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Three strikes don’t automatically mean you’re out as an SMSF trustee

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The role of trusteeship of any entity is one the courts have regularly highlighted requiring conduct of the highest standards.

In relation to SMSFs, the expectations of trustees are arguably heightened by the legislative obligations also imposed - a fact highlighted by numerous cases over recent years.

Background

The nuances however that will be focused on by decision making authorities in any particular factual matrix can at times be difficult to reconcile.

For example, in Fitzmaurice and Commissioner of Taxation (Taxation) [2019] AATA 2217, the tribunal specifically confirmed that verbal advice from the accountant for the SMSF was not something that was appropriate to rely on, partly because the primary responsibility for compliance lies with the trustee of an SMSF, not the advisers to the fund.

Merchant – Overview

In contrast, in the recent high profile decision involving Billabong Surf Clothing co-founder Gordon Merchant, in addressing a similar point, the tribunal held that although the three relevant breaches were serious, the offending SMSF transaction was one put forward by former EY Partner Ian Burgess (no relation), and despite EY also being the auditor of the SMSF, at no time were the apparent superannuation compliance issues raised with the member.

The SMSF related decision in Merchant and Commissioner of Taxation [2024] AATA 1102 was part of a series of cases heard together that saw various transactions successfully attacked by the Tax Office, including pursuant to the anti-avoidance regime under Part IVA.

Relevant to the issue of the member retaining directorship of the corporate trustee, the situation triggering the disqualification was as follows:

(a) the SMSF agreed to acquire from a discretionary trust controlled by the fund member a substantial number of shares in Billabong that had a high cost base, which crystallised a significant capital loss for the trust (the transaction was separately held to have been for the dominant purpose of allowing a capital gain on a related transaction to be offset against the loss created by the 'wash sale');
(b) pursuant to section 126A(2) of the Superannuation (Industry) Supervision Act (SISA), the Tax Office disqualified Gordon Merchant as a director of the corporate trustee of the SMSF due to the following serious contraventions:

(i) the requirement to comply with operating standards under section 34 of the SISA, in particular to give effect to the investment strategy;
(ii) the sole purpose rule in section 62 of the SISA; and
(iii) section 65 of the SISA, by using the resources of the SMSF to give financial assistance to a member of the fund or relatives.
Interestingly, the Tax Office did on review consider Gordon Merchant to be a fit and proper person, despite the above breaches.

Investment strategy

In refusing to disqualify Gordon Merchant, relevantly the tribunal confirmed as follows:

1. The SISA and Superannuation (Industry) Supervision Regulations (SISR) do not impose a direct requirement that, in making a particular investment decision (as opposed to formulating the strategy), the trustee must consider or reconsider each of the following matters. Rather, in making an investment decision, the trustee must 'give effect' to the then existing investment strategy which will have been formulated having regard to the circumstances of the entity and review that strategy regularly. The items to be considered in developing the investment strategy are those set out in SISR 4.09(2)), namely:
(a) the risk involved in making, holding and realising, and the likely return from, the entity's investments, having regard to its objectives and expected cash flow requirements;
(b) the composition of the entity's investments as a whole, including the extent to which they are diverse or involve exposure of the entity to risks from inadequate diversification;
(c) the liquidity of the entity's investments, having regard to its expected cash flow requirements;
(d) the ability of the entity to discharge its existing and prospective liabilities;
(e) whether the trustees of the fund should hold a contract of insurance that provides insurance cover for one or more members of the fund.

2. Here the SMSF failed to give effect to its investment strategy, given:
(a) the predominant reason for the acquisition was to crystallise a capital loss in the trust;
(b) none of the criteria in the investment strategy (such as marketability of the asset, anticipated liquidity requirements, the risk involved in making, holding and realising, and the likely return from the asset) could be shown to have been considered;
(c) the stated objective of diversification in the investment strategy had not occurred, instead the purchase led to the SMSF holding 74.4% of its assets in a single company in the class of 'shares in listed companies', as compared to the stated range of 0 to 40% across multiple companies.
Sole purpose test and financial assistance

3. As noted above, the predominant reason for the transaction was to crystallise the capital loss and a substantial purpose was to keep ultimate beneficial or economic ownership of the Billabong shares within the Merchant Group, therefore the transaction also amounted to a beach of the:
(a) sole purpose test under section 62(1) of the SISA (given neither of the above purposes was a core purpose); and
(b) prohibition on providing financial assistance under section 65(1)(b) of the SISA (which is not limited to financial assistance of a direct nature. Rather, the section also prohibits financial assistance via an intermediary, including via a discretionary trust). While the later cancellation of the capital loss (because of the application of Part IVA) may have ultimately meant that no financial assistance was provided, this fact did not undo the earlier breach.

No disqualification

4. Despite the clear breaches, the tribunal confirmed Gordon Merchant should not be disqualified, noting the following:
(a) the Tax Office had itself concluded that Gordon Merchant was a fit and proper person;
(b) at no time had his advisers suggested that the improper transaction risked breaching the provisions of the SISA, and while EY had advised there were tax risks, this was not relevant to the question of disqualification;
(c) it was fair for the member to have thought that the transaction was lawful from a superannuation compliance perspective given it would not be expected that the SMSF's auditor would put forward a transaction which would cause breaches of the SISA;
(d) appropriate and reasonable undertakings had been given by the member, which mitigated the risk of future non-compliance;
(e) while the SISA breaches were serious, they all arose from one course of conduct (being the share sale), thus this was not a case of multiple breaches on multiple occasions;
(f) no weight needed to be placed on protecting the investing public against the risk of re-offending, given the member was only ever likely to be a director of the trustee of his own superannuation fund and there was no need to protect the member from himself.

Ultimately, (as concluded in cases such as Macalister, in the matter of an application by Macalister [2021] FCA 1455) the tribunal was satisfied that there was no useful purpose served by disqualification in the peculiar circumstances of the case.

3. The power of appointment held by an appointor is unlikely to be a fiduciary power.
4. This said, if the power is used in a manner that disregards the interests of the beneficiaries, a purported change of trustee may be held to be invalid.
5. Here, there was no such evidence and therefore the change was held to be valid.

Fiduciary duty?

The Baba decision also considered the often asked question of whether an appointor role is a fiduciary one.

This was in the context that if an appointor is a fiduciary they will be unable to appoint themselves as trustee of a trust.

The case mentioned as possible authority for the conclusion was Re Skeats' Settlement (1889) 42 Ch D 522, where it was held as follows:

'The ordinary power of appointing new trustees, under a settlement such as this is, of course imposes upon the person who has the power of appointment the duty of selecting honest and good persons who can be trusted with the very difficult, onerous, and often delicate duties which trustees have to perform. He is bound to select to the best of his ability the best people he can find for the purpose.

Is that power of selection a fiduciary power or not? The answer is that he cannot exercise the power for his own benefit. Why not again? The answer is inevitable. Because it is a power which involves a duty of a fiduciary nature; and I therefore come to the conclusion, independently of any authority, that the power is a fiduciary power.'

This (as noted, without authority) conclusion, has been criticised in leading text books.

It was also discredited in Baba for the 2 following key reasons:

1. Provisions allowing for an appointor to appoint a new trustee are commonplace in discretionary trust deeds and it would be surprising if such provisions were subject to a rigid, but unexpressed, limitation preventing the appointment of the appointor.
2. If there was such a rule, the clause in the Montevento trust deed expressly preventing an appointor from appointing themselves, would have been unnecessary.

On appeal in the decision (see *Baba v Sheehan* [2021] NSWCA 58), it was further confirmed that the conclusion an appointor power is a fiduciary power is open to serious doubt. This said, the appeal decision also confirmed:

a) The doctrine of 'fraud on a power' does, however, operate to constrain the power of an appointor to appoint trustees.

b) A purported exercise of an appointor power will be void if exercised for a purpose, or with an intention, beyond the scope of, or not justified by, the instrument creating the power.

c) Here, the primary judge made an assessment of the credibility and reliability of the appointor's evidence as to his motives in exercising his power and concluded that there was no basis to justify a conclusion that the decision to change the trustee was improper.

d) Ultimately, a purpose of maintaining or exerting control of a trust, absent any evidence that the appointee intends to act other than properly in accordance with its responsibilities as trustee, is consistent with the purpose for which an appointor power is created. This conclusion is particularly the case in the context of the modern discretionary trust.

e) In other words, usually a significant, if not dominant, purpose of this type of power of appointment is to reserve to the appointor the ability to 'control' the trust by removing and replacing the trustee

(see In the Marriage of K R and M I Davidson (No 2) (1990) 14 Fam LR 817 and *Mercanti v Mercanti* [2016] WASCA 206).

The above conclusions however are predicated on the trust deed not itself prohibiting or restricting certain steps by the appointor, that is 'much will depend on the terms of the trust instrument' (see *Fitzwood Pty Ltd v Unique Goal Pty Ltd (in liquidation)* [2001] FCA 1628).

For example, in *Austec Wagga Wagga Pty Limited v Rarebreed Wagga Pty Limited* [2012] NSWSC 343, an appointor was prevented from appointing a company he heavily influenced as a replacement trustee, on the basis that the trust deed mandated that the appointor power 'not be exercised in favour of the person exercising' it.

Recent decision

In the 2024 decision of *VOVI International Pty Ltd v VOVI Australia Charity Association Incorporated* [2024] QSC 38, the primacy of the terms of the trust deed are again highlighted.

In this case, under the relevant trust deed, the power of removal and appointment of trustee was held by the appointor, or, if there was no such person, the trustee.

The term 'appointor' was relevantly defined as "Si Hang Luong, the Spiritual Leader of the VOVI religion, or in the event of his death the Spiritual Leader for the time being of the VOVI religion."

Following the death of the Spiritual Leader, a dispute arose due to the purported removal of the incumbent trustee by a self proclaimed new Spiritual Leader.

The court concluded however that neither the trust deed nor any aspect of the evidence adduced provided any guidance or recognised means of ascertaining whether anyone, and if so whom, became the Spiritual Leader for the time being of the VOVI religion subsequent to the incumbent appointor's death.

Thus, pursuant to the terms of the trust deed, the power of changing the trustee automatically passed to, and were held by, the incumbent trustee company itself.