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SUPER SPECIALISTS

Professional Risks in Splitting Self Managed Super Funds

Self managed super funds are fast becoming the superannuation structures that will give you the biggest headache and provide the greatest professional risk. Self managed super funds are one of the fastest growing and most complex superannuation structures in Australia spurred on by the changes introduce to superannuation in 2007 and the relaxation of laws governing the self managed super fund's ability to borrow to invest.

All these changes mean that you will need to familiarize yourself with these structures and the Regulations governing them as you can be sure to see more of these funds over the coming years. In addition to which, by their very nature, self managed super funds will generally hold a significant level of assets, may involve complex investment structures and have some unusual and or complex investments.

Some of the issues with which you will need to contend include:

- Determining an appropriate valuation for the member or each member's interest;
- Splitting the member's superannuation interest;
- Ensuring that any advice to split the superannuation interest does not in any way negatively impact the fund and open the fund up to scrutiny by the Australian Taxation Office ("ATO"); and
- Ensuring that your client's superannuation objectives are not adversely impacted by any splitting decisions including those not to split.

Many of you will rely on information provided by your client, their spouse and the fund's adviser, be it the accountant and/or financial adviser. This is likely to throw up all sorts of difficulties particularly where your client is the "silent" member and has little knowledge of the fund, its investments and operations.

Getting a valuation

One of the first tasks will be to value your client's interest and/or that of their spouse. Unlike other accumulation funds, this is not as simple as writing off to the Trustees and waiting for a timely response which will provide you with a valuation on a particular date.

Whilst the Trustees are required to provide certain information in accordance with Reg. 67 of the Family Law (Superannuation) Regulations 2001 ("FLSR"), you will see if you review this regulation that the information the trustee/s are required to provide is not that useful so far as obtaining a valid valuation of the interest. Therefore the only way to obtain a valuation of any kind is to request the member statement which will provide the market value of that member's interest in the fund. The member statements are generally part of the fund's financial statements and therefore you should request the financial statements for the fund.

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In making such a request you will need to remember the following:

- The financial statements will only reflect the valuation of the members' interests as at 30 June;
- The financial statements may not be prepared for some time following 30 June; and
- The member statement will only reflect the market value of their interest/s.

In requesting a valuation of a member's interest at some other point in the financial year, you may find it difficult to get an accurate valuation. The issues here include:

- Where the 30 June accounts have not yet been prepared you will find it difficult to get any valuation beyond this time;
- You will need the fund's adviser to do a set of accounts for the day you want the valuation, this is likely to incur additional costs to the fund which may not be something the Trustee/s are willing to incur; and
- Trustee/s will need to have all the financial information from 30 June to the day you are looking to do the valuation i.e. monthly bank statements, dividend notices etc.

Determining a value for the interest/s can be a very drawn out process and one with many hurdles. In my experience delays have come as a result of the dominant member/Trustee being unwilling to provide information to either the accountants or myself in a timely manner. The accountants/advisers to the fund using an interpolation approach to provide a valuation on a particular day in the financial year. In one matter the accountant was willing to make certain erroneous assumptions with regard to a valuation in December which had the result of undervaluing the member's interest.

For these reasons and the importance of obtaining a valuation which can be relied upon professionally and updated quickly and without too much additional expense, I look to reconstruct the fund based on the most recent financial statements and then request all necessary documents to allow a valuation on any day following 30 June. In doing this I am also able to address one of the other significant dangers facing you.

The fact that the financial statements provide a market value for the member/s of the fund is an important point to be remembered in all matters. The reason for this is that it does not take into account any capital gains taxes ("CGT") that may be applicable to the members' interests and therefore may result in a higher member value. This CGT trap has caught out many solicitors dealing with self managed super fund splits and resulted in a number personally compensating their client for the amount of CGT payable following the split of their clients super interest (refer to presentation for example).

You may be caught out by the CGT trap where you neglect to consider the CGT liability that may apply to the member/s account. Splitting an interest where a significant CGT liability is realized may result in the member retaining a lower superannuation benefit than was intended. This may also come as a shock to the member when they next have their accounts prepared and it is determined that a significant CGT liability is payable.

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Obtaining the financial statements is absolutely vital in managing the CGT trap. You should also look to get a copy of the trust deed to ensure that the member benefits are being calculated correctly. The deed will clearly define how a member's benefit is to be calculated and what taxes and expenses are to be included in determining the value of a member's interest.

Valuing a member's interest is further complicated where the Trustee has invested in certain assets which are difficult to value. Assets such as commercial property, vintage cars, art works, stamp collections and other specialized investments will be difficult to value and require the services of another professional to gain an accurate and reliable valuation for the purposes of determining the true value of the member's interest.

The main risks you face in valuing the self managed super fund include:

- The valuation does not accurately represent the true value of the members' interests; and
- The valuation does not account for any CGT.

These risks could result in your client receiving a smaller cut of the overall assets of the marriage and may result in your client having to meet an unexpected CGT bill.

Having requested the super fund's deed and financial statements, deriving a CGT profile of the fund will also allow you to make some important decisions when it comes time to decide on how much and how to split the fund. With many self managed super fund advisers not encountering family law matters on a regular basis or at all, your clients and the advisers may look to you with regard to splitting the assets of the fund. Any issues which result in a financial loss to the remaining or transferring member may become an issue for which you are implicated.

Splitting a self managed super fund interest

Having finally arrived at a valuation for the member/s interest in the self managed super fund it is now time to determine whether or not the interest should be split. This decision will require consideration of the other assets of the marriage, the objectives of your client and a range of other issues relevant to each individual situation. The decision will be of greater importance to older clients and those with significant assets in and out of superannuation. For those clients where the main significant asset of the marriage is the super fund may also need to carefully consider their superannuation options.

The prejudices of the client in relation to taking on some or all of the superannuation may need to be addressed as many older clients do not understand the real benefits superannuation assets can provide, particularly with some of the new changes introduced to super in 2007. Many are simply not aware of the tax savings and higher real income streams that may be achieved through super and are surprised when they are shown how their objectives may be more efficiently achieved if the spouses superannuation interest is split.

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However, before making the decision to split an interest in self managed super fund, it is always prudent to confirm that the fund in question is a complying fund. The main reason for this is that a non-complying fund can be split just like a complying fund. The risk however in splitting a non-complying fund, is that the member remaining in the fund will be the one to carry the financial costs of rectifying any and all breaches and/or paying any penalties imposed by the ATO.

It is important however that you do not think that where your client is a member of a fund which is known to be in breach of certain regulations can simply avert their responsibility with regard to these breaches by simply leaving the fund. Whilst this may better protect their superannuation interest from any penalties imposed by the ATO, there are certain penalties which the ATO can apply to them, namely, disqualifying them as a Trustee of a super fund. This may or may not be a concern for your client, particularly where they are no longer and do not ever intend on being a Trustee of their own fund again. It would be unlikely that a member remaining in a non-complying fund would not look to re-open their financial settlement to re-address the financial impact of any of the financial costs and/or penalties imposed by the ATO.

You will be relieved to know that the Auditors as part of auditing a self managed super fund's return each year are required to report material breaches. This should eliminate much of the risk of coming across a non-complying fund however the risk is not entirely removed. A recent transaction of the fund may find it in breach and where a fund has not submitted their financials for a number of years questions of compliance certainly need to be asked. You may also find with smaller accountants that they may do the accounts and also sign off on the audit which may mean the fund's compliance should be investigated further.

For these reasons I believe it is still prudent to confirm the compliance of any self managed super fund you come across in your family law matters. This can be done by simply requesting the audited accounts and confirming for yourself that the auditor has signed off on the fund.

One of the biggest issues for you to confirm in splitting a self managed super fund interest is that CGT has been taken into account. This issue has been dealt with above under the heading of "Getting a valuation". It was mentioned that you should always determine the CGT profile of the member's interest. Determining the CGT profile will allow you to determine how the interest may be split.

To assist you in making certain decisions about spitting a self managed super fund interest you should also be aware that where there is more than one member, the fund may hold the assets of the members in either pooled or segregated strategy. Holding the assets in a pooled strategy means that every member owns every fund asset in a proportion reflecting their respective member balances. In a segregated strategy each member has particular assets segregated to them. The pooled strategy is the most popular method for holding assets.

Therefore under a pooled strategy, where your client has their own member balance and they are looking to receive a split from their spouse, you should appreciate that they technically own each

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asset in proportion to their underlying member balance. Therefore, their liability to any CGT should be in the same proportion. Furthermore, in rolling their assets out of the fund their proportion of each and every asset should be sold down and transferred. This then triggers their share of the overall CGT liability. It then stands to reason that in splitting their spouse's interest they should also technically sell down each investment in a proportion representing the split amount. This will realize a CGT liability in proportion to the split amount and will be payable by the spouse when they next lodge their super fund return. This ideally spreads the CGT liability across all members' interests and providers the fairest outcome. Importantly, it ensures that sufficient funds are left behind in the fund to meet the CGT liability resulting from the rollover and split which will be payable by the remaining Trustee at some future point following lodgment of the fund accounts.

Where a situation exists that one of the Trustees dominates the relationship, you may find that the Trustee will look to pick the investments sold to minimize the CGT liability and this may result in a favourable outcome for the remaining member. Similarly, simply paying out the non-member in cash can lead to a situation where the remaining spouse will at some point realize a significant capital gain. Thus, whilst paying a split or even a rollover with cash amounts, or by raising cash through the sale of investments giving rise to a smaller CGT liability may seem to be the easiest and quickest solution it may be a costly one to the remaining member.

This situation may also be complicated by the fact that where the remaining member is considering holding certain investments until they commence a pension from the fund, they will be unlikely to ever have a CGT liability. This comes about as the investment returns for assets supporting a pension have a 0% liability. Therefore any capital gain realized after the member commences a pension with all their superannuation assets will not be taxed and the result will be a member with a higher account balance than was otherwise intended.

One way to manage this complicated CGT situation is to ensure that any amounts rolled over by one of the members and/or the amount that is split is transferred by way of an in-specie asset transfer to another complying fund. Such a transaction qualifies for the CGT rollover relief under subsection 126.140 of the Income Tax Assessment Act 1997. Any capital gain is therefore transferred to the new fund and realized when the member elects to redeem the investments. The transferred assets, where they are not sold until your client elects to commence a pension from these assets will also then not have any CGT liability and therefore fully benefit from the capital gains.

You should therefore see the importance of ensuring that your clients consider the capital gains of their or their spouse's interest and that you discuss an appropriate strategy in dealing with this liability. I understand that clients may be after an easy and straightforward resolution to their family law matters, unfortunately, where a self managed super fund is involved this may not be possible. In actual fact in looking for the quickest and cheapest solution, your client may miss out on receiving additional assets or lose assets through the payment of unnecessary CGT.

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Once you have confirmed the CGT issues and determined an amount that should be split, the next issue you may run into is whether or not the asset/s held in the fund can in fact be split. Assets such as artworks, vintage cars, stamp collections etc may be unsplittable on the basis that there may not be a buyer for the asset itself. It may also take a lot longer to sell the asset which may place the fund in breach of the prescribed time frame for the splitting process. The Trustee may not want to sell the fund's vintage car or artwork and will therefore need to consider other means of funding the liquidation of the asset so that the Trustee can effect the split. This could be achieved by the remaining member making a contribution to super, thereby providing additional liquidity in the fund from which to meet the payment split and rollover liability.

Assets such as artworks and vintage cars are more likely to be long term investments held on the belief that the longer the asset is held the greater the return. The Trustee/s would be unwilling to sell such an asset and transferring part of the asset may also be impossible. This impasse may be easier to address if your client is the sole member or their spouse was the sole member of the fund, however, if your client and their spouse were both members of the fund and the assets held in a pooled strategy, each could technically claim a proportionate level of ownership. Such a situation has the potential to maintain the animosity between the parties as a solution will need to be solved and it may be prudent that these issues be dealt with at the same time the settlement is agreed to rather than simply agreeing to a split of the superannuation interest.

Where direct property is involved, not only will you have additional valuation issues, but in selling such an asset you could potentially reduce the superannuation savings of the member remaining in the fund. This situation is most likely to occur where the one of both of the parties are running a business from the property held by the super fund. Rental payments made by the business into the fund will assist in building the superannuation asset pool of the member/s. This is quite an important benefit given the new contribution limits to superannuation.

In splitting such a fund and selling the business property, there is the potential to reduce the amount the member is able to accumulate for their retirement as the business will no longer pay rent to the super fund but to a new landlord. In addition to this the effect that such a split may have is to place the business at risk as the new landlord may increase rent significantly and may even evict the business. Therefore such an outcome could increase the risks to costs and viability of the business.

Strategies introduced on the back of the changes to a self managed super funds ability to borrow will also mean that you are likely to come up against some complex structuring. Not only will there be a property that needs to be valued but there may be additional issues that need to be considered if you decide that the member's interest is to be split or if one of the members is to roll out of the fund. In such a strategy there will also be mortgage issues which could be structured through a financial institution or through the member/s themselves. Doing anything to such a structure will need careful consideration of the implications as these could be significant and costly. Subject to such strategies not surviving you may need to be aware of any grandfathering requirements which if breached through the split or rollover could leave the fund in limbo or at risk of non-compliance.

Given the issues with self managed super funds, why then should you and your client bother with the expense of getting the information to make a decision on whether or not to split the fund?

Quite simply the risks in not doing so are just too great. There are considerable risks in not getting the valuation correct and in understanding the exact position of a member's superannuation interest. Self managed super funds are complex structures and their investment strategies are only gaining in complexity. These strategies need to be fully understood as they will impact the value and splitting decisions you will need to make. In the majority of cases the mere fact that a self managed super fund exists means that there are sufficient assets to warrant the expense of investigating not only the value of the fund but also the options available and the implications to the client in splitting their spouses interest. There is also the risk of restricting your client's ability to enjoy in the benefits of superannuation from the age of 55. The only issue that may make this an unattractive expense is where the client is of an age where superannuation is not a real concern, or where they believe their personal situation will be disadvantaged by taking some superannuation. In seeking professional advice you and your client may discover strategies that may more efficiently achieve the financial outcomes desired.

Fully appreciating that once a member commences a pension, the assets supporting the pension are not subject to tax and that over the age of 60, a superannuation pension is tax free and you can see that there is the real potential for a client to have a zero taxed existence. This very outcome fuels my passion in exploring strategies to ensure that clients fund their retirement savings appropriately and can enjoy the spoils of this tax effective environment.

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