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Case Study

ESS/SMSF tax breach causes hundreds of thousands in penalties, back taxes and interest

This case study is the epitome of a cautionary tale. While based on fact, the name and a number of otherwise obvious details have been changed to protect privacy.

Background

Charlie was an engineer who worked for an ASX-listed junior mining company. As is often the case, he and other key personnel were paid a modest salary for many years on the promise that when the company hit paydirt, the team would be generously rewarded.

During the lean income years, Charlie and his wife at that time, raised their two children in a small outback town, close to the company's tenements. Unfortunately, the marriage ended and some time after, Charlie re-partnered.

The mining company eventually discovered the mineral deposit they'd always hoped they'd find. True to his word, Charlie's employer agreed to generously reward him for his many years of hard work. Suddenly Charlie found himself many millions of dollars richer, thanks to an allocation of several million company shares and low-cost share options.

With this newfound wealth and new partner, Charlie began making plans for the future. This included jointly held finances and a Self-Managed Super Fund (SMSF). The pair were the trustees for the SMSF and on Charlie's new partner's urging, they decided a significant amount of Charlie's company shares (several million dollars worth) would be contributed to it.

Realising they needed advice to complete the transaction, Charlie's partner visited their local accountant.

Unfortunately, being from a small town, the accountant had little experience dealing with SMSFs and was unfamiliar with the complex laws relating to superannuation contribution caps and taxation. Nor was this accounting firm familiar with Executive Share Schemes or managing vast amounts of money and ill-prepared to issue a warning about the significant tax and regulatory breaches that would occur if Charlie and his partner were to proceed with the planned multi-million-dollar contribution to the SMSF.

Charlie and his partner went ahead and carried out an off-market share transfer of the company shares in order to make the contribution to the SMSF.

At this point, Charlie and his partner (and the accountant as well) were oblivious to the significant breach of tax and superannuation law that had occurred.

Soon after the SMSF transaction had been completed, Charlie discussed how he had managed his financial windfall with a co-worker. The co-worker was also the recipient of a vast number of company shares but unlike Charlie, he had sought qualified advice. He quickly realised the dire consequences Charlie had put in train for himself and raised his concerns with him.

Charlie was of course very distressed upon hearing the explanation by his co-worker and understanding that his error would soon result in hundreds of thousands of dollars in penalties, back taxes and interest. Then to make things worse, not long after, and *before* he could take action to rectify the problems, Charlie died suddenly and unexpectedly given his age and general health.

Following his death, it was determined that he had always intended for his children to receive all of his assets as an inheritance. However, poor estate planning advice meant that he failed to properly take into account his SMSF superannuation balance, which remained under the control of his new partner (who was also the remaining trustee of the SMSF).

Our Assessment

Rather than leaving a handsome inheritance for his now adult children, Charlie had created a devastating financial legacy that would take years to sort out and cost his estate hundreds of thousands of dollars to resolve.

It also caused enormous emotional distress for his children and a close relative who had been appointed executor of his estate.

Adding further insult to the injury of their earlier poor advice, the local accountant lodged Charlie's final tax returns without the executor's authorisation.

While the tax returns were later withdrawn, the ATO was now well aware of the tax position of the deceased (which was a significant tax liability due to the receipt of the low-cost company shares). Not surprisingly, the ATO followed up several months later with a demand for the situation to be addressed.

Realising the need for expert counsel, the executor contacted a Brisbane law firm to take up the case. The lawyers quickly realised the complexity of the issues and formed a professional advice team. This team included Craig Barry, Director and Tax Specialist for William Buck Chartered Accountants.

By this stage, Craig and the lawyers had ascertained:

- the SMSF had breached its contribution cap by approximately $2.5 million
- Charlie's estate owed approximately $3.5 million to the ATO of which $1.5 million made up penalties accrued due to late lodgement of final returns
- The deceased's final tax return had many errors in it connected with the complex tax rules that apply to Executive Share and Option Plans
- the SMSF was now fully controlled by the remaining trustee (Charlie's new partner) who was mostly uncooperative
- Charlie's estate was teetering on bankruptcy, and
- The beneficiaries (Charlie's adult children) had more or less given up any hope of receiving the inheritance their father had intended for them.

The Solution

Collaborating closely, Craig and the lawyers formulated a plan that was based in clear and open discussion with the ATO. They gathered and reported the facts to enable a negotiation on behalf of the executor and Charlie's children.

Without cooperation by the remaining SMSF trustee (Charlie's new partner) there was no avoiding the penalty caused by breaching the strict superannuation laws.

However, Craig was successful in persuading the ATO to waive, in full the $1.5million of accrued interest that had been levied to the deceased's estate. This was without doubt a key (and valuable) achievement brought about by Craig's significant tax law knowledge, intuitive problem-solving ability, calm demeanour and negotiation skills.

Unfortunately as the remaining SMSF trustee, Charlie's new partner refused to admit any amount of fault, ultimately the SMSF was heavily fined and the entirety of the remaining balances in the SMSF remained out of reach of Charlie's children.

A small portion of Charlie's mining company shares and options had not been contributed to the SMSF. These shares were sold and the proceeds distributed to Charlie's beneficiaries. Thanks to an improvement in share price at the time, Charlie's children ended up receiving around $500,000 each.

Settlement of Charlie's estate occurred approximately three years after his death and cost well over $500,000 in legal fees.

While this case study focuses on significant superannuation and tax issues, it is a cautionary tale about what can happen when qualified and collaborative advice is not obtained in a timely manner.

If Charlie had obtained appropriate advice regarding Executive Share Schemes and superannuation contribution strategies, and if proper estate planning was carried out prior to his death, there would have been a strong likelihood that the financial and emotional turmoil caused could have been minimised or avoided altogether.

For further information and advice for managing the significant complexity, tax obligations and impacts on financial and estate planning attached to Executive Share Schemes (past, present or future), please contact Resources Unearthed on +61 7 3007 2000 or via contact@resourcesunearthed.com.au.

Craig Barry is a Director and Tax Specialist with William Buck Chartered Accountants, Brisbane. He is also a contributor for Resources Unearthed which is a solutions hub that provides integrated tax, financial, business and legal services for executives, professionals and business owners in the mining and resources sectors.