SUPERCENTRAL

Must SMSF BDBNs comply with the 2 witness and 3-year validity rules?

- Must SMSF BDBNs comply with the 2 witness and 3-year validity rules?
- The WA Court of Appeal decides no.

There has been a continuing legal controversy as to whether Binding Death Benefit Nominations (BDBNs) for SMSFs must, in order to be valid, comply with both the 2 independent witness rule and 3-year validity period rules (2 witness & 3-year rules).

There is no controversy as to whether these rules apply for BDBNs in industry and retail superannuation funds: they do.

The 2-witness rule is that member's signing and dating of the nomination must be witnessed by two independent adult witnesses. The 3-year validity rule is that a nomination ceases to have effect 3 years after it was first signed, or last confirmed or amended by the member.

This controversy is not merely lawyers' joyfully disputing legal issues for (their) profit and (their) delight. The outcome of this controversy may dramatically affect the allocation of death benefits and also may frustrate carefully constructed estate planning arrangements. It should be noted that these rules do not apply to non-lapsing death benefit nominations, which are nominations which must (unlike BDBNs which are unilaterally made by the member) be approved by the trustee.

Essentially, a BDBN is a direction by a member to the superannuation trustee as to the allocation of the member's death benefit to or amongst the member's dependants and/or estate. The approval of the direction by the super trustee is neither required nor necessary for the direction's legal effectiveness. For both retail and industry super funds, a BDBN must satisfy the 2 witness & 3-year rule. However, for SMSFs the issue is not so clear cut.

One view is that neither the of rules apply to SMSFs (unless those rules have been incorporated into the trust deed of the SMSF in which case they apply because they have been self-imposed by the trust deed). The other view is that they do apply to SMSFs by force of the superannuation legislation and, it is irrelevant whether or not they are also incorporated into the trust deed of the SMSF.

Significance of the issue

Consider the following hypothetical: Alec and Jennifer are in a long-term relationship and are the only members of their SMSF. Alec makes a BDBN nominating Jennifer as the sole beneficiary of his death benefit payable from the SMSF. The BDBN complies with neither the 2-witness rule nor the 3-year validity rule. Alec has also fathered a daughter, Claire, from a short relationship some years previously. Alec's last will and testament nominated Jennifer as his executor and left his estate to Jennifer. Assume the terms of the SMSF provide that, in the absence of a valid BDBN, the death benefit must be paid to the estate of the deceased member. For the sake of this hypothetical, the BDBN otherwise satisfies all the other rules specified in the trust deed of the SMSF.

If either or both of the 2-witness rule or the 3-year validity rule apply to SMSFs then the BDBN is ineffective and the death benefit must be paid to Alec's Estate. If those two rules do not apply to SMSFs, then the BDBN is valid and the trustee must pay the death benefit directly to Jennifer without the death benefit forming part of Alec's Estate.

If Claire can establish that the BDBN was invalid, then the death benefit must be paid to Alec's Estate and she would be entitled, as a daughter, to make a family provision claim against the Estate. Without the death benefit being included in the Estate, any successful claim may be much diminished given the size of the Estate without the death benefit.

The WA legal case

In broad terms the above hypothetical is the factual basis of a recent legal case considered by the Court of Appeal of Western Australia. In the legal case, the SMSF was named the Holley Superannuation Fund, the trustee of the SMSF was Zuda Pty Ltd and Jennifer, after the death of Alec, became the sole member of the SMSF and became the sole director of the trustee.

As the law of Western Australia does not, unlike the law of NSW, allow superannuation death benefits to be treated as being part of the estate of Alec for the purposes of family provision claims, Claire had to argue that the BDBN was invalid. It seems (though not expressly stated in the Court's reasons) that the Estate (absent the death benefit) would not be sufficient to support a material family provision claim (assuming that the claim was successful – which sometimes can be a big assumption).

While Claire commenced the litigation, the trustee of the SMSF sought to test the purely legal issue of whether the BDBN was valid or invalid. This testing was undertaken on the assumption that the facts set out in Claire's pleadings were correct. Consequently, at first instance before the Supreme Court and on appeal to the Court of Appeal, the only issue to be decided was whether the BDBN was valid and this issue, in turn, entirely depended on whether SIS Regulation 6.17A applied to the nomination. If so, then the nomination is invalid (as it was made more than 3 years before the death of Alec and also was not witnessed in a will-like manner). If not, then the BDBN was valid.

Legislative history of the provision

As originally enacted in 1993, s59 required (subject to some exceptions which are not presently relevant) that any discretion conferred by the trust deed of a superannuation funds must either be exercised solely by the trustee or, if capable of being exercised by another individual (such as a member of the fund) then the discretion had to be exercised with the consent of the trustee. However, the provision did not apply to SMSFs as SMSFs were expressly excluded from the operation of the requirement.

Consequently, BDBNs could be made in respect of SMSFs but not in respect of retail and industry funds. In response, retail and industry funds developed non-lapsing nominations which are death benefit nominations which only became binding if and when the trustee consents to the nomination.

In 1999, s59(1) was amended to allow retail and industry funds to accept death benefit nominations without the trustee having to consent to each and every nomination (which, frankly, would have been a burdensome task). The amendment was achieved by inserting a new subsection (being s59(1A) and making s59(1) subject to the operation of s59(1A). The new subsection provided that death benefit nominations would be binding on a trustee if certain rules were satisfied. Those rules were set out in Reg 6.17A and are the 2 witness and 3-year rules.

The critical issue

The critical issue is simply did the 1999 amendment to s59 have the effect of:

(a) simply modifying the requirement as it applies to industry and retail superannuation funds to permit them to accept BDBNs (which satisfy the 2 witness and 3-year validity period rules)? or

(b) modifying both the requirement and the carve out for SMSFs – so permitting industry and retail superannuation funds to accept BDBNs (if they satisfy the 2 witness and 3-year validity rules) but now requiring BDBNs in SMSFs to satisfy the 2 witnesses and 3-year validity rules.

Interestingly, the amendment legislation did not contain any transitional measures to ensure that SMSF BDBNs made before the commencement date continue to have effect. In the absence of any transitional measures, if the amendment had the effect of also applying to SMSFs, every BDBN made before the commencement date of the amendment date would most likely have been immediately invalidated.

Previous Judicial consideration

The effect of the 1999 amendments on s59 have been considered in a number of previous cases. The first case was *Munro v Munro* [2015] QSC 61, a decision of a single judge of the Supreme Court of Queensland. The decision was that the 2 witness and 3-year validity rules did not apply to SMSFs. The Court reasoned that as s59(1) does not apply to SMSFs, so, consequently, the exception provided by s59(1A) could not apply to SMSFs. SIS Reg 6.17A sets out rules which must be satisfied for a BDBN to be within the exception provided by s59(1A). Therefore the rules for BDBNs set out in SIS Reg 6.17A do not apply to BDBNs in SMSFs. In short, the judge held the amendment simply modified the requirement as it applied to retail and industry funds.

The reasoning in *Munro v Munro* has been applied in *Re Narumon Pty Ltd* [2008] QSC 185 (single judge of the Queensland Supreme Court) and also in *Cantor Management Services Pty Ltd v Booth* [2017] SASCFC 122 (Full Court of the Supreme Court of South Australia).

Claire's arguments

In arguing for Claire's position, her counsel had to argue that the three cases were wrongly decided. Three reasons were suggested: one based upon s59, another based on Reg 6.17A and, finally, the third based upon s55A.

The s59 argument is that the true effect of the 1999 amendment was to modify both the carve-out for SMSFs as well as modifying the requirement as it applied to BDBNs in industry and retail superannuation funds. This argument was rejected at both first instance and on appeal: the modification does not apply to SMSFs as the modification is of a general provision which only applies to industry and retail funds.

The Reg 6.17A argument is based upon the rather poorly worded provision. Essentially, the argument was that this regulation imposed two independent obligations: one applied to industry and retail superannuation fund (being the obligation on the trustee to provide certain information to a member before the member makes a BDBN) and other applied to all superannuation funds (being the obligation on the trustee not to accept a BDBN if it did not satisfy the 2 witness and 3-year rules). The first obligation was made for the purpose of s59(1A), and the second obligation was an operating standard. It was argued that this two effects analysis of Reg 6.17A was supported by the decision in *Retail Employees Superannuation Pty Ltd v Pain* [2016] SASC 121, a decision of a single judge of the Supreme Court of South Australia. While Blue J did consider Reg 6.17A in detail with its drafting peculiarities, he did not ultimately reach any concluded position. In any event, the two independent obligations view of Reg 6.17A is undermined by the express text of the regulations – in Reg 6.17A(4) - being "*if the governing rules of a fund permit a member of the fund to require the trustee to provide any benefits in accordance with sub-regulation (2)*". If the italicised text was not included or could simply be ignored, then Reg 6.17A could be interpreted as imposing two independent obligations. Legislative interpretation does not operate in this manner: you cannot simply ignore the text of the legislation. The italicised text provides a linkage between the two obligations which undermines the two effects interpretation of Reg 6.17A.

The final argument was based upon s55A of the SIS Act. This provision was introduced into the SIS Act 7 years after s59 was amended as was introduced as part of the Simplified Super (or Costello changes i.e. the tax-free investment earnings in retirement and no tax on super benefits paid after age 60). The purpose of s55A was to ensure that on the death of a pensioner, the pension could not transfer or revert to non-dependants. The pension account balance had to be paid as a lump sum death benefit. This argument was not pressed (given it was fairly weak) and only supports the argument that 2 witness and 3-year rules apply to BDBNs in SMSFs if you have already made that assumption; in short the argument based upon s55A begs the question.

What is the end result?

Simply stated, the weight of judicial case law is that the 2 witness and the 3-year rules do not apply to BDBNs made for SMSFs unless the trust deed of the SMSF self posses those rules – whether by expressly setting out those rules in the trust deed or by incorporating those rules.

SUPERCentral Governing Rules

The SUPERCentral Governing Rules do not set out those rules nor are they incorporated into the Governing Rules. Consequently BDBNs for SMSFs using the SUPERCentral Governing Rules do not have to satisfy either the 2 witness or the 3-year rule.

This will be the position unless the issue goes before the High Court of Australia (and the Court reaches a different conclusion) or the relevant legislation is amended.

For more information on any aspect covered in this article, please call SUPERCentral on 02 8296 6266 or email info@supercentral.com.au.