property was held on separate trust for the purpose of the in-house asset provisions.

Therefore, it is of vital importance that documents are drafted correctly and reflect the parties' intentions and what ultimately happens in practice.

- The sole purpose test is not a panacea for all matters that appear to generally contravene the spirit of the superannuation legislation. A contravention of the sole purpose test generally requires a financial benefit to be provided or received, irrespective of whether the circumstances are inconsistent with any other provision of superannuation law. A contravention may be better captured under other areas of superannuation law. The Court considered a number of cases that have dealt with alleged breaches of the sole purpose test and noted that:

  'These decisions all exhibit one of two features: either payments were made to members otherwise than on retirement, or benefits were provided on non-arm's length terms.'

- The ATO Decision impact statement provides, however, that the ATO does not consider that this case is authority for the proposition that a fund trustee can never contravene the sole purpose test where an asset is leased to a related party simply because market-value rent is received.

- The ATO intends to review its guidance on the sole purpose test to see if the factors which may be important in determining whether a fund has been maintained for a collateral purpose can be more clearly illustrated.

- The Fund trustee was ultimately unsuccessful in a key aspect of the case. This emphasises the importance of managing client expectations and providing an honest and realistic prospect of the likely success of a matter if litigated, particularly given the time and costs associated with litigation.

- Where a Fund trustee invests in a managed investment scheme, it is important to understand the structure as set out in the constitution and any accompanying disclosure documents to ensure the investment is not an in-house asset, in light of the trust analysis in this case.

- There is some doubt over the breadth and validity of the Commissioner's power under section 71(4) of the SIS Act. This is reflected in the following comment of Justice Steward:

  'The power in section 71(4) to deem an investment to be an in-house asset that would otherwise not fit within the requisite criteria – the power to undo the application of s 71(1) is seemingly unlimited. A provision cast in such terms raises the possibility that it is an unconstitutional delegation of legislative power.'

- This case is useful in providing some context as to when the Commissioner will seek to enliven his powers under section 71(4) of the SIS Act.

Cam & Bear Pty Ltd v McGoldrick [2018] NSWCA 110

Issue:

The key issue in this case was whether the Fund's auditor had been negligent in two respects:

- failing to identify an issue with the description of the Fund's assets. In particular, the auditor's failure to obtain sufficient appropriate audit evidence to support the classification, valuation and recoverability of the Fund's other assets described as 'cash', but which were in fact unsecured loans; and
- failing to notify the Fund trustee of material and significant matters concerning the Fund, and to qualify the audit report as required.

If the auditor was negligent in the matters outlined above, a further issue to be determined was to what extent the auditor was liable for damages to the Fund.

Facts:

This appeal arises out of a claim for damages for negligence and misleading and deceptive conduct brought by the Fund trustee against the Fund's auditor.

It was alleged that the auditor breached his duty of care and engaged in misleading and deceptive conduct by failing to qualify the audit reports as to the possibility that those assets described in the Fund's financial statements as 'cash' may not be recoverable (being in fact unsecured loans to a company) and, by including in the audit reports a statement to the effect that the financial statements 'presented fairly...the financial position of the Fund and the results of its operations and its cash flows'.

The NSW Supreme Court originally held that the auditor had been negligent and engaged in misleading and deceptive conduct, but that his conduct had not caused any loss to the Fund.

The appellant is the trustee of a self managed superannuation fund with two members. The management of the Fund was entrusted to Mr Lewis. A member of the Fund, Dr Bear, was making regular contributions to the Fund by way of cheques payable, at Mr Lewis' request, to Lewis Securities. According to Dr Bear, from about 1996 until 2008, he understood from his conversations with Mr Lewis, and from financial accounts that he received from time to time, that the Fund's assets consisted of cash amounts and shares.

Each year the auditor signed and certified the audit reports without qualification. They stated that the financial statements fairly reflected the financial position of the Fund. The auditor did not have any direct communication with Dr Bear.

On or about 22 September 2008, Dr Bear told Mr Lewis that he wished to withdraw cash from the Fund. Mr Lewis attempted to dissuade him from taking this course but Dr Bear insisted. The cash Dr Bear requested was not provided and in early November 2008 Lewis Securities went into voluntary administration. Its winding up followed some months later.

The experts for both the Fund trustee and the auditor agreed that accounting standards applicable at the time of the subject audit reports defined cash as 'cash on hand and cash equivalents'. Cash equivalents were defined as 'highly liquid assets with short periods to maturity which are readily convertible to cash on hand at the investor's option and are subject to an insignificant risk of changes in value'.

The experts giving evidence in this case broadly agreed that:

- a competent auditor would be required to make appropriate enquiries to ascertain the nature, existence and valuation of the item described as 'cash';
- a competent auditor would have made enquiries about the financial condition of LSL Holdings (being the entity holding the 'cash' on behalf of the Fund); and
- the items described in the Fund's financial statements as 'Cash – LSL Holdings P/L' did not satisfy the definition of cash.

Nevertheless, the Court was required to be satisfied that, if the auditor had not been negligent, the Fund trustee would have insisted on the amounts being held in a bank in cash or otherwise in a different form than the unsecured loans.

Decision:

On appeal, the Court found for the Fund trustee.

The Court noted that while even a person with Dr Bear's lack of financial sophistication should reasonably have considered the prudence of depositing significant amounts of money with Mr Lewis' company, the auditor's negligence was of significantly greater importance in causing the Fund trustee's loss, and responsibility for the loss should be apportioned 10% to the Fund trustee and 90% to the auditor.

The Court found that the auditor owed a duty of care to the Fund trustee to take reasonable care and exercise reasonable care, skill and diligence to ensure that the financial report that is audited presents a fair description of the circumstances therein described. If the financial statements did not give a fair representation of the affairs of the company, it was incumbent upon the auditor to draw that fact to the attention of the Fund trustee and either to qualify the report or to draw to the attention of the Fund trustee the basis upon which the view had been formed.

The Court further noted that the auditor's breaches were not contributed to by the Fund trustee supplying him with incorrect information or having inadequate internal controls upon which he could reasonably place some, even if not total, reliance.

The Court also held that the auditor did not establish that Databank is liable to the Fund trustee in respect of the loss, and therefore, did not establish that Databank was a concurrent wrongdoer. While Databank compiled the annual financial statements, without knowing the basis upon which Databank was engaged, it cannot be concluded that, by doing that, Databank rendered itself liable to the Fund trustee in negligence, or for misleading and deceptive conduct.

Ryan Wealth Holdings Pty Ltd v Baumgartner [2018] NSWSC 1502

Issue:

This case considered whether the Fund auditor had breached their duty and contractual obligations to the Fund trustee by:

- failing to enquire into and report on the Fund trustee's compliance with its investment strategy under regulation 4.09 of the *Superannuation Industry (Supervision) Regulations 1994* (Cth);
- failing to bring serious mis descriptions, mis statements and other factors (including the conflict of interest of the accountant) to the Fund trustee's attention;
- failing to qualify the audit report; and
- failing to exercise reasonable care and skill.

The dispute also considered the loss of a valuable opportunity to exercise rights at an earlier time.

Facts:

On the advice of a financial planner, the Ryan Holdings Retirement Fund was established and the Fund trustee made a number of investments, being loans to various entities and investments in unit trusts (of which the adviser had a personal interest).

The Fund's financial statements described a number of the Fund's investments as 'mortgage loans'. No mortgage loans existed, however, because the loans were unsecured by any mortgage. Further, the material provided to the auditor contained no basis upon which the auditor could conclude that any security in the form of a registered mortgage existed. The auditor also failed to obtain any evidence to substantiate the existence of a mortgage loan.

This case was concerned with audits of the Ryan Holdings Retirement Fund in three successive financial years, being the financial years ending 30 June 2007, 30 June 2008 and 30 June 2009.

In each of the relevant financial years, an audit of the Fund's financial statements was carried out and an audit report issued in which an unqualified audit opinion was expressed as to two matters:

- the presentation of the Fund's financial report; and,
- the Fund's compliance with the SIS Act.

The Fund trustee argued the failures of the auditor resulted in irregularities going undetected for many years, and when those irregularities were ultimately discovered, the opportunity to redeem many of the loans and investments of the Fund, or to pursue recovery action against those on whose advice the loans and investments had initially been made, had been lost.

The Fund trustee claimed that the auditor's conduct was:

- in breach of their duties in contract and in tort;
- in contravention of his obligation as an auditor under the SIS Act;
- misleading and deceptive; and
- in breach of Commonwealth and State legislation.

The auditor's position was that, notwithstanding the admitted breaches, the Fund trustee has not demonstrated causation or loss.

In each audit report, the auditor recorded that:

- the audit evidence he had obtained was sufficient and appropriate to provide a basis for his audit opinion;
- the financial report, for the relevant financial year, presented fairly in all material respects, in accordance with the accounting policies described in the notes to the financial statements, the financial position of the Fund at the relevant financial year end date and the results of its operations; and
- the Fund trustee had complied in all material respects with the requirements of the SIS Act and the SIS Regulations specified in the report.

It was acknowledged that in planning and performing the audit to reduce audit risk to an acceptably low level, an auditor is required to consider the risks of material misstatements in the financial report due to fraud under ASA 240.

The auditor admitted that he failed to exercise reasonable care in the preparation of the audit reports on the basis that:

- the nominated assets were in substance worthless or of substantially compromised value;
- the Fund's financial statements for the relevant financial years were each materially inaccurate;
- the Fund's special purpose financial reports did not fairly present the financial position of the Fund for the relevant financial years; and
- the material available to the auditor at the time of the preparation of the audit reports did not support the expression of an unqualified opinion that the Fund's financial reports were fairly presented in all material respects.

The auditor contended that there was a conceptual difference between qualification of the audit opinion (which the auditor admitted was required) and the formation of an affirmative opinion that the financial report misstated the financial position of the Fund.

The auditor further contended that it was not the job of an auditor to affirmatively value or establish the value of assets.

Decision:

The Court held that the auditor failed to exercise reasonable care and skill to ensure that the investments were valued at net market value, and failed to exercise judgement in assessing the reasonableness of the values disclosed.

The Court noted that the Fund trustee did not exercise effective control or direction in making the loans and investments, and that the Fund trustee was unaware, or had never heard, of most of the loans and investments (and funds were dispersed without her knowledge).

The Court held that the auditor had a duty to report to the Fund trustee concerns about the obvious conflict of interest of the accountant and the high level of risk associated with the loans and investments.

The Court took the view that had reasonable care and skill been exercised, the auditor would have:

- formed the opinion that a contravention of regulation 4.09 of the SIS Regulations may have occurred, and therefore, would have been under a statutory obligation under section 129(3) of the SIS Act to report the suspected non-compliance to the Fund trustee and to the regulator; and
- qualified their audit report appropriately to refer to the non-compliance with regulation 4.09 of the SIS Regulations.

The auditor had two duties in this respect, being to verify the existence of reported assets, and enquire into the reported value of the assets.

After the 2014 financial year, the Fund trustee obtained recoveries with respect to several of the loans and investments, but many of the lenders and guarantors, by that time, were bankrupt, in liquidation or de-registered. Further, a number of the relevant parties no longer possessed policies of professional indemnity insurance.

Once the existence and loss of a chance to recover the relevant amounts have been established, damages are assessed by reference to the degree of likelihood that the commercial opportunity would have yielded success had it been pursued.

In the circumstances, the Court was satisfied that there was a substantial and not merely speculative prospect that the Fund trustee would have been financially better off exercising rights against Turnbull Hill Lawyers in 2008 than in the 2015 financial year.

The Court assessed damages in the sum of **$2,260,140**.

<u>Contributory negligence</u>

The Court considered that the Fund trustee departed from the standard of care that a reasonable person would have applied to protect his or her own interests, but that the departure from that standard was very limited.

The evidence was to the effect that when the Fund trustee was made aware of a problem, she acted upon it. Further, there was nothing on the face of the financial reports which would have indicated to the Fund trustee that there was a problem with the loans and investments.

Taking into account the fact that it was amongst the auditor's duties to protect the Fund trustee against the harm that it suffered, the Court came to the view that the loss should be apportioned 10% to the Fund trustee and 90% to the auditor.

Proportionate liability

The Court accepted that the auditor had a far higher degree of culpability than the accountant that prepared the financial statement for the Fund. This finding was on the basis that if the auditor had performed his role competently, the deficiencies in the financial statements and investments of the Fund would have been exposed at an earlier point in time.

Accordingly, the Court determined that the Fund trustee's loss should be apportioned to the accountant as to 20%.

Practical implications and lessons for advisers

The 'auditor cases' highlights some of the risks for SMSF advisers, and the implications from both a professional and financial standpoint.

The broader lessons for professional advisers that can be distilled from these cases are as follows:

- Ensure that the key contact for the client is specified in the retainer, and that the key contact is copied in on all communications, particularly where instructions are being provided by another adviser as agent for the client.

- Review the terms and conditions in client retainers, including the scope of the work to be undertaken and any exclusion or carve outs from the advice or services.

- Expect mistakes and errors to occur, and critical issues to be overlooked when providing advice and services to Fund trustees. Plan for this by implementing processes and procedures to balance the risk of human error. For example, put in place a review process to check all advice and services delivered to clients.

- Review professional indemnity insurance thresholds, terms and conditions, and in particular, check any applicable exclusion.

- Ensure client files contain all relevant information, and that detailed file notes are taken and retained.

- Ensure employees are trained to identify and manage conflict of interest scenarios. Further, run training sessions on key issues to be alive to when providing advice and services to clients, such as fraud and misuse of client funds.

- Advisers should ensure clients confirm in writing that the information provided is correct in all material particulars.

- Supporting evidence is critical, particularly where an adviser is claiming contributory negligence.