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SMSFs and Asset Protection

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1. INTRODUCTION

When most people think of self managed superannuation funds (**SMSFs**) they mostly think of a vehicle to provide retirement benefits[1] and their concessional tax treatment. In contrast, the asset protection benefit provided by SMSFs is often not considered.

In relation to asset protection and SMSFs there is broadly three types of asset protection considerations. Those are creditor risks, family law risks and death benefit challenge risks. This paper will deal with creditor risks. Therefore, all references to asset protection in this paper will be confined to asset protection as it relates to creditors.

Creditor asset protection in relation to SMSFs has 2 parts, protecting a member's benefits/interest in the SMSF from the member's creditors and protecting the assets of the SMSF against the SMSF's creditors. This paper will examine both of those parts. In addition, this paper will examine the consequences for an SMSF where a member becomes bankrupt.

Although I relied on a number of sources for this paper I would like, in particular, to acknowledge the papers of Denis Barlin, Superannuation and Asset Protection[2] and David Foulds, Superannuation and Bankruptcy[3].

All references in this paper are to the *Superannuation Industry (Supervision) Act 1993* (**SIS Act**), the *Superannuation Industry (Supervision) Regulations 1994* (**SIS Regs**) and the *Bankruptcy Act 1996* (Cth) (**Bankruptcy Act**) unless otherwise stated.

PART 1 – PROTECTION FROM MEMBER'S CREDITORS

2. CONTRIBUTIONS

The first consideration in relation to asset protection in relation to member's creditors is how contributions can be attacked or clawed back from the SMSF. The 2 ways in which a creditor can broadly attack contributions made by, or on behalf of, a member is under the Bankruptcy Act and under common law/equity.

Bankruptcy Act

Under the Bankruptcy Act a trustee in bankruptcy could seek to have contributions clawed back from a SMSF under the following provisions:

- section 58 – property of the bankrupt;
- section 120 – transfers made for no or under market value consideration;
- section 121 – transfers with the purpose of defeating creditors;
- section 128B – super contributions made to defeat creditors; and
- section 128C – contributions made by third persons for the purpose of defeating creditors.

Section 58 – property of the bankrupt

When considering the Bankruptcy Act the starting point is to note that when a person becomes bankrupt their property vests in the hands of the trustee in bankruptcy at the date they become bankrupt.[4]

[1] Which must be the sole purpose of an SMSF under section 62 of the *Superannuation Industry (Supervision) Act*.
[2] Available at - http://www.13wentworthselbornechambers.com.au/wp-content/uploads/2014/02/corporateappointors.pdf
[3] Foulds, D, *Superannuation and Bankruptcy*, presented at Television Education Network's 9th Annual SMSF Conference, 4 September 2014, Gold Coast
[4] Section 58 of the Bankruptcy Act

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The commencement date of the bankruptcy invariably occurs before the trustee in bankruptcy is appointed.[5] This means that during the period from when the bankruptcy commences and the appointment of the trustee in bankruptcy, the bankrupt continues to control his/her property including the ability to make super contributions.

This occurred in Official Trustee in *Bankruptcy v Trevor Newton Small Superannuation Fund Pty Ltd*[6] (**Small**). Relevantly in Small, Mr Small made a $92K contribution on 23 July 1997 and although the trustee in bankruptcy was appointed after this date, his actual bankruptcy commenced on 14 March 1997. Therefore, at the time he made the contribution, Mr Small was bankrupt and his assets (including the money used for the contribution) belonged to the trustee in bankruptcy and consequently could be clawed back by the trustee in bankruptcy.

Section 120 – transfers made for no or under market value consideration

Section 120 of the Bankruptcy Act allows a creditor to claw back transfers of property (including superannuation contributions) where the transferee paid no consideration or less than market value consideration in the following timeframes:

- If the bankrupt was solvent at the time of the transfer (contribution):
    - 2 years from the commencement of bankruptcy if the transfer is to an unrelated party;
    - 4 years from the commencement of bankruptcy if the transfer is to a related party;
- If the bankrupt was not solvent at the time of the transfer – 5 years.

Famously, section 120 was effectively neutered for super contributions by the High Court decision of *Cook v Benson*[7]. The High Court found that the (unrelated) trustee of the super fund gave valuable consideration for the contributions it received, in the form of the promise to provide rights and benefits when the contributors became entitled on death or retirement.

It was because of the decision of *Cook v Benson* that sections 128B and 128C of the Bankruptcy Act were introduced (discussed below).

On the basis of *Cook v Benson* it would appear that section 120 will never have any application in a super contribution situation, given that section 120 can only apply where there is no consideration or under market value consideration given. However, some obiter dicta in the judgment by Neave JA in the Victorian Court of Appeal decision of *Australasian Annuities Pty Ltd v Rowley Super Fund Pty Ltd*[8] (**Rowley Super**) suggest that the application of *Cook v Benson* may not always apply to SMSFs. In this regard her honour made the following comments:

> 145 The purpose of [the] Bankruptcy Act 1966 (Cth), s 120, is to prevent creditors from being disadvantaged by the transfer of property made by a person shortly before he or she becomes bankrupt. [129] In this case, by contrast, the question did not turn on whether the transaction was caught by s 120, but rather on whether RSF should be regarded as a volunteer for the purposes of the application of the knowing receipt principle. The transaction in this case was not at arm's length, as it was in Cook. RSF was bound by the obligations in the trust deed and by superannuation legislation. But its directors and the beneficiaries of the superannuation trusts were Steven, Barbara and their two sons. Subject to compliance with taxation requirements, the beneficiaries might have rolled over their superannuation to another company, to hold it on similar trusts.
>
> 146 Unlike the commercial trustees in Cook, RSF was not a purchaser, who 'in a commercial sense [provided] a quid pro quo for the monies paid to it as trustee. '[130]
>
> 147 There is strong authority for the proposition that the vesting of money in a person to hold on trust is not normally regarded as consideration for equitable purposes. In

[5] See note 3
[6] (2001) 114 FCR 160
[7] (2003) 114 CLR 370
[8] [2015] VSCA 9

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> Tooheys Ltd v Commissioner of Stamp Duties (NSW) [131] the issue was whether a trust deed providing for the payment of moneys to be held by trustees as a pension fund for employees was dutiable, because it was a declaration of trust made without consideration in money or money's worth. The majority of the High Court affirmed the Full Court of the New South Wales Supreme Court's decision that it was a dutiable instrument.[132] In the Full Court, Walsh J, (the other members of the Court agreeing) observed that:
>
> 'An acceptance of a trust and an agreement to hold the trust property upon the terms of the trust and to administer it accordingly, do not constitute the giving of consideration by the trustees for the property so accepted. If it were so, every trust would have to be regarded as created for full consideration.'[133]
>
> 148 In the High Court, where the decision was upheld, Dixon J remarked that:
>
> '[T]he trustees as the parties creating the trust by declaration of trust obtained no consideration in money or money's worth. The placing of the trust fund in the trustees' hands was no consideration for the present or future equitable interests created.'[134]
>
> 149 Where property is held on trust for the purposes of a commercial superannuation fund, and the member of the fund is required to pay management fees, as in Cook, consideration has been provided by the recipient, but that is not the case here.
>
> 150 RSF is a family company incorporated to hold property in a self-managed superannuation fund. In my opinion it would be 'artificial in the extreme' [135] to treat it as a purchaser for valuable consideration when it received AA's monies. For these reasons I would have been inclined to distinguish Cook and hold that RSF was a volunteer.

It is important to note that the comments of Neave JA were not followed by her two fellow justices (Warren CJ and Garde AJA) who both found that in accordance with *Cook v Benson*, valuable consideration was given for the contributions. However, I am sure that the above comments of Neave JA will be tested again in the future and it is possible that the Courts could follow that reasoning.

Section 121 – transfers with the purpose of defeating creditors

Section 121 of the Bankruptcy Act allows a trustee in bankruptcy to claw back transfers of property where the transferor's main purpose in making the transfer is:

- to prevent the transferred property from becoming divisible among the transferor's creditors; or
- to hinder or delay the process of making property available for division among the transferor's creditors.

The transferor's main purpose in making the transfer will be taken to be one of the two above purposes if it can reasonably be inferred from all the circumstances that, at the time of the transfer, the transferor was, or was about to become, insolvent.

Unlike section 120 there is no time limit to claw back transfers under section 121. This was shown famously in the High Court decision of *The Trustees of the Property of John Daniel Cummins, A Bankrupt v Cummins*[9] when a transfer over 10 years before Mr Cummins became bankrupt was clawed back.

There is an important exception to this ability for the trustee of bankruptcy to claw back transfers (including contributions) where the following criteria are met:[10]

- the consideration that the transferee gave for the transfer was at least as valuable as the market value of the property; and
- the transferee did not know, and could not reasonably have inferred, that the transferor's main purpose in making the transfer was one of the two above purposes; and

[9] [2006] HCA 6

[10] Section 121(4) of the Bankruptcy Act

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- the transferee could not reasonably have inferred that, at the time of the transfer, the transferor was, or was about to become, insolvent.

Given the decision of *Cook v Benson* this would appear to rule out the application of section 121 to most super contributions (at least to unrelated trustees of super funds). However, in the decision of Small the contributions to an SMSF were clawed back under section 121 on the basis that the bankrupt and his accountant were the only directors of the corporate trustee of the SMSF and that they were aware that Mr Small was, or was about to become, insolvent at the time of the super contributions.

Section 128B – personal super contributions made to defeat creditors

Section 128B of the Bankruptcy Act allows a trustee in bankruptcy to claw back transfers to super funds after 28 July 2006 where the transferor's main purpose in making the transfer is:

- to prevent the transferred property from becoming divisible among the transferor's creditors; or
- to hinder or delay the process of making property available for division among the transferor's creditors.

Like section 121 the transferor's main purpose in making the transfer will be taken to be one of the above two purposes if it can reasonably be inferred from all the circumstances that, at the time of the transfer, the transferor was, or was about to become, insolvent.[11]

As can be seen, section 128B is almost identical to section 121. However, the biggest difference between the two sections is the additional considerations for determining the transferor's purpose, as outlined in section 128B(3) as follows:

> (3) In determining whether the transferor's main purpose in making the transfer was the purpose described in paragraph (1)(c), regard must be had to:
>
> (a) whether, during any period ending before the transfer, the transferor had established a pattern of making contributions to one or more eligible superannuation plans; and
>
> (b) if so, whether the transfer, when considered in the light of that pattern, is out of character.

Section 128B(3) has been designed to force the Courts to consider whether "out of character" contributions indicate that the transferor was aware of impending insolvency. In that regard large out of character contributions made shortly before a person becomes bankrupt are not automatically clawed back but rather they could be used to determine whether the contributions were made to defeat creditors. If that determination is made, then the contributions can be clawed back.

In order to best protect that contributions will not be clawed back under section 128B a person should, where possible, make a constant pattern of contributions over a period of time rather than large sporadic contributions. To my knowledge no cases have yet considered section 128B and in particular 128B(3), so we are yet to know how the Courts will interpret what a "pattern of making contributions" is and what is "out of character" of that pattern.

It is important to note that section 128B (and section 121) contains both subjective and objective tests in determining whether a transferor has a purpose to defeat creditors. If the trustee in bankruptcy relies on either of subsections 128B(2) or (3) then the tests are objective. If the trustee does not rely on either of those subsections then the test is subjective.

Another difference between sections 128B and 121 is that there is no equivalent to s121(4) in s128B. That is, there is no defence that the transferee super fund gave market value consideration. This is to ensure that a *Cook v Benson* defence cannot be utilised by the bankrupt or the super fund trustee.

[11] Section 128B(2)

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Another important thing to note is that section 128B(5) creates a rebuttable presumption of insolvency at the time of the transfer if it is established that the transferor:

- had not, in respect of that time, kept such books, accounts and records as are usual and proper in relation to the business carried on by the transferor and as sufficiently disclose the transferor's business transactions and financial position; or

- having kept such books, accounts and records, has not preserved them.in what form can death benefits be paid?

Given that section 121 closely matches section 128B this raises the question as to whether section 121 will ever have any application in an SMSF context. Although section 121 is unlikely to ever apply in an attempt to claw back super contributions or other property transferred to an SMSF, it still could apply to transfers to entities controlled by an SMSF or in which an SMSF has an interest (eg a company or a trust).

Section 128C – contributions made by third persons for the purpose of defeating creditors

Section 128C deals with contributions made by third persons for the purpose of defeating creditors. It largely mirrors section 128B except that it requires a scheme of which the bankrupt was a party and that the bankrupt's purpose for entering into the scheme was one of the two purposes outlined above.

This section could cover, for example, an employee asking that all of his/her salary is salary sacrificed into super before he/she becomes bankrupt or a bankrupt directing that his/her salary be paid as contributions to his/her spouse.

Common law and equity

The Victorian Court of Appeal decision of *Rowley Super*[12] is an important reminder that, in addition to claims under the Bankruptcy Act, creditors can attack contributions using common law and equitable remedies.

In *Rowley Super*, Steven Rowley was found to be the controlling mind of both the trustee of a discretionary trust and the corporate trustee of his SMSF. As a result of this, when Mr Rowley breached his fiduciary duties to the corporate trustee of the discretionary trustee by taking large amounts out of the trust in order to make contributions to his SMSF, the corporate trustee of his SMSF was found to have "knowing receipt". As a consequence, the SMSF was forced to return the contributions to the corporate trustee (by then in liquidation) for knowingly receiving trust property as a result of a director breaching his fiduciary duties.

3. BENEFITS IN THE SUPER FUND

A bankrupt's super benefits in an SMSF are generally protected under section 116(2)(d)(iii) of the Bankruptcy Act which provides that a bankrupt's interest in a regulated super fund (which will include an SMSF) will not form part of the property that a trustee in bankruptcy can claim.

It is important to note that while section 116(2)(d)(iii) prevents a member's benefits from being subject to claims, it does not mean that transfers to super funds (that become the bankrupt's benefits) cannot be clawed back by one of the claw back rules (eg sections 120, 121 or 128B). This position was confirmed in *Small*.

Another protection method for benefits is contained in reg 13.13 of the SIS Regs. That regulation provides that a the trustee of a fund must not recognise, or in any way encourage

[12] For a detailed discussion of this case see - http://static1.squarespace.com/static/516cccdae4b0bacecd415c77/t/5587643de4b05f53d8ad16df/1434936381094/Director%E2%80%99s+breach+of+fiduciary+duties.pdf

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or sanction, a charge over, or in relation to a member's benefits. Although on the face of it, this appears to mean that a member could never charge their benefits in the fund it should be noted that reg 13.13 is an "operating standard" under the SIS Act. This means that if the trustee of an SMSF does not comply with this requirement it could be subject to a penalty or sanction. It does not mean that if an SMSF trustee recognises a charge, in breach of reg 13.13 that such recognition is void.[13]

4. BENEFITS PAID OUT OF THE SUPER FUND

The protection of benefits paid out of an SMSF depends on the form of the payment. Lump sums are protected,[14] while pension payments are not. For pension payments, if the member is over the bankruptcy income threshold, then half of their pension payments must be paid to the trustee in bankruptcy.

For most super fund members this will mean that they can avoid losing their super if they become bankrupt by ensuring that super is paid out as a lump sum. For the limited class of members that must receive their super in the form of a pension this cannot be avoided.

It's important to note that the protection for lump sums, only relate to lump sums received on or after the date of bankruptcy. Therefore, lump sums paid prior to that date will not be protected. This could create the situation where a person could bring forward bankruptcy in order to ensure that they can access their super in a protected manner.

5. DEATH BENEFITS

Death benefits are subject to the same rules as benefits taken during a member's life (discussed above), that is lump sums are protected. The protection for lump sum death benefits does not appear to apply if the death benefits are paid to the deceased member's estate and from the estate to a bankrupt beneficiary.

One special rule for death benefits is found in section 128C(5) which provides that death benefits are ignored for the purpose of considering the pattern of contributions for a member.

Where a potential beneficiary of a death benefit is bankrupt then consideration could be given to paying the bankrupt beneficiary the death benefit in the form of a lump sum. Alternatively, the death benefit could be paid to the deceased member's estate and from the estate to a discretionary testamentary trust.

PART 2 – PROTECTING SMSF ASSETS

6. ATTACKING SMSF ASSETS

SMSF assets subject to claims

Some people believe that SMSF assets have a special protection from creditor claims. Unfortunately, this is not the case. Assets held in SMSFs are subject to the same risks as those assets would face if they were held in other structure.

Some protection can be found in reg 13.14, which prohibits a super fund trustee from charging the super fund assets. Like reg 13.13 (discussed above), reg 13.14 is an operating standard and therefore if a super fund trustee charges the super fund assets in breach of reg

[13] Section 34(3) of the SIS Act

[14] section 116(2)(d)(iv) of the Bankruptcy Act

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13.14 the super fund trustee may be subject to penalties or a sanction but it does not mean that the charge will be void.[15]

That said, reg 13.14 does give SMSF trustees the ability to refuse to give charges over the SMSF assets in situations where charges are usually given. I have seen this occur in the following situations:

- where an SMSF trustee enters into a development agreement with a developer and refuses to allow the developer to charge land as security for the development;
- where an SMSF holds an interest in an unrelated company or trust and the SMSF trustee refuses to charge its shares/units in the company/trust as a guarantee for the company/trust's loan; and
- in a commercial contract under which the SMSF is being asked to charge its asset (eg a building contract).

In addition to "normal claims" an SMSF trustee is at risk of specific claims from the Australian Taxation Office (**ATO**) for breaches of its regulatory provisions of the SIS Act or from tax penalties. These penalties can be high, such as the 47% tax rate on non-arm's length income and where a fund is made non-compliant and the market value of the assets[16] of the fund are subject to a tax rate of 47% (effectively allowing up to half of the SMSF to be lost in tax).

Because of the personal liability of the SMSF trustee, it is preferable for the trustee to be a company and for that company not to hold assets in its personal capacity.

SMSF trustee personally liable

Like any other trust, the trustee of the SMSF (as legal owner of the assets and the party entering into legal obligations) is personally liable for the debts of the SMSF. This means in the absence of a right of indemnity from the SMSF assets, or if those assets are insufficient to meet the claim, then the SMSF trustee must meet the claim from his/her/its assets.

It is important to note that an SMSF trustee will not always be able to access the SMSF assets to meet the SMSF liabilities. This could be because the SMSF trustee is prevented from accessing the assets of the SMSF under the terms of the SMSF trust deed or under common law. This could be because the loss is caused by the SMSF trustee's dishonesty or from breaches of the SMSFs fiduciary duties. An example of this occurred in *Wooster v Morris*[17] when the SMSF trustee and the former trustee had the Court costs ordered against them personally and were prevented by the Court from exercising their right of indemnity against the SMSF's assets to pay those costs.

7. PROTECTING SMSF ASSETS FROM CLAIMS

There are two main methods for protecting SMSF assets from claims, these are using a special purpose SMSF or using a company/trust to hold risky assets.

A standalone SMSF offers the best protection, as any claims from the asset of the standalone SMSF will only be met from the assets of the standalone SMSF. However, a standalone SMSF will result in higher costs and administration and will require funding by way of contributions or rollovers.

The use of companies and trusts is another option. Careful consideration of the super and tax laws must be undertaken before an SMSF invests in a company or trust. A detailed examination of those laws is beyond the scope of this paper.[18] Any claims against the asset holding company/trust will be limited to the assets held by that company or trust. The assets

[15] section 34(3) of the SIS Act
[16] less the value of the SMSFs non-concessional contributions
[17] [2013] VSC 594
[18] For a more detailed discussion of those laws see my paper SMSFs Engaging in Property Developments - http://sladen.com.au/news/2014/9/8/smsfs-engaging-in-property-developments

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of the shareholding/unit holding SMSF should be protected. However, it should be noted that the Courts are increasingly taking a "look through approach"[19] to trust and company groups (in which there is commonality of control) and in some cases finding the shareholder/beneficiary liable for the company/trust actions. An example of this is the case of *Montgomery Wools Pty Ltd as trustee for Montgomery Wools Pty Ltd Superannuation Fund v FCT.*[20] For this reason, my preferred option is the standalone SMSF, however there are a number of reasons why a company/trust may be preferred including lower costs, less administration, the ability to bring in other investors and lower duty costs.

PART 3 – THE EFFECT OF THE BANKRUPTCY OF A MEMBER ON AN SMSF

Where a member of an SMSF becomes bankrupt, they are no longer permitted to be a trustee of the SMSF or a director of a corporate trustee of an SMSF. A bankrupt is a "disqualified person"[21] under the SIS Act and disqualified persons are prohibited from holding such positions.[22]

An SMSF trustee/corporate trustee director must "immediately" resign upon becoming a disqualified person.[23] The bankrupt must also "immediately" inform the ATO in writing upon becoming a disqualified person. The ATO has indicated that it will accept the immediate notification requirement if the notification has been made within 28 days of being disqualified.[24]

Once the bankrupt member ceases to be trustee/director of the corporate trustee the SMSF will no longer qualify as an SMSF under section 17A of the SIS Act. This cannot be rectified by appointing an attorney of the member as a trustee/director in his/her place as this exception does not apply to disqualified persons[25].

In that situation the SMSF has 6 months to make sure it complies with the requirements of section 17A. [26] This will mean that the bankrupt member's benefits must be paid out the SMSF either as a benefit payment or as a rollover to a non-SMSF super fund or that the SMSF is converted into a small APRA fund.

A corporate trustee will also be a disqualified person if one of the following requirements of section 120(2) of the SIS Act is met:

(a) the body corporate knows, or has reasonable grounds to suspect, that a person who is, or is acting as, a responsible officer of the body corporate is:

  (i) for a person who is a disqualified person only because he or she was disqualified under section 126H--disqualified from being or acting as a responsible officer of the body corporate; or

  (ii) otherwise--a disqualified person; or

(b) a receiver, or a receiver and manager, has been appointed in respect of property beneficially owned by the body; or

(c) an administrator has been appointed in respect of the body; or

[19] For a more detailed discussion on the look through approach see may paper Unit trusts and superannuation – does the look-through approach exist? - http://static1.squarespace.com/static/516cccdae4b0bacecd415c77/t/5416722fe4b05a3412c213e5/1410757167216/Unit+Trusts.pdf

[20] [2012] AATA 61

[21] as defined in section 120 of the SIS Act which includes a bankrupt

[22] section 126K(1) of the SIS Act

[23] section 126K of the SIS Act

[24] see the ATO's guide "Disqualified persons and SMSFs"

[25] section 17A(10) of the SIS Act

[26] section 17A(4) of the SIS Act

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(d) a provisional liquidator has been appointed in respect of the body; or

(e) the body has begun to be wound up.

If the corporate trustee becomes disqualified then a new non-disqualified trustee will need to be appointed. Alternatively, the corporate trustee could restructure so that it is no longer a disqualified person, although such a penalty will not necessarily absolve the trustee from penalties for being a trustee of a super fund while being a disqualified person.

In the situation where a trustee becomes a disqualified person, the SMSF trust deed should be reviewed as many deeds provide that SMSF trustees automatically cease to be a trustee in such a situation. Similarly, the constitution of a corporate trustee should be reviewed to see if the director of the corporate trustee is automatically removed if he/she becomes bankrupt.

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