MOIN & ASSOCIATES
WILLS & ESTATES BULLETIN – ISSUE #2

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Special issue:

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Simple steps to achieve maximum asset protection for your SMSF

1. Self-managed superannuation funds (**SMSFs**) are excellent asset protection vehicles when structured properly. This article will discuss simple steps which can be taken to ensure that the asset protection features of your SMSF are not inadvertently undone and that you achieve the maximum protection possible.

Basic position

2. Superannuation enjoys a privileged position as generally being a protected asset under the *Bankruptcy Act 1966* (**the Act**). This is provided by protections found in section 116(2) which excludes certain property of the bankrupt individual from being available for the bankrupt's creditors:

- Section 116(2)(a) – property the bankrupt holds on trust for another person; and

- Section 116(2)(d) (which is subject to sections 128B, 128C and 139ZU):

  "*(i) policies of life assurance or endowment assurance in respect of the life of the bankrupt or the spouse or de facto partner of the bankrupt;*

  (ii) the proceeds of such policies received on or after the date of the bankruptcy;

  (iii) the interest of the bankrupt in:

  (A) a regulated superannuation fund (within the meaning of the Superannuation Industry (Supervision) Act 1993); or

  (B) an approved deposit fund (within the meaning of that Act); or

  (C) an exempt public sector superannuation scheme (within the meaning of that Act);

  (iv) a payment to the bankrupt from such a fund received on or after the date of the bankruptcy, if the payment is not a pension within the meaning of the Superannuation Industry (Supervision) Act 1993 ;"

Protected contributions

3. Most contributions to an SMSF prior to the date of bankruptcy are automatically protected. This is because once the property (i.e. the contribution) has vested in the fund it attains the protection given by section 116(2)(d)(iii).

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4. However, be aware that bankruptcy commences at a date up to 6-12 months earlier than the actual sequestration date. The exact timing of the commencement is complicated and beyond the scope of this article. The point however is that monies contributed from personal funds after the commencement date (which is this date earlier than the sequestration date) are not protected because it is after-acquired property which, pursuant to the Act, is available to the TIB for distribution to creditors.

5. Note also that if you are bankrupt and your employer is making superannuation guarantee contributions to your SMSF on your behalf, contributions over 9% are not protected and will be assessed by the TIB as income.

Void transactions

6. Section 120 of the Act provides that transactions by the bankrupt which are for less that market value within 4 years of bankruptcy to a related party, which could include an SMSF, are void against the trustee-in-bankruptcy (**TIB**) if the transferor is insolvent at the time. This section gains teeth because section 123(3A) provides a rebuttable presumption of insolvency if proper records are not kept. This means that contributions to your SMSF when you are insolvent, may be able to be undone by the TIB.

7. Section 121 of the Act provides that any transfer of property made predominantly for the purpose of defeating, delaying or hindering a creditor is void against the TIB. There is no time limit to transactions which are subject to section 121. This means that if you made a large contribution to your SMSF, and it could be shown that this was done with the purpose of defeating a creditor, it will be susceptible to being undone by the TIB.

8. Whilst neither of these sections are targeted at superannuation, they could potentially be used to claw-back a contribution to an SMSF if the relevant requirements are met.

Void contributions

9. Sections 128B and 128C provide a claw-back regime which makes certain contributions to superannuation void.

10. Section 128B provides that contributions after July 2006 will be void if:

    - the property (including money) would have been part of the bankrupt person's estate if it had not been contributed to superannuation; and
    - the member's main purpose in making the contribution was to:
        - prevent the transferred property from becoming divisible among the transferor's creditors; or
        - hinder or delay the process of making property available for division amongst the transferor's creditors.

11. Section 128C provides that like contributions from third parties which meet the above criteria are also void.

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12. In working out whether a contribution is void under section 128B(1), we need to know the transferor's main purpose in making the contribution. Section 128B(2) provides that the transferor's main purpose is taken to be for the purpose of defeating a creditor, if it can be reasonably inferred from the circumstances at the time of the transfer the transferor was or was about to become insolvent.

13. There is again a rebuttable presumption of insolvency if the transferor's books and accounts and records from that time are not sufficiently complete and accurate to disclose its true financial position.

14. Section 128B(3) further provides that in determining the main purpose of the member when making a contribution, the Court must have regard to the member's pattern of contributions to superannuation prior to the transfer (or lack thereof) and whether the transfer in question, when considered in light of that pre-existing pattern, is out of character.

15. The effect of section 128B(3) is that if you are ordinarily in the habit of making of superannuation contributions, then all of your contributions of your usual or regular amount right up until the commencement of bankruptcy will be protected. However, if you make a large lump sum contribution shortly prior to commencement of the bankruptcy, which is contrary to your history of contributions, this contribution will likely be void against the TIB.

Lump sum withdrawals

16. Amounts received on or after the date of bankruptcy from an SMSF are protected. Please note that these are amounts which are withdrawn from the account of the bankrupt (see *Morris* case below).

17. Any withdrawals from superannuation received **prior to** the commencement of bankrupt are not protected.

Pension payments

18. Pension payments received after the commencement of bankruptcy are not protected.

19. Pension payments will be assessed as income by the TIB along with all other income of the bankrupt pursuant to section 139K.

20. See the below table for the current income thresholds (indexed annually) as provided by the Australian Financial Security Authority.

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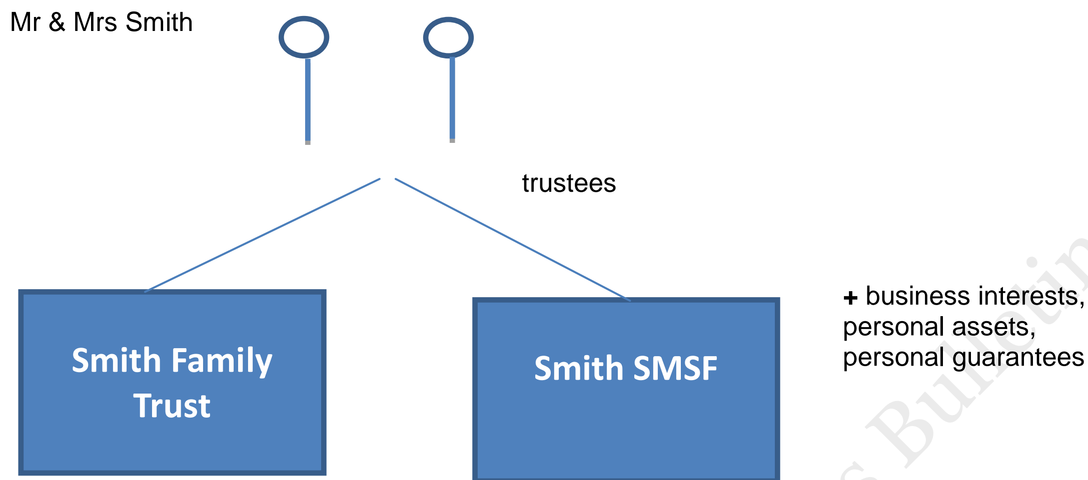
Income contributions[1]

Income contributions	Limit	Bankruptcy Act & Regulations
Base Income Threshold Amount (BITA) no dependants Used when calculating a bankrupt's income contributions	(net of tax) $54,736.50	s139K
Actual Income Threshold Amount (AITA) with dependants Used when calculating a bankrupt's income contributions which vary according to the number of dependants.		s139K
Number of dependants	Income limit	
0	$54,736.50	
1	$64,589.07	
2	$69,515.36	
3	$72,252.18	
4	$73,346.91	
over 4	$74,441.64	
Limits updated twice a year: 20 March and 20 September		

Saving a penny, costs a pound

21. The use of individuals as trustees of a SMSF or using a common corporate trustee for both a family trust and an SMSF carry asset protection risks.

[1] Table sourced from www.afsa.gov.au



In the above structure Mr and Mrs Smith are personally the trustees of their SMSF as well as their family trust. They are personally the legal owners (but not necessarily beneficial owners) of the assets of the Smith Family Trust, the Smith SMSF and also other assets they hold in their own names such as their home, business interests.

22. Unfortunately this simple structure means that if Mr & Mrs Smith incur an obligation in any of their roles (i.e. as trustee of the SMSF, a family trust or an individual role) that obligation can potentially attach to the assets of the other structures.

23. For example, many guarantee documents provide that when you sign a guarantee you charge all property you own or hold in support of that guarantee. The guarantee documents regularly go further and state not only do you charge property you own personally, but also you charge property you hold on trust for **any trust** including SMSF properties.

24. This causes 2 immediate problems. Firstly, you have inadvertently granted a charge or mortgage over assets of your SMSF in breach of the regulation 13.14 or the *Superannuation Industry (Supervision) Regulations 1994*: a trustee of an SMSF must not grant a charge or encumbrance over an asset of an SMSF.

25. This can be an issue upon audit for the fund.

26. More seriously however it breaks the asset protection sanctity of the SMSF because its assets are then liable to be sold or otherwise dealt with by the chargee or mortgagee if the person who gave the guarantee are called upon pursuant to that guarantee.

27. In this second structure below, the Smiths have incorporated a company, Smith Pty Ltd, to be trustee for both their family trust and the SMSF. This is better than the first structure, but remains problematic for asset protection.

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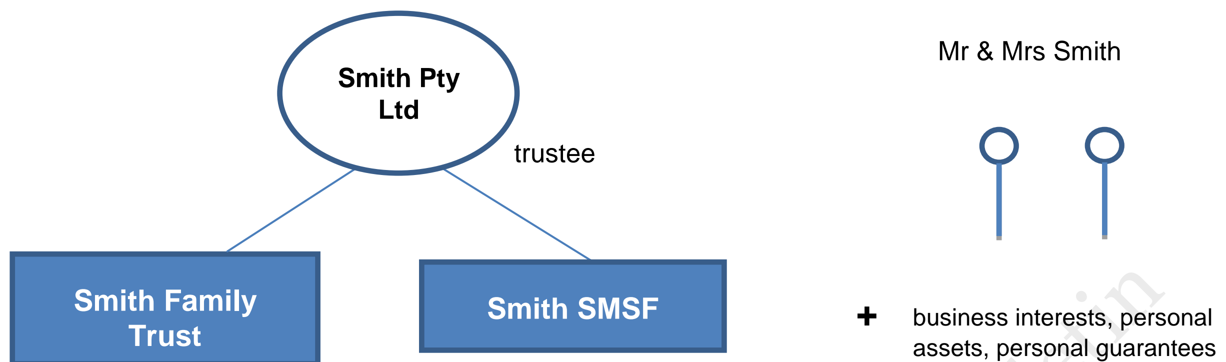

Guarantees and charges granted by Smith Pty Ltd may attach to assets of the SMSF

The same issues arise. Guarantees and charges granted by Smith Pty Ltd in its capacity as trustee of the Smith Family Trust may also inadvertently be granted over the assets of the Smith SMSF.

28. If the member/s are on good terms with their financier, they ought to be able to approach their financier and arrange for the charges over the SMSF assets to be formally released. This release ought to be obtained in writing. This removes the charge from the asset and the fund is no longer at risk of failing audit. It also removes the risk of the asset being ceased, sold or otherwise deal with by the charge/mortgagee in the event of financial difficulties for the trustee.

29. Query whether if Mr Smith had inadvertently granted charges over his SMSF, and then became insolvent, would his financier show the same forbearance and willingness to release the charges as it had shown when he was solvent?

30. The fact that the charges over SMSF assets breach the SIS Regulation does not affect their legal validity. The charges remain valid and enforceable notwithstanding they are a breach of the Regulation and the financier will have a great temptation to exercise its rights over the assets of the SMSF in order to recover its losses.

31. Our recommendation is that if there are charges inadvertently granted over the SMSF in such a situation, that it be rectified as soon as possible in a formal manner. The parties ought to receive the releases in writing and should not rely on any oral assurance from the financier that it will not exercise its rights.

32. It would be tempting to change trustees in such a situation without regard to the charges. This ought not to be done as the charges may continue to exist in equity over the assets, notwithstanding the change of trustee. Further, the former trustee holds a right of indemnity out of the trust assets which cannot be excluded as a matter of law. Therefore if the company which was formerly the trustee becomes insolvent, the liquidator of the company may have recourse to the assets of the SMSF in order to recover losses.

33. Ideally, the Smiths would use separate trustees for the SMSF and the family trust so the structure is as set out below:

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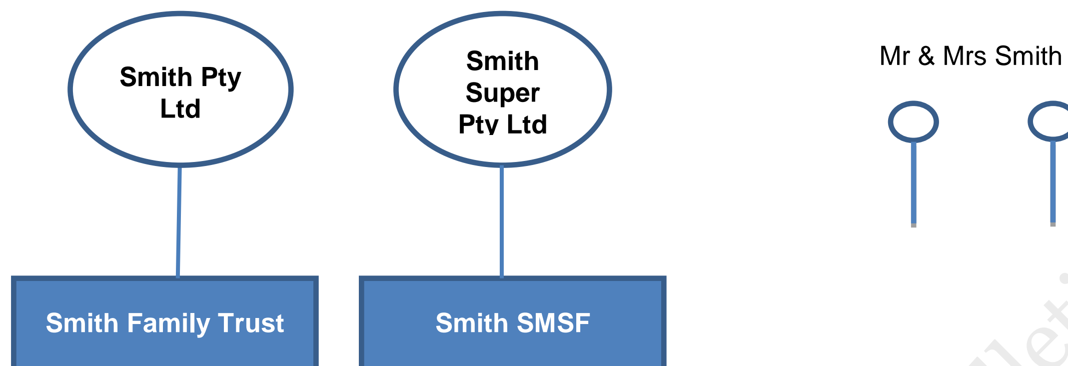

The activities of Smith Pty Ltd, and Mr & Mrs Smith, will not cause asset protection concerns for Smith Super Pty Ltd.

This is the ideal structure. A separate corporate trustee ought to be used for family trusts as from the SMSF. The individuals should not be individually the trustees.

Loss of control upon bankruptcy

34. If a member of an SMSF becomes bankrupt, they will lose control of their SMSF.

35. Neither the *Trusts Act 1973* nor the *Bankruptcy Act 1966* automatically removes a trustee from their role when they become a bankrupt. However they are liable to be removed by application to the Court but this does not happen automatically. The bankrupt member must resign as trustee of their SMSF. (Note however there may be provisions within the trust deed for the SMSF which provide that the trustee is removed upon bankruptcy.)

36. Pursuant to section 126K of the SIS Act, an undischarged bankrupt commits an offence if they are trustee of an SMSF or other superannuation entity.

37. If the member is a director of a corporate trustee then, pursuant to sections 206A and section 206B of the *Corporations Act 2001*, they will cease to be a director of the company upon becoming a bankrupt or entering into a personal insolvency agreement.

38. As we know that pursuant to section 17A and the definition of an SMSF, members must be either a trustee, or a director of the corporate trustee at all times, the trusteeship of the SMSF must be addressed.

39. There are 3 options; namely:

    (1) The bankrupt member might roll-out of the SMSF but the remaining members retain the fund.

    (2) The SMSF can transform into a small APRA fund (**SAF**) by the appointment of an independent trustee company which has been approved by the Australian

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Prudential Regulation Authority (**APRA**) to act as a trustee of a superannuation entity.

The advantage of becoming a SAF is that there is no technical need to sell fund assets. The new trustee company can simply take the place of the existing trustee. However, practically professional trustee companies will be reluctant to accept the trusteeship of a fund which has peculiar or unconventional assets. For example, if the SMSF held business premises which were being leased by a related entity of the member, you might wish to check with the trustee if they would accept such an arrangement.

Naturally, trustee companies will charge fees.

(3) All members of the fund roll their accounts into public/retail/industry funds. The advantage of this is simplicity. The bankrupt will no longer have any management role for their superannuation savings. The disadvantage is that all of the assets of the fund will need to be sold before the accounts can be rolled into a public fund. This may incur capital gains tax. That said, it may also be necessary to sell some assets when converting to a SAF.

Simple steps

40. In summary, the following steps can be taken the maximise the asset protection provided by your SMSF:

(4) Appoint a corporate trustee for your SMSF, which is not the trustee of any other trust and does not hold any assets or undertake any trading in its own right.

(5) Obtain a specific legal advice before making contributions to your SMSF, or making any withdrawals, if bankruptcy is a possibility for any of the members of your fund.

(6) If a member is or may become a bankrupt, review pensions in place and consider whether the pensions could be restructured and perhaps whether lump sum withdrawals are more appropriate.

41. Finally, you should consider whether protected monies ought to stay with the bankrupt. As we know, bankrupts are able to receive superannuation and life insurance (as discussed above) without those monies being at risk of being divisible amongst the bankrupt's creditors. However, consider whether it is prudent for the bankrupt to hold the monies in any event. Are they the appropriate financial manager for those monies?

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42. Further, is there a risk that those protected monies may become inter-mingled with non-protected moneys, may grow or accrete and over time and lose the clarity of their characterisation as protected monies? Bankruptcy lasts for 3 years ordinarily and it can be extended in particular circumstances. I would suggest that protected monies ought to be held by someone or some entity, other than the bankrupt.

Cameron Cowley
1 May 2017

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Our Estate Planning Team

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- Wills
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