PS LA 2006/19 - Self-managed superannuation funds - issuing a notice of non-compliance

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PS LA 2006/19
Self-managed superannuation funds – issuing a notice of non-compliance

This practice statement outlines what factors we take into account in deciding whether to issue a self-managed super fund with a notice of non-compliance.

This practice statement is an internal ATO document which is an instruction to ATO staff.

Taxpayers can rely on this practice statement to provide them with protection from interest and penalties in the following way. If a statement turns out to be incorrect and taxpayers underpay their tax as a result, they will not have to pay a penalty. Nor will they have to pay interest on the underpayment provided they reasonably relied on this practice statement in good faith. However, even if they don't have to pay a penalty or interest, taxpayers will have to pay the correct amount of tax provided the time limits under the law allow it.

1. What this practice statement is about

As the regulator of self-managed super funds (SMSFs), we are responsible for determining whether or not an SMSF is a complying superannuation fund.

This Practice statement sets out the factors you should consider when deciding whether to issue a notice of non-compliance to an SMSF.

2. Compliance requirements for SMSFs

For an SMSF to qualify for concessional income tax treatment, it must first be a complying superannuation fund.[1] A complying superannuation fund is one that satisfies the conditions set out in section 42A of the *Superannuation Industry (Supervision) Act 1993* (SISA).[2]

An SMSF is a complying superannuation fund for a year of income if:

- the fund was a 'resident regulated superannuation fund' at all times during the year of income when it was in existence, and
- the trustees of the fund have not contravened any regulatory provisions[3] during that year of income.

If the fund satisfies these conditions we may give the trustee a notice of compliance in relation to a year of income.[4]

Where the trustee has contravened a regulatory provision, we may consider that a notice of compliance should nevertheless be given after considering[5]:

- the taxation consequences of treating the entity as non-complying
- the seriousness of the contravention
- all other relevant circumstances.

For income tax purposes, an SMSF will be a complying superannuation fund if:

- we have issued a notice of compliance in the current or previous years of income
- the fund has not subsequently been issued with a notice of non-compliance.

3. Issuing a notice of non-compliance – general considerations

Issuing a notice of non-compliance is one option available when a fund trustee contravenes any regulatory provisions[6] for a year of income.

Whether it is appropriate to issue a notice of non-compliance will depend on the individual circumstances of the case. When making the decision you should look to achieve a fair and reasonable outcome, and take into account the principles of the:

- Taxpayers Charter
- Compliance model
- Good decision making model.

However, you should also carefully consider whether issuing a notice of non-compliance is the most

[1] See sections 42A and 45 of the *Superannuation Industry (Supervision) Act 1993* (SISA). The entity must also meet the definition of a regulated superannuation fund in sections 10 and 19 of the SISA.
[2] All further legislative references are to the SISA, unless otherwise indicated.
[3] The term 'regulatory provision' is defined in section 38A and includes any provision of the SISA or the *Superannuation Industry (Supervision) Regulations 1994* (SISR 1994).
[4] Section 40.
[5] Subsection 42A(5). See also *Triway Superannuation Fund v. FC of T* [2011] AATA 302; (2011) 83 ATR 766.
[6] See section 39 for contraventions that may cause a fund to be issued with a notice of non-compliance.

appropriate outcome, given that there are other compliance options available.[7]

4. When it is appropriate to issue a notice of non-compliance

The factors to consider when deciding if it is appropriate to issue a notice of non-compliance are:

- taxation consequences of non-compliance
- seriousness of the behaviour or contravention
- other relevant circumstances.[8]

Note: all factors are equally relevant and are to be considered on a case by case basis, with no one factor being determinative.

Taxation consequences of non-compliance

If an SMSF is made non-complying, its taxable income is taxed at the top marginal tax rate rather than the concessional tax rate of 15% in each year it is non-complying.[9] An additional amount will also be included in the assessable income of the fund in the year it is made non-complying. This amount will be the market value of the fund's assets just before the start of the income year it is made non-complying less any contributions not previously included in the fund's assessable income.[10] As such the decision to make an SMSF non-complying will have a serious financial impact on the fund and is not a decision that should be taken lightly.

We will consider whether it would be reasonable for the fund to be treated as a complying fund and still receive concessional tax treatment. This will depend on the particular circumstances of the case, the seriousness of the contravention, and the trustee's attitude to complying with the regulatory provisions.

Seriousness of the behaviour or contravention

Any one of the following circumstances may prove decisive individually, but they must be considered collectively when determining the seriousness of a contravention:

- Was the trustee reckless?
- Did they intentionally disregard the relevant legislation?
- Was an honest mistake involved?
- To what extent were the fund's assets affected?
- How many contraventions were there?
- Over what period of time did these contraventions occur?
- The seriousness of any specific contravention.

Other relevant circumstances

Other relevant circumstances may include, but are not limited to:

- the trustee's willingness to comply with the law, to rectify the contravention and/or take action to prevent it happening again
- the trustee's skill and knowledge in managing the affairs of their fund
- the fund's compliance history before and after the contravention – a fund with an acceptable history may be treated more favourably than a fund with a poor history
- the events that led to the trustee's contravention – for example, serious illness, the death of a close relative (or a trustee), natural disasters
- any decisions made by us that may have contributed to the trustee's action, for example, if the trustee relied on a ruling that was subsequently withdrawn or changed[11]
- whether alternative sanctions (see section 6 of this Practice statement) may be more appropriate in the particular circumstances
- other legal consequences of the contravention, for example, an assessment of a member under Division 304 of the ITAA 1997 for early access to benefits.[12]

5. When it is not appropriate to issue a notice of non-compliance

Generally, you should not issue a notice of non-compliance where other compliance options may be more appropriate such as:

[7] See section 6 of this Practice statement.
[8] Refer to paragraph 42A(5)(b).
[9] Refer to section 26 of the *Income Tax Rates Act 1986*.
[10] Refer to section 295-325 of the *Income Tax Assessment Act 1997* (ITAA 1997).
[11] Reference should be made to PS LA 2011/27 *Determining whether the ATO's views of the law should be applied prospectively only.*
[12] You should consider whether an assessment under Division 304 of the ITAA 1997 would lead to a heavy tax burden. For example, where a non-complying SMSF is taxed at 45% for early release of benefits, the inclusion of those benefits in a member's assessable income under Division 304 at a 45% marginal rate could impose a heavy tax burden on the member. The member (who is also a trustee) is effectively taxed at 90% for the same amount.

- we have accepted an enforceable undertaking (formal or informal) by the trustee to rectify a contravention or wind-up the fund, and the trustee is genuinely attempting to satisfy the terms of that undertaking
- there are no longer any remaining assets in the fund or where the fund's assets have been removed from the SMSF in breach of the payment standards and the trustee or individual is unable to restore the SMSF to its full and proper asset level within a reasonable period
- the trustee is genuinely making an effort to meet a direction to rectify a contravention pursuant to section 59
- the trustee has wound-up the fund prior to any ATO compliance action[13], and all money in the SMSF has been rolled over to an fund regulated by the Ausralian Prudental Regulatory Authority (APRA) and is being (and will continue to be) independently managed. However, where subsequent ATO compliance action indicates serious contraventions by the trustee preceding the wind-up, we reserve the right to make the SMSF non-complying and amend the necessary returns.

6. Alternate compliance options

Depending on the circumstances of the case, one or a combination of other sanctions may be determined as more appropriate, including:

- issuing a direction to undertake education if the contravention occurred after 1 July 2014[14]
- issuing a direction to rectify a contravention that occurred after 1 July 2014[15]
- accepting an undertaking from the trustee to rectify the contravention[16]
- preventing the SMSF from appearing in Superannuation Fund Lookup if the relevant fund or the individual trustee poses a continuing risk to compliance
- imposing tax penalties such as failure to lodge penalties
- disqualifying the trustee[17]
- suspending or removing the trustee[18]
- seeking wind-up of the fund and rollover of the fund assets into an APRA-regulated fund through an oral or written request by the trustee or individual
- freezing the assets of the fund if there is a risk of the members' benefits being eroded[19]
- seeking a court order[20] or seeking civil and/or criminal penalties through the courts.[21]

7. How long will a notice of non-compliance be in effect?

A notice of non-compliance will be effective from the start of the year of income for which it is issued, and all following years of income, until such time as the fund is issued a notice of compliance.

8. Examples

The following are examples to illustrate the application of the principles in this practice statement.

Example 1 – SMSF breaches in-house asset rules and fails to comply with an enforceable undertaking

A husband and wife were the trustees of their own SMSF. The husband was also the sole director and general manager of a related company. The SMSF made several loans to the husband's related company. The reason for the loans was to assist the company through a difficult financial period.

The SMSF, during the period in question, had lent more than 40% of its assets to the husband's company. This resulted in the SMSF breaching the 5% in-house asset limit on loans to related parties. The company made one initial repayment, however, no further repayments were made over the next two and a half years.

During this period of non repayment, the husband suffered from a chronic illness which affected his ability to manage the company's operations. The company's premises also sustained significant flood damage in two consecutive years, and these floods were followed by a general downturn in trading in their region.

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[13] Unless it was decided that the actions of the trustee preceding the wind-up warranted that action.
[14] Section 160.
[15] Section 159.
[16] Section 262A. See also PS LA 2006/18 *Self-managed superannuation funds – enforceable undertakings*.
[17] Section 126A. See also PS LA 2006/17 *Self-managed superannuation funds – disqualification of individuals to prohibit them from acting as a trustee of a self-managed superannuation fund*.
[18] Subsection 133(1). This would only occur in exceptional circumstances.
[19] Section 264. This would only occur in exceptional circumstances.
[20] Subsection 262A(4).
[21] Part 21.

The loan was outstanding for over two and a half years, and the trustees made no attempt to rectify the situation.

We determined that the loan arrangement was a serious contravention because not only had the SMSF breached the in-house asset rules, the trustees had also failed to take appropriate steps to ensure that the loan was repaid.

Given the circumstances, it was decided to impose administrative penalties on the trustees and allow an enforceable undertaking where the trustees committed to ensuring that the loan was repaid.

After the initial repayment, the trustees ceased to genuinely engage with us and failed to comply with the terms and conditions of the enforceable undertaking.

Given the seriousness of the contravention and the trustees failure to rectify it, we decided it was reasonable to issue the fund with a notice of non-compliance. We considered these factors outweighed the taxation consequences of making the fund non-complying.

Example 2 – SMSF fails to lodge annual returns

An SMSF was established on 1 July 2012. The trustee lodged *Self-managed superannuation fund annual returns* for the 2012-13 and 2013-14 years of income, but has not lodged returns for the 2014-15, 2015-16 and 2016-17 years of income. The ATO has requested the lodgment of the outstanding returns on several occasions. The trustee has disregarded every request without offering any reasons.

Failure by the trustee of a fund to lodge a return for a year of income constitutes an offence. Each of the contraventions is serious because lodging returns is a fundamental requirement of the regulatory regime and the trustee is expected to know this requirement. The number of contraventions involved and the trustee's disregard of the ATO's requests add to the seriousness of the contraventions.

We decided it would be reasonable to give the fund a notice of non-compliance which we issued on 1 July 2018 effective from the start of the 2015–16 income year and for all following income years. This is because of the seriousness of the contraventions, the trustee's attitude to compliance as indicated by the trustee's disregard of the ATO's requests, and the fact that there are no relevant circumstances to mitigate the trustee's failure to lodge the outstanding returns.

Example 3 – SMSF enters into a dividend stripping arrangement and breaches a range of regulatory provisions

An SMSF acquires shares from its members, at less than market value, in a related private company with significant previously taxed accumulated profits. The acquired shares represent 30% of the SMSF's total assets.

The private company distributes these accumulated profits to the SMSF as franked dividends. Being in pension phase, the SMSF treats the franked dividends and franking credits as exempt current pension income and receives a large refund of franking credits while avoiding the 'top up' income tax that the members would pay if they received the dividends.

A number of serious contraventions of the regulatory provisions have occurred:

- the SMSF has contravened the prohibition on acquiring private company shares from its members[22]
- the share acquisition represents more than 5% of the SMSF's total assets and is therefore in breach of the in-house asset rules
- the SMSF has contravened the requirements for maintaining accounts and statements by failing to value its assets at market value[23]
- the SMSF has not been maintained solely for the purposes permitted by the sole purpose test.[24]

We decided it would be reasonable to give the fund a notice of non-compliance because of the seriousness of the contraventions, and because the contraventions arose out of a deliberate attempt to avoid tax.

9. Relevant cases

Refer to the following AAT decisions for further guidance:

- *Montgomery Wools Pty Ltd (as trustee for Montgomery Wools Pty Ltd Super Fund) v. Commissioner of Taxation* [2012] AATA 61; 2012 ATC 10-233; (2012) 87 ATR 282
- *Triway Superannuation Fund v Commissioner of Taxation*, Re [2011] AATA 302
- *Shail Superannuation Fund v. Commissioner of Taxation,* Re [2011] AATA 940; 2011 ATC 10-228; (2011) 86 ATR 339
- *Triway Superannuation Fund v. Commissioner of Taxation*, Re [2011] AATA 302; (2011) 83 ATR 766
- *Trustee for the R Ali Superannuation Fund v. Commissioner of Taxation* [2012] AATA 44; 2012 ATC 10-231; (2012) 86 ATR 826.

[22] Section 66.
[23] Section 35B; Regulation 8.02B of the SISR 1994.
[24] Section 62.

- *ZDDD v. Commissioner of Taxation* [2011] AATA 3; (2011) 81 ATR 872

10. Review rights

The decision to issue a notice of non-compliance under subsection 40(1) is a reviewable decision.[25] A request to reconsider must be made within 21 days and clearly state, in writing, the reasons for the request.[26] If dissatisfied with the outcome, the person may then apply to the Administrative Appeals Tribunal for a further review.

11. More information

For more information see:

- enforceable undertakings – PS LA 2006/18
- disqualifying a trustee – PS LA 2006/17
- Self-managed superannuation funds – How we deal with non-compliance
- Check your fund is an Australian super fund

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[25] Section 10.
[26] Section 344.