ASSET PROTECTION

Individuals have long sought to protect their personal and business assets by separating ownership from risk, but particularly in the light of various recent high profile legal cases and prosecutions, the Australian government appears committed to giving creditors greater access to assets (including superannuation) controlled by a bankrupt and its associates.

The erosion of asset protection is an issue of particular concern for certain classes of professionals (such as doctors, engineers, accountants and lawyers) and business people where there are restrictions on the type of entities through which they can conduct their business [which is generally the main source of risk of personal liability]. Even where such professionals are able to practice through a company the directors may remain personally liable for the company's liabilities, even if they have not breached their duties as directors, and may not be able to 'hide behind the corporate veil' like other business proprietors, so their personal assets remain at risk of being attacked by creditors.

Not surprisingly such persons (quite reasonably) wish to structure their affairs in a manner which protects their personal and family assets from business and professional risks.

Strategies

Once upon a time the classic asset protection strategy involved:

- structuring asset holding and business entities, separately, prior to entry into business;
- ensuring the principal place of residence was not owned by the spouse at risk (so generally owned by the spouse not at risk, generally the wife);
- ensuring the spouse not involved in the business did not give any personal guarantees;
- holding investments and other assets in discretionary trusts (against which claims could not be made by creditors).

Sections 120 and 121 of the *Bankruptcy Act 1966* have always allowed the Trustee in Bankruptcy ('the TIB') to recover property disposed of prior to bankruptcy within the (originally 2 year) 'relating back' period, but recent amendments to the *Bankruptcy Act* ('the Act') effective from 27/7/06, and the effect of recent High Court cases (in particular the *Cummins* case and *Peldan v Anderson* in 2006 and the *Westpoint/Carey/Richstar Enterprises Pty Ltd* judgment in the Federal Court) have considerably extended the powers of the TIB and cast some doubt on the use of discretionary trusts as an effective asset protection mechanism.

The TIB is also now empowered to recover superannuation contributions paid by a bankrupt in certain circumstances.

This article does not attempt to cover each of the above issues exhaustively, but professionals and business people should be aware of recent changes in the law affecting asset protection.

Who should own the principal place of residence?

In the 1984 High Court case of *Calverley v Green* the High Court held that if 2 people contributed the purchase price in unequal shares and the property was purchased in joint names there is a presumption that the property is held by the purchasers in trust as tenants in common, in the proportions in which they contributed the purchase price.

(This was a case relating to the division of property after the break down of a de facto relationship.)

However in the more recent *Cummins* case (involving a NSW QC bankrupted in relation to not lodging tax returns for many years) the High Court held that where a husband and wife purchase a matrimonial home, each contributing to the purchase price, and title is registered to the name of one of them it may be inferred that it was intended that each of the spouses should have a one half interest in the property, regardless of the amounts contributed by them.

The effect of this judgment may be that a husband and wife may each be deemed to have a 50% share in the equity in the matrimonial home regardless of whether the title is in both names or only one name, and regardless of how much each party contributed to the acquisition of the property. In this case the court ordered the wife to transfer to the TIB 50% of the net proceeds of sale of the matrimonial property.

On this basis persons wishing to protect their assets by placing the matrimonial home in the name of one spouse may be unsuccessful if the other spouse becomes bankrupt, as the spouse holding the property may be presumed to hold the whole of the property in trust for both parties, as to a one half share each, and the TIB may be able to recover half the value of the matrimonial property, and to force the parties to sell the property to realise the bankrupt's share.

Superannuation contributions

Previously the assets of a bankrupt in a superannuation fund were only exempt up to the amount of the pension RBL (previously approximately $1.35M.)

However under new rules which came into effect on 1/7/07 there is no monetary limit on the amount protected by superannuation and exempt from realisation from the TIB.

But later amendments to the *Bankruptcy Act 1966* effective from 27/7/06 (Section 128B) mean that if a person who later becomes a bankrupt contributes to a superannuation fund after 28/7/06 in circumstances where the contribution would probably have become part of the bankrupt's estate or been available to creditors and the bankrupt's main purpose in making the transfer was:

- to prevent the transferred property being divisible among the transfer's creditors; or
- to hinder or delay the process of making property available for division among creditors;

the transfer is void against the TIB and may be recovered for the benefit of creditors.

In establishing the main purpose in making the transfer regard must be had to whether:

1) there had previously been a pattern of contribution to superannuation funds;

2) the transfer, when considered in the light of that pattern, is out of character, and

3) it could reasonably be inferred from all of the circumstances that at the time of the contribution the transferee was or was about to become insolvent.

The abolition of the RBL is of very substantial advantage to persons facing bankruptcy, but care must be taken to ensure that the TIB does not get the opportunity to attack assets in the superannuation environment because of Section 128B.

The official receiver has the power to issue a notice to the superannuation fund freezing the fund to prevent the bankrupt dealing with the clawing back of 'out of character' superannuation contributions.

Claw back provisions

However in certain circumstances the TIB is also able to access assets owned or controlled by other persons (e.g. Section 120 - Undervalued Transactions, Section 121 - Transfers to Defeat Creditors, Division 4A of Part VI - Orders in Relation to Property of Entity Controlled by Bankrupt).

Prior to 31/5/06 Section 120 of the *Bankruptcy Act* generally permitted the TIB to claw back transfers of property or money made by the bankrupt prior to bankruptcy, where the recipient of the transfer:

- gave no consideration for the transfer; or
- gave consideration that was less than the market value of the property at the time of the transfer.

However the TIB could not use Section 120 to claw back transfers:

(a) that occurred more than 2 years prior to bankruptcy if the bankrupt could prove it was solvent at the time the transfer was made; or

(b) more than 5 years prior to bankruptcy - if the bankrupt was not solvent at the time that the transfer was made.

(A person is solvent if they are able to pay all their debts as and when they become due and payable.)

Section 121 generally renders void any transfers of property made prior to the individual becoming bankrupt where the main purposes of the transfer was to defeat creditors, regardless of how long ago such transfer occurred.

The claw back provisions referred to above were strengthened effective from 31/5/06 to increase the claw back period from 2 years to 4 years prior to bankruptcy where the bankrupt transferred the asset to a related entity for less than market value (even if the bankrupt was solvent at the time of the transfer).

(Other transfers, where the bankrupt was solvent at the time, are subject to the 'old' 2 year period [Section 120(3)(b)].)

Where the bankrupt was insolvent at the time of the transfer the claw back period remains at 5 years (regardless of whether the recipient was a related entity or not).

If a transfer for less than market value is made to a related entity, provided 4 years has elapsed before the transferor becomes bankrupt, AND the transferor (the bankrupt) was solvent at the time, the 'relating back' provisions of Section 120 should not pose insuperable difficulties.

Careful attention should also be paid to Section 121 of the *Bankruptcy Act*, although we understand in practice this section is less often used in practice except where the TIB considers there has been blatant attempts to defeat or defraud creditors. There is now no time limit on transactions which can be attacked under this section.

Section 121(2) deems the transferor's main purpose in making the transfer to be to defraud creditors if at the time of the transfer the transferor was or was about to become insolvent.

(This is why, among other steps, we suggest that at the time of undertaking any transfers of property a certificate of solvency be obtained from your accountant certifying as to your solvency at the time).

The legislation inserts a rebuttable presumption of insolvency where the bankrupt:

- had not kept proper books and accounts sufficiently disclosing the transactions and financial position of the business; or

- kept such books but has not preserved them;

and expressly provides that a right to live in a transferred property is not consideration for the purposes of Section 120 unless the right relates to a settlement or agreement under the *Family Law Act*.

Numerous other changes were also made to the legislation.

Bankruptcy and Family Law amendments

Amendments to bankruptcy legislation which received royal assent on 18/3/05 were aimed at:

- integrating family law and bankruptcy proceedings relating to the division of property;

- improving the ability of the TIB to collect income contributions from bankrupts;

- preventing the misuse of binding financial agreements to defeat creditors' claims.

There have previously been a number of problems with regard to dividing up property when bankruptcy and family law proceedings occur simultaneously, as there are inconsistencies between the laws that govern the division of property between spouses and the division of property amongst creditors.

Traditionally in bankruptcy proceedings ownership of assets determines who is entitled to that asset.

On the other hand under family law, the legal ownership of a property does not always reflect non-financial contributions of a spouse, and so the Family Court has discretion to alter ownership to take into account non-financial contributions.

The amendments clarify the rights of the TIB and non bankrupt spouses and enable family law and bankruptcy issues to be deal with at the same time by extending the powers of the Family Court, and giving the Family Court sole jurisdiction in bankruptcy where there is a bankrupt spouse.

Taxation

Care should also be taken to ensure at the time of any transfer the main purpose of such transfer can be substantiated as being for reasonable and usual family circumstances (eg asset protection and providing for your family in the event of any unforseen circumstances etc).

As regards tax effectiveness, structures or entities in which assets are held must always be appropriate to the circumstances of the individual client, and the nature of the transaction or business venture contemplated.

Conclusion

As a general comment, trusts continue to be a popular choice in most circumstances for very good reasons.

If properly structured they provide asset protection, but any potential downside such as the potential re-emergence of entity taxation or adverse capital gains tax or stamp duty treatment should be carefully considered.

From an estate planning point of view some balance of risk may be acceptable.

This will always be the client's decision, but most people seek some high level of reassurance that the assets they have acquired through their hard work will not disappear in the event of unanticipated claims against them.

Many opportunities for structuring resolve around the distinction between ownership and effective control.

Careful regard should also be had to the possible consequences of divorce or any matrimonial or defacto partner dispute.

Obviously there is no single solution or simple rules (other than that it is generally not desirable that assets be accumulated in the name of a party potentially susceptible to the risk of claims).

The high costs of stamp duty (now) and potential capital gains tax (possibly now and later) highlight the importance of careful consideration of your current circumstances, likely future needs and possible risks.

The rules relating to clawing back of assets of bankruptcy are complex and this brief note does not attempt to address them in any detail. You should not rely on this brief summary. Detailed advice should be sought in relation to your specific circumstances or intentions.

If you have any specific queries or if we can be of further assistance please do not hesitate to contact Ken Waddington or Brendan Bathersby of our office.