Multiple generations in one SMSF – a great idea or a disaster waiting to happen?

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SMSF Solutions

Problem solved

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1 / Introduction

Most SMSFs have just one or two members (typically a couple). However, the law allows up to 4 members and for many families the question arises – should children and parents sometimes belong to the same fund?

As with most SMSF matters, there are pros and cons and many of these have been explored in a recent flurry of articles on the subject.

In this article, we consider both sides of the argument but ultimately our position remains that multi-generational funds will *generally* be the exception rather than the rule.

2 / What reasons do people often have for inviting another generation into their fund?

These are many and varied.

It is worth noting at the outset that sharing a fund with another generation could take many forms. At one extreme the family might genuinely pool their superannuation resources – the SMSF then becomes a family investment vehicle. At the other extreme, there might be only one generation with their entire superannuation balances in the fund while other members (of an older or younger generation) might just have a token amount to give them a 'presence' in the fund.

2.1 / Cost saving & engagement

Parents often cite cost savings for their children (compared to expensive 'public' superannuation) and the ability to ensure that their young adult children take their superannuation seriously as reasons to share a self managed superannuation fund.

2.2 / Reflecting reality

At the opposite end of the spectrum, it is becoming increasingly common for adult children to manage the financial affairs of their elderly parents. Currently, the very elderly often do not have self managed superannuation funds but that is likely to change over the next 20 years given the popularity of SMSFs amongst today's recent retirees. In the future, then, many retirees may find themselves managing not only their own SMSF but also their parents'. Particularly after one parent dies, it may make sense to cut down the administrative burden this entails by combining into one fund.

Could this be achieved another way? Remember that it is possible to be a trustee (or director of the corporate trustee) without also joining the fund as a member. The 'child' could therefore simply become a trustee rather than merging superannuation funds. This could be done either in place of the parent (as long as the child holds an enduring power of attorney for the parent) or in addition to the parent (assuming there is only one parent). Finally, the child could be a member of the fund with a nominal balance – thereby entitling them to also be a trustee. Importantly, it is not necessarily to genuinely share the fund simply to legitimise the management role that the child may be playing.

2.3 / A larger pool to invest

Some investments (e.g. property) require scale to invest effectively. Combining several family members in one fund simply increases the total investment pool. It may give all parties better diversification, the ability to have a part share in large investments that would be impossible individually, the ability to reach minimum thresholds for investments that have them etc.

At a practical level, this is particularly relevant where a family runs a business together and wishes to buy the business premises in super. Even if the fund borrows to buy the property, the loan will clearly be repaid more quickly (and in fact the borrowing power of the fund will be greater) if there are four members' contributions being used to pay it off rather than only two.

Could this be achieved another way? It is worth noting that two separate superannuation funds can often co-invest in a single asset. For example, they could own a property as tenants in common. They could even each borrow to finance the investment although the lender would only be able to take part of the property as security. Often a commercial lender will be unwilling to do this.

2.4 / Providing cash flow for pensions

All pensions are designed to draw down superannuation balances over time. Even if a client always draws the minimum possible, there will eventually come a point where the fund's assets need to be sold down to make the required payments. If a client has children who are making contributions to super (or have employers doing so on their behalf), one benefit of combining is that *their* cash flow can finance *the client's* pension. In effect, the cash contributions are being used to buy a share of some of the fund's existing assets. Because this is all happening within the fund (rather than by actually selling / buying assets), none of the usual costs associated with buying and selling assets such as tax, brokerage etc come into play.

Could this be achieved another way? The trustee can make payments in specie if the member is able to elect (in advance) that a particular payment should be treated as a partial commutation and taxed as a lump sum. While the net effect is that the asset(s) exit the superannuation environment (unlike above where the children's contributions finance pension payments and the asset remains in the fund), it at least ensures that the pensions can be paid without the family losing assets they want to retain. It is also worth noting that there is nothing preventing the members purchasing assets from the fund for cash – with that cash then being used to pay pensions.

2.5 / Leaving key assets in super

In funds that hold key assets such as a property, it will often be in the family's interests to leave them in the most favourable tax environment (superannuation) as long as possible. Unfortunately, when both members of a couple have died, it is generally compulsory to pay whatever remains of their superannuation as a lump sum to their beneficiaries or their estate. This will effectively force the family to either sell the property or at least transfer it out of the SMSF.

In contrast, if the children have made contributions over many years and these have been used to buy new assets (e.g. shares), it may be possible to use these *other* assets to pay some or all of any benefits due when you die. This may well enable the family to leave part or all of the property in super well beyond one generation.

That same logic can apply to any asset where there is some value in leaving it in the fund. For example, funds invested in pre-99 unit trusts or companies may wish to retain those investments as they provide far more investment flexibility than we have today.[1] If the children are able to use their contributions to take over these units or shares over time, they can effectively inherit that structure and all the flexibility that goes with it.

It is worth bearing in mind that a pre-99 trust or company could significantly change its investments over time and yet remain protected by the grandfathering rules. Even if the trust or company didn't borrow when it was set up, it can generally[2] borrow today.

Certainly funds with these valuable structures should consider carefully before allowing them to be forced out of the SMSF when the parents die.

2.6 / Optimising anti-detriment deductions when a member dies

The anti-detriment benefit is a tax deduction that can be claimed by certain funds when they pay a death benefit. Tax deductions are only valuable if the fund has some taxable income. Additional members (particularly members receiving concessional contributions) can be a useful source of table income.

Could this be achieved another way? The need for the children to be triggering taxable income within the fund does not arise until the death benefit is to be paid out. Hence the children could simply join after their parents have died.

2.7 / Dealing with reserves

Reserves can present excellent opportunities for SMSF but also one substantial dilemma: how to distribute them without having them count as a concessional contribution. The common approach to distributing reserves that are no longer needed is by way of an additional interest rate (giving the same rate to all members means the allocation is exempt from the concessional contributions cap as long as that rate is less than *5%*).

Children potentially play a useful role here – by providing additional balances which can receive this bonus interest rate and therefore distribute the reserve more quickly. However, they also present a major equity challenge – what if the children have very different account balances (and therefore receive very different allocations)? What if

[1] It's never this simple but to illustrate: these trusts and companies can do things an SMSF trustee would never dream of doing – leasing to, investing in and lending to related parties with very few restrictions. There are still some caveats. For example, the arrangements need to be on an arms length basis. Nonetheless, the structure is invaluable where excellent investment opportunities arise and the SMSF is not ordinarily allowed to take advantage of them.

[2] There is an exception where the pre-99 trust is also a so-called SIS regulation 13.22C trust / company (aka as an 'ungeared trust'). Tread carefully and seek advice before borrowing if this is the case as borrowing now may affect other opportunities available to the trustee.

there are several children and only some belong to the fund? What estate planning challenges are created by the premature death of the parents while the fund still has substantial reserves if the fund is ultimately controlled by just some of the children at that point?

2.8 / Moving overseas

One of the challenges faced by SMSF members who move overseas for an extended period is how to deal with their SMSF. They face two separate tests – both of which must be met at all times.

Test 1 : The Central Management & Control Test.

To meet this test, the trustee must simply ensure that the central management & control of the fund is ordinarily in Australia. If the parents move overseas (say returning to a country of origin in retirement) but wish to retain their Australian superannuation fund, having the children join can 'even up' the management and control of the fund – ensuring that it remains here. For example, a four member fund with two members overseas (the parents) and two in Australia (the children) will meet this test if each member is also a trustee or director of the trustee company. The same applies in reverse if (say) an adult child and his or her spouse move overseas but intend to ultimately return – one set of parents could join the fund and again meet the central management & control test.

Could this be achieved another way? Most certainly it would be more common to address a central management & control issue by managing the trusteeship (not membership) of the fund.

For example, in the first scenario described above, the parents would often remain the only members but simply appoint one or more of the children as trustees or directors of the trustee company in place of the parents (providing the child(ren) held an enduring power of attorney). In fact, this arrangement would generally be preferable as it would mean that ALL children could share legal control of the fund rather than being limited to just two.

Similarly, if it was the children who had moved overseas, the parents could become trustees (or directors) in their place.

Finally, anyone holding an enduring power of attorney could also simply be an alternate director for a corporate trustee. While it would be important to ensure that it was always clear who was acting as the relevant decision maker (and this is arguably harder with alternate directors) it could certainly be done and would be a more traditional approach to resolving a central management & control issue than asking other members to join.

Test 2 : the active member test

This second test is harder to meet without having additional members join the fund and is therefore a more likely trigger to having multiple generations in one fund.

The most common scenario is where an adult child (and spouse) more overseas but wish to retain their Australian self managed superannuation fund. Furthermore, they wish to continue contributing to it. They can resolve their central management and control test

issues by having others act as trustee in their place. However, the active member test broadly requires that the balances attributable to the active (contributing) Australian members must be at least 50% of the total of all active members' balances. Simply having the parents act as trustees will not address this second test. However, it may be easily achievable if the parents have larger balances and are able to not only transfer their superannuation into the child's fund but also make contributions (to ensure that they remain 'active').

Could this be achieved another way? A more common approach to resolving this issue would be for the overseas residents (in this case the children) to contribute to a public offer fund which – due to its size – is highly unlikely to breach the active member test. They would need to do this whilst out of Australia and then rollover the balance to their SMSF on their return. Alternatively, they could make their contributions to their parents fund but have each party leave their existing balances untouched.

2.9 / Larger asset base for in-house assets

SMSFs may invest in in-house assets – generally investments in, loans to or assets leased to related parties. However, these investments are limited to 5% of the fund's assets. Clearly, a larger fund provides greater scope for such an investment. If, for example, a family operated a business together and wished to buy a particular piece of equipment to lease to their business, a larger fund might make the difference between whether or not this is possible through their superannuation fund. Of course, there are a range of other matters to consider when determining whether or not this is appropriate (the sole purpose test, arms length rental arrangements etc).

Could this be achieved another way? Two separate funds could purchase the asset as tenants in common.

3 / Why do most people not do it?

Despite all these points, the most common structure is still just one or two members (of the same generation) in a self managed superannuation fund.

There are three quite powerful reasons that drive that decision.

3.1 / Control

As soon as a fund is shared with other parties, they all surrender control over their own financial affairs to some degree. Of course, the same is true if a fund is shared between two members of a couple but they are generally more likely to have aligned financial goals.

Some examples of the control challenges presented by a multi-generational SMSF are:

- Superannuation funds are trusts and decisions are made by the trustees. If the trustees are individuals decisions must generally be made together (as it is the group, not the individuals, that makes a single decision). Hence one recalcitrant trustee can create havoc by decision making.

If the trustee is a company, most constitutions operate on a '1 director 1 vote' basis and hence complete loss of control is less likely when (say) a couple invite two children to join their fund. However, when one dies the survivor could easily be outvoted – in other words, control changes in a heartbeat (or lack of heartbeat!).

Some trust deeds and/or constitutions address this problem by offering 'proportional voting' (where the extent of an individual's control over decision making is influenced by the size of their balance in the fund). It is worth bearing in mind, however, that sometimes events that appear completely unconnected can significantly influence control unintentionally. For example, a re-contribution strategy will see substantial sums leave the fund even for short periods – control may well change during that process. The payment of a death benefit will also result in large sums leaving the fund and potentially altering the delicate balance between different members' interests.

- Once the parents die, that position is made even riskier if they have other children who are not members of the fund. Effectively the siblings who *do* belong have far greater power over how the super is dealt with than those who *do not*. The most famous case on this issue is the NSW case of Katz v Grossman [2005] NSWSC 934. This case actually did not involve the child (Linda Grossman) belonging to her parents' fund – rather she was appointed as a trustee when her mother (Evelin Katz) died. However, it illustrates exactly how challenging the matter of control can be.

  After Evelin died, Erwin Katz and Linda Grossman were the only trustees of Erwin's superannuation fund. He had indicated that he wanted his superannuation divided equally between his two children (Linda Grossman and Daniel Katz). However, he had not issued binding instructions to that effect. When he died, Linda Grossman was the sole trustee. She (completely validly) appointed her husband as a trustee of the fund and together they decided to pay the entire death benefit to her – leaving her brother Daniel with nothing. Her father's fatal mistake was leaving only one of his children in control of his fund with no constraint on her ability to deal with his death benefit.

- If one of the children gets divorced, the court can order that his or her superannuation is split with the ex-spouse. While the spouse can't take more than he or she is owed, it may mean that the fund has to sell assets unexpectedly.

  As touched on above, there are mechanisms that can be put in place to mitigate some of these risks. However, no method is perfect and in our view, there are certainly substantial additional control risks if children belong to the fund – made almost impossible if some but not all of the children belong.

3.2 / Different directions

Some families have good reason for sharing investments – for example, those in business together may well have a shared interest in buying the business premises. Others, however, may find they wish to head in completely different directions which starts to undermine the usefulness of being in the same SMSF.

For example, retirees may find their appetite for fluctuations in their balances reduces over time, particularly if they are drawing down their capital to live on. The next generation, however, may take quite a different view if they are many years away from being allowed to draw on their super.

While it is certainly possible to run the two generations' investments separately within the same fund, doing so may well start to undermine the very reasons they joined forces in the first place.

3.3 / Longevity of the arrangement

What works for the family now may not work in the long term for a variety of reasons. The prompt for a change may be as simple as one of the children getting married and wishing to establish a fund with his or her spouse.

Unwinding a shared arrangement after it has served its purpose can be fraught as it may well trigger capital gains tax and stamp duty on the sale or transfer of assets. Achieving equity between the members leaving the fund and those remaining can be challenging even on quite simple things like unrealised capital gains and losses. Of course it can all be done but each new issue to be resolved leads to an opportunity for argument and ill-feeling.

4 / So is it horses for courses or not?

Our starting point with clients is still to treat most SMSFs as a single generation vehicle (with children being added after the death of both parents in order to use tax deductions etc if applicable). However, there are certainly a number of circumstances where combining the generations sooner rather than later makes sense.